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Moving into ETFs: The Growing Conversion Trend

The conversion of European mutual funds into ETFs is gathering pace. Deirdre McIlvenna, Funds & Investment Management partner and BBH's Antonette Kleiser discuss the drivers of this trend and key considerations for asset managers.

Introduction

With the booming interest among investors for exchange-traded funds ("ETFs")[1], asset managers are increasingly seeing the benefits of converting existing mutual funds into ETFs. The conversion trend has been gaining momentum in the United States in recent months, and has been successfully implemented in Europe, where ETF assets under management ("AUM") has surged from US$57 billion in 2005 to US$1.2 trillion in 2020[2] .

The move into ETFs in Europe has largely been the result of investor demand for the funds' low fee structure, ease of trading, and greater liquidity and transparency compared with typical passive UCITS funds. During the financial turmoil sparked by COVID-19, public research by the International Organization of Securities Commissions ("IOSCO") found that ETFs are generally well-equipped to handle extreme market volatility.[3] In addition, regulators have given ETFs a boost by demanding asset managers place greater emphasis on providing value for money[4].

In December 2019, Maples and Calder, the law firm of the Maples Group in Ireland advised Credit Suisse Asset Management ("CSAM") on the first European mutual fund conversion to an ETF through the creation of the Credit Suisse Index Fund (IE) ETF ICAV[5]. The Maples Group provided CSAM with consolidated legal, registration and listing services, combining expert local knowledge and multi-jurisdictional solutions, with full project management functionality.

The conversion involved a cross-border merger of three existing Luxembourg-domiciled index mutual funds into a newly established umbrella ETF authorised as an Irish UCITS ICAV. CSAM decided to transition the current funds based on growing demand from its shareholder base for access to ETFs and its own previous success in launching ETF products.

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[1] https://www.ici.org/system/files/2021-05/2021_factbook.pdf

[2] https://www.statista.com/statistics/1199455/aum-etfs-europe/

[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD682.pdf

[4] https://eyfinancialservicesthoughtgallery.ie/regulatory-focus-on-value-for-money-in-etfs/

[5] https://docs.extraetf.com/download/IE00BJBYDR19/en/PR/

BBH was appointed as depositary and administrator to the new Irish UCITS umbrella. In this role, BBH leveraged its deep ETF product expertise and worked with CSAM to launch its ICAV as well as share insight on the conversion of the mutual funds into exchange traded funds. With its expertise and experience servicing both UCITS and ETFs both in Luxembourg and Ireland, BBH helped CSAM make the conversion as seamless as possible for the manager and its fund shareholders.

Recently, Deirdre McIlvenna, a Funds & Investment Management partner at the Maples Group and Antonette Kleiser, a senior vice president of Brown Brothers Harriman for European ETF Products, discussed this trend and shared their unique insights on the process of converting a European mutual fund into an ETF.

Key Excerpts from Discussion

Antonette Kleiser, BBH: What is driving the trend toward converting mutual funds to ETFs?

Deirdre McIlvenna, Maples Group: First of all, there are the general advantages of an ETF, including lower costs, greater transparency and added liquidity due to the interaction between the primary and secondary markets. And ultimately, like most decisions of this nature, it will be driven by investor demand – for many investors an ETF is considered an attractive wrapper for all of the above reasons.

There are two key options available to an asset manager that is seeking to offer an ETF - they can look at setting up a completely new fund, or alternatively look at a conversion of a mutual fund. The real advantages of conversion are scale and track record. ETFs require significant assets to make them worthwhile to asset managers – by converting from a mutual fund to an ETF, you can potentially launch the ETF with significant AUM. The second advantage is you get to bring along the performance history of the fund, which is a big consideration for attracting new investors.

Kleiser: Attracting assets in the first six months of a fund's existence appear to be key to a fund's success – how can this be managed?

McIlvenna: Self-seeding for certain managers raises difficulties. There's a potential conflict element that some asset managers struggle to overcome. If you're able to bring independent assets and transfer them across to the ETF (subject to necessary shareholder approvals, etc.), it is a very effective way of achieving scale without encountering the type of internal conflicts that may arise.

Kleiser: What are some of the key legal considerations for a conversion?

McIlvenna: First and foremost, it is essential to bring shareholders into the discussions at an early stage to secure the necessary consents. A mutual fund conversion into an ETF will result in a shift in the ownership arrangements for direct investors, essentially changing the manner in which their shares are held. So it is important to engage with them, setting out in clear terms the overall impact of the change and providing shareholders with an opportunity to consider such a conversion.

Many mutual funds are unlisted. By converting into an exchange-traded product, a new set of compliance obligations from exchange listing rules are introduced. In addition, there are operational considerations that need to be taken into account in support of a UCITS ETF, such as the preparation and dissemination of a Portfolio Composition File and the processing of different order types. Some of these requirements can result in additional providers and partners for the asset manager to support their ETFs, for example, authorised participants ("APs") and market makers (which provide the ETF's liquidity), a listing agent, and an agent to calculate the indicative NAV.

Furthermore, distribution strategies will also need to be adapted for the ETF, with investor relations and marketing teams needing to be educated on the nuances of the ETF wrapper to ensure that they can market and promote the ETF appropriately and at the right level of the ecosystem in order to maximise their distribution efforts. Fortunately, we are able to provide many of these services seamlessly within the Maples Group, to make the process much more straight forward for asset managers.

McIlvenna: Managers should also consider the ability of the fund's existing service provider to service an ETF. To that end Antonette, what should a manager look for in choosing an ETF service provider?

Kleiser: It's important for the service provider to provide technical ETF support to the client throughout the decision-making and planning process, providing thought leadership and support through the product development cycle. The service provider should also have extensive experience with the ETF landscape so they can provide the manager with the latest market insights and trends, not only in product growth but covering the shifting regulatory, oversight and operational elements as well. The service provider should have deep relationships to help the manager navigate the ecosystem and broker introductions with APs, market makers, calculation agent facilities and paying agents. A really good service provider will support them throughout the process by having a leader dedicated to the project.

McIlvenna: **This past year, BBH supported CSAM in their conversion and also supported the first mutual fund to ETF conversion in the US. With this experience in mind[6], how do you see the conversions trend playing out in Europe and what 'transferable skills' do you see being sought in the European market?**

Kleiser: BBH is proud to have supported both CSAM and Guinness Atkinson's mutual fund-to-ETF conversion in the US, the first conversion of its kind in that market. These transitions represent a new opportunity for fund managers to bring assets and historic track records to newly listed ETFs and could spark another wave of product development and offer a new path for managers to enter the ETF market, in Europe and the US. As a service provider, BBH offers first-hand experience of supporting these conversions, a flexible service model backed by purpose built ETF technology and a consultant-like approach to ETF product innovation. These elements can help managers wanting to scale up and grow, in addition to our ability to stay apace with the regulations.

[6] https://www.bbh.com/apac/jp/bbh-who-we-are/bbh-news/pressroom/bbh-supports-the-first-conversions-of-mutual-funds-to-etfs.html

Kleiser: What are the main drivers for managers coming to Ireland to set up their ETFs? Noting that, for the CSAM conversion, they moved mutual funds based in Luxembourg to a new structure in Ireland.

McIlvenna: Ireland's reputation for being a leading jurisdiction for ETFs in Europe is well known and there are various reasons for that. The admin and support services are well established here in Ireland and they've developed a level of expertise in ETF servicing. In addition, the Central Bank of Ireland (the "Central Bank") has pitched itself as the leading regulator in Europe for ETFs. That's a huge driver in terms of where you're going to base yourself. Generally, European providers domicile in Luxembourg because they're distributing locally. Luxembourg seems to be more focused on synthetic products whereas Ireland is more focused on physical products.

Kleiser: BBH has a number of US-based ETF clients looking at Europe for potential cross-border ETF expansion. Some of these managers already have existing UCITS mutual funds and may see opportunity to convert those to ETFs. What should these firms be aware of in the conversion process that may differ in Europe compared to the US?

McIlvenna: One difference is that European ETFs are still primarily passive funds that track an index, which have low expense levels. In the US, the Securities and Exchange Commission in 2019 gave approval for non-transparent funds and semi-transparent funds, which do not provide full disclosure of a fund's assets on a daily basis in order to protect the 'secret sauce' of active investment strategies. The Central Bank still requires daily disclosure of fund assets, which helps explain why active fund managers have been hesitant to offer ETFs in Europe. We remain hopeful that this will change in the near-term and if the Central Bank alters its position, I would expect that you will see many more ETFs coming into Ireland.

Authors

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