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DEBUTING THE ETF SHARE CLASS — AND ITS CHALLENGES AND FUTURE

In this article, we describe the requirements for complying with the SEC's exemptive orders permitting ETF share classes and certain share class exchanges. We then explore some of the issues presented by the dual class *structure that may challenge fund advisers and sponsors, such as product management issues (e.g., potential transparency into mutual fund holdings, inhibiting capacity control), operational concerns (e.g., effecting exchanges of mutual fund class shares for ETF shares), and regulatory compliance issues (e.g., identifying appropriate peer groups in connection with Section 15(c) reviews and approvals). We also consider future developments and approaches that may be taken by industry members to launch, manage, and distribute ETFs as a share class.*

By Kevin R. Gustafson and Keri E. Riemer *

In a monumental move for the asset management industry, on November 17, 2025, the U.S. Securities and Exchange Commission (the "SEC") issued an order[1] (the "Order") for an exemption that will permit an open-end management investment company (or series thereof) registered under the Investment Company Act of 1940, as amended (the 1940 Act) to offer one class of exchange-traded shares that operates as an exchange-traded fund (an ETF share class or ETF class shares), and one or more classes of shares that are not exchange-traded (each, a mutual fund share class or mutual fund class shares). The exemptive order came more than two years after the application seeking relief from various sections of the 1940 Act and Rule 22c-1 thereunder in order to offer such share classes was first filed on July 13, 2023 by the applicants, including a registered investment company and its investment adviser.[2] Since the initial application was filed, close to 100 other applications have been filed requesting similar relief, and many registered investment company applicants have received such relief, subject to the conditions set forth in the Application and related notice issued by the SEC (the "Notice").

[1] DFA Investment Dimensions Group Inc., et al., Investment Company Act Release No. 35786 (November 17, 2025) (Order); DFA Investment Dimensions Group Inc., et. al., Investment Company Act Release No. 35770 (Sep. 29, 2025) (Notice).

[2] DFA Investment Dimensions Group Inc., et al., SEC File No. 812-15484 (July 13, 2023). The application was subsequently amended three times, with the third amended application (the "Application") being filed September 26, 2025 as the final version.

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The relief granted by the Order marks a significant change for the registered investment company industry, impacting not only funds, but also their advisers, service providers, and investors in ways that challenge and raise new questions regarding long-standing practices. While it invites new opportunities for business growth for funds and their sponsors, and provides more options for investors, the relief also presents business, reputational, and regulatory risk for fund advisers, boards of directors/trustees (each, a Board), and service providers.

Our discussion below summarizes the history of ETF share classes and the conditions for relying on the Order. We also discuss some of the anticipated and potential legal, regulatory, and operational ramifications for funds offering both an ETF share class and mutual fund share classes (each, a dual share class fund), and such funds' advisers, Boards, and service providers. For purposes of this article, we have assumed that all dual share class funds will be subject to the same material restrictions and requirements as those set forth in the Application and the Notice.[3]

HISTORY OF THE ETF AS A SHARE CLASS

The exemptive relief provided by the Order is a significant development, but it did not introduce the dual share class structure to the U.S. market. Rather, some funds have been offering both mutual fund share classes and ETF share classes for over two decades. The SEC previously granted exemptive relief to an ETF sponsor that permitted certain index mutual funds to offer both mutual fund share classes and ETF share classes.[4] However, the SEC would not extend the same exemptive relief to permit a dual class structure for actively managed mutual funds, indicating that it had regulatory and policy concerns about dual share class funds. When the SEC adopted Rule 6c-11 under the 1940 Act (the "ETF Rule") in 2019, it explicitly acknowledged these concerns. In the adopting release relating to the ETF Rule, the SEC stated that dual share class funds required exemptive relief from Section 18 of the 1940 Act, and the ETF Rule did not provide such relief because doing so would raise policy considerations that were different than those the SEC was seeking to address in the ETF Rule. The SEC expressed its concerns about transparency and cross-subsidization, noting that some shareholders might bear the costs of activities unrelated to their share class, and that funds with a dual share class structure do not provide daily portfolio transparency, whereas ETFs that operate in reliance on the ETF Rule are required to do so.[5] The SEC advised that sponsors seeking to form dual share class funds should request relief through the exemptive applications process. Accordingly, beginning in February 2023, certain fund sponsors began to seek such exemptive relief through the application process, and, after years of engagement with the SEC and its staff, the Order was issued.[6]

REQUIREMENTS AND CONDITIONS OF THE ETF SHARE CLASS

Reliance on the Order requires the applicants to comply with various conditions.

[3] Our discussion does not address the specific operational challenges associated with dual share class funds, such as those associated with shareholder exchanges of mutual fund class shares for ETF class shares and varying dividend distribution schedules, or issues relating to service providers' procedures and systems.

[4] Vanguard Index Funds, et al., Investment Company Act Release Nos. 24680 (Oct. 6, 2000) ("Notice") and 24789 (Dec. 12, 2000) (Order) and related application; Vanguard Index Funds, et al., Investment Company Act Release Nos. 26282 (Dec. 2, 2003) (Notice) and 26317 (Dec. 30, 2003) (Order) and related application; Vanguard International Equity Index Funds, et al., *footnote continued from previous column…*

Investment Company Act Release Nos. 26246 (Nov. 3, 2003) (Notice) and 26281 (Dec. 1, 2003) (Order) and related application; Vanguard Bond Index Funds, et. al., Investment Company Act Release Nos. 27750 (Mar. 9, 2007) (Notice) and 27773 (Apr. 2, 2007) (Order) and related application.

[5] Exchange-Traded Funds, Investment Company Act Release No. 33646 (Oct. 24, 2019).

[6] As with all exemptive orders, the Order applies only to the Application; other applicants need to complete their own exemptive application process and may not rely on the Order to offer a dual share class fund.

Transparency

As noted, the SEC has previously expressed concern about cross-subsidization and transparency in connection with the dual class structure. In the Application, the applicants agreed to comply generally with the substantive provisions of the ETF Rule, which, among other things, requires daily portfolio holdings disclosure. As such, the applicants must provide the same daily portfolio transparency as is required by the ETF Rule for all classes of dual share class funds.

Cross-Subsidization

To address cross-subsidization concerns, the Order requires satisfaction of, among other conditions, actions intended to address potential conflicts of interest and ensure the undertaking of cost-benefit analyses of the dual share class structure on an ongoing basis. The Application provides a framework for monitoring and oversight that involves an initial evaluation and approval of the structure by the Board, an ongoing monitoring process of the structure, and ongoing Board approval of the structure.

- **Initial Assessment and Approval** — The adviser of the fund seeking to implement a dual share class structure must provide the Board with an "Initial Adviser Report" providing information about the reasonably expected benefits and costs to each class separately and the fund as a whole. This description must include, to the extent applicable, (1) information about the sources of potential cost savings and other benefits of the dual share class structure and (2) how the ETF share class and the mutual fund share class(es) will be impacted by reasonably expected cash flows and costs stemming from portfolio transactions; reasonably expected cash levels; reasonably expected distributable capital gains; and, with respect to existing funds, the extent, and reasonably expected realization, of any unrealized capital gains/losses or carry over capital losses. The report must also discuss how the adviser expects to manage the reasonably expected costs associated with a fund transitioning to a dual share class structure, whether the fund's investment strategy is compatible with a dual share class structure, and any other identified potential material conflicts of interest.

  Based on the Initial Adviser Report and a presentation by the adviser regarding the process by which it intends to monitor the operation of dual share class structure and the structure's impact on the fund and fund shareholders (the "Ongoing Monitoring Process"), the Board must initially approve the proposed dual share class plan pursuant to Rule 18f-3 under the 1940 Act (the "Plan").[7] In connection with the Board's approval, the Board must conclude that the Plan is in the best interests of each mutual fund share class and each ETF share class individually and in the best interest of the fund as a whole.

- **Ongoing Monitoring Process** — Prior to the Board's approval of the Plan (and the dual share class structure), the fund's adviser must present to the Board a proposed framework for ongoing monitoring of certain numerical thresholds intended to assist the Board in its ongoing oversight of the dual share class structure. These thresholds, which may be based on the adviser's historical experience with similar funds and must be reasonably designed to help identify material conflicts of interest between the mutual fund share class(es) and the ETF share class, will relate to costs associated with portfolio transactions, cash levels, and capital gains distributions. The adviser must also recommend to the Board the method for calculating the thresholds and the time periods over which to measure the fund's performance against the thresholds. Once the dual share class structure and monitoring framework are in place, the adviser must promptly notify the Board if a threshold is exceeded and advise the Board of the cause and any proposed remedial actions to be taken by the fund.

- **Ongoing Board Approval** — Once a fund starts operating pursuant to its Board-approved Plan (*i.e.*, the fund has implemented its dual share class structure), the Board will be required to evaluate the structure at least annually and determine that the Plan continues to be in the best interests of each share class individually and the fund as a whole. To help inform its determination, the fund's adviser must provide the Board with an "Ongoing Oversight Report," which must include information about (1) the benefits to each class of the dual share class

[7] Rule 18f-3 under the 1940 Act (Rule 18f-3) permits funds to issue multiple share classes provided that, among other things, (1) the classes have specified differences in expenses, rights, and obligations (and are permitted, though not required, to have certain other differences); (2) class voting is required for certain matters; and (3) income and expenses are allocated across classes. Under Rule 18f-3, the fund's board of directors/trustees must approve a written plan detailing the multiclass structure based on a finding that the plan is in the best interests of each class and the fund.

structure; (2) for each class, a discussion of the material negative consequences and material conflicts of interest, including how creation and redemption activity in the ETF share class has affected the mutual fund class(es) and how purchase and redemption activity in the mutual fund class(es) has affected the ETF share class; (3) any performance difference between the mutual fund share class(es) and the ETF share class due to a difference in dividend declaration and record dates; and (4) any other information that the Board requests. Based on the Ongoing Oversight Report, the Board must consider the fund's structure and find that the Plan continues to be in the best interests of each class and the fund as a whole.[8]

As described below, each of these elements will impose additional burdens and risk on a fund's adviser and Board, not just in connection with the initial approval of a dual share class structure, but also on an ongoing basis.

FOUR LEGS OF THE STOOL: ALL NECESSARY REGULATORY APPROVALS FOR ETF SHARE CLASSES COMPLETED

In addition to the exemptive relief provided in the Order described above, to effect the dual share class structure and list in the market, there were three other necessary regulatory approvals. First, a post-effective amendment to the fund's registration statement relating to the ETF share class would need to be submitted to the SEC for review by its staff. Second, to permit a share class to list as an ETF, the generic standards used in the listing rules for each of the listing exchanges would need to be amended to expressly include this type of fund as eligible to list.[9] Finally, the remaining leg of the four-legged regulatory stool was the need for specific trading-related relief to apply to the ETF share class, which had previously been issued by the SEC to ETFs in connection with the adoption of the ETF Rule. That 2019 action provided specific relief to broker-dealers and authorized participants transacting directly with an ETF. On its face, however, the relief did not apply to ETF share classes, thus creating a potential regulatory risk gap in the vital trading and market support of an ETF share class. To address this, the SEC took action to extend the trading-related relief to ETF share classes.[10] As might have been expected, within days of the last leg being attached to the stool, a fund sponsor launched a new ETF share class off of an existing mutual fund in reliance of this collection of regulatory approvals and exemptions.

FUND SPONSOR PERSPECTIVE: CONSIDERATIONS AND CHALLENGES FOR ETF SHARE CLASS OFFERINGS

Despite the fact that nearly 100 applications seeking dual share class structure exemptive relief have been submitted, implementing such a structure will not come without a variety of challenges. Many of these challenges have already been identified and sought to be addressed, and others are not yet known.

Investor Experience

Mutual fund shareholders that maintain accounts directly with their fund may experience operational support challenges should they wish to invest in an ETF share class offered by that fund. For example, they will likely need to set up an account with an intermediary (*e.g.*, a brokerage account) to hold the shares, and they will likely face differences in fund-related matters, such as investor privileges associated with the share classes (*e.g.*, automatic dividend investment features applicable to mutual fund class shares will not be available for ETF class shares), and investor experience differences, such as distinct customer support contacts. Sponsors may need to consider how to educate fund shareholders and other outreach efforts to avoid investor confusion or complaints.

Board Approval of the ETF Share Class and the Obligations of Monitoring and Board Reporting

As described above, fund advisers subject to an exemptive order will be responsible for providing the Board with the information they need to approve the Plan (and thus the dual share class structure) initially and

[8] Alternatively, the Board may approve amendments to the Plan that allow the Board to find that the Plan is in the best interests of each class and the fund as a whole.

[9] Subsequent to the adoption of the ETF Rule, each of the three primary exchanges sought and received an order amending their listing rules to align with the ETF Rule, thereby removing the need to separately seek additional SEC trading relief for a fund to be exchange-listed. However, the ETF Rule expressly excluded the potential of an ETF share class from eligibility to qualify as an "ETF" per the definition exclusion. On its face, the result is that each share class seeking to list would still need to seek separate, requested relief to list outside the generic listing rules. In light of this distinction, each of the three exchanges have received near identical rule change relief to adopt new generic listing standards for ETF share classes.

[10] Release No. 34-105028 (March 17, 2026).

on an ongoing basis consistent with Rule 18f-3 and their applicable order. This will likely be a time-consuming task for advisers, particularly as they develop their Initial Adviser Reports and monitoring frameworks, and work with Boards to get them comfortable with the dual share class structure, including the conflicts of interests and costs associated therewith. Advisers will need to provide numerical values based on, at least in part, projections and good faith estimates for future costs and scenarios, which could end up being significantly different than actual costs and fact patterns. For example, actual costs of transitioning to a dual share class structure could be significantly higher than anticipated costs, and actual costs savings of operating a dual share class structure could be greater than those presented in an Initial Adviser Report, which could create tension with the Board and call into question the adviser's estimation methods. It is likely that during an examination of a dual share class fund or its adviser by the SEC's Division of Examinations, the examiners will review the Initial Adviser Report, materials presented to the Board regarding the monitoring framework, any reports regarding exceeding a numerical threshold or other exceptions, and any Ongoing Oversight Reports, and examiners may raise questions regarding projections that differed from actual results or compliance exceptions. The reviewers will also likely consider whether all potential conflicts of interest have been identified, disclosed, and adequately addressed, and whether any written procedures have not been followed.

In addition, these advisers will likely be dependent upon service providers and vendors to supply at least some of the key data and metric information to them in connection with their reporting obligations, and such entities may not be willing or able to provide such data. Intermediaries that need information about the dual share class structure when assessing which share class would be in their customers' best interests may also request certain information from advisers, adding to the advisers' burden. At a minimum, it is expected that advisers will need to shoulder additional costs related to accessing all this information and producing the necessary reporting.

Potential Challenges of Product Management

Under the Order, dual share class funds will be required to provide daily portfolio holdings disclosure, which may not be appropriate for all funds, particularly actively managed funds for which proprietary research is used. Traditionally, many portfolio managers, especially those utilizing active equities strategies, have wrestled with the desire not to expose their strategies to the markets for fear of shadow-duplicators and front-runners. If those same managers were running the same strategy side-by-side in a mutual fund and in a separate ETF, there might be certain practical ways of trying to minimize those potential risks. However, in connection with a dual class structure with two different disclosure regimes, those concerns may be heightened. This might be further complicated with regards to attempts by a portfolio manager to increase or reduce certain positions and disclosure requirements, as custom baskets for rebalancing the ETF might be seen as a signal to the market of anticipated moves in the mutual fund, thereby raising concerns of potential price harm to the mutual fund shareholders.

In addition, for some funds and strategies, advisers may need the flexibility to close or restrict new purchases or otherwise control capacity for investment strategy exposures, such as by instituting a "soft close" for new investor purchases. Adding an ETF share class would inhibit the adviser's capacity management, as ETFs have very limited ability to suspend the issuance or redemption of creation units.

Moreover, generic exchange listing rules now require information barriers between the portfolio management and potentially other teams at the adviser, such as in instances where the fund sponsor has an affiliated broker-dealer or is using a proprietary index. For an ETF share class to be eligible for listing, a portfolio manager for a dual share class structure fund must consider what ETF-related restrictions regarding material non-public information ("MNPI") and physical barriers might need to be implemented or otherwise be applied.

POTENTIAL CHALLENGES OF ONGOING FUND OPERATIONS AND COMPLIANCE

Externally, the offering of an ETF share class on a mutual fund requires a significant operational buildout at the major custodian banks, as well as at the industry's primary transaction clearing and settlement entity for securities, The Depository Trust Company ("DTC"), and the FundSERV operating technology platform, as dual share class processing, settlement, and price validation need to be accommodated.

A critical, yet unresolved operational matter is the issue of effecting the "exchange privilege." As described in the applications for exemptive relief, this privilege is the right of a shareholder of a non-ETF share class of a mutual fund to be able to exchange its shares for ETF class shares, proportionately, and without the need to sell and repurchase — thereby avoiding the recognition of tax gains or losses. Moving into an ETF — even if it is in the form of a share class — still requires the

shareholder to open a brokerage account (which may be distinct from its transfer agency or advisory account for the mutual fund), and the exchange would need to be done mathematically to a rounded share number of the ETF.[11]

Critical agreements, including authorized participant agreements for the ETF, will need to be framed accurately to reflect that the ETF at issue is a share class of another fund. Further, advisers will need to contemplate compliance with best execution policies and procedures, including in connection with approved broker-dealers, authorized participants for the ETF.

Internally, key compliance policies and procedures for the funds and their advisers under Rule 38a-1 under the 1940 Act and Rule 206(4)-7 under the Investment Advisers Act of 1940, will need to be added or otherwise evaluated for gap analysis and enhancement, including procedures related to: (1) the ETF Rule; (2) Rule 2a-5 under the 1940 Act, which relates to fair valuation of portfolio assets; (3) liquidity risk management programs and other aspects of Rule 22f-4 under the 1940 Act; and (4) handling of MNPI, among others.

In addition, some mutual fund complexes engage certain authorized third parties to help them manage liquidity and redemptions related to the holdings of the mutual fund, including the facilitation of potentially tax-advantaged transactions. It is possible that mutual funds utilizing a liquidity management partner could launch an ETF share class, which separately might be able to assist the fund overall with a degree of tax management. In such circumstances, the fund sponsor would need to evaluate, among other things, potential risks of conflicts of interest.

Moreover, the distinct role of a statutory distributor (principal underwriter) of an ETF can differ materially compared to a mutual fund distributor. Due to the primarily technical nature of an ETF distributor's review and consent (or rejection) of each creation unit for the ETF at the cutoff time each day, many fund sponsors have chosen to outsource these ETF-specific tasks to a specialized third-party distributor rather than absorb the costs of building that technology and expertise internally. This model generally works when the ETF is a separate entity, but an adviser using such a model would need to evaluate how it can accommodate ETF-specific responsibilities if the fund retained an affiliated distributor for a single fund offering both mutual fund and ETF share classes, or whether other accommodations would need to be made to manage these tasks.

[11] Unlike mutual funds, ETFs do not issue (and cannot be held in) fractional shares.

POTENTIAL CHALLENGES OF PRODUCT STRUCTURE SELECTION AND BOARD APPROVALS UNDER SECTION 15(c)

Apart from the specific Board considerations noted above related to complying with the Order, contemplating an ETF share class raises at least three important considerations for the adviser and the Board in connection with the Board's approval (and renewal) of the investment advisory agreement under Section 15(c) of the 1940 Act (15(c)).

First, a Board may wish to consider if the share class is the best structure (as compared to a stand-alone ETF), and is there anything unique regarding the investment profile or other factors that might impact the desirability or avoidance of one of those structures. This comparison is also referenced in exemptive applications, but is also relevant in connection with, among other things, the 15(c) review process. Now that bringing a strategy in an ETF has more than one option as to structure to come to market, diligent review of that comparison becomes more relevant for the record and for decision-making by the Board.

Second, one of the so-called "Gartenberg factors" to be considered by a Board when assessing an advisory agreement is the appropriateness of advisory fees charged to the fund. For a fund with mutual fund and ETF share classes, the Board will want to make a meaningful comparison of advisory fees if the disclosed management fee for a mutual fund share class is to be compared to an advisory fee contained within an ETF's reported unitary fee. This is also true of comparisons to management fees of third-party peer ETFs, where the only disclosed fees are the all-inclusive unitary fees (*i.e.*, a single asset-based fee that includes, among other fees and expenses, a nonitemized fee paid to the ETF adviser). Accordingly, there may be some difficulty in identifying true "peer" funds against which fees may be compared, as well as comparing classes, so Boards will need to carefully consider these factors.

As noted above, Boards may want to understand how "peer" funds are identified for fee comparison purposes, but also performance comparison purposes. For example, the Board of a newly formed ETF may question a comparison to an ETF share class that might have immediate scale (and thus launch with a lower fee).

In light of these considerations, Boards may increasingly turn to data providers and other service partners to assist and advise them on these and other unique features.

DISTRIBUTION AND INTERMEDIARY CONSIDERATIONS

Fund advisers aren't the only market participants that will face legal and regulatory challenges associated with a fund's dual class share structure. While the role of broker-dealers and other intermediaries is not substantively discussed in the Application, they will play a key role in the distribution of a dual share class fund's shares.

Perhaps the most significant challenge to distribution platforms' acceptance of offering an ETF share class alongside other share classes of a mutual fund relates to the anticipated impact of Regulation Best Interest,[12] which requires broker-dealers and their associated persons to, among other things, act in the best interests of their retail customers at the time that they make recommendations regarding securities transactions or securities-related investment strategies. Accordingly, broker-dealers are required to consider the comparative costs, among other aspects, of a fund's share classes when determining which class would be in the best interest of a customer.

If offered alongside other share classes of a mutual fund on the same distribution platform, if an ETF share class were to be more cost-effective and offer other benefits compared to a mutual fund share class of the same fund, it would be difficult for a broker-dealer to recommend the mutual fund share class instead of the ETF share class. As such, concerns have been raised that, in light of their Regulation Best Interest obligations, broker-dealers will typically determine that an ETF share class is in their customers' best interests, which could, in turn, have a negative impact on the future growth of mutual fund share classes. Nevertheless, some customers may be more familiar with mutual funds and be quizzical about a recommendation to invest in an ETF share class. As such, intermediaries may need to work with their customers to get them comfortable with understanding the differences between the shares.

A further consideration related to fund distribution cost is the role that a Rule 12b-1 (Rule 12b-1) distribution fee may have related to comparative costs amongst offered share classes. For example, a mutual fund may have a Rule 12b-1 distribution plan in place for a particular share class to make payments to the platform to educate that platform's participants around the manager and the investment strategy. However, the same fund may also have an ETF share class possibly offered on the same platform, but in using the current model the shareholders of that ETF would not pay a Rule 12b-1 fee, which would be going to that same platform. Yet, for one fund with two share classes, each of which is permitted on the platform, the shareholders of only one of those classes is paying the distribution fee, with the other share class potentially benefitting from that payment. The adviser might need to evaluate in this circumstance whether there is a difference in treatment amongst the classes as a result, and whether one receives more favorable treatment as a result.

CONCLUSION: WHERE DO WE GO FROM HERE?

While there will likely be over 100 different fund sponsors that might seek and then obtain ETF share class relief, it is not known how many of them might eventually implement that share class and launch the ETF. However, we expect to see certain developments in the short and long term as a result of this material transformation in the funds industry, including:

- Many managers, even those who have received their own relief, will wait and watch first-movers iron out the operational and distribution kinks before introducing their own ETF share class.
- Unitary fee structures and total expense ratios with broken-out management fees will either be aligned or changed altogether by fund sponsors to allow for easier comparisons.
- ETFs may start to charge a Rule 12b-1 fee, in part to ease some of the regulatory concerns for comparing the class shareholders, and in part to address the economics issues of the platforms.
- In light of the challenges associated with the ETF share class, some of which we have covered in this discussion, some fund managers considering an ETF share class option may opt to instead convert an entire mutual fund to an ETF if that approach works better for its structure.
- There may be an increase in fund reorganizations, with managers looking to consolidate stand-alone ETFs into an ETF share class and vice versa. ■

[12] Regulation Best Interest: The Broker-Dealer Standard of Conduct, SEC Rel No. 34-86031 (June 5, 2019); 84 Fed. Reg. 33318 (Jul. 12, 2019).