SMA-to-ETF (351) Conversions

Benefits and Overview

351 Conversion

Separately Managed Account (SMA)-to-ETF conversions are gaining interest and growing in practice among asset managers, emerging as an operational & tax management solution that has attracted new ETF market entrants and driven recent high-profile launches.

At a high-level, this brief explores and summarizes the what, why and how from a Client and Manager perspective.

WHY ETFs?

Structural strengths and enhanced product choice have elevated ETFs as vehicle of choice for investors, while regulatory progress and efficient capital markets have honed the structure as a tool for active asset managers.

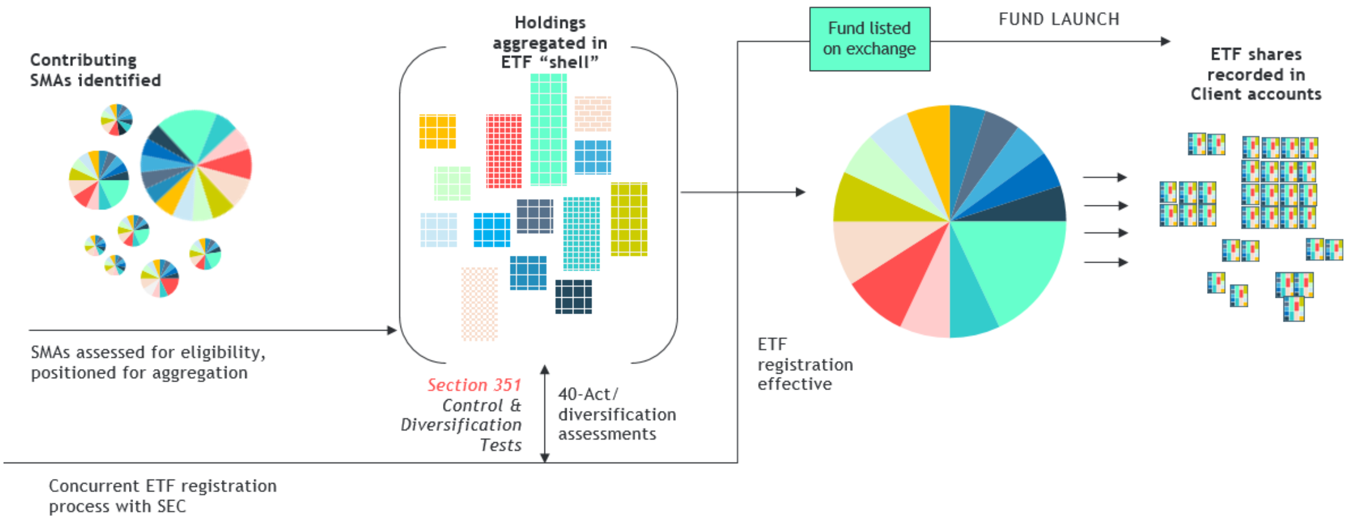
ETF shareholders enjoy improved tax-efficiency, liquidity and ease of access, while managers benefit from operational streamline and

WHAT IS AN SMA-TO-ETF CONVERSION?

This conversion involves the aggregation of eligible SMAs into a pooled structure, which will then be assessed at a top-down level for 351-specific control and diversification tests as well as '40-Act compliance, as the Manager proceeds through concurrent ETF registration with the SEC. In the pre-conversion process, each SMA will be reviewed, harvested for losses, and assigned a carryover cost basis at the individual shareholder level; that exercises/defines the constituents and starting basis ofthe ETF. Once the SEC green-lights the ETF, that pool of SMA is transferred into the new ETF. Finally, the new ETF shares are distributed back into the accounts of the contributing shareholders. A rough process illustration is below.[1]

[1] Source: SEI. Diagram is a highly stylized summary of the 351 exchange, and is intended to help visualize the movement of securities.

ILLUSTRATION: SMA-TO-ETF CONVERSION



EMPHASIS ON TAX

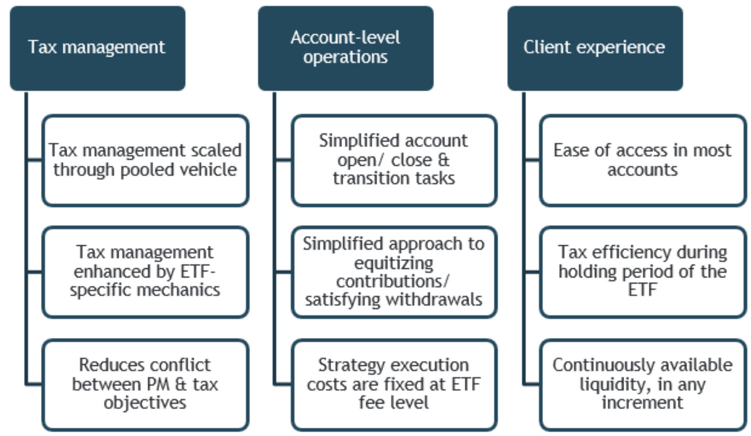
Through conversion via Section 351, Clients are afforded a one-time, tax-efficient method of migrating their holdings to a tax-efficient vehicle. These transactions generally involve taxable accounts with an overall net unrealized gain position[2], because 351 allows for tax-deferred conversion from the view of the contributing account holder. *It's important to understand that the individual-level Portfolio basis is not "stepped up," and unrealized capital gains are not "erased."* Instead, this process allows for the securities to be transferred in-kind rather than sold; the gains thus remain unrealized. Each client's ETF shares will be issued with cost basis and holding period that account for the history of the contributed investment. Going forward, the ETF shareholder enjoys improved tax efficiency during the ETF holding period.

[2]Summary characteristics of contributing accounts in most SMA 351 conversions; eligibility requirements are described elsewhere in this brief.

WHY ARE MANAGERS INTERESTED?

Consider the common scenario for SMA 351 conversion: an asset manager has a pool of "seasoned" private wealth accounts that, over time, have come to demand an extra layer of trading and operational support to account for tax friction. Meanwhile, in light of that sensitivity and the tax overhang of low-basis stock, the underlying investment portfolio has drifted further from the manager's target investment model. In aggregate, the Manager spends a lot of time balancing the pursuit of the stated investment strategy against individual tax management objectives.

OPERATIONAL ADVANTAGES OF THE ETF



While it can be a lengthy, high-touch process, conversion is often justified by the immediate operational relief and go-forward ability to both scale tax management *and* better ensure portfolio alignment of the strategy.

There are clear long-term benefits of transitioning taxable client accounts to an ETF, but many Managers would hesitate to liquidate a capital gains-rich SMA in order to make that transition – hence the importance of Section 351, which provides the incentive for Clients to welcome this transition. Eligible accounts involved in the formation of an ETF via 351 exchange are viewed as conducting an exchange (rather than a sale) of securities – i.e., swapping SMA constituents for shares of an ETF. No capital gains are realized through that transfer, and the ETF position will enjoy improved tax efficiency[3] in the post-launch holding period.

0

351 conversion is an effective entry method into ETFs. As compared to ETFs launched "from scratch," ETFs that launch with significant assets tend to enjoy greater visibility, achieve faster economic breakeven, attract market-maker attention (and thus competitive liquidity) and may satisfy platform AUM/ volume

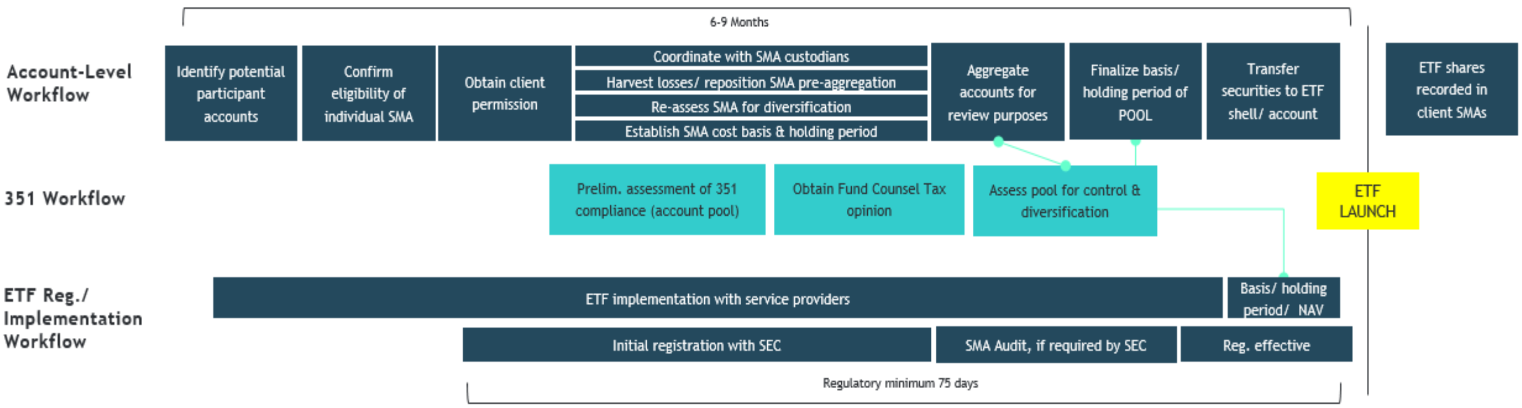
Here we summarize the steps, noting that some are sequential and some concurrent:

- ✓ **Identify potential participant accounts**
- ✓ **Confirm eligibility of accounts (see pg. 3)**
- ✓ **Preliminary pool-level assessment of 351 criteria (see pg. 3)**
- ✓ **Obtain client permission for conversion**
- ✓ **Coordinate with SMA custodians**
- ✓ **Initiate ETF registration process with SEC**
- ✓ **Proceed with ETF implementation with service providers**
- ✓ **Realize all available losses, reposition individual SMA**
- ✓ **Obtain Fund counsel Tax opinion[4]**
- ✓ **Form "shell" – account aggregation**
- ✓ **Assess pool of securities for diversification and alignment with investment strategy**
- ✓ **Launch ETF**
- ✓ **ETF shares recorded in Client accounts (typically, the original SMA)**
- ✓ **Post-launch repositioning/ rebalance through market trades, CIBs, etc.**

---

[3] There is no guarantee that an ETF will not distribute a capital gain; instead, ETF primary market mechanics allow the Fund manager to utilize in-kind redemption in effort to manage the Fund's overall cost basis, minimizing the likelihood or size of capital gains distributions.

[4] This opinion covers the non-taxable nature of the transaction and is needed to protect the fund from penalty should the IRS challenge the transaction in the future. Most audit firms recommend Managers obtain this opinion to help assure against an uncertain tax position.



We emphasize that nothing stated here is intended as comprehensive or a substitute for direct evaluation of these complex tax and regulatory rules and requirements. We intend only to provide a baseline to support initial or exploration-phase consideration of 351 exchanges as a concept.

KEY RULES: CONTROL & DIVERSIFICATION

Section 351(e) of the Internal Revenue Code does not detail a method for conversion; instead, it states that a tax-free transaction is possible under that rule if the SMAs:

- collectively own 80% or more of the Fund after the transaction, and
- each contribute a "diversified" portfolio to the Fund

The SMA conversion process is targeted at ensuring the eligibility of contributing accounts relative to 351, and then ensuring that the aggregate pool meets control and diversification requirements.

PARTICIPATING ACCOUNTS

Because Managers undertake SMA conversions specifically for the tax-deferral opportunity, most participating accounts are taxable with a net unrealized-gain position. Below is a summary and information on key factors that inform eligibility and/ or practicality at the level of a particular SMA.

1. **Type of account (i.e., as per W-9: individual, partnership, corporation, etc.)**
   C-Corps should not participate, due to the potential for specific ETF-level tax consequences.[5]

[5] While a Subchapter-C Corporation is able to participate in the transfer of assets to a Fund on a tax-free basis as described, certain rules generally require the Fund to pay tax if appreciated transferred assets are sold by the C-Corp within the 10 years following the transfer. This rule does not apply to Subchapter S corporations, most tax-exempt corporations or certain charitable remainder trusts. Alternatively, a C-Corp participant may make a deemed-sale election on its income tax return to recognize the net unrealized gain at conversion; this mark-to-market election would enable a C-Corp to participate, but the contributed portfolio will carry over at market value to the new ETF and the C-Corp must pay tax from the realized gain.

2. **Tax status of an account**
   Tax-exempt accounts *may* participate in a conversion but typically would not, as there is no tax incentive; instead, the Manager would likely liquidate holdings and fund the ETF position out of cash. Further, participating accounts are *not* permitted to contribute unrealized losses to the new ETF (basis is stepped-up in conversion), so there is no Fund-level benefit in including depreciated positions from a tax-exempt account.

3. **Net unrealized gain or loss**
   Each SMA should be contributing a net unrealized gain to the ETF pool. *Taxable* accounts with net-unrealized losses would not participate; either the SMA would be liquidated and the cash used to buy ETF shares, or losses would be harvested and the remaining securities contributed to the SMA.

4. **Diversification**
   Each SMA must contribute a "diversified" portfolio to the transaction. To meet this standard, the SMA cannot have more than (i) 25% of its total assets invested in the securities of a single issuer, and (ii) 50% of its total assets invested in the securities of five or fewer issuers. In practical terms, this requirement precludes an SMA from contributing just a handful of low-basis positions to the ETF. Cash should be excluded from the diversification assessment *and* the transaction itself – instead, the Client should simply use that cash to purchase ETF shares once the Fund is live.

5. **Availability of lot-level historical cost basis data**
   Average cost basis data cannot be used for these transactions, and the transfer requires lot-level information to establish cost basis and holding period at the aggregate position level. Managers/ advisors should confirm the availability of account-level historical tax lot data (basis and transaction date) before obtaining client permission or proceeding with the conversion.

THINGS TO KNOW

- ✓ An SMA-to-ETF conversion is typically a complex, multi-month undertaking whereby the Advisor (Manager) will intermediate between their Clients, the SMA service providers and the ETF service providers
- ✓ The Manager will need to obtain Client permission at the outset and potentially periodically throughout the process (noting that permission via negative written consent may be possible)
- ✓ Clients must be apprised of the tax-deferred nature of the conversion; not that taxes will be "erased"
- ✓ In the course of the ETF registration process, the SEC will be made aware of the 351 conversion plans for the ETF (which is also generally noted in the prospectus); the regulator *may or may not* require an audit of the individual SMAs
- ✓ The contributing SMAs must individually and in aggregate be diversified
- ✓ The contributing SMAs must individually and in aggregate represent the constituents the ETF would be likely to hold consistent with its long-term investment strategy; i.e., 351 conversion should *not* be regarded as a method of tax-deferred account transition for accounts that bear no relationship to the intended investment strategy
- ✓ Track record carryover is not guaranteed and may not be practical, due to the underlying account dispersion
- ✓ 351 conversion is a one-time event; once the ETF is live, Clients will not be able to contribute in-kind to the ETF on a tax-deferred basis

Source and Disclosures

This article was written and is offered by SEI Investment Manager Services and is for informational and educational purposes only. It should not be construed as specific investment, accounting, legal or tax advice.

The material included herein is based on the views of SEI. Statements that are not factual in nature, including opinions and language summarizing operational requirements and processes, make assumptions and constitute only current opinions that are subject to change without notice. Nothing herein is intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. While considerable care has been taken to ensure the information provided is accurate and up-to-date, no warranty is given as to the accuracy or completeness of any information and no liability is accepted for any errors or omissions in such information or any action taken on the basis of this information. Neither the Securities and Exchange Commission, Internal Revenue Service nor any other federal or state agency has reviewed, approved or affirmed the accuracy of this information.