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# SEC Adopts Amendments to Modernize Fund Shareholder Reports and Disclosures

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## Amendments 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

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### SUMMARY

On October 26, 2022, the Securities and Exchange Commission (the “SEC”) adopted, by a unanimous vote, its previously proposed<sup>1</sup> amendments to the mutual fund and exchange-traded fund disclosure framework for annual and semi-annual shareholder reporting, with the goal of modernizing the disclosure framework for such funds and better tailoring fund disclosures to retail investors’ needs.<sup>2</sup> The final amendments modify the scope of rule 30e-3 to exclude open-end funds (as defined below) so that shareholders of such funds will directly receive in paper the new tailored annual and semi-annual reports. The final rules also amend investment company advertising rules with the stated goal of promoting more transparent and balanced statements concerning investment costs. The amendments to the disclosure framework and investment company advertising rules were adopted substantially as proposed with certain modifications.

Proposed amendments to funds’ prospectus disclosure of fund fees, expenses and principal risks and a new rule providing an alternative approach to satisfy prospectus delivery requirements for existing fund investors were not adopted. Among other things, the proposed amendments would have refined existing 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.<sup>3</sup> This change would have addressed, in part, concerns that current AFFE disclosure requirements overstate the costs of investing in business development companies (“BDCs”), and as a result, deter funds from investing in BDCs.<sup>4</sup> Commissioner Hester M. Peirce,

in her statement supporting the rulemaking but noting that more can be done to improve mutual fund disclosure, emphasized that the final rules “jettison[ed]” the change to the AFFE disclosure, which she called a “small but important proposal” that could have facilitated investments in BDCs and the reintroduction of BDCs into indexes.<sup>5</sup>

The amendments will be effective 60 days after the date of publication in the Federal Register. However, as described below under “Compliance Dates,” extended transition periods will be available for compliance with certain amendments.

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## **SUMMARY OF THE AMENDMENTS**

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 for potential investors does not necessarily extend to disclosures that funds make to their existing shareholders. In June 2018, in connection with adopting rule 30e-3 under the Investment Company Act, which provides for an optional “notice and access” method to allow funds to satisfy their obligations to transmit shareholder reports, the SEC sought feedback on retail investors’ experience with fund disclosure and on ways to improve that disclosure.<sup>6</sup> 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.<sup>7</sup>

The amendments 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. Consistent with the proposal, the amendments generally do not extend to investment companies not registered on Form N-1A, such as closed-end funds, BDCs, unit investment trusts or issuers of variable annuity contracts.<sup>8</sup> The amendments require fund registrants to prepare separate shareholder reports for each series of a multi-series open-end fund, and, in a change from the proposal, the amendments also require separate shareholder reports for each class of shares of a multi-class fund.<sup>9</sup>

The amendments are 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 amendments, 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.<sup>10</sup>

In addition, the amendments modify the definition of “appropriate broad-based securities market index” and in doing so require that all open-end funds compare their performance to the overall applicable securities market. The final rules also amend the advertising rules for all registered investment companies (including closed-end funds) and BDCs.

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The amendments provide a transition period of 18 months following the effective date, except that amendments that address representations of fees and expenses that could be materially misleading will apply on the effective date. Key aspects of the amendments are briefly summarized below.

### Tailored Shareholder Reports for Retail Shareholders

Consistent with the proposal, the final rules add a new Item 27A to Form N-1A, amending the disclosure framework for open-end funds to provide for more “concise and engaging”<sup>11</sup> 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;
- limiting the information that may be contained in open-end fund shareholder reports as provided in Item 27A; and
- allowing for more user-friendly and interactive electronic versions of shareholder reports.

New Item 27A amends the definition of an “appropriate broad-based securities market index” and in doing so requires that open-end funds compare their performance to the overall applicable domestic or international equity or debt markets, as appropriate, for purposes of both fund annual reports and prospectuses.<sup>12</sup> In support of its determination to adopt this amendment, the SEC cited a recently published study by its Office of the Investor Advocate<sup>13</sup> and emphasized that it continues to believe that a comparison to the overall market is important contextual information for investors and noted the final rules will allow funds to include narrower indexes, reflecting the market segments in which the fund invests, in the performance presentation.<sup>14</sup> Though the SEC declined to publish a list of permissible indexes or further restrict permissible indexes by incorporating more specific criteria regarding index methodology, the SEC did provide general guidance and examples of the types of indexes that would satisfy the final rules.<sup>15</sup> For instance, a fund that invests primarily in the equity securities of a non-U.S. country could utilize an index representing the overall equity market of that country, while a fund that invests primarily in the equity securities of U.S. healthcare companies should show its performance against the overall U.S. equities market (and not a benchmark consisting only of healthcare companies).<sup>16</sup> The SEC also clarified that it does not believe that indexes that focus on particular characteristics such as “growth,” “value,” “ESG” or “small- or mid-cap” represent the overall market.<sup>17</sup> The changes to the definition of “appropriate broad-based securities market index” will require a very large number of open-end funds to change their current practices regarding the index or indexes shown in their prospectuses and reports to shareholders.

In a change from the proposal, the final rules require funds to tag shareholder report contents in Inline XBRL in accordance with rule 405 of Regulation S-T and the EDGAR Filer Manual to make shareholder report disclosure more readily available and easily accessible for aggregation, comparison, filtering and other analysis.<sup>18</sup>

### Availability of Additional Information on Form N-CSR and Online

The final rules adopt, substantially as proposed, changes to Form N-CSR and website availability requirements.<sup>19</sup> Under the amendments, certain in-depth information currently included in an open-end fund's annual and semi-annual reports, which is deemed less retail-focused and more relevant to investors and financial professionals who desire more in-depth information, will instead be available online, delivered free of charge upon request, and filed on a semi-annual basis with the SEC on Form N-CSR.<sup>20</sup> In particular, a fund's complete financial statements and schedule of investments must be filed on Form N-CSR in lieu of including this information in the fund's shareholder reports, while a graphical representation of holdings will be retained in the shareholder reports.<sup>21</sup> Shareholder reports will contain cover page legends directing investors to websites containing this information.<sup>22</sup>

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

Under the existing framework, funds may rely on rule 30e-3, which generally permits a fund to satisfy its shareholder report transmission requirements by making reports and other materials available online and providing shareholders a notice of online availability (also known as "notice and access" delivery).

Consistent with the proposal, and notwithstanding substantial industry comment to the contrary,<sup>23</sup> the final rule amends the scope of rule 30e-3 to exclude open-end funds, with the goal of ensuring that shareholders in open-end funds will instead directly receive the new tailored annual and semi-annual reports in paper or, if the shareholder elects, electronically.<sup>24</sup> The SEC stated in the adopting release that it continues to believe that this approach represents a more effective means of improving investors' ability to access and use fund information.<sup>25</sup> The SEC also stated its belief that the new rule will preserve much of the expected cost savings that funds and investors expected to gain through reliance on rule 30e-3.<sup>26</sup>

### Fee and Expense Information in Investment Company Advertisements

The amendments to investment company advertising rules, adopted largely as proposed, 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.<sup>27</sup> The amendments also address representations about a fund's fees and expenses that could be materially misleading.<sup>28</sup> These amendments apply to all registered investment company and BDC advertisements.<sup>29</sup>

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## COMPLIANCE DATES

The amendments will be effective 60 days after the date of publication in the Federal Register. The SEC is providing the following transition periods for certain of the amendments:

Shareholder reports for funds registered on Form N-1A will have to comply with the Form N-1A amendments if they are transmitted to shareholders 18 months or more after the effective date. These funds also will have 18 months to comply with amendments to rule 30e-3 and Form N-CSR.

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There will be a transition period of 18 months after the effective date for amendments to the advertising rules for registered investment companies and BDCs, except that amendments that address representations of fees and expenses that could be materially misleading will apply on the effective date.

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ENDNOTES

- 1 Our [firm publication](#) dated August 13, 2020 summarized key aspects of the proposed amendments.
- 2 Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, SEC Release Nos. 33-11125; 34-96158; IC-34731 (October 26, 2022) (“Adopting Release”), *available at* <https://www.sec.gov/rules/final/2022/33-11125.pdf>. See also SEC Fact Sheet: Shareholder Reports for Mutual Funds and ETFs; Fee Information in Investment Company Advertisements (October 26, 2022), *available at* <https://www.sec.gov/news/press-release/2022-193>.
- 3 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 (August 5, 2020), *available at* <https://www.sec.gov/rules/proposed/2020/33-10814.pdf>, at 293.
- 4 See *id.* at 295, n.611.
- 5 Commissioner Hester M. Peirce, Statement on Final Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements (October 26, 2022) (“Peirce Statement”), *available at* [SEC.gov | One Good Step, More to Go: Statement on Final Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements](#). In his statement supporting the adoption of the rulemaking, Commissioner Uyeda remarked that that he agreed with Commissioner Peirce that the SEC should address concerns regarding AFPE disclosure requirements. See Commissioner Mark T. Uyeda, Statement on Final Rule Regarding Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements (October 26, 2022), *available at* [SEC.gov | Statement on Final Rule Regarding Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements](#).
- 6 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>.
- 7 Adopting Release at 15, n.40.
- 8 *Id.* at 49-50.
- 9 *Id.* at 120.
- 10 See *id.* at 6-7.
- 11 *Id.* at 13.
- 12 *Id.* at 65-70.
- 13 See Alycia Chin, Jonathan Cook, Jay Dhar, Steven Nash, and Brian Scholl, *How do Consumers Understand Investment Quality? The Role of Performance Benchmarks*, Office of the Investor Advocate Working Paper 2022-01 (“Chin, et al.”), *available at* <https://www.sec.gov/files/performance-benchmarks-2022-01.pdf>.
- 14 Adopting Release at 73-79.
- 15 *Id.* at 77-78.
- 16 *Id.* at 77. Such a fund could also show its performance against an additional, more narrowly tailored healthcare index.
- 17 *Id.* at 77.
- 18 *Id.* at 189-90.

ENDNOTES (CONTINUED)

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19 *Id.* at 127-31.

20 *Id.* at 127-29.

21 *Id.* at 133. 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.

22 *Id.* at 24, 53-54.

23 In addition to drawing industry comments, the amendments to the scope of rule 30e-3 also drew concerns from within the SEC. Commissioner Peirce found the rulemaking's elimination of e-delivery under rule 30e-3 "puzzling," noting that rule 30e-3 had taken effect only last year. Peirce Statement. She "would have supported eliminating this option for funds if [the SEC] were pivoting entirely to an access equals delivery approach," but found no clear rationale supporting the elimination of this option while paper delivery remains the default method of disclosure to shareholders. *Id.*

24 *Id.* at 25, 159-68.

25 *Id.* at 163-64.

26 *Id.* Although the SEC did not directly substantiate this statement, it had earlier referenced supporting comments indicating that the brevity of the new shareholder reports would result in cost savings. See *id.* at 160 ("One commenter specifically stated that the proposed new concise shareholder report '... deliver[s] significant cost savings over requiring delivery of 100+ page shareholder reports.'")

27 *Id.* at 173-85.

28 *Id.* at 185-88.

29 *Id.* at 173.

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