BLACKWATER

THE NEXT BIG THING: ETF SHARE CLASSES.

ONE PORTFOLIO, TWO WRAPPERS. GENIUS

Introduction

Innovation in asset management is often perceived through the lens of new products—particularly in the rapidly expanding ETF market. Yet one of the most transformative shifts currently unfolding lies not in product features but in fund structure.

The ETF share class model, which allows mutual funds and ETFs to operate under a single portfolio umbrella, is emerging as a powerful tool for modern fund design and distribution.

Once exclusive to Vanguard through patent protection, this structure is now gaining traction globally. As operational frameworks evolve and regulatory pathways begin to open, especially in the United States, the industry is preparing for a future where investors can access a single strategy via the vehicle that best suits their needs—whether mutual fund or ETF.

The Vanguard Model and U.S. Exclusivity

In 2001, Vanguard introduced a structure allowing ETFs to function as share classes of existing mutual funds. This provided access to the same pool of assets through two distinct wrappers, offering flexibility for investors while delivering significant benefits for asset managers:

- Tax efficiency, as ETF share classes utilize in-kind redemption processes to reduce taxable events.
- Operational streamlining, with one portfolio instead of duplicative product management.
- Asset scale advantages, improving liquidity, pricing, and cost effectiveness.

Vanguard formalized its innovation with a U.S. patent in 2005, effectively preventing competitors from adopting the model for nearly two decades. The patent's expiration in May 2023 has sparked renewed interest among U.S. asset managers to implement the same structure—subject to regulatory approval.

Regulatory Outlook and Industry Adoption

Following the expiration of the Vanguard patent, the number of firms seeking SEC exemptive relief for ETF share class implementation has grown rapidly. As of April 2025, more than 50 U.S. asset managers have filed applications. Industry data from Cerulli indicates strong expectations for approval:

- 93% of applications include ETF share class provisions.
- 74% focus on active mutual funds; 26% on passive strategies.
- 69% of ETF issuers have either filed, plan to file, or are actively evaluating the structure.

The benefits to investors and advisors are clear. The model allows broader investment access through preferred vehicles, supports scale-driven cost efficiencies, and reduces administrative duplication. Furthermore, it enables firms to expand ETF offerings without cannibalizing existing mutual fund assets.

At the ETF Exchange conference in Las Vegas in March, the structure emerged as a dominant topic of discussion. For most asset managers, the prevailing sentiment is that regulatory approval is not a matter of "if," but "when." Many firms are now working internally to assess product suitability, prepare operational infrastructure, and develop phased rollout strategies.

However, the SEC has yet to grant broad approval. Key regulatory concerns include:

- Cross-subsidization between share classes
- Redemption process disparities (cash vs. in-kind)
- Expense allocation and voting rights issues
- Potential for investor confusion
- Fund governance and fiduciary oversight

Distribution Considerations

Even if regulatory hurdles are addressed, distribution challenges remain. Broker/dealer platforms have shown hesitancy in supporting dual-share-class structures. Broker/dealers in the US are subject to Reg BI (Best Interest), which require them to offer investments that are in the best interest of the investor. When ETFs are offered as a share class, advisors will have to decide if the investors holding the existing mutual fund are the right investment going forward or if they should be moving them to the ETF share class.

Operational complexity is another key concern, particularly around handling flows from both traditional fund platforms and ETF authorized participants.

Additionally, transparency expectations differ across vehicles, at least in the US. ETFs typically require daily portfolio disclosure, which may not align with mutual fund managers' practices—especially those managing active strategies.

That said, there is broader optimism about distribution potential within the registered investment advisor (RIA) channel, where independent platforms are seen as more adaptable to structural changes. Many firms view the ETF share class as an opportunity to streamline product suites while meeting evolving investor demand.

European Experience and Regulatory Clarity

While the U.S. prepares for potential regulatory approval, Europe, Canada and Australia has already set a precedent. In 2014, the dual-share-class model was first introduced in Europe when Source ETF partnered with Ashmore to offer actively managed ETFs as share classes of mutual funds providing exposure to emerging market bonds.

More recently, in 2023, HSBC Asset Management implemented ETF share classes on its fixed income index mutual funds, representing a meaningful step forward in integrating the structure across traditional and ETF fund ranges.

Importantly, European regulators have long permitted this model. A prior requirement to include "ETF" in the name of the overall fund—regardless of the number of listed share classes—posed a barrier to adoption. This naming requirement has since been removed, allowing asset managers to pursue dual-share-class models without compromising branding or structural clarity.

Operational Considerations

Asset managers exploring ETF share classes must be prepared to address significant operational complexities:

- Service provider alignment is critical. Fund accountant and custodian must be unified across share classes to ensure efficient trade processing, NAV calculation, and investor reporting.
- Dealing complexity arises from managing flows through both traditional mutual fund channels and ETF creation/redemption mechanisms.
- NAV timing and valuation must be carefully managed, as mutual funds often rely on prior-day NAVs, while ETFs require same-day calculations to support intraday trading.
- Cash management practices, especially in mutual funds, could lead to unexpected performance drag for the ETF class.
- Transparency requirements for ETFs may necessitate adjustments to existing portfolio management processes.
- US dividend withholding tax double taxation treaty benefits for Irish-domiciled funds are dependent on the fund being traded on an exchange and unlisted share classes may impact the ability to avail of these benefits.

Despite these hurdles, many firms are proactively analysing the share class model as a route to market, specifically mutual fund managers new to ETFs who perceive the model as "low hanging fruit" and an easy entry point to the ETF market.

Strategic Advantages of ETF Share Classes

If widely adopted, the ETF share class structure offers numerous strategic benefits:

- Broader distribution reach without launching separate funds
- Seamless performance history via shared track records
- Cost savings through consolidated infrastructure
- A more efficient path to market with minimal need for seed capital
- Enhanced scalability, enabling pricing improvements and better execution across asset bases

The model is also aligned with evolving investor behavior. As more investors demand ETF-like characteristics such as liquidity, transparency, and cost efficiency, while still relying on legacy fund platforms, the dual-share-class structure offers a compelling middle ground.

Conclusion

The ETF share class model potentially represents a major shift in fund architecture—one that enables scale, reduces complexity, and meets the growing demand for investor choice across wrappers. As more than 50 firms await U.S. regulatory guidance, the momentum is clearly building.

While the European market provides a tested model with regulatory clarity, the U.S. market remains at a pivotal juncture. The structure's potential benefits for operational efficiency, distribution flexibility, and investor access are clear. The challenge lies in addressing regulatory concerns and aligning intermediaries with the new framework.

This is not likely to be a rapid, "Big Bang" transformation. But over time, the ETF share class model could represent one of the most impactful structural shifts in modern fund management.

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About us

At Blackwater, we drive the success of the ETF industry through strategic recruitment, brand development, and career advancement.

We connect top talent with leading firms, shape compelling brand narratives, and provide expert guidance to help businesses and professionals excel. With tailored education and deep industry insights, we empower our clients to build high-performing teams, enhance their market presence, and achieve long-term success.

If you would like to discuss any of the above, reach out to

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