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Tailored Shareholder Reports

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On October 26, 2022, the Securities and Exchange Commission (SEC) adopted final rule and form amendments (the Final Rules¹) representing major reforms to: (1) shareholder reports for open-end mutual funds and exchange-traded funds (ETFs) registered on Form N-1A under the Investment Company Act of 1940, as amended (1940 Act) (collectively, Open-End Funds); and (2) advertising rules for all registered investment companies, including Open-End Funds, closed-end funds and business development companies (BDCs) (collectively, Registered Funds). The Final Rules will fundamentally transform shareholder reports, turning them into condensed documents that may be as short as three pages in length.

Many aspects of the Final Rules closely follow elements of the SEC's originally proposed changes from August 2020 (the Proposed Rules), particularly with respect to the content and transmittal of shareholder reports and the advertising rules. Specifically, the Final Rules change the scope of Rule 30e-3 to exclude Open-End Funds, requiring paper delivery of shareholder reports unless a shareholder affirmatively opts in to e-delivery, and change the definition of "broad-based securities market index" in Form N-1A as discussed further herein. Additionally, several major changes in the Proposed Rules relating to prospectus disclosure and delivery obligations, including proposed Rule 498B, proposing a new prospectus fee summary table, and establishing a 10 percent standard for principal risk disclosure, were *not* adopted in the Final Rules.

While the Final Rules adopt a "layering" approach to the disclosures required in shareholder reports in an effort to best meet the different informational needs of different investors, the SEC did not adopt proposals changing the approach to fund disclosures that would have made shareholder reports the primary communication with existing investors and prospectuses the primary communication with new investors. Unlike the Proposed Rules, which would have represented the largest overhaul of prospectus structure in over a decade, the Final Rules largely do not change prospectus content. Instead, the Final Rules transform shareholder reports into concise and comparable disclosure documents. The SEC believes this approach will allow shareholders to better understand key information about their investments.

This article discusses in detail the changes to the format, content, and delivery of Open-End Fund shareholder reports and changes to investment company advertising rules. It also outlines the differences between the Proposed Rules and Final Rules, particularly as they pertain to Open-End Fund Prospectus disclosures and delivery requirements.

Amendments to Item 27 of Form N-1A and the Repeal of Rule 30e-3

Tailored Shareholder Reports

In an effort to establish a "layered" disclosure framework for shareholder reports, the SEC added Item 27A to Form N-1A, creating a new "concise

and visually engaging” form of shareholder report focusing on information the SEC believes is particularly important for retail shareholders to assess and monitor their fund investments on an ongoing basis, namely fund expenses, performance, and portfolio holdings. As discussed in more detail below, “to ensure that all fund investors will experience the anticipated benefits of the new tailored shareholder reports” they must be transmitted to shareholders, rather than mailing a simple notice of availability.

Other information that was previously included in the shareholder report that is considered by the SEC to be “less retail-focused” and more relevant to financial professionals and investors who desire more in-depth information, will instead be made available on Form N-CSR, which will be: (1) filed with the SEC on EDGAR; (2) available on the fund’s website, as described in the shareholder report; and (3) available to be delivered to investors upon request, free of charge.²

Open-End Funds will have the flexibility to make electronic versions of their shareholder reports more user-friendly and interactive. In addition, Open-End Funds will be required to tag the information in their shareholder reports using Inline XBRL structured data language.

Series and Class Specific

Critically, the New Rules will require that Open-End Funds produce an individual shareholder report, separate from other series of the same registrant. However, in a significant change from the Proposed Rules, the Final Rules also require a separate shareholder report to be produced for each share class of a multi-class fund, resulting in shareholders only receiving reports applicable to the particular share class of the particular fund in which they invest. The SEC requested comment on whether a shareholder report should be limited to a single class but, after considering comments received, the SEC determined that shareholders only receiving reports applicable to their share class would make it easier for such shareholders

to navigate the shareholder report disclosure and understand how it applies to their own investments in Open-End Funds.

The SEC considered adopting an approach whereby all share classes could be included in a shareholder report if the Open-End Funds were to provide additional disclosure regarding share class availability and eligibility to assist shareholders in understanding the various available share classes. However, the length and complexity associated with shareholder reports that include multiple series and/or classes was determined by the SEC to be inconsistent with the Final Rules’ goal of creating a clear and concise shareholder report. Further, the SEC determined that the length and complexity of a shareholder report that includes all share classes of a multiple share class fund would make it more difficult for shareholders to identify information pertaining to their investment, which may differ depending on the share class in which the shareholder is invested. The SEC recognized that while different share classes of a fund hold an interest in the same portfolio and certain disclosure would be identical for all classes, significant disclosure will vary among the various share classes. Accordingly, the SEC concluded that limiting shareholder reports to one class of a multiple class fund is appropriate in order to ensure shareholders can easily assess and monitor their ongoing investments.

Content of the Tailored Shareholder Report

As discussed below, the Final Rules prescribe the limited content that can be included in the new, streamlined shareholder report.

Cover Page or Beginning of the Report

The Final Rules require each shareholder report to contain certain information on the cover or beginning of a report including:

- Fund/Class Name;
- Ticker Symbol;
- Principal US Market(s) for ETFs;

- A statement identifying the report as either an annual or semi-annual report;
- A legend that states:

“This annual shareholder report contains important information about [the Fund] for the period of [beginning date] to [end date]. You can find additional information about the Fund at [Fund website address]. You can also request this information by contacting us at [toll-free telephone number and, as applicable, email address]”; and

- If an annual report describes material fund changes, the following bold face type statement must be included:

“This report describes changes to the Fund that occurred during the reporting period.”

Expenses

In accordance with the Final Rules, shareholder reports will be required to include a simplified expense table showing certain “costs” associated with a hypothetical \$10,000 investment, both as a percentage of a shareholder’s investment in the Open-End Fund (that is, the expense ratio), and as a dollar amount. The Final Rules do not include the proposed requirements that the expense table include the Open-End Fund’s total return during the period nor the inclusion of an explanation that expense information does not reflect shareholder transaction costs associated with purchasing or selling fund shares. In addition to instructions as to how to calculate the amounts included in the expense table, the Final Rules provide instructions related to the permitted types of footnotes to the expense table, each as described below:

- *Extraordinary Expenses*—If a fund incurred “extraordinary expenses” during the reporting period, a fund may briefly describe what the

expenses would have been if the extraordinary expenses had not been incurred.

- *Feeder Fund*—If a fund is a feeder fund, the fund must reflect the aggregate expenses of the feeder fund and the master fund in an expense table and can include a footnote stating the expense table includes the expenses of both the master and feeder fund.
- *Shareholder Report Covering Less than a Full Reporting Period*—A fund must include a footnote to the table noting the report covers less than a full reporting period and explain that the expenses for a full reporting period would have been higher than the figures shown.

Management’s Discussion of Fund Performance

The Final Rules retain the management’s discussion of fund performance (MDFP) section that typically appears in annual shareholder reports but condense the section to include only specified disclosure and information. The narrative disclosure that is required to be included in the MDFP section of the annual report will contain disclosure that “must ‘briefly summarize’ the ‘key’ factors that materially affected the Open-End Fund’s performance during the last fiscal year.” The “Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements” adopting release (Adopting Release) provides examples as to what these factors may be, namely, relevant market conditions and the investment strategies and techniques utilized by the adviser. Further, the Final Rules incorporate an instruction to this section that encourages the inclusion of charts, graphs, bulleted lists or tables to indicate how an Open-End Fund has performed instead of lengthy discussions that may be generic or too broad.

The Final Rules also retain the requirement to include a performance line graph, updated from the format included in the Proposed Rules to reflect

the shift from a multiple-class to a single share class report. The line graph will show performance of a \$10,000 investment into the relevant share class of the Open-End Fund, as well as an appropriate broad-based securities market index, over a 10-year period. The Final Rules also permit the inclusion of additional more narrowly-based indexes that reflect the Open-End Fund's relevant market sectors. The Adopting Release notes that the Final Rules will limit the time frame for the line graph to a 10-year period so as to avoid unrealistic investor performance-related expectations and allow investors to easily identify volatility. Additionally, the Final Rules include an instruction that defines a "broad-based" securities market index, which will be discussed in detail later in this article.

Further, the Final Rules retain the current requirement to include a table presenting average annual total returns of an Open-End Fund in the relevant annual report. This table will include the average annual total returns for the past 1-, 5- and 10-year periods for the Open-End Fund's relevant share class, the average annual total returns of an appropriate broad-based securities market index and the Open-End Fund's average annual total returns without sales charges for the Open-End Fund's relevant share class. Additionally, the Final Rules allow for the Open-End Fund to include a legend or footnote to describe any material change that occurred during the relevant period.

Finally, with respect to any Open-End Fund that has a policy or practice of maintaining a specified level of distribution to shareholders, the Final Rules require that an Open-End Fund unable to maintain such a policy or practice must disclose this in the MDFP section of their annual report, along with any instances when distributions result in returns of capital.

Fund Statistics

Certain fund statistics are also required to be included in an Open-End Fund's shareholder report per the Final Rules. The enumerated list of statistics

that are required to be included within the shareholder report include:

- Net assets;
- Total number of portfolio holdings;
- Portfolio turnover rate (excluding money market funds); and
- Total advisory fees paid by the fund during the reporting period.

An Open-End Fund is also permitted to disclose further statistics that it believes would help shareholders understand an Open-End Fund's activities and operations during the reporting period, so long as any additional statistics that are included are reasonably related to the Open-End Fund's investment strategy. In a change from the Proposed Rules, the Final Rules mandate that the required statistics be presented prior to any additional statistics so as to enhance the comparability of fund statistics across various Open-End Funds. The statistics must abide by the following guidelines: if a statistic is also required under Form N-1A, the Form N-1A instructions describing the calculation method must be followed; statistics included in or derived from fund financial statements or financial highlights must be sourced from the most recent financial statements or financial highlights; and any description of the significance or limitation of any disclosed statistics may be included in a parenthetical or similar presentation but not as a footnote, as a footnote was thought to diminish the effectiveness of the disclosed information and run counter to the SEC's goals of clear and concise shareholder reports.

Graphical Representations of Holdings

The Final Rules retain the current requirements related to the graphical representation of holdings with certain revisions. Open-End Funds will be required to include one or more tables, charts or graphs within their shareholder report illustrating the Open-End Fund's portfolio holdings by categories as of the end of the reporting period. Funds

are permitted to show holdings based on an Open-End Fund's net exposure to a particular category of investments, but only if an Open-End Fund's holdings are depicted based on total exposure to a particular category of investments. Additionally, the Final Rules updated the current instructions related to the depiction of portfolio holdings according to credit quality, requiring any disclosures to be brief and concise, and requiring the inclusion of a statement as to why a particular credit rating was selected.

In addition to the graphical representation of holdings and fund statistics required by the Final Rules, the Final Rules permit an Open-End Fund to disclose, in a table or chart that appears near the Open-End Fund's graphical representation of holdings, an Open-End Fund's largest 10 portfolio holdings, along with the percentage of the Open-End Fund's net asset value, total investments, or total exposure attributable to each holding.

Material Fund Changes Section

The Final Rules also include a list of items, material changes to which must be disclosed in an annual report. Such material fund changes must have occurred since the beginning of the reporting period and include changes to an Open-End Fund's:

- Name;
- Investment objective or goals;
- Annual operating expenses, shareholder fees, or maximum account fees, including the introduction or termination of an expense reimbursement or fee waiver arrangement (whether or not they result in increases in fees);
- Principal investment strategies;
- Principal risks; and
- Investment adviser(s) or subadviser(s).

The Final Rules permit an Open-End Fund to describe other material changes that it wishes to disclose to its shareholders, including other changes that may be helpful to investors in understanding the operations and performance of the

Open-End Fund over the reporting period. The Final Rules do not define materiality for purposes of this requirement, but note that it is not necessarily a change that would require a fund to file an amendment to an Open-End Fund's registration statement under Rule 485(a) under the Securities Act of 1933, as amended (the Securities Act), as some commenters had requested. The SEC, however, noted that materiality is and has been a "bed-rock" principle in the securities laws, and cited to the *Basic v. Levinson* legal materiality standard instead.³ In this regard, the Adopting Release highlights the importance of examining the facts and circumstances in determining whether a change is material, and provides certain considerations in making that determination.

The SEC notes that Open-End Funds may wish to consider the following items when determining whether a change should be considered material: the nature of the change; whether it reflects a material change in an Open-End Fund's risk profile or the way the Open-End Fund is currently being managed; which sections of the prospectus the change affects; and how likely the change would be to influence a shareholder's decision to continue to invest in the Open-End Fund. Further, the Final Rules do not require, but instead permit, disclosure of changes that the Open-End Fund plans to make in connection with its next annual prospectus update if such changes are considered to be material.

Additional Provisions

The Adopting Release further approved three additional provisions, as proposed. First, Open-End Funds may include disclosure not enumerated in Item 27A if the information is necessary to make the required disclosure not misleading. Second, a required disclosure may be omitted if it is inapplicable and a required legend or narrative may be modified if comparable information is included. Finally, no information may be incorporated by reference into the shareholder report.

Changes in and Disagreements with Accountants. Per the Final Rules, Open-End Funds will be required to include a discussion of certain disagreements with accountants that have resigned or have been dismissed. In such an instance, the Final Rules require a concise statement discussing whether the former accountant resigned, declined to stand for re-election, or was dismissed, including the date of such occurrence, as well as a high-level plain-English description of any disagreement with the former accountant during the Open-End Fund's two most recent fiscal year ends and any subsequent interim period, as applicable. Importantly, Open-End Funds will not be required to include a statement indicating the absence of changes in or disagreements with accountants. Furthermore, the Final Rules require that a more detailed and fulsome description of changes in and disagreements with accountants, which mirrors the current requirements, be included on Form N-CSR.

Statement Regarding the Availability of Certain Other Information. The Final Rules require Open-End Funds to include at the end of the report a brief, plain-English statement providing investors with direction to the availability of certain additional information located on the Open-End Fund's website. The Final Rules require references to the Open-End Fund's prospectus, financial information, holdings and proxy voting information, as applicable and must incorporate a means of immediately accessing this additional information such as the inclusion of a QR code or hyperlink.

Householding Disclosure. The Final Rules retain the current provision with respect to householding (which allows a fund to deliver a single paper copy of shareholder reports, prospectuses and proxy statements to investors who reside at the same address to avoid duplication of such documents), whereby Open-End Funds will include disclosure in their annual report indicating how a shareholder may revoke consent to householding of an annual report. Including such disclosure in the annual report satisfies the annual notice requirement, whereby

Open-End Funds must explain to investors who provided implied or written consent to householding how they can revoke their consent.

Format and Presentation of Shareholder Reports

The Adopting Release discusses the adoption of new general instructions related to the format and presentation of the shareholder report. Under the new general instructions, shareholder reports must use plain-English and investor-friendly principles, its contents must appear in the order as is required by Item 27A of Form N-1A, and the report must include legibility requirements applicable to printed documents in a format that promotes effective communication as described in Instruction 8 of Item 27A(a).

Electronic Shareholder Reports

The SEC is adopting general instructions describing requirements for any electronic shareholder reports including ordering and presentation requirements, flexibility to provide additional tools and features, and links for immediate access to information. Open-End Funds will have the flexibility to make electronic versions of their shareholder reports more user-friendly and interactive. With respect to added tools and features that would appear on a website or would otherwise be provided electronically, Open-End Funds are permitted to include any instructions necessary for the use and interpretation of interactive graphics or tools. Further, any tools or features included electronically or on the website must adhere to any requirement of Item 27A of Form N-1A.

Differences Between Annual and Semi-Annual Reports

The Final Rules contain nearly identical requirements for annual and semi-annual reports. However, unlike annual reports, semi-annual shareholder reports are not required to include the items discussed above with respect to the "Management's

Discussion of Fund Performance” or disclosure of material changes sections. The Final Rules do not require the noted disclosures but Open-End Funds are given the option to include these items in semi-annual reports. Any voluntary disclosure must comply with the requirements of Item 27A of Form N-1A.

Changes to Rules 30e-3 and 30e-1(d)

As foreshadowed by the Proposed Rules, the Final Rules change the scope of Rule 30e-3 (Rule 30e-3) of the 1940 Act, to exclude Open-End Funds, thereby eliminating the ability of Open-End Funds to rely on the Rule to satisfy shareholder report transmission requirements by making shareholder reports available online and mailing a notice of availability of the reports. Now, Open-End Funds once again will be required to mail shareholder reports to all shareholders, unless a shareholder affirmatively confirms their request to receive their shareholder reports via electronic delivery. Although Rule 30e-3 was adopted only four years ago to allow Open-End Funds to rely on the Rule 30e-3 beginning January 2021, the SEC concluded that investors will benefit from receiving streamlined information delivered directly to them, rather than receiving a notice with no substantive content and thereafter having to locate the information electronically.

In the Adopting Release, the SEC noted its belief that the new disclosure approach for shareholder reports is a more effective means of improving investor access and use of fund information while also preserving the expected cost savings that would be experienced by choosing to rely on Rule 30e-3. The SEC asserted the Final Rules would lead to a greater “per-fund” reduction in the cost of transmitting a shareholder for Open-End Funds that do not rely on Rule 30e-3 as compared to those that rely on Rule 30e-3. The SEC further clarified that variable contract unit investment trusts (UIT) may no longer rely on Rule 30e-3 to satisfy shareholder report transmission requirements with respect to

underlying funds registered on Form N-1A despite the fact that UITs currently may rely on Rule 30e-3 to satisfy their shareholder report transmission requirements under Rule 30e-2 of the 1940 Act.

Additionally, the Final Rules rescind Rule 30e-1(d) under the 1940 Act (Rule 30e-1(d)), which allows for a copy of an Open-End Fund’s prospectus or statement of additional information to be transmitted in place of the shareholder report, if it includes all of the information required to be included in the shareholder report. According to the Adopting Release, Rule 30e-1(d) is rescinded as it was rarely utilized and is inconsistent with the SEC’s layered disclosure framework adopted through the Final Rules. The changes to Rules 30e-3 and 30e-1(d) are a reversal from the access equals delivery approach used in other shareholder communications, and require Open-End Funds to again rely on a dated electronic delivery framework.

Further, the Final Rules will permit the shareholder report to be transmitted with additional documents so long as the shareholder report is given “greater prominence.” Materials that are considered exempt from the “greater prominence” requirement include summary prospectuses, statutory prospectuses (both as defined in Rule 498 under the Securities Act), or notices of the online availability of proxy materials under Rule 14a-6 under the Securities Exchange Act of 1934, and other shareholder reports.

Items Omitted from the Tailored Shareholder Reports

The SEC’s “layered” disclosure framework provides a significant shift of information being relocated out of the shareholder report and into the Form N-CSR filing, or omitted from the requirements of both the reports and the filings. Specifically, the Final Rules require Open-End Funds to shift the following items so that they are filed on Form N-CSR, posted on an Open-End Fund’s website, and available in paper form upon request by a shareholder:

- Detailed discussion of changes in and disagreement with accountants, while a summary will be retained in the annual shareholder report;
- Complete list of fund portfolio holdings;
- Financial statements;
- Financial highlights, while certain data points will be retained in the shareholder reports;
- Results of any shareholder votes;
- Remuneration paid to directors, officers and others; and
- Statement regarding the basis for the board's approval of any investment advisory contract.

Further, the Final Rules eliminate the disclosure previously required in Item 27 of Form N-1A regarding information on management and fund directors, as well as statements regarding the liquidity risk management program. These items are not relocated to Form N-CSR but rather removed entirely as the information is required to be included in the Open-End Fund's registration statement or other filings. The Adopting Release provides that the SEC determined that it was unnecessary to include management information in both an annual report or Form N-CSR and an Open-End Fund's statement of additional information, and that the currently-required liquidity risk management narrative disclosure does not meaningfully augment existing liquidity risk management disclosure or reporting requirements.

Open-End Fund Prospectus Disclosure

Although the Final Rules do not include SEC action on a number of the Proposed Rules with respect to Open-End Funds' prospectus disclosure and prospectus delivery requirements, they do include certain requirements that will impact Open-End Funds' registration statement disclosures.

Definition of Broad-Based Securities Market Index

As noted above, the Final Rules modify the definition of an "appropriate broad-based securities

market index" in Form N-1A, which will impact the MDFP in Open-End Funds' shareholder reports, and performance disclosures included in their prospectuses. Specifically, Item 27A of Form N-1A now defines a "broad-based" index as one that "represents the overall applicable domestic or international equity or debt markets, as appropriate." In the Adopting Release, the SEC stated that the definition is designed to ensure that a broad-based index "reasonably represents" the overall securities market in which the fund invests. However, the SEC acknowledged that performance disclosure based on a narrow segment of the market may be useful for comparison purposes and Open-End Funds will continue to be permitted to include narrower indexes that reflect the market segments in which an Open-End Fund invests as secondary indexes. Importantly, the SEC stated that comparisons to a narrow segment of the market are not a substitute for an index "that provides information about the performance of the fund against the broader market."

While the Adopting Release does not include a list of permissible indices or criteria regarding index selection methodology, the SEC provided general guidance and examples of the types of indexes that would satisfy the definition of a "broad-based" index. The SEC noted that a broad-based index need not include every security in a given market, and for an Open-End Fund investing primarily in the equity securities of a non-US country, an index representing the overall equity market of that country would satisfy the definition. Conversely, an appropriate benchmark for an Open-End Fund that invests in equity securities of a subset of the US market, such as healthcare companies, should reflect the overall US equities market, rather than consisting of only healthcare companies. Importantly, the Adopting Release states that indexes including characteristics such as growth, value, environmental, social and governance factors or small- or mid-cap do not represent the overall market, and therefore would not be

appropriate broad-based securities market indexes pursuant to the Final Rules.

Also, with respect to what does qualify as a broad based index, the Adopting Release notes that an “appropriate” broad-based securities market index may include components that do not directly overlap with an Open-End Fund’s investments, if the index’s components share similar economic characteristics to the Open-End Fund’s investments, such that they provide an appropriate comparison point. For instance, the Adopting Release acknowledges that Open-End Funds such as multi-asset and alternative strategy funds that do not invest within a single overall debt or equity market could select an index that shares other economic characteristics with an Open-End Fund, such as an index with similar volatility to the Open-End Fund. The SEC also permits Open-End Funds investing in both equity and debt securities to include more than one appropriate broad-based securities market index, as well as a blended index combining the performance of multiple indexes as a secondary index.

The definition of a “broad-based” securities market index is likely inconsistent with the current practices of many Open-End Funds, which often pursue investment objectives and strategies with a focus on specific markets, sectors, capitalization ranges or security types, and select benchmarks that would be relevant to investors seeking exposure to such a strategy. The Final Rules, therefore, may result in significant changes to the selection and presentation of benchmarks in Open-End Funds’ prospectuses. One potential outcome could be that nearly all Open-End Funds include more than one benchmark index, with a broad-based index as well as one or more narrower secondary indexes reflecting the specific market segments in which the Open-End Fund primarily invests. Such an outcome could require Open-End Funds to pay additional index licensing fees, which the SEC acknowledges in the Adopting Release. In addition, notwithstanding the SEC’s guidance in the Adopting Release, Open-End Funds could experience difficulty in determining

whether an index, even a commonly used market index such as the S&P 500, truly “represents the overall applicable domestic or international equity or debt markets, as appropriate,” given its focus on larger-capitalization companies. Accordingly, Open-End Funds will have to consider the selection of a broad-based index, which could lead to consolidation in the indexes selected for comparison by Open-End Funds.

Proposed Changes to Prospectus Fee Disclosures

The Proposed Rules also included proposed amendments to Form N-1A fee disclosure, which ultimately were not adopted. The Proposed Rules would have moved the current fee table out of the summary portion of the prospectus and into the statutory portion, replacing it with a “fee summary” that was intended to be more concise than Open-End Funds’ current fee tables, focusing on the “bottom line” costs of investment in an Open-End Fund.

Among other things, the Proposed Rules would have replaced the current terminology used in the fee table with new plain English terms that the SEC believed would have been understood by more investors. The new table would have used the terms transaction fees, purchase charges, exit charges and early exit fees, and dropped current references to traditional industry terms shareholder fees, sales charges, deferred sales charges and redemption fees. The Proposed Rules also would have replaced the annual fund operating expenses section of the current fee table with one or two line items in the summary fee table: “ongoing annual fees” and, if applicable, “ongoing annual fees with temporary discount.”

The Proposed Rules also would have revised the treatment of Open-End Funds with significant investments in other funds. An Open-End Fund that invests 10 percent or less of its total assets in acquired funds (excluding money market funds) would have been permitted to omit the acquired fund fees and expenses (AFFEs) from the calculation of ongoing annual fees in the summary fee table and from the

line item in the fee table in the statutory portion of the prospectus. Any omitted AFFEs would instead be disclosed in a footnote to the fee table and fee summary. Portfolio turnover would have been disclosed in both the fee summary and the statutory portion of the prospectus.

In the Adopting Release, the SEC noted that comments received on the Proposed Rules with respect to fee disclosure were “mixed,” with some commenters supporting the use of simplified fee disclosures, and others noting that having multiple different fee presentations could be confusing to investors and burdensome for Open-End Funds. The SEC noted that commenters also opposed many of the proposed new terms, and recommended that the SEC verify the proposed approach through additional investor testing. With respect to the disclosure of AFFEs, the SEC reported that a number of commenters suggested that the approach would decrease transparency with respect to acquired fund fees and expenses. Although the SEC noted that “[h]elping investors more readily understand fund fees and expenses is an important priority,” it believed that the comments received raised issues meriting further consideration.

Proposed Changes to Prospectus Risk Disclosure

The Proposed Rules would also have changed the principal risk disclosure included in an Open-End Fund’s prospectus, which ultimately were not adopted. In particular, they would have limited the “principal risks” eligible to be disclosed in an Open-End Fund’s prospectus to those that satisfied a “10 percent standard.” In the Proposing Release, the SEC explained that this standard was an effort to limit the often expansive risk disclosure currently presented in Open-End Fund prospectuses, and it would have required an Open-End Fund to judge (1) if a risk would place more than 10 percent of the Fund’s assets at risk in the current environment; and (2) whether it is reasonably likely that a risk will, due to changing conditions, breach this 10 percent standard in the future.

The proposed 10 percent standard also would have applied to determining whether investing in a particular sector presents a principal risk. More volatile investments, such as short sales or derivatives, would have satisfied the 10 percent standard if such investments would subject an Open-End Fund to a risk of loss with respect to more than 10 percent of its assets, even if the Open-End Fund uses a lower percentage of assets to make such investments. Additionally, a proposed new instruction to Form N-1A would have required funds of funds to include only principal risks of the investing fund rather than disclose the principal risks of each underlying fund.

The Proposed Rules also would have required Open-End Funds to list principal risks in the summary portion of the prospectus in the order of importance, with the most significant risks appearing first, and would have prohibited the fund from listing risks in alphabetical order. The proposed instruction would specifically have permitted an Open-End Fund to make determinations regarding the relative importance of risks using any reasonable means. The Proposed Rules also would have included language to promote more concise prospectus risk disclosure.

In the Adopting Release the SEC stated that concerns regarding the difficulty and subjectivity of determining which risks currently or prospectively placed more than 10 percent of an Open-End Fund’s assets at risk contributed to the removal of the proposed change to prospectus risk disclosure from the final rule. The SEC also stated that commenters were concerned with the prospect of accurately ordering risks based on a subjective methodology and the potential of increased liability relating to such disclosures.

Prospectus Delivery Requirements

Apart from the matters discussed above, the Final Rules did not adopt a number of the Proposed Rules with respect to Open-End Funds’ prospectus disclosures and delivery requirements. The SEC’s decision not to adopt these proposals means there will be no changes to Open-End Funds’ prospectus delivery requirements or to prospectus fee or principal risk

disclosures. SEC Chair Gary Gensler stated that he has requested that the SEC Staff “continue discussions with market participants given the broad range of comments we received,” opening the door to the future proposal of changes to Open-End Funds’ prospectus disclosure and delivery requirements.

Proposed Rule 498B and Treatment of Annual Prospectus Update

The statutory requirements dictating fund delivery of prospectuses are contained in Section 5(b)(2) of the Securities Act. Proposed Rule 498B would have largely disrupted existing practices surrounding prospectus delivery. Section 5(b)(2) requires that a fund or financial intermediary deliver a prospectus to an investor in connection with the purchase of fund shares. Section 10(a)(3) of the Securities Act provides that the audited financial information included in a fund’s prospectus must be no more than 16 months old. In light of these requirements and related rules under the 1940 Act, Open-End Funds update and deliver their prospectus and SAI on an annual basis to maintain a current registration statement. The Proposing Release recognized that, while there is no ongoing prospectus delivery requirement with respect to an Open-End Fund’s existing shareholders, many Open-End Funds deliver an updated prospectus to existing shareholders annually to avoid the need to track each shareholder’s additional purchase activity throughout the year. According to the Proposing Release, most Open-End Funds send a summary prospectus, rather than the longer, more detailed, statutory prospectus, to shareholders, as permitted by Securities Act Rule 498.

In direct conflict with the statutory requirements of Section 5, Proposed Rule 498B would have permitted an Open-End Fund to satisfy its annual prospectus delivery obligations to existing shareholders by transmitting only the streamlined shareholder reports and notices of any material changes with respect to certain sections of the prospectus. While the SEC left the door open to further proposals in this area, for now, the SEC seems to believe

Rule 498B is a step too far. To rely on Rule 498B as proposed, an Open-End Fund would have been required to: (1) make its current summary prospectus, statutory prospectus, SAI, and most recent shareholder reports publicly accessible on its website, free of charge; and (2) provide shareholders notice of material changes within three business days of a post-effective amendment filing or the filing date of a prospectus supplement. Material changes included changes in an Open-End Fund’s name, investment objective or goals, principal investment strategies and risks, as well as others.

Additionally, under Proposed Rule 498B, Open-End Funds would no longer have been required to distribute prospectus supplements to existing shareholders. Instead, Open-End Funds would have been permitted to deliver a shareholder report that described any material changes that occurred since the beginning of the reporting period. If material changes were not described in a shareholder report, an Open-End Fund would have been required to provide notice to shareholders of such changes, either by delivering the prospectus supplement describing the changes or by providing a separate notice.

In the Adopting Release, the SEC noted that, although many commenters were supportive of Rule 498B, they suggested significant modifications, and that other commenters expressed concerns regarding the fact that existing investors would not continue to receive an updated prospectus annually, the proposed requirement to deliver notices of material fund changes, and the potential for increased shareholder litigation. While noting that improving the disclosure framework and investors’ experience with Open-End Fund disclosure remains an important priority, the SEC stated that commenters “raise issues that merit further consideration.”

Gone Today, Here Tomorrow?

As a result of the SEC not adopting Rule 498B, Open-End Funds will continue to be required to deliver shareholder reports to existing investors, but will not be able to treat these reports as satisfying

their prospectus delivery requirements to existing shareholders purchasing additional shares. Instead, Open-End Funds will continue to either track additional shareholder purchases throughout the year, or provide annual prospectus updates to all existing shareholders. In addition, Open-End Funds will continue to be required to disclose to existing shareholders material changes via supplement, rather than through the use of shareholder reports and notices. Accordingly, the Final Rules generally increase the current delivery requirements for Open-End Funds with respect to shareholder reports, without a corresponding abatement in prospectus delivery requirements.

It is unclear what, if any, inferences can be drawn from the SEC's decision not to adopt the Proposed Rules with respect to prospectus fee and risk disclosures. Although the proposed requirement to order risks by importance would have codified recent SEC Staff guidance and statements, the SEC's determination not to adopt an instruction to Form N-1A does not indicate a repudiation of this guidance. In addition, the Adopting Release notes that the comments received on the prospectus proposals merit "further consideration," and SEC Chair Gensler stated that he had requested that the SEC Staff "continue discussions with market participants given the broad range of comments we received," opening the door to the future adoption of changes to Open-End Fund prospectuses. It is likely that any further action on these proposals would differ from the Proposed Rules, and may be subject to industry review and comment before any final changes are adopted. In particular, only Commissioner Hester Peirce was a member of the Commission at the time of the Proposed Rules. Therefore, future proposals may more closely reflect the concerns of Chair Gensler and the other Commissioners. Nevertheless, certain of these proposals are consistent with SEC and Staff priorities, including helping investors better understand Open-End Funds' fees and disclosures and providing more streamlined prospectus disclosure.

Investment Company Advertising Rules

The SEC adopted, largely as proposed, the Proposed Rules to amend the investment company advertising rules set forth in Rules 482, 156, and 433 under the Securities Act and Rule 34b-1 under the 1940 Act. The Final Rules will require certain investment company advertisements to include standardized figures and provide reasonably current information, reflecting the SEC's desire to promote transparent and balanced presentations of fees and expenses. Unlike the amendments with respect to shareholder reports, which apply only to Open-End Funds, the amendments to the advertising rules will generally apply to all Registered Funds, including Open-End Funds, registered closed-end funds, and BDCs.

Rule 156 Amendments

The Final Rules also amend Rule 156, as proposed, to provide that representations about fees or expenses in investment company sales literature associated with an investment in a Registered Fund could be misleading because of statements or omissions involving a material fact. The Adopting Release provides as examples situations in which portrayals of such fees and expenses omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading. The Adopting Release notes that, consistent with the current Rule 156 framework, whether a particular description, representation, illustration, or other statement involving a Registered Fund's fees and expenses is materially misleading depends on evaluation of the context in which it is made.

The amendments to Rule 156 reflect the SEC's concern that Registered Funds and intermediaries may, in some cases, be incentivized to understate or obscure the costs associated with a Registered Fund investment, particularly with respect to Registered Funds that market themselves as "zero expense" or

“no expense” funds based on information in their prospectus fee tables and without also disclosing that investors or the fund may incur other costs (for example, wrap fees or compensation to a securities lending agent). Accordingly, pursuant to the Final Rules, an advertisement could be deemed misleading if, among other things, it:

- Advertises low investment costs, based solely on a Registered Fund’s prospectus fee table, and does not reflect or recognize other categories of costs that may be supplementing or replacing a more traditional management fee (for example, intermediary costs, securities lending costs).
- Presents one component of a Registered Fund’s total operating expenses, such as the fund’s management fee, without stating that there are other costs associated with a fund investment or providing the total operating expense figure.

Rule 482 Amendments

As proposed, amended Rule 482 under the Securities Act will require that Registered Fund advertisements providing fee and expense figures include: (1) the maximum amount of any sales load or any other nonrecurring fee; and (2) the total annual expenses without any fee waiver or expense reimbursement arrangement (collectively, the required fee and expense figures). The required fee and expense figures are based on the methods of computation that the Registered Fund’s 1940 Act or Securities Act registration statement form prescribes for a prospectus. Accordingly, if a Registered Fund is not required to present total annual expense figures in its prospectus, the amendments to Rule 482 would not be applicable. The Adopting Release also notes that, as these requirements would only apply to Registered Fund advertisements including fee and expense *figures*, an advertisement including only general narrative information about fee and expense considerations would not be required to include the required fee and expense figures.

Advertisements will be permitted to include other fee and expense figures, but will have to present the required fee and expense figures at least as prominently as any other fee and expense figures included in the advertisement. For example, the Final Rules permit an advertisement to include a Registered Fund’s fees and expenses net of certain amounts, such as a fee waiver or expense reimbursement arrangement. However, an advertisement could not present the net figures more prominently than the required fee and expense figures. In addition to meeting the proposed content and presentation requirements, advertisements that include a Registered Fund’s total annual expenses net of fee waiver or expense reimbursement arrangement amounts would also need to include the expected termination date of the arrangement.

The Final Rules also include timeliness requirements for fee and expense information, which would apply to fee and expense figures, as well as to related narrative information. The Final Rules require fee and expense information to be as of the date of the Registered Fund’s most recent prospectus or, if the Registered Fund no longer has an effective Securities Act registration statement, as of its most recent annual report. A Registered Fund would, however, be able to provide more current information, if available. In the case of a new Registered Fund that does not yet have an effective registration statement, fee and expense information is required to be as of the date of the Registered Fund’s most recent prospectus filed with the SEC. Open-End Funds would need to provide their maximum sales load (or other non-recurring fee) and gross total annual expenses as of the date of the Open-End Fund’s most recent prospectus. A registered closed-end fund that does not maintain an effective registration statement would need to provide its gross total annual expenses as of the date of the fund’s most recent annual report. The registered closed-end fund will not have a maximum sales load to report in its advertisement because it does not have an effective Securities Act registration

statement and cannot presently sell the fund's securities.

Rule 34b-1 and Rule 433 Amendments

The Final Rules also amend Rule 34b-1 under the 1940 Act and Rule 433 under the Securities Act in order to incorporate the new requirements in Rule 482 with respect to fees and expenses content, presentation, and timeliness. The amendments to Rule 34b-1 provide that any sales literature of a Registered Fund is deemed to have omitted a fact necessary to make the statements therein not materially misleading, unless the sales literature meets Rule 482's fees and expenses content, presentation, and timeliness requirements. The amendments to Rule 34b-1 would, for example, apply to sales literature that is excluded from the definition of "prospectus" in Section 2(a)(10) of the Securities Act and thus is not subject to Rule 482. Additionally, the amendments to Rule 433, which establishes conditions for the use of post-filing free writing prospectuses, require a registered closed-end fund or BDC free writing prospectus to comply with the new fees and expenses content, presentation, and timeliness requirements of Rule 482, if the free writing prospectus includes fee and expense information. Accordingly, supplemental sales literature subject to Rule 34b-1 that would not otherwise be subject to Rule 482 will be required to meet Rule 482's fee and expense presentation requirements. In addition, regardless of whether a registered closed-end fund or BDC advertisement uses Rule 482 or Rule 433 (for free writing prospectuses), the advertisement would be subject to the same requirements regarding fee and expense information as prescribed in Rule 482.

While the amendments to Rules 482, 34b-1, and 433 are similar to requirements that currently apply to a subset of fund advertisements under the Financial Industry Regulatory Authority (FINRA) Rule 2210 (that is, certain non-money market fund open-end management investment company advertisements that provide performance information),

the Final Rules would apply more broadly to all investment company advertisements and supplemental sales literature.

Conclusion

The tailored shareholder report amendments and the amendments to the scope of Rule 30e-3 will become effective 60 days after publication in the Federal Register. However, the Final Rules including both the tailored shareholder reporting and Rule 30e-3 amendments for registered investment companies under the 1940 Act, provide an 18-month transition period after publication in the Federal Register. The amendments to Rules 482, 433, and 34b-1 will be effective 18 months after the effective date, whereas the amendments to Rule 156 will be effective as of the effective date.

The 18-month transition period will allow fund complexes time to prepare for the significant changes that will be required as a result of the Final Rules. Fund complexes will be required, among other things, to update their policies, procedures and operational frameworks related to shareholder reporting, design and implement the website availability requirements for the new Form N-CSR items, communicate with shareholders regarding the changes to Rule 30e-3 as well as allow time for fund complexes that rely on Rule 30e-3 to transition to the proposed disclosure framework, and coordinate with financial printers and intermediaries to prepare and deliver class-specific shareholder reports.

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NOTES

- ¹ *Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements*, Investment Company Act Release No. 34731 (Oct. 26, 2022); <https://www.sec.gov/rules/final/2022/33-11125.pdf>.
- ² *Id.* at 128.

- ³ See *Basic v. Levinson*, 485 U.S. 224, 231 (1988) (To fulfill the materiality requirement there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available).

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