The Rise of ETF Share Classes of Mutual Funds

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J.P.Morgan

Overview

With record inflows throughout 2024, exchange-traded fund (ETF) assets have hit $14.85tn.[1] U.S. exchange-traded product (ETP) assets have shot through the $10tn milestone,[2] European ETP assets have reached an all-time high over $2tn,[3] and global active ETFs surpassed the $1tn mark in 2024.[4] In essence, the global ETF market shows no sign of slowing down.

One of the key focus areas for ETFs globally in 2025 is ETF share classes of mutual funds. This concept is not just a focus in the U.S.[5] It is also attracting attention across Europe's main ETF domiciles (Ireland and Luxembourg) and also in a number of APAC markets where ETFs are continuing to gain market share.[6]

Historically in the U.S. market, only Vanguard had approval to launch ETF share classes of a mutual fund based on an exemptive relief approval from the Securities and Exchange Commission (SEC) in 2000. Vanguard had a patent approved associated with the share class model, but it expired in 2023. At that time, Vanguard had amassed more than $2tn in assets across 70 ETFs that have the ETF share class structure.[7]

The expiration of the Vanguard patent in 2023, and the fact that ETF share classes were not included in Rule 6C-11, the so-called ETF Rule, has led to an explosion of exemptive relief filings to the SEC by existing ETF issuers and mutual fund issuers in the U.S. At the time of publishing, there are 42 such filings with the SEC, a number that continues to grow on a weekly basis. To date, though, there has been no indication on an imminent approval from the SEC, although the acting chair of the SEC Mark Uyeda has directed SEC staff to prioritise a careful review of all applications.

There has also been an increased focus on the ETF share class of a mutual fund structure in the European ETF market in 2024 and into 2025. In 2024, the Central Bank of Ireland (CBI) aligned its treatment of ETF share classes to the model applied in Luxembourg, where only the ETF share class now needs be named as an ETF. The previous interpretation of a European Securities and Markets Authority (ESMA) guideline was that the whole mutual fund needed to be rebranded as an ETF if there was an addition of an ETF share class. That was a deterrent to mutual fund managers in the market.

[1] *ETFGI reports the global ETFs Industry gathered a record $1.88 trillion US dollars during 2024, ETFGI, January 16, 2025*

[2] *ETFI reports the ETFs industry in the United States gathered a record US$1.17 trillion during 2024, ETFGI, January 20, 2025*

[3] *ETFGI reports the ETFs industry in Europe gathered a record 270.42 billion US dollars in net inflows during 2024, ETFGI, January 20, 2025*

[4] *ETFGI reports that assets invested in actively managed ETFs listed globally reached a new record of US1.17 trillion at the end of 2024, ETFGI, January 30, 2025*

[5] *For added details on the rise of active ETFs in the U.S. and asset manager guidance, read: Amid Active ETF Rise, Issuers Seek to Meet Investors Growing Needs, J.P. Morgan, November 2024*

[6] *For a more in-depth regional analysis of this trend, read: The Active ETF State of Play: A Worldview of the Growing Trend, J.P. Morgan, March 2025*

[7] *Vanguard's One-of-a-Kind Fund Design Is About to Get Some Competition, Bloomberg, February 9, 2023*

What is leading to the **increased appetite for a share class model?**

Another year of significant outflows from mutual funds combined with continued net new inflows into ETFs increases the need for traditional mutual fund managers to have an ETF offering. While the passive ETF market is home to the majority of ETF assets, the emergence of active ETFs across the globe, especially in North America, has seen a new wave of ETF issuers enter the market.

In 2024, active ETFs represented almost half (48%) of overall new ETF launches globally[8], signaling the targeted entry point for traditional mutual fund managers looking to launch ETFs. Many mutual fund managers are seeking to offer their flagship mutual fund strategies in the ETF wrapper. A significant number of managers have explored a mutual fund-to-ETF conversion, with 130 such conversions completed since 2021.[9] In 2024, there were 57 mutual fund conversions, up from just 15 in 2021 – highlighting the significant growth in this option for launching an ETF range.[10]

In the U.S., some mutual fund managers may see the option of launching an ETF class of the existing mutual fund as a neater alternative to fund conversion, giving them an ETF range within the existing mutual fund structure. The primary market creation and redemption mechanism for ETFs in the U.S. facilitates the fund in removing or reducing a capital gains tax exposure by transacting the underlying securities in-kind. Currently

[8] *ETFGI reports the global ETFs industry reached a new milestone with 1,988 new products launched in 2024, ETFGI, January 20, 2025*

[9] *70% of converted ETFs Snag Net Inflows Since 2021, Ingites, January 6, 2025*

[10] *ETF 2025 - How ETF trends are shaping market growth, EY, February 17, 2025*

this is not standard practice for mutual funds. However, the option of the availability of such an exemption is core to the review being completed by SEC at present.

The addition of an ETF class to a mutual fund is also seen as a quicker approach to entering the ETF market without launching a new legal structure or executing a mutual fund to share class conversion. While it may be a relatively quicker alternative (if approved), it may not come with all the benefits of an ETF such as capital gains tax exemptions, access to double taxation treaties and other benefits afforded to an ETF. Launching a successful ETF strategy is not just as simple as adding a share class to an existing mutual fund and expecting it to gain assets. An issuer needs to focus on the addition of capital markets services, a specific ETF distribution plan, platform strategies, and operational impacts as part of a successful launch plan.

In Europe, share class structures are the norm for ETFs, but there has been limited success in adding ETF classes to mutual funds. However, recent changes in share class naming conventions, and the growth of active ETFs, is pushing more mutual fund managers to seek an avenue for entering the ETF market. In turn, the ETF share class of a mutual fund is coming into focus.

In Australia, the dual-access model, which houses listed and unlisted classes in the same fund, is a favored entry point to the ETF market for a number of asset managers in the market.

The addition of a share class may be a good option for some mutual fund managers. It should not, however, be seen as the panacea for all managers seeking to gain assets through the booming ETF growth across the globe.

If an asset manager has an existing ETF range and the suitable ecosystem in place to service ETFs, then the option of adding an ETF share class to a range of mutual funds is a good option to offer the mutual fund strategy in the ETF wrapper. However, if the ecosystem is not in place then there may be limited success in just adding the ETF class to a mutual fund.

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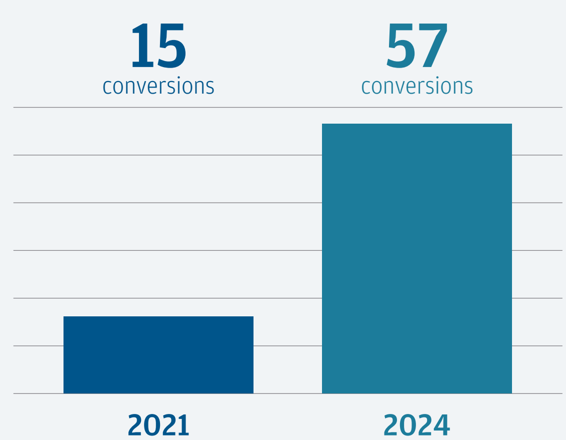
Source: ETFGI



What are some of the **potential challenges to adding an ETF share class to a mutual fund?**

EQUITABILITY

It is critical that there be no contagion to the ETF share class from dealing on the mutual fund share classes (and vice versa).

TAX BENEFITS

Adding an ETF share class to a U.S. mutual fund may not automatically give the mutual fund the tax relief benefits availed of by traditional ETFs in the market. In Europe, there is a risk that an ETF could lose certain tax treaties if combined with a mutual fund such as the U.S. double taxation treaty afforded to Irish domiciled ETFs on U.S. equities.

SUITABILITY

Is the mutual fund strategy suitable in the ETF wrapper, or will the fund need to significantly rebalance the portfolio to better suit an ETF? The underlying portfolio of assets may not be suitable to an ETF structure based on liquidity, tradability, and transparency.

PORTFOLIO TRANSPARENCY

Daily portfolio transparency, while not required across all markets, is seen as a benefit to the ETF structure. A number of mutual fund managers may not wish to provide this level of insight into their portfolio.

PRODUCT EXPERTISE

There is significant expertise required when launching, managing and servicing an ETF in terms of portfolio management, capital markets, client engagement, sales support, distribution, and operational servicing that would not be in place for a traditional mutual fund.

PERFORMANCE IMPACT

Mutual funds may carry significant cash balances to cover redemptions or as a result of subscriptions that are not fully invested, which would lead to unexpected cash drag at the ETF share class level.

INVESTOR CHARGING MECHANISMS

Swing pricing, which is a common feature of mutual funds, is not applicable to ETFs. Therefore a complex model where swing pricing exists at the mutual fund share class but not at the ETF class would need to be developed.

FUND & PORTFOLIO MANAGEMENT

Expertise in the security and FX trading required when managing an ETF portfolio is a key consideration to ensure the product is managed in line with investor expectations.

PRICING & VALUATION POINTS

A wide range of mutual funds have their NAV calculated on a prior day basis, whereas ETFs have their NAV calculated and reported on the current day to meet the demand of the primary and secondary market. Adding an ETF share class may lead to operational restructuring of the overall fund.

OPERATIONAL COSTS

Combining an ETF and mutual fund brings about a more complex operating model with dealing coming through a traditional mutual fund channel as well as the primary market via authorised participants. This could lead to increased costs across the servicing spectrum for the asset manager.

COSTS

ETF-specific costs such as capital markets, exchange listings, market specific ETF Servicing operations, distributers, exchange reporting, and others are all still incurred when adding an ETF share class to a mutual fund.

As an issuer, how do I navigate the growing interest in ETF share classes of mutual funds?

While combining traditional mutual funds with ETF share classes may well be a suitable solution for certain strategies and products, it may not be the best fit for every asset manager looking to enter the ETF market.

The strategy of launching a separate ETF range or the conversion from a mutual fund to an ETF may offer a better solution for entering the ETF market.

Regardless of the end solution, it is critical to consider all factors before determining the optimal entry point.

Given the intricacies of ETF share classes of mutual funds and their evolving status in particular regions around the world, issuers need a trusted partner with global expertise to help them meet investors' end demands. As ETFs grow in popularity and issuers aim to append ETF share classes to existing mutual funds to meet investor demand, issuers would do well to work with a service provider that can deliver holistic, end-to-end ETF services, including subject matter expertise, product development, market making, liquidity, ETF securities lending, and support to create and value an ETF's basket of securities. J.P. Morgan leverages its extensive infrastructure to empower asset managers and investors to service their ETF assets throughout the trade lifecycle.

READ MORE

- [Amid Active ETF Rise, Issuers Seek to Meet Investors' Growing Needs]
- [The Active ETF State of Play: A Worldview of the Growing Trend]

Notice

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