

## SEC PROPOSES OVERHAUL OF FUND DISCLOSURE

On Aug. 5, 2020, the Securities and Exchange Commission (SEC) proposed rule and form amendments designed to modernize fund disclosure for mutual funds and exchange-traded funds (ETFs) registered on Form N-1A (open-end investment management companies) and amend the advertising rules for open-end funds, closed-end funds and business development companies (Proposal).<sup>1</sup> The proposed disclosure framework would result in significant changes to the current disclosure regime for mutual funds and ETFs. The Proposal is designed to incorporate the information received by the SEC in its June 2018 request for comment on retail investors' experience with fund disclosure and ways to enhance such disclosure (Fund Investor Experience RFC), which articulated fund shareholders' preference for concise, layered disclosure that highlights key information and uses design features to make disclosure easier to understand. The revised framework would feature concise, visually engaging shareholder reports highlighting information the SEC believes is most pertinent to fund shareholders. The Proposing Release also includes changes to fund prospectus delivery requirements and prospectus disclosure items.

This Alert includes a summary of the Proposal, followed by a detailed discussion and list of issues for funds and advisers to consider. A one-page overview of the Proposal can be found [here](#).

### SUMMARY

The key features of the Proposal include the following:

- Shareholder reports would serve as the primary fund disclosure document for shareholders and would include condensed and more visually appealing content to highlight information the Staff believes is particularly important to retail investors, including:
  - fund expenses;
  - performance;
  - illustrations of holdings; and
  - material fund changes.

The Proposal encourages funds to use graphic or text features, such as tables, bullet lists, and Q&A formats in their shareholder reports. The SEC's press release related to the Proposal includes a [hypothetical streamlined shareholder report](#) that is illustrative of the Staff's vision and may serve as a useful tool for fund groups.

- Shareholder reports would be streamlined by moving financial highlights, financial statements, including the schedule of investments, and other information out of the shareholder report and into new sections of Form N-CSR, which would be filed semi-annually, available online, and delivered upon request;
- New Rule 498B would permit funds to forego providing annual update prospectuses to existing shareholders and instead provide timely notification of material changes to certain Form N-1A items specified in the Rule which, together with the new summary of material changes required in annual reports, would keep shareholders informed;

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<sup>1</sup> Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, Release Nos. 33-10814; 34-89478; IC-33963 (Aug. 5, 2020) (Proposing Release).

- Rule 30e-3, which allows registered funds to satisfy the shareholder report transmission requirement by providing notice of their availability online, would be modified to exclude mutual funds and ETFs. Rule 30e-3 becomes effective Jan. 1, 2021, and, if the Proposal is adopted, funds will need to determine whether to rely on Rule 30e-3 for what could be an abbreviated period between Jan. 1, 2021, and the effective date of the proposed rule change;
- The Proposal makes significant changes to prospectus disclosure requirements, including:
  - replacing the existing fee table in the summary section of the statutory prospectus with a simplified fee summary;
  - moving the existing fee table to the statutory prospectus;
  - replacing certain terms in the current fee table (e.g., “purchase fee” instead of “maximum sales charge”); and
  - allowing funds with investments in other funds below a specified threshold to disclose “acquired fund fees and expenses” in a fee table footnote rather than in the fee table itself.
- The Proposal would also codify prior Staff guidance and comments regarding prospectus disclosure of principal risks, including:
  - requiring principal risks to be presented in order of importance rather than listed alphabetically;
  - prohibiting the inclusion of non-principal risks in the prospectus; and
  - adding Form N-1A instructions on how to determine when a risk is principal.
- The Proposal also amends the advertising rules to require open-end and closed-end investment companies and business development companies to provide more transparent and balanced presentations of fees and expenses in investment company advertisements that are consistent with relevant prospectus fee table presentations.

As of the date of this Client Alert, the Proposing Release has not yet been published in the Federal Register. Comments on the Proposal will be due 60 days after publication.

## **DETAILED DISCUSSION**

### **I. Proposed Changes to Shareholder Reports/Form N-CSR**

#### **A. Shareholder Reports**

The primary focus of the restructured fund disclosure framework is the shareholder report. Proposed new Item 27A of Form N-1A (Item 27A) would govern the substantially revised scope, content, format and presentation of a fund’s shareholder report.

Under Item 27A, the length of a fund’s annual report would be significantly reduced by moving many of the currently required disclosure items, such as a fund’s financial statements, out of the shareholder report and into newly created sections of Form N-CSR. The remaining disclosure is expected to be concise, tailored to a retail shareholder’s experience and presented in a visually engaging format.

The changes in the Proposal with respect to the scope, content, format and presentation of an annual report, as well as the proposed requirements for electronic annual reports, would also generally apply to semi-annual reports. For semi-annual reports, a fund would not be required to include a management’s discussion of fund performance (MDFP) (consistent with current requirements) or the new section summarizing material fund changes, but if the fund chooses to include either or both sections, the disclosure must comply with the requirements of Item 27A. While the SEC is not currently proposing any changes to the existing requirements for transmitting shareholder reports semi-annually, it is requesting comment on proposed alternatives to this requirement. For example, the SEC has observed that funds tend to update more frequently fund fact sheets and other information included on the fund websites and is seeking comment on how funds might be able to leverage the more updated information already provided to shareholders in lieu of, or in addition to, semi-annual disclosure.

### **Scope of Annual Report**

Item 27A would require the preparation of a separate annual report for each series, although the report may cover multiple classes of such series. This is intended to reduce the length and complexity of multi-series reports, and also to reduce potential investor confusion. Item 27A would require an annual report to include only the information specifically permitted or required by Item 27A, with the flexibility to include additional disclosure if necessary to make the required disclosure not misleading. This is intended to promote consistent and impartial disclosure of relevant information to shareholders. Item 27A would, however, permit a fund to disclose that certain additional information is available on its website if the fund reasonably believes that a shareholder would find this information important. A fund is permitted to include additional information in the same “transmission” as the annual report, so long as the annual report is given greater prominence than the other included materials.<sup>2</sup> Item 27A would not permit a fund to incorporate by reference any information into its annual report in order to satisfy the content requirements.

Item 27A would apply only to open-end investment companies registered on Form N-1A. The Proposing Release notes that the SEC is waiting to evaluate the impact of recently adopted changes to the disclosure framework for closed-end funds and variable insurance contracts before proposing additional changes that would affect these funds.

### **Contents of Annual Report**

The table below summarizes the proposed contents of a fund’s annual report under Item 27A and describes how the contents compare to the current disclosure requirements under Form N-1A.

CURRENT DISCLOSURE	PROPOSED ACTION	PROPOSED DISCLOSURE AMENDMENTS
N/A	<b>Add</b>	Identifying information on cover page or at beginning of report
Expense Example <b>(Item 27(d)(1))</b>	<b>Modify</b>	One expense example only, with additional data points
MDFP <b>(Item 27(b)(7))</b>	<b>Modify</b>	Summary of narrative discussion; revised performance presentation

<sup>2</sup> See *id.* at 58. The “greater prominence” requirement would not apply to certain disclosure materials a fund may transmit with the annual report, such as a prospectus.

CURRENT DISCLOSURE	PROPOSED ACTION	PROPOSED DISCLOSURE AMENDMENTS
N/A	<b>Add</b>	Fund statistics section identifying, at a minimum, the fund's net assets, total number of holdings and portfolio turnover rate
Graphical Representation of Holdings <b>(Item 27(d)(2))</b>	<b>Modify</b>	Additional instructions for presenting information on certain types of investments
N/A	<b>Add</b>	Description of material fund changes that occurred during the reporting period
Changes in and Disagreements with Fund Accountants <b>(Item 27(b)(4))</b>	<b>Modify/Move</b>	Summary only in annual report; include full disclosure in Form N-CSR and online, and deliver upon request <sup>3</sup>
Statement Regarding Liquidity Risk Management Program (LRMP) <b>(Item 27(d)(6)(ii))</b>	<b>Modify</b>	Revise for more concise, tailored disclosure
Statement Regarding Availability of Quarterly Portfolio Schedule, Proxy Voting Policies and Procedures, and Proxy Voting Record <b>(Item 27(d)(3)-(5))</b>	<b>Modify</b>	Consolidate into general reference to availability of additional information
N/A	<b>Add</b>	Householding disclosure (as applicable)
Financial Statements, including Schedule of Investments <b>(Item 27(b)(1))</b>	<b>Move</b>	Include in Form N-CSR and online, and deliver upon request
Financial Highlights <b>(Item 27(b)(2))</b>	<b>Move</b>	Include in Form N-CSR and online, and deliver upon request; certain data points to be retained in annual report
Results of Shareholder Votes During the Period <b>(Rule 30e-1(b))</b>	<b>Move</b>	Include in Form N-CSR and online, and deliver upon request
Remuneration Paid to Directors, Officers, and Others <b>(Item 27(b)(3))</b>	<b>Move</b>	Include in Form N-CSR and online, and deliver upon request
Statement Regarding Basis for the Board's Approval of Investment Advisory Contract <b>(Item 27(d)(6)(i))</b>	<b>Move</b>	Include in Form N-CSR and online, and deliver upon request
Management Information and Statement Regarding Availability of Additional Information about Fund Directors <b>(Item 27(b)(5)-(6))</b>	<b>Remove</b>	No longer required in shareholder reports, as is already disclosed in the SAI and may not be relevant to a retail shareholder's experience
Rule 30e-3 Disclosure, if applicable <b>(Item 27(d)(7))</b>	<b>Remove</b>	No longer applicable to open-end funds

<sup>3</sup> Any materials proposed to be moved to Form N-CSR and made available online must also be delivered by the fund or financial intermediary through which shares of the fund are purchased and sold upon request by a shareholder within three business days (in paper or electronic form, as applicable).

CURRENT DISCLOSURE	PROPOSED ACTION	PROPOSED DISCLOSURE AMENDMENTS
Other Information Included at Fund's Discretion (e.g., president's letters)	<b>Limit</b>	Include only information permitted or required under Item 27A

The Proposal also emphasizes heavily the SEC's focus on providing shareholders with a more visually engaging report through the use of graphics and text features, such as charts, tables and bullet lists throughout. The following discussion summarizes the contents of an annual report under Item 27A.

### *Cover Page/Beginning*

Item 27A would specify the following fund information to be included on the cover page or at the beginning of an annual report:

- name;
- share classes (if applicable);
- tickers;
- listing exchange (for ETFs);
- a statement identifying the report as an "annual shareholder report"; and
- a prescribed legend describing what the annual report covers and where to find additional information for the fund.<sup>4</sup>

The Proposing Release notes that this information is currently not required in an annual report, although it is already typically included by funds.

### *Fund Expenses*

Item 27A proposes to simplify the current fund expense presentation required by Item 27(d)(1) of Form N-1A. Currently, a fund must disclose fund expenses using both actual returns and a hypothetical 5% return. Item 27A would require only one expense example using the fund's actual returns, and a more detailed breakdown of the figures. The example would also present the costs paid as a percentage of the investment, which is intended to help shareholders compare expenses of different funds. The current and proposed expense example tables are shown below.

#### **Current Expense Examples (\$1,000 investment over a prior six-month period)**

	BEGINNING ACCOUNT VALUE [DATE]	ENDING ACCOUNT VALUE [DATE]	EXPENSES PAID DURING PERIOD [DATES]
<b>Actual</b>	\$1,000	\$ _____	\$ _____
<b>Hypothetical (5% return before expenses)</b>	\$1,000	\$ _____	\$ _____

<sup>4</sup> See *id.* at 68 n.139 and accompanying text (stating that a hyperlink to a fund's website must direct a shareholder to where the additional informational materials are available, which could be a centralized landing page with prominent links to the relevant materials).

**Proposed Expense Example (\$10,000 investment over prior one-year period)**

FUND/CLASS	BEGINNING ACCOUNT VALUE [DATE]		TOTAL RETURN BEFORE COSTS PAID		COSTS PAID		ENDING ACCOUNT VALUE (AT NAV) <sup>5</sup> [DATE]	COSTS PAID AS A PERCENTAGE OF YOUR INVESTMENT
	\$10,000	+	\$ _____	-	\$ _____	=	\$ _____	___%

Additional proposed changes to the expense example include, among others, removal of the narrative preamble and inclusion of a footnote to explain any costs that materially affected fund performance (e.g., acquired fund fees and expenses). The Proposing Release notes that certain figures in the expense example would be derived from the fund’s audited financial statements or financial highlights.<sup>6</sup> Other instructions currently in Form N-1A would remain unchanged, including those relating to disclosure of extraordinary expenses and aggregation of master and feeder fund expenses.

***MDFP***

Item 27A would still require annual shareholder reports to include a MDFP but requires a more concise format, including a brief summary of the key factors that materially affected fund performance during the reporting period. The Proposal encourages the use of graphics and text features, such as bullet lists, to present this information.

Item 27A would modify the performance line graph and performance table currently included in the MDFP by permitting only one share class to be presented in the line graph alongside the appropriate broad-based securities market index (broad-based index).<sup>7</sup> The line graph presentation would be limited to the last 10 fiscal years as contrasted with a fund’s current ability to show more than 10 years of performance history.

The current performance table presenting a fund’s average annual total returns for the past 1-, 5- and 10-year periods would be modified to also include the following information for the same periods: (1) average annual total returns of a broad-based index; (2) average annual total returns without sales charges; and (3) average annual total returns of each class covered in the annual report.<sup>8</sup> In addition, Item 27A would simplify the legend accompanying the performance presentation, and would permit funds to include additional information on material changes occurring during the period that would give context to the performance presented (e.g., a change in investment strategy).

<sup>5</sup> An ETF would also be required to show its ending account value at market price. *Id.* at 76.

<sup>6</sup> For example, the costs paid as a percentage of a shareholder’s investment would be the fund’s expense ratio in its financial statements or financial highlights. *See id.* at 79-80.

<sup>7</sup> A fund would have discretion to choose which share class to present in the line graph, consistent with similar instructions on presenting performance in the prospectus. *See* current instruction 3 to Item 4(b)(2) of Form N-1A.

<sup>8</sup> Currently, average annual total returns are shown inclusive of sales charges. *See* current Item 27(b)(7)(ii)(B) of Form N-1A.

The SEC is also proposing to clarify the definition of an “appropriate broad-based securities market index” to mean an index that represents ‘the overall applicable domestic or international equity or debt markets, as appropriate.’<sup>9</sup> Of note, in the Proposing Release the SEC stated its observation that “[s]ome funds, for example, disclose their performance against a benchmark index that may not provide a performance indicator of ‘the overall applicable stock or bond markets,’ such as an index tied to a particular sector, industry, geographic location, asset class, or strategy (e.g., growth or value indexes). While indexes based on narrow segments of the market may be useful for comparison purposes, we believe that all funds should compare their performance to the overall market.”<sup>10</sup> The current definition under Form N-1A of a broad-based index does not specify what the index should represent, only that it cannot be affiliated with the fund, its adviser or underwriter, unless the index is widely recognized and used.<sup>11</sup> A fund would be permitted to use more than one broad-based index as reflective of the fund’s strategy (i.e., a balanced fund could present both an equity and a debt index), and the use of additional indexes, such as blended indexes or narrower indexes, would also be encouraged.

Advisers should consider whether the proposed clarification to the definition of broad-based index would require a fund to include a new broad-based index in its disclosure documents and, if so, any marketing or cost implications.

Under Item 27A, a fund with a policy to maintain a specified level of distributions would disclose only if it was unable to maintain the specified level during the past fiscal year, along with information on distributions resulting in return of capital. A fund with such a policy would no longer be required to disclose the effect of the policy on its strategies and per share NAV. The Proposing Release notes that this information would be more meaningful to a shareholder that expects to receive regular distributions from the fund under the policy.

### ***Fund Statistics***

Item 27A proposes to add a new section to the annual report disclosing fund statistics as of the end of the reporting period, including the fund’s: (1) net assets; (2) total number of portfolio holdings; and (3) portfolio turnover rate. A fund would be permitted to include additional statistics it believes are helpful and are reasonably related to the fund’s investment strategy (i.e., a fixed income fund could include statistics on the credit quality of its portfolio). Item 27A would encourage the use of tables, bullet lists, graphics or text features to present this information in a useful format. A fund would also be required to follow any instructions associated with a statistic that is disclosed elsewhere in Form N-1A (e.g., yield) and to use or derive a statistic from the fund’s financial statements or financial highlights, if able. A fund would be permitted to include additional disclosure regarding the significance or limitations of certain statistics, such as a description of tracking error for a fund that seeks to track an index.

<sup>9</sup> Proposing Release at 98-99. The SEC has used a similar description as that proposed by Item 27A in other guidance. *See* Disclosure of Mutual Fund Performance and Portfolio Managers, SEC Release No. IC-19382, at n.21 (Apr. 6, 1993).

<sup>10</sup> *Id.*

<sup>11</sup> *See* current instruction 5 to Item 27(b)(7) of Form N-1A. This requirement would still apply, in addition to the proposed clarification.

### ***Graphical Representation of Holdings***

Item 27A would permit a fund to present its holdings as a percentage of total or net exposure to particular categories of investments, in addition to presenting by percentage of NAV or total investments. This is intended to address funds that primarily use derivatives, or use long and short positions, to implement their investment strategy. For a fund that presents its holdings based on credit quality, Item 27A would revise the currently required disclosure to be more concise.<sup>12</sup>

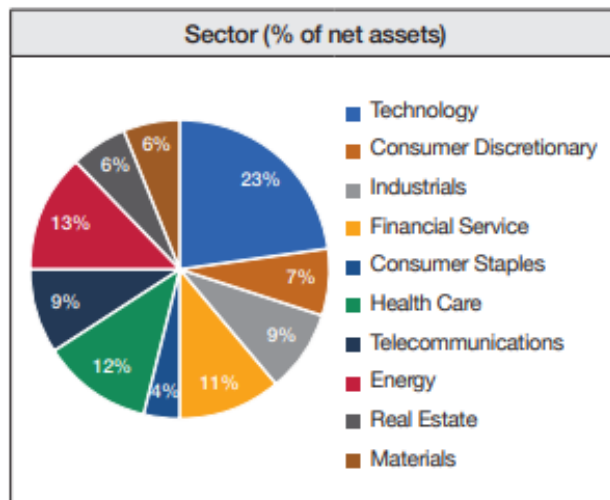
### ***Material Fund Changes***

Item 27A proposes to add a new section to the annual report that would briefly describe material changes to a fund that occurred during the reporting period, or that the fund plans to make in connection with its annual prospectus update. The Proposing Release notes that this section is intended to highlight for a shareholder the key changes to his or her investment.

Under Item 27A, a fund would be required to briefly describe any material changes to the fund name; investment objective or goals; increase in annual fees, transaction fees or maximum account fees;<sup>13</sup> principal investment strategies; principal risks; investment adviser(s), including sub-adviser(s); and portfolio manager(s). A fund would have discretion to disclose additional material changes outside of the foregoing enumerated items. Materiality would be determined based on the facts and circumstances of a fund and the specific change.<sup>14</sup>

The Proposal acknowledges the possibility that a fund may be required to disclose a planned material change in the fund's annual report while the description of the material change is under review by the SEC staff as part of the fund's annual prospectus update. Under these circumstances, a fund could include only a high-level summary of the change in the annual report as the exact disclosure may be subject to further modification.

SAMPLE GRAPH FROM SEC PRESS RELEASE



<sup>12</sup> See current Item 27(d)(2) of Form N-1A. The Proposing Release notes that current disclosures in response to this item tend to vary in length. See Proposing Release at 129-30.

<sup>13</sup> See *id.* at 132 n.272 and accompanying text (noting that decreases in such fees are not required to be disclosed, but can be voluntarily disclosed).

<sup>14</sup> The Proposing Release provides an example of a portfolio manager change for an index fund, which may not be deemed to be material given the involvement of the manager in making portfolio decisions for the fund.



## ***Other Proposed Disclosure Changes***

Item 27A would require a fund to disclose in the annual report only a high-level summary of any changes in and disagreements with fund accountants,<sup>15</sup> and a brief summary of the information regarding a fund's LRMP. Item 27A would also consolidate several currently required statements regarding a fund's schedule of portfolio holdings and proxy information into a general statement indicating that certain information is available on the fund's website, along with specific references to such information. The statement would also include references to other information not included in the annual report, such as the information proposed to be moved to Form N-CSR (e.g., financial statements), as well as the fund's prospectus. Last, Item 27A would continue to permit a fund to include in an annual report the required notice to shareholders who have consented to householding.<sup>16</sup>

The Proposing Release reminds funds that disclosure regarding a fund's LRMP should be tailored to the specific fund discussed in the shareholder report rather than rely on generic or standard disclosures.

## **Format and Presentation of Annual Report**

Item 27A would require the information in an annual report to be presented in the same order as the information appears in Item 27A, similar to the current instructions for summary prospectuses.<sup>17</sup> Item 27A would also require the use of plain English in a format addressed to the investor, and would encourage the graphical presentation of information. In addition, Item 27A would impose certain legibility requirements for printed reports.

## **Electronic Annual Reports**

The proposed disclosure reform would require funds relying on Rule 498 or proposed Rule 498B to make the most recent annual report available online. The requirement to present information in an annual report in a specific order would also apply to electronic reports (e.g., those on a website or delivered electronically). The Proposal encourages funds to incorporate electronic tools into online disclosure, such as calculators, pop-ups and interactive features but would require that the default presentation of any information electronically would be the information required by Item 27A. The Proposing Release notes that any information that is used online, but is not required to be included in an annual report, would be subject to the same Federal securities laws as any other website or electronic content that the fund produces or disseminates, such as fund advertisements subject to Rule 482.<sup>18</sup>

<sup>15</sup> See Proposing Release at 146-48. The complete disclosure required by Item 304 of Regulation S-K would instead be included in the proposed Form N-CSR.

<sup>16</sup> Rule 30e-1 requires a fund relying on the householding provision to explain to shareholders annually how they may revoke their consent to householding, which can be satisfied by including a statement in the fund's annual report. Because the proposed changes to the annual report require a strict following of Item 27A, this provision must be expressly permitted by Item 27A.

<sup>17</sup> See General Instruction C.3.a to Form N-1A.

<sup>18</sup> See Proposing Release at 165 n.340 and accompanying text (explaining that an investment company advertisement under Rule 482 is considered a section 10(b) omitting prospectus, and is therefore subject to liability under section 12(a)(2) of the Securities Act and the anti-fraud provisions of the Federal securities laws).

## B. Form N-CSR and Rule 30e-1

As described in the table above, certain information currently included in a shareholder report is proposed to be moved to a fund's filing on Form N-CSR. This layered disclosure approach is intended to provide retail shareholders with the most relevant information about their investment through the annual report, while still making a broader range of information accessible to them or to other types of investors or industry participants.

### Contents of Form N-CSR

The following information currently required in a fund's shareholder report is proposed to be moved to Form N-CSR (and made available online and delivered upon request):

- financial statements, including the schedule of investments;<sup>19</sup>
- financial highlights;
- changes in and disagreements with accountants;
- results of any shareholder vote;
- remuneration paid to directors, officers and others; and
- the basis for the board's approval of the investment advisory contract.

The information proposed to be moved to the Form N-CSR and made available online would either appear in the shareholder report in a more concise and relevant fashion for shareholders, be communicated or available to shareholders in other fund disclosure documents, or not be considered relevant for a retail investor. For example, the information included in a fund's schedule of investments would still be presented in a shareholder report through the fund's graphical representation of holdings. Any of the materials proposed to be moved to Form N-CSR and made available online must also be delivered to a shareholder upon request (paper or electronic, as applicable) within three business days of receipt of the request.

### Website Availability

A fund would be required to make available online all of the information included in the proposed Form N-CSR, which would need to be available from 70 days after the end of the relevant fiscal period until 70 days following the next relevant fiscal period, consistent with the current timing requirements for filing Form N-CSR. The proposed amendments to Rule 30e-1 would also require a fund (other than a money market fund) to post its full schedule of portfolio holdings online within 70 days of the close of its first and third fiscal quarters, which would complement the schedule made available through its financial statements for the second and fourth quarters. These schedules would need to be available online for a full fiscal year. The proposed amendments to Rule 30e-1 would require online materials to be presented in a format convenient for reading online and for printing, and a user must be able to retain permanently an electronic copy of the materials, free of charge.

#### **New Online Requirements:**

The Proposal would require a fund to make available online certain information previously included in its shareholder report and now required in Form N-CSR. A fund would also be required to post online its full schedule of portfolio holdings as of its first and third quarters, which must remain publicly accessible for a full fiscal year.

<sup>19</sup> The proposed amendments to Form N-CSR would no longer permit a fund to use a summary schedule of investments under Rule 12-12C of Regulation S-X. Because the schedule would only be made available online or upon request, expenses associated with printing and mailing lengthy schedules would be accordingly reduced. *See id.* at 194-95.

A fund would have discretion as to how best to present the information online – it could choose to post the Form N-CSR in full on the specified website or could group the information by series or by type of material. The proposed amendments would also include a safe harbor provision where a fund could satisfy its requirement to timely transmit shareholder reports even if it did not meet the online posting requirement for a temporary period.

## II. Proposed Rule 498B and Treatment of Annual Prospectus Updates Under Proposed Disclosure Framework

The Proposal creates new Rule 498B under the Securities Act of 1933 (Securities Act), which provides an alternative to the current practice of annually delivering updated prospectuses to existing shareholders. Rule 498B would permit (but not require) a fund to satisfy any requirements under Section 5(b)(2) of the Securities Act that a prospectus precede or accompany the carrying or delivery of securities to a fund's existing shareholders so long as the fund meets certain conditions contained in the Rule. These conditions would include, among others:

1. A fund prospectus has been previously sent or given to the existing shareholders to satisfy any obligation under Section 5(b)(2) of the Securities Act, such as in connection with their initial investment in the fund;
2. A fund's current summary prospectus<sup>20</sup>, statutory prospectus, statement of additional information (SAI) and most recent annual and semi-annual reports (collectively, the Rule 498B online fund documents) are available for shareholders to access online; and
3. Notices of material changes to certain fund information will be delivered to existing shareholders when these changes occur.<sup>21</sup>

The Proposing Release states that this proposed change in the delivery requirements with respect to a fund's prospectus would not alter a fund's prospectus liability, and a fund that chooses to rely on Rule 498B would still be subject to the same prospectus and registration statement liability and anti-fraud provisions as if the fund had sent or given its prospectuses to existing shareholders.

**The liability framework under the new summary shareholder report and reliance on Rule 498B will need to be examined closely by fund groups.**

### A. Prior Delivery of a Prospectus to an Existing Shareholder

The first condition of Rule 498B is that a fund's prospectus must have been previously sent or given to an existing shareholder. Under proposed Rule 498B, an "existing shareholder" would generally be a shareholder (i) to whom a summary or statutory fund prospectus was sent or given to satisfy any obligation under Section 5(b)(2) of the Securities Act and (ii) who has held fund shares continuously since that time.<sup>22</sup> With respect to a shareholder in a money market fund, an existing shareholder would include a shareholder who has continuously maintained

<sup>20</sup> The SEC notes in the Proposing Release that inclusion of the summary prospectus in the Rule 498B online fund documents was purposeful. The Proposing Release notes the SEC's concern that the modification of the prospectus delivery requirements may reduce the economic incentive for a fund to prepare a summary prospectus and proposes to require the posting online of a summary prospectus under Rule 498B to encourage funds to continue to prepare summary prospectuses. *See id.* at 237-38.

<sup>21</sup> Rule 498B(b) and (c).

<sup>22</sup> Rule 498B(a).

(or has been a beneficial owner of) an account since the summary or statutory prospectus has been given.<sup>23</sup>

## **B. Online Posting Requirements**

The second condition of reliance on Rule 498B provides that the Rule 498B online fund documents must be posted online. The Proposing Release notes that the Fund Investor Experience RFC demonstrated shareholders' preference for receipt of concise disclosure about their fund investment, with more detailed disclosure available online. The online posting requirement of Rule 498B is designed to provide more detailed disclosure online for shareholders in a convenient, centralized location, which is available for prompt delivery to shareholders upon request.

Proposed Rule 498B includes requirements with respect to the online posting of the Rule 498B online fund documents, some of which funds already must comply pursuant to other SEC guidance and other requirements that would be new:

### **Online posting requirements with which funds must already comply:**

- The Rule 498B online fund documents must be publicly assessable and available free of charge at the website address specified on the cover page or at the beginning of a fund's annual and semi-annual report to shareholders;
- The Rule 498B online fund documents must be human-readable and capable of being printed on paper; and
- Persons accessing the Rule 498B online fund documents must be capable of permanently retaining, free of charge, an electronic version of such documents in a format that meets the requirements described above.

### **Online posting requirements that would be new:**

- The statutory prospectus and SAI must allow an accessing person to move directly back and forth between each section heading in a table of contents of such document and the section of the document referenced in that section heading; and
- The summary prospectus must permit accessing persons to move directly back and forth between (1) each section of the summary prospectus and any section of the statutory prospectus and SAI that provides additional detail concerning that section of the summary prospectus; or (2) links located at both the beginning and end of the summary prospectus, or that remain continuously visible, and tables of contents of the prospectuses and SAI.<sup>24</sup>

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<sup>23</sup> *Id.* The definition of existing shareholder excludes an investor that holds a fund through a separate account funding a variable annuity contract offered on Form N-4 or a variable life insurance contract offered on Form N-6.

<sup>24</sup> Rule 498B(c).

In the case that a fund's Rule 498B online fund documents are not available for a time in the manner required by the Rule, Rule 498B provides a safe harbor that states that the Rule's website requirements shall be deemed met provided that a fund meets certain conditions.<sup>25</sup>

### C. Disclosure of Material Fund Changes

The third condition of reliance on Rule 498B requires that, if a material change is made to a fund with respect to any of the topics described in new Item 27A of Form N-1A,<sup>26</sup> and the fund files a post-effective amendment to its prospectus or a prospectus supplement, the fund must provide existing shareholders with notice of that change within three business days of either the effective date of the post-effective amendment filing or the filing date of the prospectus supplement. This provision would not apply to changes previously disclosed in the fund's most recent annual report to shareholders. The Rule would also allow funds the flexibility to disclose other material changes on a discretionary basis.

This mailing could be in the form of the prospectus supplement filed, an amended prospectus, or another form of notice that discusses the change (so long as any separate notice is filed with the SEC). If a shareholder does not specify a delivery preference, Rule 498B would require the notice to be provided in paper.<sup>27</sup> However, notices of material changes could also be delivered electronically consistent with current SEC guidance if a shareholder elects electronic delivery. Householding is permitted with respect to the mailing of these notices of material changes provided that the traditional requirements of householding under Rule 154 of the Securities Act are met.

### D. Delivery Requirements of 498B Online Fund Documents

Rule 498B allows delivery of the Rule 498B online fund documents to requesting shareholders to be delivered in a manner consistent with each shareholder's delivery preference. For paper deliveries, Rule 498B provides that, when requested, a fund or intermediary must send the requested paper documents at no cost to the requestor, by U.S. first class mail or other reasonably prompt means, within three business days after receiving the request.<sup>28</sup> Rule 498B would allow the delivery of an electronic copy of the requested document to be satisfied by providing a direct link to the document so long as certain conditions in the Rule are met.<sup>29</sup>

## III. Amendments Narrowing the Scope of Rule 30e-3

Subject to certain requirements, Rule 30e-3 permits investment companies to satisfy shareholder report delivery requirements by making these reports and other materials available online and providing a notice of that availability to shareholders. In light of the Proposal making shareholder reports the featured disclosure document, the SEC is proposing to amend Rule 30e-3 to exclude open-end investment companies registered on Form N-1A from the scope of Rule 30e-3. As a

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<sup>25</sup> Rule 498B(c)(1)(iv) (requiring conditions similar to the safe harbors in Rule 30e-3 under the Investment Company Act and Rule 498(e)(4) under the Securities Act).

<sup>26</sup> Please refer to Proposed Changes to Shareholder Reports/Form N-CSR – Shareholder Reports – Contents of Annual Report - Material Fund Changes in this Alert for a list of these topics.

<sup>27</sup> See Proposing Release at 248 n. 519 and accompanying text.

<sup>28</sup> Rule 498B(d)(1)(i).

<sup>29</sup> Rule 498B(d)(i)(ii). The requirements include: (i) a current version of the document must be directly accessible through the link from the time the email is sent through a date that is six months after the date the email was sent; and (ii) the email must explain how long the link will remain useable and that, if the recipient desires to retain a copy of the document, he or she should access and save the materials.

result, open-end funds would be required to send the new streamlined shareholder reports to shareholders and not be permitted to only provide notice of such reports.

The Proposing Release notes that the shift from the notice and access model to a model that contemplates direct transmission of shareholder reports reflects what the SEC believes to be shareholder preferences. The Proposing Release contemplates that if the narrowing of the scope of Rule 30e-3 is adopted, a fund that has previously relied on Rule 30e-3 may wish to send a communication to investors regarding the change and could do so in an annual report sent to investors.

#### IV. Proposed Amendments to Fund Prospectus Disclosure Requirements

In response to feedback concerning the difficulty retail investors have in understanding and utilizing the fee, expense and principal risk disclosures in current fund prospectuses,<sup>30</sup> the SEC is proposing certain amendments in order to improve the clarity of fee and expense information and to streamline the presentation of principal risk disclosure. In doing so, the SEC hopes to improve investor comprehension and facilitate investors’ ability to make informed investment decisions.

##### A. Prospectus Fee and Expense Disclosures

The SEC is proposing amendments to simplify the presentation of fees and expenses in prospectuses in response to investor feedback indicating that such information is not clearly disclosed and is difficult to understand. Accordingly, the SEC proposes to replace the current fee table in the summary section of the statutory prospectus with a “fee summary” that focuses on the bottom-line figures of an investment in the fund. In addition, the SEC proposes a simplified version of the expense example.

A comparison of the current fee table format to the proposed fee summary is as follows:

CURRENT FORM N-1A FEE TABLE	PROPOSED FORM N-1A FEE TABLE
<i>Shareholder Fees</i> (fees paid directly from your investment)	<i>Transaction Fees</i> (fees paid each time you buy or sell)
Maximum Sales Charge (Load) Imposed on Purchases (as a percentage of offering price) _____%	Purchase Charge (as a percentage of your investment) [Up to] _____% (Or [up to] \$ ____, if you invest \$10,000)
Maximum Deferred Sales Charge (Load) (as a percentage of _____) _____%	Exit Charge (as a percentage of _____) [Up to] _____% (Or [up to] \$ ____, if you invest \$10,000)
Maximum Sales Charge (Load) Imposed on Reinvested Dividends [and other Distributions] (as a percentage of _____) _____%	Maximum Purchase Charge Imposed on Reinvested Dividends [and Other Distributions] (as a percentage of _____) _____ [Up to] _____% (Or [up to] \$ ____, if you invest \$10,000)
Maximum Sales Charge (as a percentage of _____) _____%	Maximum Combined Purchase and Exit Charge (as a percentage of _____) _____%

<sup>30</sup> The Proposing Release states that investor preferences regarding fund disclosure was “informed by many sources, including responses to the Fund Investor Experience RFC, prior investor testing and surveys, and past reform initiatives.” See Proposing Release at 18.

CURRENT FORM N-1A FEE TABLE	PROPOSED FORM N-1A FEE TABLE
Redemption Fee (as a percentage of amount redeemed, if applicable) _____%	Early Exit Fee (as a percentage of amount redeemed) [Up to] _____% (Or [up to] ____, if you invest \$10,000)
Exchange Fee _____%	Exchange Fee [Up to] _____% (Or [up to] ____, if you invest \$10,000)
Maximum Account Fee _____%	[This item moved to its own heading, see immediately below.]
	<b>Maximum Account Fee</b> [Up to] _____% (Or [up to] ____, if you invest \$10,000)
<b>Annual Fund Operating Expenses</b> (expenses that you pay each year as a percentage of the value of your investment)	<b>Ongoing Annual Fees</b> (estimated expenses that you pay each year as a percentage of the value of your investment)
Management Fees _____%	Ongoing Annual Fees _____ % (Or \$ ____, if you invest \$10,000)
Distribution [and/or Service] (12b-1) Fees _____%	Ongoing Annual Fees with Temporary Discount _____% (Or \$ ____, if you invest \$10,000) *Discount expected to end on [date].
Other Expenses _____% _____% _____% _____%	[Funds that invest 10% or less of their total assets in acquired funds may omit AFFE from the Ongoing Annual Expenses and instead disclose this amount in a footnote.]
Acquired Fund Fees and Expenses _____%	
Total Annual Fund Operating Expenses _____%	

In addition, revised Form N-1A instructs funds not to include all line items in their fee disclosures if such fees equal \$0 or are not applicable to such funds. The SEC also proposes that funds not be permitted to include footnotes and other extraneous disclosure in the fee summary, which is intended to streamline the presentation of fees.<sup>31</sup>

The proposed fee summary also requires that applicable charges be expressed as a dollar amount (assuming a \$10,000 investment), as opposed to only including the impact of such charges as a percentage amount. The change is intended to better communicate the impact of costs to investors.

<sup>31</sup> The SEC also proposed an exception to permit footnotes if otherwise omitting such information would cause the disclosure to be materially misleading. *See id.* at 290.

The revisions to Form N-1A also revise the requirements for disclosure of fees and expenses associated with acquired fund fees and expenses (AFFE).<sup>32</sup> Currently, any fund that invests in acquired funds must disclose in the fee table the amount of fees and expenses that the fund indirectly incurs from such investments.<sup>33</sup> The SEC's amendments would permit funds that invest 10% or less of their total assets in acquired funds to omit the AFFE line item and instead disclose such expenses in a footnote to the fee table and fee summary.<sup>34</sup> For funds where AFFE represents a more significant part of the fund's ongoing annual fees, *i.e.*, more than 10% of the fund's total assets are invested in acquired funds, the current AFFE disclosure in the fee table would be retained. Additionally, the SEC is proposing to omit all money market fund investments from the 10% calculation.

The SEC is proposing a simplified version of the expense example. The proposed expense example would show costs only over the one and 10-year period (or one and three-year period for new funds), rather than the current presentation of one, three, five, and 10-years. The change is intended to simplify the example while still providing meaningful disclosure regarding the effect of fees over both the short-term and long-term. In addition, the SEC is proposing to modify the preceding narrative to enhance clarity and brevity.

## **B. Prospectus Risk Disclosures**

The Proposal would make the following amendments to Form N-1A that are intended to make the principal risk disclosures in the summary prospectus more specifically tailored to each fund and generally more concise.

- Add a General Instruction to preclude a fund from disclosing non-principal risks in the prospectus.<sup>35</sup>
- Add the term “briefly” in the current requirement to summarize the principal risks;
- Require funds to describe principal risks by order of importance, with the most significant risks appearing first (and an explicit statement that funds should not describe principal risks in alphabetical order);<sup>36</sup>
- Add an instruction for a fund to, where appropriate, tailor its risk disclosures to reflect how the fund operates, as opposed to generic, standard risk disclosures that may be added for all funds in a fund complex.

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<sup>32</sup> The SEC is also proposing two technical amendments to the AFFE disclosure requirements. The first would require funds that have been in operation for less than a full year to calculate AFFE using the number of days since the date the fund made its first investment, rather than using the number of days in the fund's fiscal year. Such amendment is intended to reflect a more accurate calculation for new funds. Second, the SEC proposes to permit funds to explain that the total ongoing annual fees in the fee table do not correlate to the expense presentation in the fund's shareholder reports (as opposed to the average net assets provided in the fund's financial highlights). *See id.* at 301-02.

<sup>33</sup> *Id.* at 293. However, AFFE may be reflected in the current “other expenses” line item if such expenses do not exceed 0.01 percent of the fund's average net assets.

<sup>34</sup> The SEC notes that the footnote would have to include: (1) the amount of the fund's AFFE, and (2) a statement that the fund's total ongoing annual fees in the table and fee summary would be higher if these fees and expenses were included. *See id.* at 300.

<sup>35</sup> *Id.* at 310. This amendment is in response to the SEC's observation that risk information is often too lengthy and may detract from investors' understanding of the principal risks of a fund.

<sup>36</sup> The SEC proposes to also include an instruction that funds may use any reasonable means to determine the significance of risks. *See id.* at 312.



The Proposal would also add three new instructions to the statutory prospectus principal risk disclosure requirement of Form N-1A:

- A new instruction that states that in determining whether a risk is a principal risk, a fund should consider both whether the risk would place more than 10% of the fund’s assets at risk and whether it is reasonably likely that a risk will meet this 10% standard in the future;<sup>37</sup>
- A new instruction for “fund of funds” indicating that risks of an underlying fund should not be included in the acquiring fund’s prospectus unless it is a principal risk of the acquiring fund;
- A new instruction for funds whose strategy permits investments in different types of assets at the manager’s discretion. The fund would have to disclose that an investor may not know (and has no way to know) how the fund will invest in the future and the associated risks.

The proposed instruction that a fund should consider investments that would put 10% of its assets at risk as principal risks is reminiscent of a similar instruction that was rescinded in its overhaul of Form N-1A in 1988 that instructed a fund to consider investments that would put 5% of its assets at risk as principal risks.

Funds of funds will likely need to analyze their underlying investments to see which underlying fund risks are the principal risks of an investing fund at any given time.

### C. Prospectuses and SAIs Transmitted Under Rule 30e-1(d)

The SEC is proposing to rescind Rule 30e-1(d),<sup>38</sup> which permits a fund to transmit a copy of its prospectus or SAI in place of its shareholder report if it includes all of the information that would otherwise be required to be contained in the shareholder report. In addition to noting the different purposes that each document has historically served, the SEC states in the Proposing Release that rescinding Rule 30e-1(d) would avoid consolidation of fund disclosures into a single complex document that would likely cause shareholder confusion.

## V. Investment Company Advertising Rule Amendments

The SEC is also proposing to amend investment company advertising rules to promote transparency and improve accuracy of fees and expenses in investment company advertisements. The SEC states that such amendments were informed by its observations about investment company marketing practices in light of increased industry focus and competition on fees. The proposed amendments would apply to all open-end and closed-end investment companies and business development companies<sup>39</sup> and would require that an advertisement that discusses fees and expenses include certain standardized figures and provide reasonably current information. The SEC is also proposing amendments to address potentially misleading statements about fees and expenses in such advertisements.

The proposed advertising amendments are the only aspect of the Proposal applicable to open-end *and* closed-end investment companies.

<sup>37</sup> *Id.* at 314. The proposed instruction is designed to clarify the meaning of the term “principal risk” and provide quantitative guidance as to what a fund should consider when determining if a risk is a principal risk. In addition, the “reasonably likely” language is designed to reflect that a risk may become a principal risk over time due to changing conditions or if the fund changes its strategies.

<sup>38</sup> *See* 17 CFR 270.30e-1(d).

<sup>39</sup> *See* Proposing Release at 321.

## A. Fee and Expense Figures

The SEC is proposing amendments to incorporate certain content, presentation and timeliness requirements for fee and expense information in investment company advertisements. The proposed amendments include, among others, the following:

- **Content.** Proposed amended Securities Act Rule 482<sup>40</sup> would require that any investment company advertisement presenting 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. The figures would be computed based on the methods of computation that the fund's Investment Company Act of 1940 (Investment Company Act) or Securities Act registration statement form prescribes for a prospectus. In addition, an advertisement that does not present fee or expense figures, *i.e.*, if the advertisement only includes general, narrative information about fees and expenses and does not include any numerical fee or expense amounts, would not need to include such figures. The SEC notes that the requirement is intended to promote consistent fee and expense computations across advertisements to facilitate investor comparisons across funds.
- **Presentation.** The SEC is also proposing to require that the advertisement present the new fee and expense figures as prominently as any other included fee and expense figures (for example, expenses net of certain amounts such as fee waivers or expense reimbursements).
- **Timeliness.** The SEC is proposing that fee and expense information be disclosed as of the date of the fund's most recent prospectus or, if the fund no longer has an effective registration statement under the Securities Act, as of its most recent annual report. The proposed timeliness requirement is designed to prevent advertisements from including outdated information about a fund's fees and expenses.

The SEC is proposing to also amend Rule 34b-1 and Securities Act Rule 433 to incorporate the proposed content, presentation and timeliness requirements of Rule 482 in order to ensure that such requirements are applied consistently across all registered investment company and business development company advertisements and sales literature.<sup>41</sup>

## B. Misleading Statements

Securities Act Rule 156 prescribes certain factors that should be considered when evaluating whether a particular statement involving a material fact is or might be misleading in investment company sales literature.<sup>42</sup> The SEC is proposing to amend Rule 156 to specifically provide that weight should be given to representations about the fees or expenses associated with an investment in a fund that could be misleading because of statements or omissions involving a material fact. The Proposing Release states that the amendment is designed to address concerns that an advertisement may present a fund's fees and expenses in a way that materially misleads an

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<sup>40</sup> Securities Act Rule 482 establishes certain content, legend and filing requirements for investment company advertisements. *See* 17 CFR 230.482. *See also* Proposing Release at 322.

<sup>41</sup> Securities Act Rule 433 allows registered closed-end funds and business development companies to use free writing prospectuses in accordance with Rule 433 (and other advertisement rules) instead of relying on Securities Act Rule 482. *See* 17 CFR 230.433. Investment Company Act Rule 34b-1 applies to supplemental sales literature by any registered open-end company, registered unit investment trust, or registered face-amount certificate company, and includes many of the same requirements as Securities Act Rule 482. *See* 17 CFR 270.34b-1. *See also* Proposing Release at 323.

<sup>42</sup> *See* 17 CFR 230.156. *See also* Proposing Release at 324.

investor to believe the costs associated with an investment are lower than they actually are.<sup>43</sup> In the Proposing Release, the SEC contemplates certain examples where this may occur, such as when a fund is presented as a “zero expense” or “no expense” fund or is advertised to have “low investment costs,” without disclosing that the fund may incur other categories of costs, or if the advertisement omits relevant explanations regarding how fee waiver or reimbursement arrangements can impact the fund’s costs once they expire.<sup>44</sup>

## VI. Comment Period, Effective Date and Issues to Consider

The SEC requested comments on most aspects of the Proposal, and also included a feedback flier in the Proposal that funds can fill out if that is preferable to submitting a tailored comment letter. The comment period will be 60-days after publication in the Federal Register. If the Proposal is adopted, the SEC proposed a general compliance date of 18 months after the effective date of the amendments.

The Proposal raises many technology and implementation challenges, costs-related concerns, liability questions and other issues. The following is a list of issues that funds and advisers may want to consider:

ISSUES TO CONSIDER
<ul style="list-style-type: none"> <li>• Will new website linking technology be required to comply with the new Rule 498B requirement to link similar information found in the prospectus, SAI and shareholder reports?</li> </ul>
<ul style="list-style-type: none"> <li>• Will funds be exposed to additional liability by having to explicitly identify what changes are considered material?</li> </ul>
<ul style="list-style-type: none"> <li>• Will the SEC’s requirement to identify disclosure changes in the shareholder report under the heading of material changes result in more frequent Rule 485(a) filings by funds?</li> </ul>
<ul style="list-style-type: none"> <li>• Will the proposal require more or less frequent stickering of prospectuses that would be required to be mailed to shareholders?</li> </ul>
<ul style="list-style-type: none"> <li>• Will fund groups need to accelerate their standard annual prospectus update process to comply with the requirement to include material changes in a fund’s annual report?</li> </ul>
<ul style="list-style-type: none"> <li>• Should the SEC make the summary shareholder report optional rather than required, to provide funds flexibility to tailor communications to the needs of their shareholders?</li> </ul>
<ul style="list-style-type: none"> <li>• How will funds communicate additional disclosures to shareholders that previously were communicated via annual reports, such as tax disclosures?</li> </ul>
<ul style="list-style-type: none"> <li>• Has the cost of excluding open-end funds from reliance on Rule 30e-3 been appropriately accounted for given the significant resources that many funds and advisers have already invested in compliance with this rule?</li> </ul>
<ul style="list-style-type: none"> <li>• Is disclosure of key features of a fund’s LRMP necessary, given the broad oversight responsibilities of the Board, and will LRMP disclosure be helpful to shareholders?</li> </ul>

<sup>43</sup> See Proposing Release at 332.

<sup>44</sup> *Id.*

## ISSUES TO CONSIDER

- Because there appears to be no ability to restate expenses in the new fee table, how will funds communicate new changes to expenses (such as reductions in certain fees) given that the annual report expense information is backward looking?
- Are the SEC cost estimates accurate in light of the significant disclosure changes, such as the requirement to mail shareholder reports and to create a separate shareholder report for each fund?
- What would be the impact of funds having to bear additional costs to license an additional broad-based index if necessary to meet the SEC's clarified definition?

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