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SIDLEY UPDATE

SEC Proposes Wholesale Overhaul to Mutual Fund and Exchange-Traded Fund Shareholder Reporting

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A package of new proposals by the Securities and Exchange Commission (the *SEC*) would streamline shareholder reports for mutual funds and exchange-traded funds (*ETFs*), would allow annual reports to stand in for many annual prospectus update mailings, and generally reimagines how funds communicate with current shareholders. These are strikingly ambitious changes that, if adopted, will require significant investment and thought to implement.

> *"The Commission is committed to improving the Main Street investor experience and modernizing information content and delivery. By encouraging fund disclosures that use modern communication techniques to emphasize clearly and concisely the information investors find most useful, today's proposal should facilitate better-informed decision making."*— SEC Chairman Jay Clayton

Highlights

The proposed amendments would do the following:

- *Apply mainly to mutual funds and ETFs and only on a limited basis to closed-end funds and business development companies (BDCs).* Most of the proposed amendments would apply only to investment companies registered on SEC Form N-1A — so, mutual funds and ETFs. The proposed advertising rule changes would apply to registered investment companies more generally, including closed-end funds and BDCs.

- *Replace existing shareholder reports with a wholly new and slimmer format*. Among other things, annual and semi-annual reports (1) would no longer include financial statements or financial highlights and instead will include graphics-heavy summary materials, (2) would relate to only one fund per report (that is, reports could no longer contain contain multiple funds), (3) could no longer include optional content, and (4) for the annual report, would include a summary of material changes during the relevant performance period[1]. The SEC previewed a hypothetical version of such a streamlined shareholder report (the Hypothetical Streamlined Shareholder Report). Most of the

[1] Generally, a fund would have discretion to determine whether to disclose a material fund change from a prior period connection with its performance presentation; however, if the performance presentation would be misleading without the disclosure, the fund must disclose the material fund change.

information no longer included in the shareholder reports would be included in Form CSR, which would be required to be mailed (or emailed, if the investor elects to receive documents electronically) to investors promptly and at no cost on their request.[2] In addition, the information that a fund would newly have to file on Form N-CSR would also be required to be available on the fund firm's website.

- *Require that these new shareholder reports be mailed (or emailed, with respect to shareholders electing electronic delivery) to shareholders and not be eligible for the "notice and access" terms of Rule 30e-3 under the Investment Company Act*. Because most of the proposed amendments would have an 18-month compliance period, they cannot go into effect until well into 2022 at the earliest. Meanwhile, many firms will commence their Rule 30e-3 notice-and-access mailings over the course of 2021 as that rule goes into full effect. There thus will be at least some period in which Rule 30e-3 operates as originally anticipated when adopted two years ago. The release adopting Rule 30e-3 is available here.

- *Establish an optional approach for prospectus delivery to existing shareholders, which could leverage the new requirement to include an annual summary of material fund changes in annual shareholder reports.* Funds would have the option of no longer sending an annual prospectus update mailing to their existing shareholders. Instead, they could rely on the fact that material fund changes are covered in the annual shareholder report mailing; shareholders would be "kept current" on key events through the new annual shareholder report and through timely notifications of material fund changes.[3]

- *Simplify prospectus disclosure of fees and expenses and principal risks*. The proposal calls for a simplified fee and expense presentation in lieu of the existing fee table and expense example. The proposal would also relax the requirement to disclose "acquired fund fees and expenses" (AFFE) related to investments in other funds. In addition, the proposal would apply a 10% "assets at risk" threshold to determine whether a risk is a "principal risk." New form instructions would encourage brevity, emphasizing the "most significant risks," and tailoring the presentation of risks for each fund rather than using standardized presentations across multiple funds.

- *Require standardized treatment of expenses in fund advertising*. The principal fund advertising rules (Rules 482 under the Securities Act of 1933 (the Securities Act) and Rule 34b-1 under the Investment Company Act of 1940 (the Investment Company Act) already require standardized calculation and presentation of investment performance in advertising. Expanding on that principle, the SEC now proposes that all registered investment companies be subject to new requirements on standardized presentation of expenses. Importantly, this would not require expense disclosures in advertising, but if expense information is given, then it must follow a standardized format. The SEC also

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2 See *https://www.sec.gov/news/press-release/2020-172*.

3 The SEC's theory for this rests on two points. First, because a prospectus is relatively unchanged year to year, the shareholder might be better served by a summary of material changes than receiving the entire annual prospectus update. Second, because the annual prospectus update and annual report typically are mailed within a month or two of each other, the SEC suggests receipt of these two close-in-time documents can be confusing and appear redundant.

proposes additional expense-related language in Rule 156 under the Securities Act, a rule that sets out general antifraud principles for fund advertisements. In particular, the SEC expresses concern with the rise of advertising for marketing "no expense" or "zero expense" funds that, in the SEC's view, potentially obscures other embedded fees and expenses that can affect investment performance.

Background

Most funds currently use what the SEC refers to as a "layered disclosure approach" by providing a summary prospectus to investors with respect to initial investment decisions and making available (online and copies sent upon request) the fund's longer "statutory prospectus" and statement of additional information.[4] The proposed amendments contemplate a similar approach for shareholder reports, where a fund's shareholder reports would highlight key information most of interest to retail investors while moving information that may be of more interest to financial professionals and other investors that want more in-depth fund information to separate reports.

Slimmer Shareholder Reports

The heart of the proposed amendments is wholesale revision of the shareholder reports, with a goal of distilling them to the most salient and quickly absorbed information. The SEC uses some simple data to make its case, observing that the average report is more than 100 pages long and can run over 600 pages.

By contrast, the hypothetical streamlined shareholder report that the SEC provided in the press release announcing the proposed amendments is just a few pages long and heavy on graphics and white space. The SEC is quick to add, however, that the hypothetical streamlined shareholder report is not intended to present a "typical" annual report under the proposed amendments. Rather, it illustrates for investors what a more concise, tailored shareholder report could look like.

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[4] In developing its proposals, the SEC drew significantly on the results of a retail investor feedback process [See pg. 18 of proposed amendments release] that the agency commenced in June 2018 while also considering prior investor testing and surveys from past disclosure reform initiatives. See Request for Comment on Fund Retail Investor Experience and Disclosure, Investment Company Act Release No. 33113 (June 5, 2018) (Fund Investor Experience RFC). The results indicate that retail investors generally prefer a concise, layered approach to disclosure and may not read some, or all, of a fund's shareholder report due to the report's length and complexity. Likewise, some shareholders are "overwhelmed by the volume of fund information they currently receive." The SEC acknowledges that the feedback initiative generated sometimes conflicting views. Some shareholders prefer email or website content while others prefer paper mailings for at least some material. Some prefer more communication while others prefer less. The SEC also provides a feedback flier in Appendix B to the Release for investors to use to provide feedback to the release.

The SEC emphasizes taking advantage of technology to improve investor experiences. A theme running through the discussion is that "static," paper or PDF-based document formats should be reconsidered in favor of digital content techniques. The SEC speaks favorably about allowing hover-over or pop-up content and layering in interactive tools that allow the investor to develop information tailored to the investor's circumstances. The SEC also pointedly proposes updates to its form instruction language that would drop paper-based phrases like "cover page."

The following changes would shape the new format:

- *Fees.* At the top of every report would be a section showing expenses borne during the period based on a hypothetical $10,000 investment. Expenses would be shown in dollars and basis points.

- *Separate Annual and Semiannual Shareholder Reports for Each Fund*. Most funds are organized in "series," with potentially many separate investment portfolios in a single trust or corporate entity. Typically, results for series funds are included in one, entitywide shareholder report — a practice the SEC cites as contributing to the reports' complexity and length. The proposed amendments would require separate shareholder reports for each fund. The amendments would not, however, require a separate shareholder report for each share class of a fund that represents interests in the same investment portfolio.

- *Financial Statements, Financial Highlights, Portfolio Holdings, and Other Information No Longer Included*. Financial statements would be filed with the SEC on Form N-CSR (as they are now) but would no longer be incorporated into the shareholder reports. Form N-CSR also would include the financial highlights currently presented in the shareholder reports.

    - Most of Form N-CSR also would be required to be posted on a fund firm's website.

    - Complete quarterly portfolio holdings information still would be available, either as a component of the semiannual and annual financial statements or (for funds other than money market funds) by making available first and third fiscal quarter holdings information on the fund firm's website. The information must be available within 70 days after the close of each such quarter and would be kept on the website long enough so that full fiscal year results are online at all times.

    - Other information proposed for removal from shareholder reports and inclusion instead in Form N-CSR includes (1) matters submitted to a shareholder vote, (2) the aggregate remuneration paid to directors, officers, and affiliates, (3) the fund board's approval of the fund's investment advisory contract, and (4) certain disagreements with and changes in accountants (replacing full disclosure of any such disagreements in the report with a high-level summary).

- *Emphasis on Graphics and Key Statistics.* Shareholder reports would be required to provide, as they are today, graphical representations of the fund's holdings by certain categories (e.g., type of security, industry sector, geographic region, credit quality, or maturity). The reports also would provide for prominent placement of these key fund statistics: (1) net assets, (2) total number of portfolio holdings, and (3) portfolio turnover rate. Additional statistics are permitted when the fund believes they would aid shareholder understanding of the fund's operations. The SEC emphasizes that any statistics provided should be brief, quantitative measures that address significant

factors relevant to a fund. Throughout, the SEC encourages tables, bullet lists, and other graphic features that promote accessibility of information.

- *Disclosure Generally Limited to That Expressly Required or Permitted.* Generally, under the proposed amendments, a fund's shareholder reports would include only information required or permitted to be included; however, additional information would be permitted in the report as necessary to make required disclosure items not misleading. For example, a change in the fund's investment policies or structure might require related supplemental explanations of expense, performance, or portfolio holdings information to make the base disclosure not misleading. The release indicates that any such supplemental information should be as brief as possible. A fund may modify any required legend or narrative information, so long as it contains comparable information. There is no page or word limit for the shareholder reports.

- *Management Discussion of Fund Performance Retained but Trimmed*. The SEC indicates that shareholders appreciate qualitative discussion of fund performance and will continue to require it in annual reports and permit it in semiannual reports. However, the SEC believes current discussions can be too long, too dense, and repetitive. Various proposed instructions encourage briefer, more pointed discussion and the use of white space, sidebars, Q&A style, and similar techniques. Commonly added voluntary content such as the "president's letter" or portfolio manager interviews or profiles would no longer be permitted but could be included in mailings of the reports, so long as the report itself is kept more prominent than any supplemental material.

- *Annual Report Only: Discussion of Material Changes*. As a new requirement, a fund would "briefly describe" in its annual report any material changes with respect to a specified list of events that occurred since the last annual report or are anticipated to occur in the coming year. These are further discussed below in connection with proposed Rule 498B.

- *Performance Line Graph and Performance Table.* These components of the current shareholder report are largely unchanged. However, note the following proposals:

    - Instructions for the performance line graph in the prospectus be modified to (1) prohibit funds from using periods of more than 10 fiscal years (the SEC is concerned that using longer time periods may make volatility more difficult to identify) and (2) clarify that the "broad-based index" against which fund performance is compared in the graph is "one that represents the overall applicable domestic or international equity or debt markets, as appropriate."

    - The current requirement that a fund's annual report include an annual average return table for the one-, five-, and 10-year periods be modified to include (1) the average annual returns of an appropriate broad-based securities market index, (2) the fund's average annual total returns without sales charges as well as the current disclosure showing returns with applicable sales charges, and (3) average annual returns for each class covered in the report. Given that the

new index requirement is more prescriptive than is currently required, this is likely to generate comment.

- The longstanding disclaimer that "past performance does not necessarily predict future results" be modified to read instead that "past performance is not a good predictor of the fund's future performance."

- *Brief Statement on Liquidity Risk Management Programs (LRMP).* The SEC observed that LRMP disclosures filed to date have been less useful to shareholders than they anticipated and in some cases lean toward a long recitation of program elements. The SEC is not eliminating the requirement but is proposing changes to encourage more focused discussion. The SEC is proposing to replace current disclosure with a brief summary of the program that would include (1) key factors or market events that materially affected the fund's liquidity risk during the reporting period, (2) key features of the program, and (3) effectiveness of the program over the past year. The discussion would be tailored to the fund and not generic.

> *"One area in which I am interested is performance reporting — particularly the existing requirement that funds report performance by reference to a 'broad-based securities index.' The recommendation proposes to clarify that the scope of this term is more specific than some currently understand it to be. This may well shorten the list of index benchmarks that funds can use in their reporting."*
> — SEC Commissioner Elad Roisman

Shareholder Report Mailing Requirements; Changes to Rule 30e-3

As proposed, shareholder reports would be provided in paper form unless the shareholder consents to electronic delivery. The reports would not be eligible for the notice-and-access terms of Rule 30e-3, which would be amended accordingly.

- *Industry Reaction*. This aspect of the proposals will no doubt be a topic of significant debate, especially because of the prominence that Rule 30e-3 has in existing fund disclosures. Currently, the cover of nearly every fund prospectus includes a statement that shareholder report mailing changes are coming into effect. In addition, fund firms, intermediaries, and their service providers are developing protocols around Rule 30e-3 and in some cases have incorporated related cost and administrative efficiencies into their forward-looking commercial analyses.

- *Transition Timeline*. Because the new proposed amendments would have an 18-month compliance period, they cannot go into effect until well into 2022 at the earliest. Meanwhile, many firms will be eligible to commence their Rule 30e-3 notice-and-access mailings over the course of 2021 as that rule goes into full effect. Given uncertainties around any rulemaking (in that the current proposal may not be adopted in the form or on the timeline now suggested) and the amount of administrative effort put into Rule 30e-3 preparation, we assume many firms will go ahead with their Rule 30e-3 planning and

notice-and-access mailings. In doing so, they would simply accept that the end result may be a shorter period when such mailings are permitted than originally anticipated.

Proposed Rule 498B — A New Option for Ongoing Disclosures to Existing Investors

The SEC envisions the changes in the annual and semiannual reports as part of a wholesale reordering of how fund information is provided. As already described, part of this is that certain shareholder information that may be more relevant for financial professionals than retail investors would no longer be included in a fund's shareholder report but instead would be made available in other forms (e.g., online, delivered free of charge upon request, and filed with the SEC semiannually on Form N-CSR).

Just as significant is the concept of shareholder reports as the main source of fund disclosures for existing shareholders. In particular, open-end funds would be given the option under proposed Rule 498B of relying on shareholder reports instead of delivering prospectus updates to existing shareholders each year.

Under the proposed rule, provided the fund is also in compliance with amendments to Item 27A of Form N-1A (the new shareholder report requirements), Rule 30e-1, and Form N-CSR, an investor would receive a fund prospectus (or summary prospectus) in connection with his or her initial investment in a fund (consistent with current practice), but the fund would not deliver annual prospectus updates to existing investors; instead, the fund's shareholders reports would be the source of updates, and the fund's prospectus would be available online and by request. A condition of proposed Rule 498B is that the fund must have a summary prospectus available (the SEC observes that more than 90 percent of funds already produce a summary prospectus).

- *Shareholder Notice of Key Changes*. To ensure that shareholders continue to be apprised of key information, proposed Rule 498B lists significant events that require prompt notice to shareholders. These would be material fund changes involving (1) a change in the fund's name, (2) a change in the fund's investment objective, (3) material increases in fees, (4) a change in the principal investment strategies, (5) a change in the principal investment risks, (6) a change of investment adviser, or (7) a change of portfolio manager. Under the proposed rule, shareholders would be entitled to prompt notice of any material change involving these matters. Notice could be provided through the annual report either on a forward-looking basis (e.g., when the matter is known ahead of time and therefore can be described in the report as a change to be implemented in the coming year) or when transmission of the annual report is otherwise sufficiently prompt (e.g., when the matter happens to arise in time to be included promptly in the report). All other material changes involving these matters would require a separate, prompt notice to shareholders.

Likely Concerns With the Proposed Approach. Proposed Rule 498B does not address when a change is material and presumably will require traditional legal analysis and judgments as to materiality. It is possible, however, that one effect of the proposed rule could be new pressure on judgments as to when a particular change — especially in terms of risk disclosure — is sufficiently material that it warrants a special mailing to current shareholders. The proposed rule also would present judgment calls around when a summary of a change set out in the annual

report, assuming it treats the matter in less detail than the prospectus itself, is sufficiently complete. Following on that, "gap risk" arising from two different disclosure regimes, one for new investors and one for current shareholders, is likely to be among the most significant areas of discussion around this aspect of the proposals.

Prospectus Changes — Fees and Expenses

As proposed, a fund's prospectus would include a simplified fee summary in the summary section of the prospectus, or, for funds relying on Rule 498, the summary prospectus. Funds would be required to include the full fee table in the statutory prospectus. Key elements of the proposed fee and expense disclosures include these:

- *Initial Explanatory Statement*. The fee summary would begin with a statement that the fee summary shows amounts the investor could pay to buy, hold, and sell shares of the fund (i.e., transaction fees) and that these costs reduce the value of the investment. In addition, the statement would say that the investor may pay other fees, such as brokerage commissions, to financial intermediaries and that such fees are not reflected in the fee summary and example.

- *Fee Table and Expense Example*. As with current disclosures, the proposed fee summary would be in two parts: first, a summary fee table showing fund transaction fees, maximum account fee (if applicable), and ongoing annual fees, and second, a simplified expense example showing expenses over one and 10 years (or one and three years for a new fund). It also is proposed that many line items be renamed. For example, "Total Annual Fund Operating Expenses" would become "Ongoing Annual Fees," and "Fee Waiver and/or Expense Reimbursement" would become "Temporary Discount." The proposed table also would provide the expenses associated with a $10,000 investment rather than the $1,000 investment currently used.

- *AFFE*. So-called AFFE disclosures would be relaxed. Currently, if the indirect fees and expenses borne through investments in other funds (acquired funds) contribute more than one basis point to the acquiring fund's overall expenses, then those indirect fees and expenses are given their own line item in the acquiring fund's fee table. By contrast, the proposal would require line item disclosure only when more than 10 percent of the acquiring fund's assets are invested in other funds. AFFE expense disclosure has been a source of some confusion since its implementation in 2007 and has been of special concern to BDCs (many believe the disclosure creates a disincentive for mutual funds to invest in BDCs).

Prospectus Changes — Principal Risks

The discussion of principal risks in a fund's prospectus is a core element of its overall disclosure profile and draws careful review by the fund firm throughout the year. It also almost always draws comments during SEC staff reviews. Key elements of the proposed changes to principal risk disclosure:

- *10 Percent Assets at Risk Threshold*. As proposed, a principal risk would be a risk that would place (or is reasonably likely to place) more than 10 percent of a fund's assets at risk. Given that such a formal threshold has not been in place in the past and that informally SEC disclosure staff and fund firms generally used a lower threshold, the likely effect here is that some risks currently presented as principal risks will no longer be considered principal. That outcome then has to be considered in light of another proposed change — that only principal risks may be included in the disclosure. It is not at all clear that funds will welcome a reduction in the scope of their risk disclosures.

- *Emphasis on Brevity*. The SEC observes that it sees highly variable risk disclosure, with some funds listing just a few principal risks and others listing 20 or more. Likewise, the SEC reports that total word counts in risk disclosure can vary from less than 200 words to more than 7,000. The proposed amendments would seek to address this through new instructions encouraging brevity. There are, however, significant countervailing pressures. It is the rare fund filing that is rewarded during SEC staff review for its brevity; instead, staff comments generally encourage (and sometimes dictate) ever more detailed disclosures. There is also — as with the discussion after the bullet above — the reality that funds may prefer longer disclosures, which they may see as more protective.

- *Ordering Risks by Importance*. The amendments propose generally ordering risks by importance. This is, however, a difficult and subjective task. The level of a specific risk in relation to other risks can be difficult to assess and often is subject to change due to factors not under the control of the fund (e.g., market conditions, specific country/region risks). This aspect of the proposal is thus likely to draw considerable comment.

- *Fund-specific, tailored risk disclosure*. The SEC expresses concern that fund firms often use the same "risk library" to populate risks across prospectuses for multiple funds and suggests that while this may be appropriate for a subset of risks, such as general market risk, it is less desirable for other types. Here again, practical considerations come into play. Varying language fund by fund can be a difficult and subjective task.

> *"[R]equiring funds to disclose principal risks in order of importance, as opposed to alphabetically or otherwise, just makes sense and reduces the chance that important risks may be obscured."*
> — SEC Commissioner Allison Herren Lee

Proposed Advertising Rule Amendments

At present, investment company advertising rules limit how a fund presents its performance in advertisements but do not regulate how a fund presents its fees and expenses in advertisements. The proposed advertising rule amendments — which would apply to Securities Act Rules 156, 433, and 482 and Investment Company Act Rule 34b-1 — generally would apply to all investment companies, including mutual funds, ETFs, registered closed-end funds, and BDCs. The proposed amendments would require that advertisements that reference fees and expenses include timely and complete standardized fee and expense information. The amendments address in some detail how advertising would incorporate the effect of temporary fee or expense caps,

with the general effect that both gross and net expense information must be shown with equal prominence and would require disclosure of the expected end date for the caps.

Proposed Compliance Dates

The SEC generally proposed a compliance date of 18 months after the effective date of the proposed amendments. The delayed effectiveness is intended to provide an adequate transition period for funds to update their prospectus and shareholder report disclosures as well as to provide adequate time to come into compliance with the new fee and expense requirements for investment company advertisements. Funds could rely on Rule 498B to satisfy prospectus delivery requirements for existing shareholders beginning on the effective date of the Proposed Amendments, provided that the fund is also in compliance with the amendments to Item 27A of Form N-1A, Rule 30e-1, and Form N-CSR.

There is no proposed additional compliance period relating to the Rule 156 amendment after the amended rule is effective.

Requests for Comment

There is a 60-day comment period. The SEC has included 271 requests for comment, many of which have multiple subparts and subquestions. For organizations that are considering participation in the comment process, careful review of these many requests for comment will be required.

> *"… this release, at nearly 700 pages, is simply too long. The verbal explosion that has occurred in our releases over the last twenty years means that only securities attorneys and compliance professionals, who are paid well to read such things, wade through this much material and come away confident that they have a reasonable grasp of what is being proposed. … One of the stated goals of today's proposals is for funds to create shorter, less complicated disclosure documents, drafted in plain English. A worthy goal, indeed, and one I think the Commission should make greater effort in achieving itself."* — SEC Commissioner Hester Peirce

Our Take

The SEC has proposed a strikingly ambitious overhaul of how registered mutual funds and ETFs communicate with shareholders over time. Many of these changes would modify long-established practices. Transition costs will be significant.

Firms also are likely to be "bandwidth challenged" by the sheer volume of change, especially if these amendments must be implemented at the same time as other major SEC rules. There no doubt will be lively debate around how these changes affect a fund firm's liability profile as the changes affect core disclosure practices.

All that said, the proposals represent a thoughtful and detailed reimagining of the shareholder experience. Significant work has been done to put new ideas forward, with careful consideration of the needs and interests of retail investors — a signature area of interest for this Commission.

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