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ETF Share Classes: A Path Forward

Richard Coyle, Barry Pershkow, and Morrison Warren

On February 8, 2023, Perpetual US Services, LLC (Perpetual) filed an application for exemptive relief from certain provisions of the Investment Company Act of 1940 (the 1940 Act) that, if ordered, would permit Perpetual to create and operate an actively managed open-end investment company with an exchange-traded fund (ETF) share class (ETF Class)[1] and one or more mutual fund share classes (a Mutual Fund Class).[2] Unlike a traditional ETF, a fund that would operate under the proposed structure cannot rely on Rule 6c-11 under the 1940 Act, which generally permits the operation of an ETF without separate exemptive relief.

The US Securities and Exchange Commission (SEC) specifically declined to permit ETF Classes as part of its adoption of Rule 6c-11, citing certain policy concerns.[3] However, the SEC did not close the door on ETF Classes entirely. Instead, the SEC indicated that requests to operate ETF Classes should be made via the exemptive application process where the SEC and the Staff of the SEC's Division of Investment Management (Staff) can consider the relief on an individual basis.[4]

In order to receive an exemptive order from the SEC to maintain an ETF Class, an issuer will likely be required to address the SEC's policy concerns. The Perpetual Application sets forth a number of common-sense proposals. However, these may not be the only solutions to the SEC's concerns and interested parties may propose different approaches.[5] As of the date of this article, the SEC has granted only one ETF Class exemptive order, which predated the adoption of Rule 6c-11. The SEC's disinclination to act on subsequent similar applications, or grant relief in connection with its adoption of Rule 6c-11, merits attention in light of the SEC's stated mission to facilitate capital formation and the requirement under the Administrative Procedure Act (APA)[6] that agency action not be "unlawfully withheld or unreasonably delayed" and that final agency action not be arbitrary or capricious.

Background

In 2000, Vanguard received exemptive relief that allowed its index-tracking mutual funds to adopt an ETF Class structure.[7] It now has over 70 funds with $2 trillion[8] in assets under management that operate pursuant to this relief. Vanguard also was issued a patent on the structure that expired in early 2023.[9] Perhaps as a consequence of Vanguard's patent, prior to 2023, only one mutual fund sponsor, Van Eck, filed for ETF Class relief for index-based funds.[10] That application was never acted upon by the SEC. In 2014-2015, Vanguard sought relief to operate its actively managed mutual funds with an ETF Class. The SEC also declined to issue an order in that case.[11]

During the period between Van Eck's application for index-based ETF Class relief and Vanguard's application for actively managed ETF Class relief,

the Staff began developing various policy concerns with the ETF Class structure that it likely did not consider in 2000 when the SEC originally granted Vanguard its index-based relief. This work by the Staff also coincided with the SEC's long consideration, proposal, and eventual adoption of Rule 6c-11 under the 1940 Act. Accordingly, when the SEC adopted Rule 6c-11 in 2019, it similarly elected not to provide relief from the relevant portions of Section 18 of the 1940 Act or expand the scope of Rule 18f-3 under the 1940 Act to allow mutual funds to utilize the ETF Class structure for either index or actively managed ETFs. Broadly, the SEC publicly, and the Staff privately, has questioned whether: (1) a Mutual Fund Class or ETF Class could operate to the detriment of the other through inequitable cost subsidizations (primarily brokerage costs); (2) the potential existed for the Mutual Fund Class to create federal income tax liabilities for the ETF Class that are less common in stand-alone ETFs; (3) a Mutual Fund Class's typical need to retain some amount of cash or cash equivalents to meet redemptions could place a drag on an ETF Class's performance;[12] and (4) the requirement that an ETF under Rule 6c-11 (and also presumably an ETF Class) publicly publishes its portfolio holdings on a daily basis would negatively impact Mutual Fund Class shareholders. In all likelihood, for its application to be granted, an applicant will need to demonstrate that such concerns are overstated or inapplicable or it will have to propose conditions that either mitigate or disclose these concerns.

Benefits to Investors and Fund Sponsors

Potential Lower Fees and Increased Viability

The adoption of an ETF Class structure may bring down the expenses for all investors in a given fund. There are several mechanisms by which the structure could lower investor expenses, but perhaps the most obvious is that a combined Mutual Fund Class and ETF Class could lead to greater economies of scale and the ability to spread common fund expenses over a larger shareholder base.

Moreover, ETFs and mutual funds typically are sold through different distribution channels. A Mutual Fund Class and ETF Class could be distributed through both mutual fund and ETF distribution channels. This growth potential is especially pronounced when compared to standalone ETFs, which for various reasons are not usually offered in 401(k) and other defined contribution plans.

There are other mechanisms by which the inclusion of an ETF Class and a Mutual Fund Class could be expected to lower fund expenses, especially for Mutual Fund Class shareholders. ETFs, in general, are subject to greater fee pressure than mutual funds. It is possible that a fund sponsor wishing to add an ETF Class to an existing mutual fund will decrease its management fee across all classes to competitively price the ETF Class within the broader market. Secondly, a mutual fund with an ETF Class may be able to leverage the ETF Class's in-kind creation and redemption mechanism to lower portfolio transaction costs for Mutual Fund Class shareholders that otherwise would have been absent.

Another potential benefit to investors and fund sponsors is the potential for increased viability. A fund with both a Mutual Fund Class and ETF Class is likely to have a better chance of success and long-term viability as compared with a standalone mutual fund or standalone ETF. This is especially true with regard to ETFs, whose success typically depends on a successful seed and initial launch in order to achieve a size that is viable.

Improved Federal Income Tax Consequences

There are also a number of federal income tax advantages that ETFs benefit from that mutual funds do not. First, there is the ability of a fund's portfolio managers to employ the in-kind creation and redemption process that is central to the operation of an ETF to allow a Mutual Fund Class

shareholder to defer the realization of capital gains until they sell their shares.[13] In a traditional mutual fund, when the fund sells portfolio securities either to rebalance its portfolio or to meet redemption requests, to the extent such securities have appreciated in value, the sale of such securities will cause the fund to realize capital gains in connection with those transactions. To avoid taxation at the Fund level, and sometimes to maintain regulated investment company (RIC) qualification, shareholders in such a fund will be taxed on their share of these gains either with or without a distribution regardless of whether the fund's taxable gains correspond to the shareholders' economic gains. The possibility of needing to pay capital gains taxes when a shareholder's investment has not itself increased in value is one of the most oft-cited downsides of investing in a mutual fund. The inclusion of an ETF Class in a fund may allow a fund's portfolio managers to utilize certain tax strategies to minimize the capital gains realized by all the fund's shareholders, including the Mutual Fund Class shareholders.[14]

The ETF Class Structure Has Advantages over Alternatives

There are compelling reasons not only for funds to seek ETF Class relief but also for fund sponsors to seek it. The structure presents an attractive option to mutual fund sponsors who are seeing accelerating outflows from the traditional open-end mutual fund structure to ETFs. In 2022, mutual funds saw outflows of $900 billion, while ETFs experienced inflows of $600 billion. This $1.5 trillion net difference in flows is by far the largest to date.[15]

Mutual fund sponsors wishing to stay ahead of this asset migration trend are currently forced to choose between two flawed options. They can, with board approval, "clone" their mutual fund's strategy in an ETF wrapper or convert the mutual fund to an ETF. Cloning a fund, which means the fund sponsor simply registers the same strategy in an ETF, was the preferred solution for many years. Fidelity did this in 2020 by cloning the Fidelity Magellan Fund, perhaps the most widely known actively managed mutual fund in history. However, cloning creates duplicative administrative costs and functions while running the risk that the ETF will cannibalize the mutual fund, leaving two potentially less viable funds. Cloning also raises concerns about potential differences in the level of fees and/or expenses associated with the two products when marketing the fund to distribution platforms and individual investors. In addition, once a fund is cloned there is typically no seamless way for an investor in the mutual fund to convert their shares into shares of the ETF.

In the alternative, a mutual fund sponsor can directly convert the mutual fund to an ETF, a solution with its own significant drawbacks. Beyond the legal and administrative expense of undergoing this transaction, there are inherent structural differences between mutual funds and ETFs that make outright conversions an imperfect solution for fund sponsors. A mutual fund's use of fractional shares and the need to hold ETF shares in a brokerage account cause inevitable "asset slippage," as not all of the mutual fund's shares can be directly converted to ETF shares. Additionally, the mutual fund's sponsor may lose touch with its shareholders, as ETF shareholders are generally unknown to anyone other than their brokers and other intermediaries.[16] Lastly, not all of the mutual fund shareholders may wish to be converted, but will either be converted or forcibly redeemed under the "all or nothing" approach of the conversion. Additionally, a mutual fund that converts to an ETF may lose its ability to be included in tax-advantaged retirement accounts.

This highlights another benefit to Mutual Fund Class shareholders of Perpetual's proposed structure (also a featured part of the original Vanguard model, the DFA Application, and the First Trust Application, the Fidelity Application). The structure outlined in the Perpetual Application contains a conversion privilege that allows for a shareholder to

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seamlessly convert from a Mutual Fund Class to the ETF Class.[17]

As evidenced by the $1.5 trillion net difference experienced in asset flows in 2022 alone, certain investors are expressing a preference for the tradability, tax efficiency, transparency, and generally lower costs offered by ETFs. However, if they are currently invested in mutual funds with managers or strategies that are not currently offered in an ETF, they are forced to choose between the structural benefits of the ETF and a fund manager or strategy they may prefer. The proposed structure provides investors with the opportunity to avail themselves of the sponsor's strategy either in mutual fund form or ETF form, while also allowing them to be a part of a single viable investment vehicle.

The Relief Required to Create and Operate an ETF Class

The Perpetual Application seeks relief, pursuant to Sections 6(c) and 17(b) of the 1940 Act, from the various provisions of the 1940 Act that would be needed to operate an ETF, including Sections 2(a)(32), 5(a)(1), 17(a) 22(d), 17(a)(1) and 17(a)(2) of the 1940 Act and Rule 22c-1 under the 1940 Act. Because the ETFs contemplated under the Perpetual Application would comply in all respects with Rule 6c-11 under the 1940 Act, this article does not discuss the details of the relief sought from those provisions.

The critical relief for an ETF Class structure involves Sections 18(f)(1) and 18(i) of the 1940 Act. Section 18(f)(1) of the 1940 Act provides that "it shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer."[18] The term "senior security" is defined in Section 18(g) of the 1940 Act to include "any stock of a class having priority over any other class as to distribution of assets or payment of dividends."[19] Section 18(i) provides that every share of stock issued by an open-end investment company "shall be a voting stock and have equal voting rights with every other outstanding voting stock."[20]

The SEC generally takes the position that certain material differences in the rights accorded to, or expenses paid by, different shareholders of the same investment company raise senior security issues under Section 18. Because Mutual Fund Class shareholders and ETF Class shareholders will pay different expenses, have different redemption and trading rights, and have different dividend entitlements, relief is required from Sections 18(f)(1) and 18(i) of the 1940 Act.

Sections 18(f) and 18(i) of the 1940 Act were intended, in large part, to protect investors from certain abuses associated with complex investment company capital structures, including excessive leverage, conflicts of interest and investor confusion among a fund's share classes. These provisions also were designed to address certain inequitable and discriminatory shareholder voting provisions that were associated with many investment company securities present prior to the enactment of the 1940 Act.

Rule 18f-3 under the 1940 Act created a limited exception from Sections 18(f)(1) and 18(i) for certain funds but requires, among other things, that each share class of a fund have the same rights and obligations as each other class.[21] An ETF cannot rely on Rule 18f-3 to operate as a share class within a fund because the rights and obligations of the ETF Class shareholders would differ from those of the Mutual Fund Class shareholders (for example, Mutual Fund Class shareholders would purchase and redeem shares at net asset value (NAV) and ETF Class shareholders would purchase and redeem shares at market price). Therefore, absent any separate relief from Sections 18(f)(1) or 18(i) of the 1940 Act, an ETF structured as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio cannot operate.

The core conditions in the original Vanguard orders[22]—that a board oversee any differential treatment among the Mutual Fund Class and ETF Class and annually determine that the multi-class structure is in the best interest of all shareholders—presumably satisfied any policy concerns maintained by the SEC when it issued those orders. However,

the Staff has indicated that heightened board oversight requirements, more detailed board reports, and required board findings, alone, would not be sufficient for the SEC to issue Section 18 relief. We think that any relief from Section 18 and the rules thereunder would be contingent upon an applicant offering solutions to the policy concerns outlined in the Rule 6c-11 Adopting Release and the additional concerns raised by the Staff noted above.

Solving SEC Concerns with ETF Classes

The following discussion details the primary concerns of the SEC and the Staff and ways that an applicant might seek to address them in an application.

Brokerage Cost Subsidization

The most acute concern of the Staff about maintaining both a Mutual Fund and an ETF Class is that ETF Class shareholders will end up unfairly paying brokerage costs associated with activities related to the mutual fund. Many (but not all) ETFs are able to acquire or dispose of portfolio holdings through in-kind transactions with authorized participants by using an ETF's unique creation and redemption mechanism. A mutual fund, on the other hand, typically executes all purchase and redemption transactions in cash, incurring greater brokerage expenses than an ETF. The SEC's concern is that some of these expenses may be unfairly allocated to ETF Class shareholders when the activities driving those expenses were not connected to the operation of the ETF Class. For example, when mutual fund shares are purchased with cash, a mutual fund will experience brokerage costs to deploy that cash; similarly, when mutual fund shares are redeemed in cash, a mutual fund will experience brokerage costs to sell portfolio assets and convert them into cash for the redeeming shareholder. In this instance, ETF Class shareholders would be subsidizing the Mutual Fund Class shareholders by assuming expenses that would otherwise be borne by the Mutual Fund Class shareholders.[23]

The Perpetual Application proposes to mitigate this concern by requiring the fund administrator to allocate brokerage expenses incurred by the Mutual Fund Class or ETF Class directly to the affected class. These expenses would then be incorporated into the daily net asset value that is struck for the Mutual Fund Class and ETF Class. In other words, the Mutual Fund Class and ETF Class each will bear its own brokerage costs. Perpetual argues that this method of cost allocation would prevent brokerage cost subsidization by the ETF Class of the Mutual Fund Class. Applicants that seek to allocate costs will likely have to demonstrate the efficacy of the proposed mechanics.

Other applicants may choose to address the Staff's concerns about brokerage cost subsidization differently. For example, an adviser to the Mutual Fund Class and ETF Class could absorb brokerage costs as part of its investment management fee. Alternatively, and recognizing that the amount of brokerage costs discussed above are unknowable in advance, an applicant could propose a condition that the issuing trust's board of trustees, on an annual and net basis, review quantifiable brokerage cost subsidizations experienced by either the Mutual Fund Class or ETF Class and cause the subsidizing class to reimburse the subsidized class. Additionally, the brokerage amounts paid by and reimbursed to the Mutual Fund Class or ETF Class, as the case may be, could be disclosed on an annual basis in the prospectus of the fund. Although this solution addresses subsidizations retroactively, and thus doesn't guarantee that the shareholders affected by any subsidization will be the same shareholders of either the Mutual Fund Class or ETF Class when such true-ups are made, the class itself would be whole.

Managing Federal Income Tax Consequences

Tax efficiency is one of the notable advantages that in-kind ETFs provide over mutual funds. While

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a mutual fund may need to sell securities, and trigger a taxable event, to meet redemption requests (unless it otherwise holds a cash position sufficient to meet redemption levels), many ETFs conduct redemption activity through in-kind exchanges of the ETF's shares for portfolio securities. This typically avoids triggering any capital gain tax liability at the fund level. However, even ETFs that use the in-kind redemption mechanism are not precluded from generating federal income tax liability in certain circumstances.

The proposed ETF Class structure could have negative federal income tax consequences for the ETF Class shareholders if the Mutual Fund class receives net redemptions that exceed its available cash and is therefore required to sell assets to meet those redemptions, all while no creation or redemption activity occurs with respect to the ETF Class. Still, because federal income taxes are paid as of a calendar year end, and no single day necessarily determines whether the ETF Class would experience negative federal income tax consequences, there are methods that can be employed throughout the year that should mitigate such risk.

First, the Mutual Fund and ETF Class may use equalization accounting. Virtually all mutual funds and ETFs elect to be taxed as RICs under the Internal Revenue Code of 1986. This classification allows taxation of income and gains to be attributed to the RIC's shareholders, leaving the fund with no tax liability of its own. In order to maintain RIC status and avoid excise taxes, a fund must annually distribute approximately all of its taxable income and realized gains to its shareholders. By doing so, a RIC may treat the distributions as dividends that are deductible from taxable income (a dividends-paid deduction). If a RIC fails to distribute its taxable income, then the fund incurs both an income tax liability on all or some portion of its taxable income and an additional excise tax of 4 percent. Thus, distributions that are approximately equal to total annual taxable income are critical to funds maintaining RIC status and, thereby, avoiding tax liability at the entity level and receiving the benefit of the dividends-paid deduction. As an alternative to distributing typical dividends, a RIC may allocate a portion of the RIC's earnings and profits to the redeeming shareholder. Typically, the shareholder recognizes a capital gain or loss for the difference between the shareholder's basis in and the net asset value of the shareholder's shares in the fund at the time of sale. The fund, however, can elect to treat a portion of the redeemed value as distributed income and gains and thus receive deemed dividend status for that portion. This deemed dividend treatment is asymmetric; that is, the redeeming shareholder incurs only a capital gains tax liability for the sale of shares, while the fund receives the dividend deduction as if income and gains are actually paid out. This practice is known as "tax equalization" or "equalization accounting."[24]

Second, in cases where a Mutual Fund Class has historical performance, an investment adviser will have the benefit of the historical record of the mutual fund to better understand the patterns and levels of redemption requests, and would be able, in turn, to understand how it can best set cash levels predictively and, therefore, manage any potentially negative federal income tax consequences of the structure.

Third, an investment adviser could use a committed or non-committed line of credit facility to meet unusual levels of redemptions where tapping that line would be more cost-effective than potentially experiencing a taxable event. Cash holdings or a credit facility also can be utilized to immediately cover the redemption and allow flow-triggered trades to be spread over a longer period. A gradual rebuild with unforced trades may reduce the cost implications that redemptions cause to a fund from both a net asset value and tax perspective.

However, the scenario that would give rise to potentially negative tax consequences—that Mutual Fund Class redemptions will occur at a consistent level, without corresponding ETF Class

redemption activity—has a seemingly low probability of manifestation. Under foreseeable market conditions, applicants may find that it is unlikely that a Mutual Fund Class will receive redemption orders that so far exceed the Mutual Fund Class's historical data-driven, predicted cash levels, while the ETF Class would receive no creation unit redemption orders. To the extent this scenario does develop, we think that the tools discussed above should greatly assist an adviser in managing that risk. We also note that this kind of risk can be adequately disclosed in a fund's registration statement and the management of such risk can be overseen by a fund's board.

Cash Drag

The Staff also has expressed concern about the impact of a Mutual Fund Class's "cash drag" on the returns of the ETF Class. A mutual fund may hold a portion of its portfolio in cash or cash equivalents to meet potential redemptions or for other investment purposes. The diminution of returns that occurs because these assets are not invested in the market is known as cash drag. An ETF that seeks to track the returns of an index is generally not subject to much cash drag because it always seeks to remain fully invested in tandem with its underlying index. An actively managed ETF, however, can and usually does hold some level of cash or cash equivalents, not necessarily to meet redemption requests, but rather to: (1) await investment opportunities; (2) take defensive positions, that is, hold as a store of stable value as markets decline; (3) serve as a stand-alone investment in times of higher interest rates; and/or (4) engage in liquidity management.

In its application, Perpetual states that it does not expect cash drag (if any) on the Mutual Fund Class to negatively impact the ETF Class because it is seeking relief covering only actively managed funds, which, as noted above, may and do hold cash for any number of legitimate reasons. Perpetual included statistics in its application showing that the mutual funds that would initially seek to utilize the relief generally hold cash positions in the range of 1 percent to 3 percent and do so for the primary purpose of awaiting investment opportunities. The percentage of cash or cash equivalents held by those mutual funds was shown to be similar to the percentage held by actively managed, in-kind ETFs, suggesting that the impact of cash drag (if any) would be comparable for the Mutual Fund Class and ETF Class in the types of funds covered by the application.

Other applicants may have a Mutual Fund Class that holds higher levels of cash than an ETF Class in order to meet redemptions. In order to address any cash drag in those circumstances, an applicant may need to propose conditions related to disclosure and board oversight that mitigate those concerns.

Portfolio Transparency

The Staff also has raised concerns that the Mutual Fund Class could be subject to front-running because of the requirement that an ETF Class display its portfolio holdings daily whereas a mutual fund only has to display its holdings quarterly. The Perpetual Application states that a fund would only utilize an ETF Class structure where the adviser believes that displaying the holdings of both the Mutual Fund Class and the ETF Class portfolio holdings on a daily basis would not negatively impact shareholders in the fund.

This could mean that a fund's strategy and portfolio holdings do not require shielding. It also could mean that, in the case of actively managed funds, because the adviser would not be forced to adhere to an index and its rebalancing periods, it could use T+1 accounting to shield its portfolio. Rule 6c-11 under the 1940 Act requires that the portfolio holdings that form the basis for the ETF's next calculation of current NAV per share must be the ETF's portfolio holdings as of the close of business on the prior business day. Accordingly, for actively managed strategies, a fund and its adviser have the ability to protect current-day trades. To the extent that an adviser believes that investors can be protected from other parties' front-running any actively managed

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strategy the adviser would employ, this concern can be squarely addressed.[25]

Alternatively, and although it could certainly add significant complexity to any ETF Class application, a sponsor could propose a non-transparent ETF model for its ETF Class, which would allow the ETF Class to display its holdings on a quarterly basis, consistent with the requirements of a mutual fund.

Other Considerations under the SEC's Mission and the Administrative Procedures Act

While the SEC and the Staff have outlined valid considerations and concerns with respect to the operations of an ETF Class structure, the Perpetual Application demonstrates that there are workable solutions and factors that substantially mitigate such concerns that go far beyond the conditions outlined in the Vanguard orders. Thus, a question is raised as to whether, either through its denial of extending relief to ETF Class applicants via Rule 6c-11 under the 1940 Act[26] or by refusing to issue an exemptive order to ETF Class applicants that meet the conditions of Section 6(c) of the 1940 Act,[27] the SEC is acting in contravention to both its stated mission and the Administrative Procedures Act (APA). We suggest that, by continuing to disallow entrants other than Vanguard from using the ETF Class structure, the SEC and Staff not only perpetuate a regulatory monopoly, at least insofar as such relief extends to index-based funds, but also deny sponsors and funds a meaningful solution to the imperfect alternatives outlined previously in this article.

The SEC's Mission

The SEC has a three-part mission: (1) to protect investors; (2) maintain fair, orderly, and efficient markets; and (3) facilitate capital formation. In seeking to fulfill the last prong of its mission—to facilitate capital formation—the SEC states: "[o]ur regulatory governance provides companies and entrepreneurs with a variety of avenues to access the US economy's capital markets to help them create jobs, develop life-changing innovations and technology, and provide financial opportunities for those who invest in them."[28] Capital formation means, among other things, allowing companies to access markets so that they can create jobs and develop innovations. We suggest that allowing only one-party access to the ETF Class model is antithetical to that goal; that is to say, allowing a large and well-known company access to a market, but denying such access to small and growing companies, creates barriers to the capital markets and perpetuates regulatory-imposed monopolies.

Of course, another part of the SEC's mission is to protect investors. The Perpetual Application and the other applications for an ETF Class have offered conditions that they believe would allow the SEC and the Staff to conclude that investors are reasonably protected from any potential differential treatment between the Mutual Fund Class and ETF Class. However, ultimately the SEC and the Staff must determine whether those conditions are sufficient to address the element of Section 6(c) of the 1940 Act that also requires that any relief be consistent with the protection of investors.[29]

The Administrative Procedures Act

The APA governs the process by which federal agencies develop and issue regulations. It includes requirements for publishing notices of proposed and final rulemaking in the Federal Register, and provides opportunities for the public to comment on notices of proposed rulemaking. The APA also addresses other agency actions such as issuance of policy statements and the approval and denial of applications. The APA provides that a final agency action must not be "arbitrary and capricious" and that agency action cannot be "unlawfully withheld or unreasonably delayed."[30] It also provides standards for judicial review if a person has been adversely affected or aggrieved by an agency action.

The APA states that judicial review is available for "final agency action." The statute does not

define when an agency action qualifies as "final," but the Supreme Court has said a final action must satisfy two criteria: "First, the action must mark the 'consummation' of the agency's decision-making process—it must not be of a merely tentative or interlocutory nature. Second, the action must be one by which 'rights or obligations have been determined,' or from which 'legal consequences will flow.'"[31] As one example, an agency notice of proposed rulemaking will generally not be reviewable, but the final rule an agency adopts after notice-and-comment procedures will be subject to judicial review. The APA directs reviewing courts to "compel agency action unlawfully withheld or unreasonably delayed" and to "hold unlawful and set aside agency action, findings, and conclusions" that violate the law or are otherwise "arbitrary and capricious."[32]

Recent litigation has suggested that denial of regulatory approvals to substantially similar investment products runs contrary to the APA. In August 2023, the US Court of Appeals for the DC Circuit issued its opinion in *Grayscale Investments, LLC v. SEC*.[33] At issue in the case was the SEC's June 2022 denial of a proposed rule change that, if granted, would have permitted Grayscale to list the shares of an ETF that principally held bitcoin. Grayscale petitioned the Court to vacate this denial on the basis that it constituted a violation of the APA.

In an unusually strident rebuke of the SEC, the Court found that the SEC's denial of Grayscale's listing application, while approving the listing application of similar investment products, was arbitrary and capricious and thus constituted a violation of the APA. The basis for the Court's decision was that the APA requires federal agencies to treat similar situations similarly. In quoting a previous case, the Court noted: "[i]n fact, "dissimilar treatment of evidently identical cases" is the "quintessence of arbitrariness and caprice.'"[34] The Perpetual Application and other similar applications propose products that are functionally identical to those offered pursuant to the Vanguard orders and include representations and conditions that would be more protective of investors and consistent with the purposes and policies of the 1940 Act than those included in the original Vanguard orders. The Grayscale case demonstrates that, if such applications are denied, courts could find that the SEC denial of Perpetual's and others' ETF Class applications violates provisions of the APA, although, for some, the time and cost of bringing litigation may serve as a barrier to obtaining such a ruling. And to the extent that the Staff refuses to make a recommendation to the SEC that it approve or deny these applications, or the SEC refuses to act on such recommendation, courts could view such refusal to act as tantamount to final agency action.

Conclusion

The current approach of the SEC and the Staff in evaluating the case for exemptive relief for ETF Classes is similar to that which it took in evaluating the case for exemptive relief for leveraged/inverse ETFs. In each case, the approach has resulted in the creation of a regulatory monopoly, or oligopoly and has had the unfortunate effect of preventing the launch of new and innovative investment products and limiting the investing public's access to a wide variety of active trading strategies in an ETF structure. In the case of ETF Classes, it seems entirely arbitrary to allow one applicant to move forward with an order and ostensibly disallow all others from substantially similar relief, particularly when applicants can demonstrate a pressing need for the relief and can offer conditions that meet the requirements of Section 6(c) of the 1940 Act.

We recognize that the process of working with the Staff on exemptive relief is an evolving process, and reflects in a sense, a laboratory, where ideas, theses and solutions can change over time. And so, we also recognize that the representations and conditions in the original Vanguard orders may not be sufficient to address concerns that the Staff may have developed since the issuance of those orders.

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However, the exemptive relief process is designed to foster the development of representations and conditions that address the SEC's and the Staff's expressed concerns. We sincerely hope that the Staff and the SEC see fit to move forward with these applications and allow investors to access the ETF Class structure.

Mr. Coyle, **Mr. Pershkow**, and **Mr. Warren** are partners at Chapman and Cutler LLP.

NOTES

1 Perpetual US Services, LLC (initially filed Feb. 7, 2023) (Perpetual Application), available at *https://www.sec.gov/Archives/edgar/data/1965046/000121390023009034/s149241_40app.htm.*

2 A mutual fund could operate either with a single ETF Class or with both a Mutual Fund Class and an ETF Class. There may be operational differences between those two scenarios. However, for purposes of this article, we assume that the term Mutual Fund Class represents either structure.

3 In the adopting release to Rule 6c-11, the SEC stated: "[R]elief from section 18 raises policy considerations that are different from those we are seeking to address in this rule. For example an ETF share class that transacts with authorized participants on an in-kind basis and a mutual fund share class that transacts with shareholders on a cash basis may give rise to differing costs to the portfolio. As a result, while certain of these costs may result from the features of one class or another, all shareholders would generally bear these portfolio costs." *Exchange-Traded Funds*, Inv. Co. Act Rel. No. 33646 (Sept. 25, 2019) at pp. 122-123, available at *https://www.sec.gov/files/rules/final/2019/33-10695.pdf* (Rule 6c-11 Adopting Release). The SEC further expounded on these concerns in a corresponding footnote, stating that "These costs can include brokerage and other costs associated with buying and selling portfolio securities in response to mutual fund share class cash inflows and outflows, cash drag associated with holding the cash necessary to satisfy mutual fund share class redemptions, and distributable capital gains associated with portfolio transactions. Rule 6c-11 Adopting Release at p. 123, n.425.

4 *See* Rule 6c-11 Adopting Release at p. 124 ("With such concerns unresolved, we do not believe it is appropriate to broadly grant relief from sections 18(f)(1) and 18(i) of the Act for share class ETFs at this time. Share class ETFs are structurally and operationally different from the other types of ETFs within the scope of rule 6c-11. We therefore continue to believe it is appropriate for share class ETFs to request relief from sections 18(f)(1) and 18(i) of the Act through our exemptive application process, and for the Commission to continue to assess all relevant policy considerations in the context of the facts and circumstances of each particular applicant." (footnote omitted)).

5 As of the date of this article, three sponsors have filed for similar exemptive relief and another has filed to allow for a Mutual Fund Class to be added to an ETF. *See*, DFA Investment Dimensions Group, et. al. (initially filed July 12, 2023) (DFA Application); available at *https://www.sec.gov/Archives/edgar/data/355437/000168035923000216/dimensional40app07122023.htm*; Fidelity Hastings Street Trust, *et. al.* (initially filed October 24, 2023) (Fidelity Application); available at *https://www.sec.gov/Archives/edgar/data/35348/000119312523261740/d564787d40app.htm*; First Trust Series Fund et. al. (initially filed January 24, 2024) (First Trust Application); available at *https: www.sec.gov/Archives/edgar/data/1497778/000144554624000655/application.htm*; and F/m Investments LLC, et. al. (initially filed August 22, 2023) (F/m Application), available at *https://www.sec.gov/Archives/edgar/data/831114/000089418923006022/rbb-fm_40-app.htm.*

6 5 U.S.C. § 706 (1946).

7 *See Vanguard Index Funds*, Rel. Nos. IC-24680 (Oct. 6, 2000) (notice) and IC-24789 (Dec. 12, 2000) (order); *Vanguard Index Funds*, Rel. Nos. IC-26282

(Dec. 2, 2003) (notice) and IC-26317 (Dec. 29, 2003) (order); *Vanguard International Equity Index Funds*, Rel. Nos. IC-26246 (Nov. 3, 2003) (notice) and IC-26281 (Dec. 1, 2003) (order); *Vanguard Bond Index Funds*, Rel. Nos. IC-27750 (Mar. 9, 2007) (notice) and IC-27773 (Apr. 25, 2007) (order).

8 *See* E. Graffeo & S. Potter, "Vanguard's One-of-a-Kind Fund Design Is About to Get Some Competition," *Bloomberg* (Feb. 9, 2023).

9 *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.

10 Van Eck Associates Corporation, *et. al.* (amendment filed January 15, 2015); available at *https://www.sec.gov/Archives/edgar/data/768847/000093041314003771/c78584_40appa.htm*.

11 The exemptive application submitted by Vanguard was never approved by the SEC. *See* The Vanguard Group, Inc. (amendment filed Oct. 9, 2015); available at *https://www.sec.gov/Archives/edgar/data/102909/000093247115007273/activeetfapp_amend3clean.htm*.

12 For example, an ETF share class that transacts with authorized participants on an in-kind basis and a mutual fund share class that transacts with shareholders on a cash basis may give rise to differing costs to the portfolio. As a result, while certain of these costs may result from the features of one class or another, all shareholders would generally bear these portfolio costs. The SEC further expounded on these concerns in a corresponding footnote that "These costs can include brokerage and other costs associated with buying and selling portfolio securities in response to mutual fund share class cash inflows and outflows, cash drag associated with holding the cash necessary to satisfy mutual fund share class redemptions, and distributable capital gains associated with portfolio transactions." Rule 6c-11 Adopting Release at p. 123, n. 425.

13 Section 852(b)(6) of the Internal Revenue Code of 1986 allows a regulated investment company to avoid the recognition of unrealized capital gains on in-kind distributions of appreciated securities to redeeming shareholders. In most instances, this means that an ETF shareholder will generally not owe taxes until they sell their shares.

14 *See generally* Elizabeth Kashner, "ETF Heartbeats Defer, Not Dodge, Taxes," available at *https://www.etf.com/sections/features-and-news/etf-heartbeats-defer-not-dodge-taxes#:~:text=Heartbeat%20trades%20eliminate%20annual%20distributions,portfolios%2C%20and%20are%20managed%20identically*.

15 *See* Isabelle Lee, "Record $1.5 Trillion Rift Opens Between Mutual Fund, ETF Flows," *Bloomberg* (Dec. 16, 2022).

16 A sponsor could seek to identify through broker-dealers the holders of an exchange-traded investment product (ETP), as it does in the case of ETPs that elect to be taxed as publicly traded partnerships and issue K-1s, but that process has substantial attendant costs and is unlikely a reasonable option in other contexts.

17 Unlike the Perpetual Application, the DFA Application, the Fidelity Application, the First Trust Application, and the original Vanguard application, the F/m Application proposes a conversion privilege whereby an ETF shareholder could convert its ETF shares to mutual fund shares. The F/m Application, however, does not address whether this structure would function essentially as an open-ending mechanism. Any time shareholders are displeased with the spread or premium/discount of their ETF shares, they could move to the mutual fund and redeem at net asset value (NAV). This could have at least one major unintended consequence: market makers and liquidity providers who regularly purchase and sell creation units will be disincentivized to make markets or provide liquidity, thereby stressing the ETF's arbitrage mechanism.

The whole premise of the ETF's two class system (authorized participants who can purchase and sell at net asset value and all others who must transact at market prices) is that the retail investor cannot obtain shares at NAV. It may be that the F/m

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Application seeks to address this through the ETF's limited universe of investments (treasuries, cash and cash equivalents) but that remains unclear from the application.

[18] *See* 15 U.S.C. §80a-18(f)(1).

[19] *See* 15 U.S.C. §80a-18(g).

[20] *See* 15 U.S.C. §80a-18(i).

[21] *See* Rule 18f-3, 17 CFR 270.18f-3.

[22] *See supra* n.7.

[23] A mutual fund may hold a certain percentage of its assets in cash to avoid having to buy and sell portfolio assets to avoid creating excessive churn. This can create what is known as "cash drag," which is the difference in performance between that earned by holding excess cash or cash equivalents and the performance that might otherwise have been experienced had the cash been invested in line with the fund's strategy.

[24] Essentially, equalization allows a fund to allocate a *pro rata* share of the earnings and profits to the redeeming shareholder after the reduction for regular dividends. Equalization does not eliminate earnings and profits entirely because only a *pro rata* share may be allocated to the redeeming shareholder. The remaining earnings and profits (and the investment company taxable income attributable to the earnings and profits) must be distributed to avoid taxation. The remaining shareholders would have both the benefit of the required distribution and the burden of the taxes associated with the distribution. This would be true of both the shares of both the Mutual Fund Class and the ETF Class.

[25] It is less clear how index-based funds would address these concerns. In the case of Vanguard, its index-based ETFs were not required by order (see *supra*, n.7) to publicly display their ETFs' holdings on a daily basis. This allowed Vanguard to shield trades by buying and selling assets in unpredictable tranches, and ultimately allowed these ETFs to largely avoid front-running. It is unlikely that any new applicant for an index-based ETF Class relief will be able to shield their trades in the way that Vanguard has.

[26] In declining to offer Section 18-type relief in Rule 6c-11 or not otherwise rescinding ETF Class relief for the one existing fund complex and sponsor, the SEC noted: "[t]wo other commenters, however, opined that Rule 6c-11 (or a separate future rule) should provide relief for share class ETFs in order to create a more level ETF playing field [and that additional] commenters echoed the importance of leveling the ETF playing field without specifically addressing share class ETFs. Another commenter urged the Commission to explore granting relief from the relevant provisions of section 18 broadly to the fund industry. Leveling the ETF playing field is a goal for Rule 6c-11, and we acknowledge that our approach will result in there being a segment of ETF assets that are unable to rely on the rule."

[27] Although in the Rule 6c-11 Adopting Release the SEC stated that "[w]e therefore continue to believe it is appropriate for share class ETFs to request relief from sections 18(f)(1) and 18(i) of the Act through our exemptive application process, and for the Commission to continue to assess all relevant policy considerations in the context of the facts and circumstances of each particular applicant," after several years of public and private discussions with the Staff, the Staff has failed to recommend that the SEC approve, and the SEC has not approved, a single exemptive application.

[28] *See https://www.sec.gov/about/mission*.

[29] Section 6(c) of the 1940 Act also requires any exemption is necessary or appropriate in the public interest and consistent with the purposes fairly intended by the policy and provisions of the 1940 Act.

[30] *See* 5 U.S.C. § 706(1)

[31] Bennett v. Spear, 520 U.S. 154, 177–78 (1997).

[32] *See* generally Jared P. Cole, Legislative Attorney, Congressional Research Service, An Introduction to Judicial Review of Federal Agency Action (2016), available at *https://sgp.fas.org/crs/misc/R44699.pdf.*

[33] Grayscale Invs, LLC v. SEC, 2023 U.S. App. LEXIS 22717, __ F.4th __ (D.C. Cir. 2023).

[34] *Id*. at __ (quoting Colo. Interstate Gas Co. v. FERC, 850 F.2d 769, 774 (D.C. Cir. 1988)).

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