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SEC Update

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SEC Proposes Amendments to the Advertising Rules for Registered Funds, BDCs, and ETFs

On August 5, 2020, the Securities and Exchange Commission (SEC) proposed amendments to the advertising rules for registered investment companies and business development companies as part of a package of comprehensive modifications aimed at improving fund fee and expense information provided to investors. The proposed amendments would apply to Rules 482, 156, and 433 under the Securities Act of 1933 (Securities Act) and corresponding Rule 34b-1 under the Investment Company Act of 1940 (1940 Act) (the investment company advertising rules).

The investment company advertising rules currently limit how investment companies present performance in advertisements, but do not regulate the presentation of fees and expenses. The proposed amendments would require that presentations of fees and expenses in advertisements are consistent with relevant prospectus fee table presentations and provide information as of the date of the fund's most recent prospectus. Consequently, if the amendments are adopted, investment companies will be required to include *gross* and *net* expense figures in all advertisements and supplemental sales literature that include fee and expense disclosure.

In addition, fund complexes will need to reconsider use of the term “zero fee,” or any similar phrases, as they may be deemed misleading without further disclosure if the amendments are adopted as proposed.

This column discusses the implications of the proposed amendments for investment companies, particularly with respect to (i) the presentation of sales loads and gross expenses in fact sheets and other sales literature; and (ii) “zero expense” fund advertisements.

Presentation of Sales Loads and Gross Expenses

The proposed amendments to Rule 482 would require that investment company advertisements that provide 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). An advertisement would not need to include the required fee and expense figures if it only included general, narrative information about fee and expense considerations and did not include any numerical fee or expense amounts.¹ In addition, the proposed required fee and expense figures would be based on the methods of computation required

to be used in the fund's 1940 Act or Securities Act registration statement.²

While investment company advertisements could include *net* figures regarding a fund's fees and expenses, the advertisement would have to present the required *gross* fee and expense figures *at least as prominently* as any other included fee and expense figures. For example, the proposed amendments would permit an advertisement to include a 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 figure more prominently than the required fee and expense figures as many advertisements currently do. In addition, advertisements that include a 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.³

The proposed amendments would also require fee and expense information to be as of the date of the fund's most recent prospectus or, if the fund no longer has an effective Securities Act registration statement, as of its most recent annual report. A fund would, however, be able to provide more current information, if available.

Separately from the proposed amendments, the Financial Industry Regulatory Authority, Inc. (FINRA) Rule 2210(d)(5) requires retail communications and correspondence that present fund performance to disclose: (1) the fund's maximum sales charge; and (2) the total annual fund operating expense ratio, gross of any fee waivers or expense reimbursements. Under Rule 2210, a fund's standardized performance information, sales charge, and total annual fund operating expense ratio (gross of any fee waiver or expense reimbursement) must be set forth prominently. While the proposed amendments are similar to the requirements of Rule 2210, the amendments would apply more broadly to *all* investment company advertisements and supplemental sales literature.

Practice Point: If the proposed amendments are adopted as proposed, fund complexes would have to review fund fact sheets and other sales literature to determine if revisions are necessary. While many fund complexes already include gross and net expense figures in fund fact sheets consistent with FINRA Rule 2210, they should carefully review whether gross figures are presented at least as prominently as net figures in *all* investment company advertisements and supplemental sales literature.

“Zero Expense” Fund Advertisements

The proposed amendments would amend Rule 156 to provide that representations about fees and expenses in investment company sales literature associated with an investment in a fund would be deemed materially misleading if they did not include relevant fee and expense information (for example, securities lending fees). In the proposing release, the SEC stated that these amendments were designed to address concerns that investment companies and intermediaries may understate or obscure the costs associated with a fund investment, particularly with respect to funds that market themselves as “zero expense” or “no expense” funds based solely on information in their prospectus fee tables and without also disclosing that investors or the fund may incur other costs. For instance, an investor in a so-called zero expense fund may encounter other investment costs that can effectively reduce the value of his or her investment in a fund, such as wrap fees or compensation to a securities lending agent. Additionally, a fund may appear to be a “zero expense” fund because its adviser is waiving fees or reimbursing expenses for a period of time, but the fund will incur fees and expenses once that arrangement expires.

Practice Point: Fund complexes with “zero expense” funds should be proactive in reviewing sales literature to confirm that appropriate disclosure regarding any investment costs to investors, including wrap fees, securities lending compensation, or

expense waivers set to expire, are included to avoid such literature being deemed misleading. In particular, fund complexes should: (1) reconsider use of the term “zero fee,” or any similar terms, as they may be misleading without enhanced disclosure; and (2) review disclosure in prospectus fee tables (and any advertisements including such fee tables) to determine whether further enhanced disclosure must be included.

Conclusion

Overall, the proposed amendments do not mark a sea change in the industry, but rather reflect a harmonization of the investment company advertising rules with, and extension of, the existing FINRA rule. If adopted, the proposed rule amendments may require changes to existing advertising templates for certain fund complexes. However, many fund complexes already include gross and net expense figures in fund advertisements consistent with FINRA Rule 2210, and therefore would be largely in compliance with the proposed amendments already. Significantly, fund complexes that market “zero expense” funds should be prepared to

revise fee disclosures and reconsider use of terms such as “zero fee,” if the proposed amendments are adopted.

The SEC put forth a series of questions to industry stakeholders in the proposing release regarding the amendments, including whether they should be applicable to all investment companies. Comments on the proposed amendments were due to the SEC by January 4, 2021.

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NOTES

- ¹ This might be the case if, for example, the advertisement only refers to the fund’s fees and expenses in the context of the disclosure required by Rule 482(b)(1), which requires a statement advising an investor to consider the investment objectives, risks, and charges and expenses of the fund carefully before investing.
- ² See Proposed Rule 482(i)(1).
- ³ See Proposed Rule 482(i)(2).

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