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SEC Proposes to Modernize Fund Shareholder Reports and Disclosures

Proposed Amendments Would Modify the Disclosure Framework for Mutual Funds and Exchange-Traded Funds to Create a New Layered Disclosure Approach to Highlight Key Information for Retail Investors

SUMMARY

On August 5, 2020, the Securities and Exchange Commission (the “SEC”) proposed comprehensive modifications to the mutual fund and exchange-traded fund disclosure framework, with the goal of modernizing the disclosure framework for such funds and better tailoring fund disclosures to retail investors’ needs.¹ The proposal is described by the SEC as a “central component” of its investor experience initiative.

The proposed modernized disclosure framework is intended to result in the delivery of more concise and engaging shareholder reports, in lieu of the lengthy and complex prospectus updates and reports fund shareholders currently receive. The proposal aims to highlight information important to retail investors by:

- requiring streamlined reports to shareholders that would include fund expenses, performance, illustrations of holdings and material fund changes;
- revising the content of these items to better align disclosures with developments in the markets and investor expectations;
- encouraging funds to use graphic or text features; and
- promoting a layered and comprehensive disclosure framework by continuing to make available online certain information that is currently required in shareholder reports but may be less relevant to retail shareholders generally.

In addition, the proposal would amend prospectus disclosure requirements regarding fees, expenses and principal risks to provide greater clarity and more consistent information. The proposal would also amend

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investment company advertising rules with the stated goal of promoting more transparent and balanced statements concerning investment costs.

The SEC requests comments on its proposal, and the proposing release also includes nearly 300 separate requests for comment on numerous specific aspects of the proposal. The public comment period will remain open for 60 days after publication of the proposal in the Federal Register.

BACKGROUND

Most mutual funds and exchange-traded funds currently rely on a layered disclosure framework with respect to the prospectus information they provide to fund investors, tailoring their disclosure to the informational needs of their investors. However, this approach to disclosure does not necessarily extend to disclosures that funds make to their shareholders. After making their initial decision to invest in a fund, fund shareholders typically receive an updated prospectus annually, as well as annual and semi-annual shareholder reports. These shareholder reports provide detailed information about a fund's operations and activities during the last full- or half-year period and often exceed 100 pages in length.² The costs of delivering prospectuses and shareholder reports, including printing and mailing costs and processing fees, are generally fund expenses borne by shareholders.

In June 2018, the SEC adopted rule 30e-3 under the Investment Company Act, providing for an optional "notice and access" method to allow funds to satisfy their obligations to transmit shareholder reports by making reports and other materials available online and providing shareholders a notice of online availability.³ This delivery method was intended to modernize the manner in which funds communicate periodic information to investors, while reducing expenses associated with printing and mailing that are borne by funds, and ultimately, by their investors.⁴ At the same time, the SEC sought feedback on retail investors' experience with fund disclosure and on ways to improve that disclosure.⁵ Based on the feedback it received, the SEC found that retail investors prefer concise, layered disclosure to the overwhelming volume of information they currently receive.⁶

SUMMARY OF THE PROPOSED MODIFICATIONS

The SEC's proposal would modify the disclosure framework for mutual funds and exchange-traded funds registered on Form N-1A ("open-end funds") in a manner that would highlight key information for investors. The proposed amendments generally would not extend to investment companies not registered on Form N-1A, such as closed-end funds, business development companies ("BDCs"), unit investment trusts or issuers of variable annuity contracts.⁷ Notably, in contrast to the approach taken by many funds today, the proposal would require fund registrants to prepare separate shareholder reports for each series of a multi-series open-end fund. The proposal would not, however, require separate shareholder reports for each class of shares of a multi-class fund.⁸

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The proposal is designed to alleviate concerns that retail shareholders of open-end funds currently receive disclosure materials that are not well-suited to their needs, leading to investor confusion or indifference. Under the proposal, the amounts and types of available fund information would remain largely unchanged; however, information deemed less useful to retail investors for assessing and monitoring an ongoing investment would be available online and delivered upon request.⁹

In addition, the proposal would amend (i) the way open-end funds present their fees, expenses and principal risks in prospectuses, responding to the concerns of retail investors that current fee, expense and principal risk disclosures are difficult to understand,¹⁰ and (ii) the definition of an “appropriate broad-based securities market index” to clarify that all open-end funds should compare their performance to the overall applicable securities market.

The proposal would also amend the advertising rules for all registered investment companies (including closed-end funds) and BDCs.

The proposal would provide a transition period of 18 months following the effective date. Key aspects of the proposal are briefly summarized below.

Tailored Shareholder Reports for Retail Shareholders

Under the proposal, open-end fund investors would continue to receive fund prospectuses in connection with their initial investment in a fund, as they do today. Thereafter, a fund shareholder would receive the proposed streamlined annual and semi-annual reports, and would no longer receive an updated fund prospectus on an annual basis if the fund elects to satisfy the conditions of proposed rule 498B under the Securities Act of 1933. The proposed amendments are intended to provide for more concise and engaging shareholder reports of open-end funds by:

- highlighting pertinent information, such as fund expenses, performance, illustrations of holdings and material fund changes;
- encouraging open-end funds to use graphic or text features, such as tables, bullet lists and question-and-answer formats; and
- allowing for more user-friendly and interactive electronic versions of shareholder reports.

The proposal would also amend the definition of an “appropriate broad-based securities market index” to clarify that all funds should compare their performance to the overall applicable securities market, for purposes of both fund annual reports and prospectuses.¹¹ Although this proposed amendment would apply only for purposes of Form N-1A, the SEC requests comments on whether the SEC should make corresponding amendments to Form N-2 with respect to the recently adopted management’s discussion of fund performance requirement for annual reports of registered closed-end funds.¹²

The proposing release notes that SEC staff has observed varying practices with respect to the benchmarks funds use, with some funds using indexes based on narrow segments of the market. The SEC states that

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the proposal would “continue to provide a fund with flexibility in selecting a broad-based index that the fund believes best reflects the market(s) in which it invests” but also that the SEC believes “all funds should compare their performance to the overall market.”¹³

In connection with the proposal, the SEC issued a hypothetical streamlined shareholder report, as it has done in other recent rulemakings that have proposed a new or modernized disclosure framework, such as the Variable Annuity Summary Prospectus and the Form CRS Relationship Summary.¹⁴ A link to the hypothetical streamlined shareholder report is available [here](#).

Availability of Additional Information on Form N-CSR and Online

Under the proposal, certain in-depth information currently included in an open-end fund’s annual and semi-annual reports, which is deemed less retail-focused, would instead be available online, delivered free of charge upon request, and filed on a semi-annual basis with the SEC on Form N-CSR. In particular, a fund’s complete financial statements and schedule of investments would be filed on Form N-CSR in lieu of including this information in the fund’s shareholder reports, while a graphical representation of holdings would be retained in the shareholder reports.¹⁵ Shareholder reports would contain cover page legends directing investors to websites containing financial statement information.

Tailored Required Disclosures for New and Ongoing Fund Investors

Currently, open-end fund shareholders generally receive an updated annual prospectus each year. Under proposed new rule 498B, new investors in an open-end fund that elects to satisfy the requirements of the proposed rule would continue to receive a fund prospectus in connection with their initial investment, but the fund would not deliver annual prospectus updates to shareholders thereafter. Instead, funds would keep shareholders informed through (i) tailored shareholder reports and (ii) timely notifications of material fund changes as they occur. Current versions of the fund’s prospectus would remain available online and would be delivered upon request.¹⁶

Exclusion of Open-End Funds from Rule 30e-3

Under the existing framework, beginning as early as January 1, 2021, funds may rely on rule 30e-3, which generally permits a fund to satisfy its shareholder report transmission requirements by providing “notice and access” as discussed above.

The proposal would amend the scope of rule 30e-3 to exclude open-end funds. Instead, open-end funds would send the tailored annual and semi-annual reports discussed above, which would serve as the central source of fund disclosure for existing shareholders. The SEC states that it preliminarily believes that this disclosure approach represents a more effective means of improving investors’ ability to access and use fund information, and of reducing expenses associated with printing and mailing, than continuing to permit open-end funds to rely on rule 30e-3.¹⁷

Prospectus Disclosure of Fund Fees and Risks

With the goal of helping investors more readily understand fund fees and risks, the proposal would amend open-end fund prospectus disclosure as follows:

- The proposal would (i) replace the existing fee table in the summary section of the statutory prospectus with a simplified fee summary, (ii) move the existing fee table to the statutory prospectus, for use by investors seeking additional details about fund fees, and (iii) replace certain terms in the current fee table with terms that the SEC believes may be clearer to investors.
- The proposal would refine current requirements for funds to disclose the acquired fund fees and expenses (“AFFE”) associated with investments in other funds by permitting open-end funds that invest 10% or less of their total assets in acquired funds to omit the AFFE line item in the fee table and instead disclose the amount of the fund’s AFFE in a footnote to the fee table and fee summary.¹⁸ This change would address, in part, concerns that current AFFE disclosure requirements overstate the costs of investing in BDCs, and as a result, deter funds from investing in BDCs.¹⁹
- The proposal would revise the instructions for open-end fund prospectus risk disclosure, with the goal of making such disclosure clearer and more specifically tailored. The proposal would (i) promote the disclosure of a fund’s principal risks, rather than additional disclosures about non-principal risks, by precluding a fund from disclosing non-principal risks in the prospectus, and (ii) tailor principal risk disclosure by specifying how principal risks can be assessed.²⁰ Specifically, the proposed new instruction specifies that a fund may use any reasonable means of determining the significance of risks, such as ordering its principal risks in a way that considers the likelihood and possible severity of any loss resulting from each risk, but the fund should not describe principal risks in alphabetical order.²¹

Fee and Expense Information in Investment Company Advertisements

The SEC has expressed concern that, as funds are increasingly marketed on the basis of costs, investment companies and intermediaries may understate or obscure the costs associated with fund investments.²² The proposal would require that presentations of investment company fees and expenses in advertisements and sales literature be consistent with relevant prospectus fee table presentations and be reasonably current. The proposed amendments also address representations of fund fees and expenses that could be materially misleading. These amendments would affect all registered investment company and BDC advertisements.

CERTAIN CONSIDERATIONS

In general, the proposal represents a significant step in modernizing the fund disclosure framework in a way that should make open-end fund disclosures more relevant and useful to retail shareholders, and should overall be well received by funds and their shareholders. The fund industry has long recognized that investors seek concise, readily understandable information about a fund’s holdings, performance, fees and risks. For example, many firms include fact sheets and similar summary materials, as well as other comparison tools, on their websites, which they believe are more useful to retail investors than the current disclosures required to be provided to fund shareholders pursuant to the SEC’s rules.

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The new framework should also substantially reduce expenses associated with delivering fund shareholder materials, including printing, mailing and processing fees. Although the actual cost savings will depend on a number of factors, as discussed in the SEC's Economic Analysis in the proposing release, eliminating the need to deliver a prospectus annually should provide substantial savings.²³ In addition, the new framework should help alleviate some of the concerns raised by commenters in response to the SEC's 2018 request for comment regarding processing fees charged by intermediaries,²⁴ which indicated that a substantial portion of the printing and mailing cost savings provided by rule 30e-3 would be offset by higher processing fees that apply to the rule 30e-3 notice.²⁵

However, we expect that some aspects of the proposal will be subject to significant comment by the fund industry and others. Sponsors of multi-series open-end funds may wish to address the costs associated with requiring separate shareholder reports for each series. Firms may also wish to address the costs and other considerations associated with the proposed amendment to the definition of an appropriate broad-based securities market index, as suggested by Commissioners Roisman and Peirce.²⁶ There may also be strongly held views on what information is to be included and excluded from the proposed streamlined reports to shareholders.

BDCs and their investment advisers are likely to focus their comments on the proposed modifications to the fee table, which would permit open-end funds that invest no more than 10% of their total assets in other funds to disclose the amount of the fund's AFFE in a footnote to the fee table and fee summary, rather than in the AFFE line item in the fee table as currently required by Form N-1A. Addressing this issue has been a focus of advocacy efforts by BDCs²⁷ and has also been the subject of various legislative efforts.²⁸ Both Commissioners Peirce and Lee highlighted the proposal to permit footnote disclosure of AFFE in their statements addressing the proposal, with Commissioner Peirce asking whether the proposed presentation would enlighten or confuse investors, and Commissioner Lee expressing her concern with the approach and seeking feedback to ensure it "promotes transparency and consistency."²⁹

Finally, it is worth noting that certain recent SEC retail investor initiatives have been of interest to various members of Congress. Following the SEC's adoption of Regulation Best Interest and the Form CRS Relationship Summary, the House of Representatives passed a bill in October 2019 along party lines which, subject to certain exceptions, would have required the SEC to engage in investor testing prior to issuing any rule relating to retail investor disclosures.³⁰ Addressing this topic, Commissioner Lee noted that the SEC "should undertake [its] own investor testing" to ensure that the proposal is properly designed for retail investors.³¹

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ENDNOTES

- 1 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, SEC Release Nos. 33-10814, 34-89478, IC-33963 (Aug. 5, 2020) (“Release”), available at <https://www.sec.gov/rules/proposed/2020/33-10814.pdf>.
- 2 Release at 9, 15.
- 3 Section 30(e) of the Investment Company Act and rule 30e-1 thereunder.
- 4 See Optional Internet Availability of Investment Company Shareholder Reports, SEC Release Nos. 33-10506; 34-83380; IC-33115 (June 5, 2018), available at <https://www.sec.gov/rules/final/2018/33-10506.pdf>.
- 5 See Request for Comment on Fund Retail Investor Experience and Disclosure, Investment Company Act Release Nos. 33-10503, 34-83376, IC-33113 (June 5, 2018), available at <https://www.sec.gov/rules/other/2018/33-10503.pdf>.
- 6 Release at 9.
- 7 The SEC notes that it has recently adopted changes to the disclosure framework for closed-end funds and variable insurance contracts tailored to these investment companies’ characteristics and, in the case of closed-end funds, to implement congressional directives, which the SEC would like to study before proposing additional disclosure amendments with respect to these types of funds. See Release at 60-61.
- 8 See Release at 52-53.
- 9 *Id.* at 10-11.
- 10 *Id.* at 11, 364-65.
- 11 In separate statements, Commissioners Peirce and Roisman highlighted the proposed amendment to the definition of “appropriate broad-based securities market index” and questioned the marginal value of such a change. Public Statement, Commissioner Hester M. Peirce, Statement on Tailored Shareholder Reports (Aug. 5, 2020) (“Peirce Statement”); Public Statement, Commissioner Elad L. Roisman, Statement on Proposal to Improve Information Available to Fund Investors (Aug. 5, 2020) (“Roisman Statement”).
- Instruction 6 to proposed Item 27A(d)(2) of Form N-1A would define “appropriate broad-based securities market index” to mean an index that represents the overall applicable domestic or international equity or debt markets, as appropriate, “that is administered by an organization that is not an affiliated person of the Fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used.” Release at 610.
- 12 See Release at 103. The requirement for closed-end funds to provide management’s discussion of fund performance in their annual reports to shareholders was adopted by the SEC on April 8, 2020, and became effective on August 1, 2020. For further information regarding this requirement, please see our publication, “SEC Adopts Securities Offering and Disclosure Reforms for Business Development Companies and Registered Closed-End Funds” (April 27, 2020), available at <https://www.sullcrom.com/sec-adopts-securities-offering-and-disclosure-reforms-for-bdcs-and-cefs>.
- 13 Release at 98-99.
- 14 See, e.g., Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts, SEC Release Nos. 33-10569; 34-84508; IC-33286 (Oct. 30, 2018) (Proposed Rule); Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, SEC Release Nos. 34-83063; IA-4888 (Apr. 18, 2018) (Proposed Rule).

ENDNOTES (CONTINUED)

- ¹⁵ Release at 190-93. Consistent with current requirements, the fund's annual financial statements would be audited and accompanied by any associated accountant's report, while the semi-annual financial statements need not be audited.
- ¹⁶ In order to rely on proposed rule 498B, open-end funds would need to comply with several conditions, including (i) making certain materials publicly accessible, free of charge, at the website address specified on the cover page or at the beginning of the fund's annual and semi-annual reports (which would include the fund's current summary and statutory prospectus, Statement of Additional Information, and most recent annual and semi-annual shareholder reports), subject to additional conditions regarding the format in which the documents are presented on the website, and (ii) notifying shareholders of a material change with respect to certain topics that the proposed rule specifies, which would be the same types of material changes required to be disclosed in the proposed annual report (*i.e.*, a change in the fund's name, a change in the fund's investment objectives or goals, an increase in the fund's ongoing annual fees, transaction fees, or maximum account fee, a change in the fund's principal investment strategies, a change in the principal risks of investing in the fund, a change in the fund's investment adviser(s), including sub-adviser(s), and a change in the fund's portfolio manager(s)). In addition, although they would not be conditions of reliance on proposed rule 498B, funds would be required by the proposed rule to (i) deliver, in a manner consistent with the person's delivery preference, a copy of the fund documents specified above to any person requesting such a copy and (ii) present such documents in a format that is convenient for both reading online and printing on paper. See Release 235-56.
- ¹⁷ *Id.* at 40.
- ¹⁸ *Id.* at 293.
- ¹⁹ See *id.* at 295, n.611.
- ²⁰ *Id.* at 309-16.
- ²¹ *Id.* at 312.
- ²² *Id.* at 331.
- ²³ See Release at 358-63; 383-87.
- ²⁴ Request for Comments on the Processing Fees Charged by Intermediaries for Distributing Materials Other Than Proxy Materials to Fund Investors, SEC Release Nos. 33-10505; 34-83379; IC-33114 (June 5, 2018) ("Request for Comments on Processing Fees").
- ²⁵ See Release at 385, n.787 (discussing comment letter of the Investment Company Institute). As described in the Request for Comments on Processing Fees, New York Stock Exchange rules provide for a processing fee of up to 15 cents for each annual and semi-annual shareholder report and either an additional "preference management fee" of up to 10 cents per distribution for "suppressed" accounts (*e.g.*, where the shareholder receives electronic delivery) or a separate tiered "notice and access fee" of 25 cents per account for the first 10,000 accounts (gradually declining based on the number of accounts to 5 cents for each account over 500,000 accounts). Request for Comments on Processing Fees at 9-11.
- ²⁶ Peirce Statement; Roisman Statement.
- ²⁷ As noted in the Release, BDCs have argued that the current AFFE disclosure requirement distorts an acquiring fund's expense ratio and has disproportionately harmed BDCs. See Release at 295, n.611.
- ²⁸ For example, on June 25, 2020, Rep. Brad Sherman (D-CA) introduced the Access to Small Business Investor Capital Act, legislation that would direct the SEC to "revise rules to exclude business development companies from certain [AFFE] reporting." H.R. 7375, 116th Cong. (2d Sess. 2020).

ENDNOTES (CONTINUED)

- ²⁹ Peirce Statement; Public Statement, Commissioner Allison Herren Lee, Statement on Proposed Summary Shareholder Report (Aug. 5, 2020) (“Lee Statement”).
- ³⁰ See H.R. 1815, 116th Cong. (1st Sess. 2019); Press Release, SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals (June 5, 2019). The bill would have applied retroactively to any such rule issued prior to the legislation’s enactment.
- ³¹ Lee Statement.

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