

SEC Proposes to Modernize Disclosure Framework for Mutual Funds and Exchange-Traded Funds, Modify Fee Information in Investment Company and Business Development Company Advertisements

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The Securities and Exchange Commission on August 5, 2020 unanimously approved proposed rule and form amendments (Proposed Rule) that would comprehensively revise and update the disclosure framework for mutual funds and exchange-traded funds (ETFs, and collectively with mutual funds and unless otherwise specified, funds) in order to better serve the needs of retail investors.¹ The Proposed Rule is part of the SEC's investor experience initiative and seeks to respond to feedback from a request for comment on retail investors' experience with fund disclosure that the SEC issued in 2018.² If adopted, the Proposed Rule would, among other things:

- Streamline and tailor shareholder reports;
- Make available online certain information currently included in shareholder reports that the SEC believes may be less relevant to retail investors and of more interest to financial professionals;
- Amend the scope of Rule 30e-3 under the Investment Company Act of 1940 to exclude investment companies registered on Form N-1A;
- Provide an alternative approach to the annual delivery of fund prospectuses, to accommodate the perceived needs of new versus existing shareholders;
- Revise the prospectus disclosure framework for fund fees and risks; and
- Refashion requirements for presentation of fund fees and expenses in advertisements and sales literature for registered investment companies and business development companies (BDCs).

This *Dechert OnPoint* provides a detailed overview of the Proposed Rule and highlights certain requests for comment. It also discusses liability and litigation concerns that may arise as a result of the Proposed Rule. Comments on the Proposed Rule should be submitted on or before 60 days following the publication of the Proposing Release in the Federal Register (as of September 1, 2020, the Proposing Release had not been published in the Federal Register).

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](#), SEC Release No. IC-33963 (August 5, 2020) (Proposing Release).

² See [Request for Comment on Fund Retail Investor Experience and Disclosure](#), SEC Rel. No. IC-33113 (June 5, 2018) (SEC Request for Comment on Fund Retail Investor Experience and Disclosure).

Executive Summary and Overview

Under the Federal securities laws, a fund (or a financial intermediary) must deliver to an investor a copy of the fund's prospectus in connection with the investor's initial purchase of fund shares.³ Currently, most funds satisfy this requirement by: providing a summary prospectus to investors in connection with their initial investment decisions; and making available online a "statutory prospectus" and Statement of Additional Information (SAI), which include more detailed information about the fund. Further, an existing fund shareholder also must receive an updated copy of the fund's summary or statutory prospectus if the shareholder purchases additional shares of the fund.⁴ Funds typically fulfill these requirements by sending all shareholders an updated summary or statutory prospectus annually.

In addition to annual prospectus updates, a fund's shareholders also receive annual and semi-annual shareholder reports (collectively, shareholder reports) that provide information about the fund's operations during the most recent full- or half-year period, respectively. As with prospectuses, a shareholder can receive shareholder reports in paper or electronically. Pursuant to Rule 30e-3, beginning on January 1, 2021, a shareholder who currently receives paper shareholder reports may instead begin receiving notices that a shareholder report is available at an identified website address. However, a shareholder may continue to receive paper shareholder reports if the shareholder notifies the fund (or the financial intermediary) that the shareholder wishes to continue to receive paper copies of the shareholder reports.

The Proposing Release notes that, based on investor feedback to the Request for Comment on Fund Retail Investor Experience and Disclosure, as well as other prior surveys and disclosure reform initiatives, the SEC believes that investors have a preference for more concise, layered disclosure with graphic representations of information rather than long, complex and technical disclosure. As such, the SEC is proposing modifications to the shareholder report disclosure framework to create a new layered disclosure approach tailored to the SEC's understanding of the preferences of retail investors. The new approach aims to highlight information that the SEC believes best helps investors assess and monitor their investments, taking into consideration their different levels of knowledge and experience. Principal components of the Proposed Rule are described below.

Shareholder Reports Tailored to the Needs of Retail Shareholders

Under the Proposed Rule, shareholder reports would be modified to highlight information that the SEC believes is particularly important for retail shareholders to assess and monitor their fund investments, including: fund expenses; performance; illustrations of holdings; and material fund changes during the reporting period. The Proposed Rule changes would require that material fund changes be included in annual reports and would permit material fund changes to be included in semi-annual reports. The Proposed Rule would: encourage the use of graphic or text features (e.g., tables, bullet lists, question-and-answer formats) to promote effective communication; and make electronic versions of shareholder reports more user-friendly and interactive. Importantly, the SEC expects that these streamlined shareholder reports would be approximately three or four pages in length. The SEC separately published a hypothetical streamlined shareholder report and requested feedback on the report.⁵

³ See Section 5(b)(2) of the Securities Act of 1933.

⁴ See Section 10(a)(3) of the 1933 Act, and Section 24(e) and Rule 8b-16 under the 1940 Act, which generally require a fund to update its registration statement (including the prospectus) with current fee, performance and financial information on at least an annual basis.

⁵ See [Hypothetical Streamlined Shareholder Report](#) (August 5, 2020).

Availability of Additional Information on Form N-CSR and Online

Under the Proposed Rule, certain information currently included in shareholder reports that may be less relevant to retail shareholders, and of more interest to financial professionals and those investors who desire more in-depth information (e.g., schedule of investments, financial highlights and other financial statement elements), would be filed on a semi-annual basis with the SEC on Form N-CSR. This information would be made available online and would be delivered upon request free of charge to shareholders.

Tailoring Required Disclosures to Needs of New and Existing Fund Investors

New investors in a fund receive a prospectus or summary prospectus in connection with their initial investments in the fund to satisfy the fund's delivery obligations under Section 5(b)(2) of the 1933 Act. Under proposed Rule 498B, a fund could satisfy its Section 5(b)(2) delivery obligations with respect to existing shareholders by providing new streamlined shareholder reports (which would include a summary in the annual report of material changes over the prior year), as well as timely notifications of material fund changes as they occur. A fund also would make available online current versions of its prospectus and deliver its prospectus to a shareholder upon request in paper or electronically, consistent with the shareholder's delivery preference. Reliance on Proposed Rule 498B would not be mandatory.

Amendments to Scope of Rule 30e-3 to Exclude Funds

Starting on January 1, 2021, funds may begin relying on Rule 30e-3, which generally permits funds to satisfy shareholder report transmission requirements by making these reports and other materials available online and providing a notice of the reports' online availability, instead of directly providing the reports to shareholders. Investors at any time may request a complete paper shareholder report, to be provided free of charge.

The Proposed Rule would modify the scope of Rule 30e-3 to exclude investment companies registered on Form N-1A (i.e., mutual funds and ETFs). The Proposing Release noted that the amendment to Rule 30e-3 would ensure that all fund shareholders experience the anticipated benefits of the proposed modified disclosure framework, which contemplates direct transmission of concise shareholder reports that serve as the central source of fund disclosure for existing shareholders. The Proposed Rule would not affect the availability of Rule 30e-3 for other registered management companies (such as registered closed-end funds) or unit investment trusts.

Modifications to Prospectus Disclosure of Fund Fees and Risks

The Proposed Rule would modify fund prospectus disclosure to help investors more readily understand fund fees and risks. Under the proposed layered disclosure framework, funds would: replace the existing fee table in the summary section of the statutory prospectus with a standardized, simplified fee summary; move the existing fee table to the statutory prospectus; and replace certain terms in the current fee table with terms that may be clearer to retail investors.

The Proposed Rule would permit funds that invest 10 percent or less of their total assets in other funds to disclose the fees and expenses associated with those investments (acquired fund fees and expenses (AFFE)) in a footnote to the fee table and fee summary, rather than as a separate fee table line item.

The Proposed Rule would modify prospectus risk disclosure by: limiting prospectus disclosure to only those risks that are "principal" risks; and requiring tailored risk disclosure rather than generic, standardized risk disclosures. For example, funds would be required to describe principal risks in order of importance, rather than alphabetically.

Fee and Expense Information in Investment Company and BDC Advertisements

The Proposed Rule would require that presentations of investment company and BDC fees and expenses in advertisements and sales literature be consistent with relevant prospectus fee table presentations and be reasonably current. The Proposed Rule also addresses presentations of fees and expenses that could be materially misleading.

Annual Shareholder Report

The Proposed Rule would replace current Item 27 of Form N-1A with a new Proposed Item 27A, which would redesign the format and content of funds' annual and semi-annual shareholder reports.

Scope of Annual Report Disclosure and Contents of the Proposed Annual Report

The Proposed Rule requires separate shareholder reports for each series of a fund, and redesigns and refines the content of annual shareholder reports. To achieve the SEC's goal of providing more tailored information to investors, the Proposed Rule directs funds to provide separate *series-specific* shareholder reports to shareholders (*i.e.*, one fund per report). These series-specific shareholder reports would be permitted to show information pertaining to multiple classes of a specific fund.

Proposed Item 27A also generally would limit the information a fund is allowed to present in each annual shareholder report to only information specifically permitted or required by Item 27A. However, funds would be permitted to include additional information necessary to prevent information from being "misleading." The Proposed Rule also redesigns the format and content presentation of annual shareholder reports. The new proposed format includes:

- **Cover Page.** The Proposed Rule sets forth specific cover page requirements, similar to those required for the prospectus cover page. While many shareholder reports already provide basic identifying information on the cover page, no specific information currently is required. The new format would require certain basic information (*e.g.*, fund name, ticker symbol, language identifying the report as an "annual shareholder report"). It also would require a legend to note the period's beginning and end dates, as well as the fund's website and contact information. If the fund is an ETF, it also requires that the cover page include the principal U.S. market on which the fund's shares are traded.
- **Expense Example.** The Proposed Rule consolidates the expense example into a single table, and increases the hypothetical investment in the fund from \$1,000 to \$10,000. These changes more closely align the expense example with that of the prospectus expense example. In addition, the new format would require funds to disaggregate the beginning and ending account values net of fees by individually disclosing: (1) the costs paid during the period, (2) the fund's total return during the period before costs were paid, and (3) the ending account value based on the fund's net asset value return. A fund also would be required to present this expense information both in dollars (*i.e.*, the ending account value based on the initial \$10,000 hypothetical investment) and as a percentage of an investor's investment in the fund (expense ratio). ETFs also must present this information based on market value return. In addition, the requirements largely remove the narrative that precedes the expense example and instead present this information in footnotes.

What were your Fund costs for the period? (based on a hypothetical \$10,000 investment)

| [Fund or Class Name] | Beginning account value [beginning date] | Total return before costs paid* | Costs paid [†] | Ending account value [end date] (based on net asset value return) | [For ETF only] Ending account value [end date] (based on market value return) | Costs paid as a percentage of your investment [†] |
|----------------------|--|---------------------------------|-------------------------|---|---|--|
| | \$10,000 | + \$[x] (plus) | - \$[x] (minus) | = \$[x] (equals) | | % |

* In this footnote, the fund would be required to describe qualitatively in plain English other costs included in total return, if material to the fund. For example, if applicable and material, the fund would note that fund investment transaction costs, securities lending costs, or acquired fund fees and expenses reduced the total return.

† In this footnote, the fund would be required to note in plain English that the actual costs paid during the period do not reflect certain costs paid outside the fund (such as purchase and exit costs charged by the shareholder’s broker-dealer).

- *Management’s Discussion of Fund Performance (MDFP) and Performance Information.* The Proposed Rule retains the requirement that a fund’s annual report include a narrative discussion of the factors that materially affected fund performance during the most recent fiscal year, but specifies that the disclosure must “briefly summarize” the “key” factors. A proposed instruction would direct funds not to include generic or overly broad discussions of factors that generally affected market performance over the last fiscal year. Funds also no longer would be permitted to include presidents’ letters, interviews with portfolio managers or other similar information in their annual reports.
- While a fund still must present an index for comparison purposes in the line graph, the Proposed Rule would change the definition of an “appropriate broad-based securities market index,” which Form N-1A currently defines as an index “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.”⁶ The proposed definition, which also would affect performance presentations in prospectuses, would require the selected index to represent “the overall applicable domestic or international equity or debt markets, as appropriate.” The Proposing Release notes that the SEC staff has observed different practices with respect to the benchmarks that funds currently use, including the use of benchmark indexes that may be more representative of particular market segments (including those tied to a particular sector, industry, geographic location or asset class or strategy). The Proposed Rule would instead clarify that funds must select an index reflective of the “overall market.” New form instructions also would allow funds to select additional indexes for comparison purposes, including a narrower index to reflect discrete market segments, or more than one broad-based securities market index. The Proposed Rule states that a fund also may choose to include a blended index (e.g., “one

⁶ Instruction 5 to Item 27(b)(7) of Form N-1A.

that combines the performance of more than one index, such as equity and debt indexes”), in addition to its primary broad-based securities market index. Under the Proposed Rule, a fund would not be permitted to use a blended index as its primary broad-based securities market index; however, the SEC has requested comment as to whether this should be permitted.

- The Proposed Rule also would amend the performance table to require disclosure of the average annual total returns of the fund and its index(es) over 1-, 5-, and 10-year periods. A fund would be required to present the annual total returns with and without sales charges, as applicable, and the returns for each share class covered in the report over the same 1-, 5-, and 10-year periods. For an annual shareholder report that covers multiple classes, a fund must present performance information of at least one class of the fund in the line graph, but has discretion to determine which class or classes to present, subject to certain limitations. A new requirement would limit the performance information disclosed to the past 10 fiscal years (and, as a result, a fund that has operated for more than 10 years may not show since-inception performance).
- In addition, the new requirements would amend the accompanying statements to the performance table and the line graph in the MDFP, to: “simplify” the statement about past performance; “contextualize” the information in the graph and table (specifically, to allow funds to disclose a material change that occurred during the performance period); and disclose the website information (for funds that provide updated performance information on their website, where an investor can access more updated performance information provided by the fund). Further, the Proposed Rule seeks to simplify the disclosure requirement regarding a “stable distribution policy,” or any policy or practice designed to maintain a certain level of distributions, to disclose those instances where a fund did not meet its specified level of distribution in its stable distribution policy or where it made distributions that resulted in returns of capital.
- *Fund Statistics.* The Proposed Rule would require annual shareholder reports to disclose: a fund’s net assets (in a graphical format); the total number of portfolio holdings; and the portfolio turnover rate as of the end of the reporting period. Further, a fund would be permitted to provide additional fund statistics, if determined to be “reasonably related to a fund’s investment strategy.” For example, if a fund was designed to track an index, the fund may determine to disclose its tracking error. The Proposed Rule would impose certain instructions for any additional statistics provided by a fund, including those to: follow any relevant Form N-1A instructions for the calculation method of those statistics; encourage the use of tables and other graphical presentation methods; use the most recent financial statements or financial highlights for statistics that are included or derived from a fund’s financial statements or financial highlights; briefly contextualize statistics in terms of significance or limitations; and require additional fund statistics to be reasonably related to a fund’s investment strategy.
- *Graphical Representation Holdings.* The Proposed Rule would remove the currently required schedule of portfolio holdings from annual shareholder reports and make certain changes to the currently required graphical presentation of fund portfolio holdings. A fund would be allowed to present the fund’s portfolio holdings in graphical format, based on its net exposure or its total exposure to particular categories of investments. The change to allow funds to present data based on investment exposure is an attempt to illustrate a fund’s “true economic exposure” by showing derivatives positions and/or both long and short positions of the fund. A fund that presents its holdings in terms of “total exposure” would be able to present its long and short positions separately, while a fund presenting its holdings in terms of “net exposure” would show the combined effect of these positions together. In addition, the Proposed Rule would change the instruction regarding the discussion of credit quality of portfolio holdings in order to encourage “brief and concise” disclosures.

- *Material Fund Changes.* The Proposed Rule would add a new section to a fund's annual shareholder report to highlight certain material changes that occurred during the most recently completed fiscal year or that the fund intends to make in its next annual prospectus update. Under the new requirements, a fund would be required to concisely disclose any "material change" that occurs with regard to any of the following items, all of which relate to specific summary prospectus disclosures:
 - Fund name (as described in Item 1(a)(1));
 - Fund's investment objectives or goals (as described in Item 2);
 - Any material increases to a fund's ongoing annual fees, transaction fees, or maximum account fee (as described in Item 3);
 - Fund's principal investment strategies (as described in Item 4(a));⁷
 - Principal risks of investing in the fund (as described in Item 4(b)(1));
 - Fund's investment adviser(s) (as described in Item 5(a));⁸ and
 - Fund's portfolio manager(s) (as described in Item 5(b)).

The above disclosures would be accompanied by a legend informing shareholders where they can find more information and/or request a copy of the fund's next annual prospectus update. A fund also would be allowed to disclose any other material change occurring with respect to items outside of the above mandatory disclosure list.

Importantly, the Proposing Release notes that a fund would not be required to disclose material changes to disclosures other than those that are provided in the summary prospectus items enumerated above (or, if the fund does not use a summary prospectus, to the corresponding items in the summary section of the statutory prospectus), because the SEC believes they are less likely to affect a shareholder's investment decisions or the shareholder report already provides similar information. Moreover, a fund would be required to disclose a change to an item listed above only if the change is "material." The Proposing Release states that a fund should determine whether a change is material based on "the facts and circumstances of the fund and the specific change." As an example, the Proposing Release notes that an index fund may determine that a portfolio manager change is not a material change that the index fund would need to disclose in its annual report, given the nature of the portfolio manager's role or involvement with respect to the index fund.

⁷ Among other things, a change to a fund's investment policy pursuant to Rule 35d-1 would need to be disclosed. Rule 35d-1 under the 1940 Act, also known as the "names rule," requires funds with names that suggest investments in certain industries, instruments, or geographic regions to invest at least 80% of the value of their assets in such investments. The rule generally requires funds to provide shareholders with at least 60 days' prior notice of a change to the fund's names rule investment policy. Under the Proposed Rule, a fund providing notice of its names rule investment policy in its annual report would satisfy these notice requirements, if the following three requirements are met: (1) the annual report is provided to shareholders at least 60 days before the fund changes its names rule investment policy; (2) the annual report contains the statement required by Rule 35d-1(c)(2) (e.g., "Important Notice Regarding Change in Investment Policy"); and (3) the envelope in which the annual report is delivered (if applicable) has this same statement, as required by Rule 35d-1(c)(3). See Proposing Release at Note 273.

⁸ A fund would not be required to disclose a sub-adviser change under the Proposed Rule if Item 5 of Form N-1A would not require disclosure of the sub-adviser in the prospectus.

The Proposing Release refers to “material changes” throughout and, as discussed above, specifies that, at a minimum, material changes to the items listed above should be disclosed as “material fund changes.” Generally, a fund must file a post-effective amendment to its registration statement that includes “material” changes at least 60 days prior to the effective date of the post-effective amendment (*i.e.*, if a fund intends to make “material” changes to its registration statement in connection with the annual update of its registration statement, the fund must file a post-effective amendment pursuant to Rule 485(a) that includes the material changes at least 60 days prior to the date on which its registration statement becomes effective). It is not explicit in the Proposing Release whether, in the SEC’s view, “material changes” for purposes of the proposed new annual report disclosure also necessarily would rise to the level of a “material” change that would require a fund to make a filing pursuant to Rule 485(a). For example, as noted above, the Proposed Rule would require material changes to a fund’s portfolio manager to be disclosed in the annual report; however, funds currently do not typically consider a portfolio manager change to be “material,” thereby requiring a post-effective amendment pursuant to Rule 485(a).⁹ Instead, funds often would disclose the change in a supplement, or sticker, to the registration statement.¹⁰

In addition to material changes that occurred during the most recent fiscal year, a fund also would be required to disclose material changes that the fund *intends* to make in its upcoming annual registration statement update. The Proposing Release states that this requirement is intended to capture all material changes in the annual report, so that investors generally would not need to review the fund’s annual prospectus update to learn of material changes. The Proposing Release notes that the SEC believes a fund generally would be aware of such material changes at the time the annual report is filed (typically around 60 days before the annual prospectus update becomes effective), because the fund is required to file a post-effective amendment to its registration statement that includes material changes at least 60 days prior to the time the amendment is effective. The Proposing Release acknowledges two scenarios that could make such forward-looking disclosure difficult for funds: (i) if material changes that are included in a post-effective amendment pursuant to Rule 485(a) are subject to the SEC staff review process so that the staff may request modifications to the intended changes; or (ii) if a material change occurs shortly before a fund transmits its annual report, so it would be difficult for the fund to disclose the change in the annual report and meet the applicable regulatory deadlines. The Proposing Release states that, in the first scenario, it would be appropriate for the fund to describe the change at a high level in the annual report to avoid including the precise prospectus disclosure, which could be subject to change. In the second scenario, the Proposing Release states that the fund would provide a timely notice of the material change to shareholders (under proposed Rule 498B or through a prospectus sticker or annual prospectus update) and would disclose the material change in its next annual report.¹¹

- *Changes in, and Disagreements with, Accountants.* The Proposed Rule would make changes to the shareholder report disclosure requirement regarding changes in, or disagreements with, accountants. The disclosure currently required would move to Form N-CSR, and the annual shareholder report disclosure would be replaced with a more user-friendly summary of the information. Specifically, the new disclosure would require the fund to explain whether the fund’s accountant was dismissed, resigned or declined to stand for re-election and the date of that decision and briefly discuss the disagreement(s), if any, with the former accountant during the last two fiscal years and during any additional time period discussed on Form N-CSR.

⁹ [Disclosure Regarding Portfolio Managers of Registered Management Investment Companies](#), SEC Rel. No. IC-26533 (August 23, 2004).

¹⁰ In the Proposing Release, the SEC requests comment on whether requiring funds to make a materiality assessment of relevant changes would introduce unnecessary subjectivity into the disclosure.

¹¹ In the Proposing Release, the SEC requests comment on whether requiring funds to disclose material changes they plan to make when updating their prospectuses would raise timing concerns, compliance difficulties, liability risks, or other concerns.

- Statement Regarding Liquidity Risk Management Program.* The Proposed Rule would maintain the currently required liquidity risk management disclosure following a board's review of the fund's liquidity risk management program during the most recent fiscal half-year.¹² However, the new requirements would specifically emphasize that this disclosure should be "tailored, concise, and informative" to aid investors' understanding of how the fund manages its particular liquidity risks. The Proposing Release notes that the many of the current disclosures are overly lengthy and not tailored to a particular fund. The Proposed Rule specifically would mandate disclosure of the key factors or market events that materially affected a fund's liquidity risk during the reporting period, the key features of the fund's liquidity risk management program, and the effectiveness of the fund's liquidity risk management program over the past year.
- Availability of Additional Information.* The Proposed Rule would require a fund to state in the annual shareholder report that more information is available on the fund's website. Current annual shareholder reports require several separate statements regarding access to the fund's quarterly portfolio schedule, proxy voting policies and procedures, and proxy voting record. The new requirements, however, would: consolidate this information into one combined statement; make reference to accessing the fund's current prospectus on the website; and allow for references to other material on the fund's website. In addition, shareholder reports posted to the fund's website would be required to provide active hyperlinks (or QR code¹³) for investors to access the above-referenced fund information.
- Householding Disclosure.* The Proposed Rule would continue to permit householding of shareholder reports based on written or implied consent. The Proposed Rule would continue to allow funds that intend to rely on shareholders' implied consent for householding purposes to disclose the intent to do so to shareholders in a statement in the annual shareholder report, unless consent is revoked by a shareholder in the household. Under current householding rules, investors who would normally receive multiple shareholder reports for each investor in the fund receive only one shareholder report for the entire household to share, unless one or more of the investors contact the fund to request separate reports (thereby revoking their consent). This practice and disclosure is consistent with Rule 30e-1 governing the delivery of shareholder reports. Rule 30e-1(f)(3) requires a fund to disclose at least yearly how a shareholder may revoke consent of householding practices. That yearly disclosure requirement remains the same.

Key areas in which the SEC is seeking comment include: whether the separation of shareholder reports by series would make the reports easier for shareholders to navigate and assess; whether the Proposed Rule strikes the proper balance in terms of removing certain content from shareholder reports, while still allowing some flexibility for the addition of certain content in the shareholder reports; and whether and how the Proposed Rule would affect the length of the shareholder reports.

¹² Investment Company Liquidity Risk Management Programs, SEC Rel. No. IC-32315 (Oct. 13, 2016) [81 FR 82142 (Nov. 18, 2016)]; Investment Company Swing Pricing, SEC Rel. No. IC-32316 (Oct. 13, 2016) [81 F.R. 82084 (Nov. 18, 2016)] (2016 Liquidity Rule Release); Investment Company Liquidity Disclosure, SEC Rel. No. IC-33142 (June 28, 2018) [83 FR 31859 (Jul. 10, 2018)] (2018 Liquidity Disclosure Release).

¹³ A QR code is a "two-dimensional barcode capable of encoding information such as a website address, text information, or contact information. For example, when included on print materials, these codes can be read using the camera on a smartphone to take the user directly to a specific website address." Proposing Release at Note 140.

Format and Presentation of Annual Report

The Proposed Rule sets forth a number of new instructions designed to make shareholder reports easier for investors to read and understand. The SEC also provided a sample annual report with the Proposed Rule to illustrate the SEC's vision for an annual report that complies with the Proposed Rule. These instructions include new requirements to present information in the shareholder reports in the same specified order as required under the amendments to Form N-1A. The requirements also emphasize that funds should use "plain English" (e.g., short, concise sentences, not legal jargon or technical terms) and make use of bullet points and graphics to break up important information. The Proposed Rule also adds legibility requirements for all printed shareholder reports, consistent with those required for prospectuses under Rule 420 of the 1933 Act. These requirements generally require that font sizes be at least 10-point in size. However, under Rule 420 funds may satisfy legibility requirements by presenting all printed information in an electronic format easily communicated to investors.

Key areas in which the SEC is seeking comment include: whether other requirements are needed to improve the readability of shareholder reports; and whether the proposed guidance is generally clear enough for funds to implement.

Electronic Annual Reports

The Proposed Rule would make changes to the availability and presentation of annual shareholder reports in electronic form. Because electronic shareholder reports do not always display a cover page in the same manner as when they are printed, the requirements that apply to cover pages also will apply to the first page of electronic shareholder reports. Similarly, the requirements regarding the order of information presented in shareholder reports remain regardless of whether or not the report is electronically accessible. The Proposed Rule also provides new instructions encouraging funds to make use of interactive electronic communication tools, such as "video or audio messages, mouse-over windows, pop-up definitions or explanations of difficult concepts, chat functionality, and expense calculators." The requirements make clear that any explanatory materials or supplemental information used as online tools may not obstruct access to, or understanding of, the required information. Thus, the "default presentation" of information must be of the content required under Item 27A. Any interactive, supplemental or explanatory tools must first start by presenting the information as required under Item 27A before providing any new or modified information. The Proposed Rule also reiterates that any additional information or electronic features used by funds in annual shareholder reports and not filed with Form N-CSR are subject to certain liability standards and filing requirements. The additional information or tools used in an annual shareholder report's electronic presentation to shareholders would be treated the same way as "any other website or other electronic content that the fund produces or disseminates" under the Federal securities laws. For example, based on the facts and circumstances, certain additional electronic features could be deemed to be advertisements for a fund subject to Rule 482, and a fund, with respect to its use of such additional features, would be subject to the same standard of liability and filing requirements that are applicable to other Rule 482 advertisements.¹⁴ A fund also would be required to maintain records of all supplemental information provided, subject to retention requirements under Section 31(a) of the 1940 Act. As mentioned above in *Availability of Additional Information*, the Proposed Rule states that shareholder reports must provide a hyperlink or QR code to any additional fund information referenced but not provided in the report, if available online.

¹⁴ The Proposing Release notes that "[a]n investment company advertisement that complies with rule 482 is deemed to be a section 10(b) prospectus" and that such an advertisement is therefore "subject to liability under section 12(a)(2) of the [1933] Act and the antifraud provisions of the Federal securities laws." See Note 340.

Key areas in which the SEC is seeking comment include: whether there should be limits on the type of information that funds can electronically link to in shareholder reports; whether the instructions are sufficiently flexible for various electronic presentation methods (e.g., phones, tablets and other devices); and whether shareholders should be warned when they are moving from the shareholder report of one series to another.

Semi-Annual Shareholder Report

Scope and Contents of the Proposed Semi-Annual Report

The scope and contents requirements of the Proposed Rule for semi-annual shareholder reports would “parallel” the requirements for funds’ annual shareholder reports. Funds are required to: provide separate reports for each series of a fund; limit the content provided in a report to items specifically required or permitted by Proposed Item 27A; and eliminate any incorporation by reference into the reports.

- *Cover Page.* The Proposed Rule would require the same information for semi-annual shareholder reports as for annual shareholder reports, noted above (except for the title of “semi-annual” instead of “annual”).
- *Expense Example.* The semi-annual shareholder report expense example would be subject to the same requirements as the annual shareholder report expense example under the Proposed Rule (discussed above).
- *MDFP.* MDFP would not be required under the Proposed Rule for semi-annual shareholder reports; however, inclusion of MDFP would be permitted in semi-annual shareholder reports, subject to the requirements of the Proposed Rule (discussed above).
- *Fund Statistics.* The Proposed Rule would require semi-annual shareholder reports to include the same fund statistics as annual shareholder reports (discussed above). These include a fund’s net assets, total number of portfolio holdings, and portfolio turnover rate, in addition to any optional fund statistical disclosures the fund chooses to include.
- *Graphical Representation of Holdings:* Semi-annual shareholder reports would be subject to the same graphical representation requirements as annual shareholder reports under the Proposed Rule (discussed above).
- *Material Fund Changes.* A fund would not be required to include a discussion of material changes in its semi-annual shareholder report, unlike in the annual shareholder report (discussed above), under the Proposed Rule, although it would be permitted to do so.
- *Statement Regarding Liquidity Risk Management.* Under the Proposed Rule, a fund’s semi-annual shareholder report would be subject to the same updates to this disclosure as the annual shareholder report (discussed above). These updates include a focus on brevity of discussion and tailoring to the specific fund. A fund would be able to choose to provide this disclosure in the semi-annual shareholder report or in the annual shareholder report, depending on the timing of its annual report on the liquidity risk management program, but the fund would not be required to include such disclosure in both reports.
- *Availability of Additional Information.* A fund’s semi-annual shareholder report would be subject to the same disclosure requirements under the Proposed Rule as the annual shareholder reports with respect to the availability of additional fund information (discussed above).

Key areas in which the SEC is seeking comment include: whether there are any “unique scope considerations” that should be considered for semi-annual shareholder reports; and whether the Proposed Rule should make changes to the frequency of shareholder reports (more or less than on a semi-annual basis).

Format and Presentation of Semi-Annual Report

Under the Proposed Rule, a fund’s semi-annual shareholder report would be subject to generally the same requirements as those that apply to annual shareholder reports (noted above). The information in a semi-annual shareholder report also would be required to be presented in the same order as required under Form N-1A. The Proposed Rule’s instructions for annual shareholder reports to write in “plain English” also would apply to funds’ semi-annual shareholder reports.

Key areas in which the SEC is seeking comment include: whether it is appropriate, or would cause confusion, to allow funds the option to disclose information in semi-annual shareholder reports that is required in annual shareholder reports.

Electronic Semi-Annual Reports

Under the Proposed Rule, a fund’s semi-annual shareholder report would be subject to the same instructions as those discussed above with respect to annual shareholder reports. The same instructions discussed above regarding ordering and presentation of information, the use of interactive electronic tools and links to outside fund information would be applicable to semi-annual shareholder reports under Proposed Item 27A.

Key areas in which the SEC is seeking comment include whether funds should be able to satisfy delivery requirements for semi-annual shareholder reports via methods other than through direct transmission to shareholders. The Proposed Rule asks commenters to consider various alternate notice and delivery options for shareholder reports (*i.e.*, direct delivery only for certain shareholder reports and electronic-posting for other shareholder reports, changing the frequency of shareholder reports (more or less than twice a year), changing the frequency of notice to shareholders regarding changes to shareholder reports).

Amendments to Form N-CSR and Availability of Contents of Form N-CSR on Fund Websites

As part of its implementation of the layered disclosure framework, the SEC proposes to amend Form N-CSR and Rule 30e-1. In order to streamline the shareholder reports as discussed above, the proposed Form N-CSR amendments would require funds to include certain information currently required in shareholder reports as part of the information provided in filings made on Form N-CSR. Amendments to Rule 30e-1 would require funds to post on their websites the information required to be filed on Form N-CSR so that fund shareholders have ready access to it.

Proposed Amendments to Form N-CSR

The SEC is proposing to require a fund to file its complete financial statements on Form N-CSR, instead of including the entirety of its financial statements in annual and semi-annual shareholder reports. The amended Form N-CSR requirement would continue to require that annual financial statements be audited, while the semi-annual financial statements need not be audited. A fund no longer would be able to provide a summary schedule of portfolio holdings, instead of a complete schedule of portfolio holdings, under an amendment to Form N-1A.

In connection with these changes, the SEC also is proposing to amend Instruction 4(e) to Item 13 of Form N-1A, to allow funds to incorporate by reference the financial statements filed on Form N-CSR into their prospectuses, mirroring the current instruction that allows funds to incorporate by reference the financial statements filed in annual shareholder reports. In order to align information provided in the financial highlights with expense information in the shareholder reports, the SEC also is proposing to amend Item 13(a) of Form N-1A to require an ETF to disclose total return based on its market share at the end of the period.

In conjunction with the proposed requirement discussed above that funds provide a summary of changes in, and disagreements with, accountants in their annual reports, the SEC is proposing to require additional, technical disclosures related to this topic on Form N-CSR. Moreover, rather than including information on matters submitted for a shareholder vote in shareholder reports, the Proposed Rule would require funds to report this information on Form N-CSR.

The Proposed Rule also would require funds to file the aggregate remuneration that the fund paid to directors, officers, and affiliated persons on Form N-CSR, rather than in the shareholder report as currently required. In addition, the Proposed Rule would require that funds provide a statement regarding the basis for the board's approval of the fund's investment advisory contract on Form N-CSR, instead of in the shareholder reports as currently required.

Key areas in which the SEC is seeking comment include: whether the proposed layered approach to disclosure would meet the informational needs of shareholders; whether direct transmission of financial statements to investors is useful; and whether funds should be able to incorporate by reference their financial highlights from Form N-CSR, as proposed, into their prospectuses.

Website Availability of Information Filed on Form N-CSR

The Proposed Rule would require funds to post online all information contained on proposed Form N-CSR. Funds could satisfy this requirement by posting their most recently filed Form N-CSR on their websites. Funds would be required to make this information available online from 70 days after the end of the relevant fiscal period until 70 days after the following fiscal period. Under the Proposed Rule, funds (other than money market funds) also would be required to post online their complete portfolio holdings as of the end of their most recent first and third fiscal quarters.¹⁵ In the SEC's view, this will complement the second and fourth fiscal quarter portfolio holdings that funds would be required to post online as part of the proposed requirements to make financial statements available online.

To ensure that shareholders will have ready access to the information required to be posted online, the SEC is proposing to require that the website address where the required information is posted would be stated on the cover page of the shareholder report and that the format of the information would be easily readable both online and in print. The Proposed Rule includes a safe harbor provision to address system outages and other technological issues, among other events. In particular, as long as a fund has reasonable procedures in place to ensure that materials are posted online as required by the Proposed Rule, and takes prompt action after the fund knows that the posted information does not comply with the Proposed Rule, the fund would be deemed to have satisfied its obligation to transmit shareholder reports, even if the posting requirements were not met for a temporary time period.

¹⁵ See Proposed Rule 30e-1(b)(2)(i). This information is already required to be filed on Form N-PORT; however, the proposed requirement to post this information on a website would "provide centralized access" to the holdings information.

The Proposed Rule also would allow funds flexibility, to a certain extent, to decide how to post the information online. For example, funds could post their most recently filed Form N-CSR and could determine how to group funds and series. The Proposed Rule would require funds to send paper copies or electronic copies of these online materials to requestors of such materials within three business days.

Key areas in which the SEC is seeking comment include: whether, as proposed, the SEC should require a fund to post online all of the information from Form N-CSR; how often and for what period of time funds should be required to post material online; the extent to which funds should be required to post portfolio holdings information on their websites; and whether funds should be required to post materials online in a specific format.

Proposed Removal of Management Table from Annual Shareholder Reports

The SEC is proposing to remove the current requirement that funds include in their annual reports a management table with information about a fund's directors and officers. Because funds also are required to include management information in their SAIs, the SEC "believe[s] it is unnecessary to include this disclosure in multiple disclosure documents." Thus, as proposed, the management information table would be removed from the annual shareholder report and would not be added to Form N-CSR.

Key areas in which the SEC is seeking comment include: whether the management information table should be included in fund annual reports; whether certain data points from the management information table should be included in fund annual reports; and whether the management information table should be included on Form N-CSR.

Proposed Rule 498B and Treatment of Annual Prospectus Updates under the Proposed Rule

Proposed Rule 498B under the 1933 Act represents an "alternative approach" to the annual delivery of fund prospectuses. Under this Proposed Rule, shareholders would continue to receive a prospectus in connection with their initial investments in a fund; however, shareholders who meet the definition of "existing shareholders" would no longer receive annual prospectus updates. Instead, these existing shareholders would receive the new streamlined shareholder reports discussed above, which would include a summary of material fund changes and timely notifications regarding material fund changes as they occur. Proposed Rule 498B was designed to accommodate the perceived needs of existing shareholders and their preferences for "simplified, layered disclosure that highlights key information."

Rule 498B defines an "existing shareholder" as a shareholder to whom a summary or statutory fund prospectus was sent or given to satisfy any obligation under Section 5(b)(2) of the 1933 Act and who has held fund shares continuously since that time.¹⁶ This definition of "existing shareholder" also would include a shareholder in a money market fund to whom a prospectus was sent or given. Importantly, however, there is no requirement that the shareholder of a money market fund must have continuously held fund shares since that time.¹⁷

¹⁶ In the Proposing Release, the SEC stated that it believes the requirement that a shareholder continuously hold fund shares is necessary because "if the investor purchased fund shares and then subsequently sold these shares, that investor would not receive notification of material fund changes that occurred when he or she did not hold fund shares."

¹⁷ However, a shareholder in a money market fund must have continuously maintained (or been a beneficial owner of) an account in that fund.

The Proposing Release notes that Rule 498B would allow a fund to satisfy any prospectus delivery obligations under Section 5(b)(2) of the 1933 Act to the fund's existing shareholders, provided that specific conditions are met. Failure to satisfy any of these conditions would mean that a fund could not rely on Rule 498B to satisfy its prospectus delivery obligations to existing shareholders. In particular, Rule 498B would require that:

- Existing shareholders previously must have been provided with a prospectus (as part as their initial investments in the fund) in order to satisfy any obligation under Section 5(b)(2) of the 1933 Act;
- A fund's current summary and statutory prospectus(es), SAI, and the most recent annual and semi-annual shareholder reports must be made publicly accessible, free of charge, at the website address specified in the fund's annual and semi-annual reports;¹⁸ and
- Existing shareholders must be provided with notices of certain material changes to the fund within three business days of either the effective date of the fund's post-effective amendment filing or the filing date of the prospectus supplement filing, by first-class mail or other means designed to ensure equally prompt receipt.¹⁹

The Proposed Rule would not specify the form of these notices and funds may, for example, send existing shareholders a prospectus supplement (as filed with the SEC). It should be noted that while most funds currently mail prospectus supplements, or "stickers," to inform shareholders of material fund changes, the requirements under Rule 498B regarding the timing and delivery methods of providing such notices likely would result in additional costs and operational challenges for funds.

The Proposing Release emphasizes that Rule 498B would not relieve funds of any legal responsibility for misleading disclosures with regard to disclosure materials that are required to be made available online; and a fund relying on Rule 498B would be subject to the same liability and anti-fraud provisions as if the fund provided the prospectus to existing shareholders.²⁰ In addition, Rule 498B, if adopted, would apply only to funds registered on Form N-1A (*i.e.*, mutual funds and ETFs), and would not apply to investors holding the fund through a separate account funding a variable annuity contract.

Rule 498B also would include delivery-upon-request and website presentation requirements, which would not be conditions for reliance on the Proposed Rule to satisfy prospectus delivery obligations. First, a fund would need to

¹⁸ Rule 498B imposes additional conditions on the format of a fund's documents made available online, including that: the format must be human-readable and capable of being printed on paper in human-readable format; and the format must provide persons with the ability to move back and forth within documents and between certain documents. In addition, Rule 498B provides a "safe harbor" if online fund documents were temporarily unavailable, provided the fund meets certain conditions.

¹⁹ Rule 498B defines "material changes" as those topics described under Proposed Item 27A(g) of Form N-1A, which include material changes to a fund's name, investment objectives, principal investments strategies, principal risks, investment adviser(s) and portfolio manager(s), as well as material increases in the fund's ongoing annual fees, transaction fees or maximum account fee. A fund also can disclose to existing shareholders other material changes on a discretionary basis.

²⁰ Section 11 of the 1933 Act provides that purchasers of an issuer's securities have private rights of action for untrue statements of material facts or omissions of material facts required to be included in the registration statement or necessary to make the statements in the registration statement not misleading. Section 12(a)(2) of the 1933 Act provides that sellers are liable to purchasers for offers or sales by means of a prospectus or oral communication that includes an untrue statement of material fact or omits to state a material fact that makes the statements made, based on the circumstances under which they were made, not misleading. Section 17(a)(2) of the 1933 Act makes it unlawful for any person in the offer and sale of a security to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

deliver within three business days of receiving a request, in a manner consistent with the requester's delivery preference, a copy of any fund documents that Rule 498B would require to be made available online, at no charge to the requester, subject to certain additional conditions. If an electronic copy is requested, a fund could send a direct link to the online document, provided that: the document is directly accessible through the link from the time that the email is sent through a date that is six months after the date that the email is sent; the email specifies how long the link will remain usable; and the email indicates that, if the recipient desires to retain a copy, the recipient should access and save the document. Second, Rule 498B would require that online fund documents be presented in a format convenient for both reading online and printing on paper, and can be permanently retained in such a format by persons accessing those materials. It should be noted that under the proposed requirements of Rule 498B, a fund would be required to prepare a summary prospectus. Currently, under Rule 498, a fund's use of a summary prospectus is optional.

Key areas in which the SEC is seeking comment include: the appropriateness of the type, scope, and delivery method of materials to be received by existing shareholders under the Rule; the appropriateness of the conditions proposed for reliance upon the Rule; the definition of "existing shareholders"; and the potential applicability of the Rule to funds that are not open-end funds.

Amendments Narrowing Scope of Rule 30e-3

Under Rule 30e-3, beginning on January 1, 2021 and subject to certain conditions, investment companies generally will be permitted to satisfy their shareholder report delivery requirements by making such reports and other materials available online and providing a notice of availability to shareholders, which is referred to as a "notice and access" option. The Proposed Rule would amend the scope of Rule 30e-3 to exclude investment companies registered on Form N-1A, which instead would be required to send tailored annual and semi-annual reports under the Proposed Rule directly to their shareholders; these reports should be sent either by mail or, if the shareholder has elected to receive shareholder reports electronically, by email. Consequently, the extended transition period and related disclosures in connection with implementation of Rule 30e-3 currently required for funds that intend to begin relying on Rule 30e-3 prior to January 1, 2022 also would no longer be required under the Proposed Rule. The Proposing Release discusses that the proposed amendments to Rule 30e-3 reflect the SEC's belief that the disclosure approach underlying the Proposed Rule represents a more effective means of improving investors' ability to access and digest fund information, and reduces fund expenses in printing and mailing as compared to the printing and mailing of a full shareholder report. If the Proposed Rule is adopted, a fund that has communicated to its shareholders its intention to rely on Rule 30e-3 or has begun relying on Rule 30e-3 (after January 1, 2021) might wish to inform its shareholders of this change and could, for example, do so in an annual report sent to investors.

Key areas in which the SEC is seeking comment include: the appropriateness of excluding funds from the scope of Rule 30e-3; and the difficulties that may arise for funds that already have begun to rely on Rule 30e-3.

Proposed Amendments to Fund Prospectus Disclosure Requirements

The SEC is proposing amendments to prospectus disclosure relating to fees and risks on Form N-1A.

Prospectus Fee Disclosures

Funds currently are required to provide in their prospectuses a fee table that includes "shareholder fees" and "annual fund operating expenses," as well as an expense example that shows the hypothetical fees an investor would pay if the investor becomes a shareholder of the fund.

Fee Summary

The summary prospectus would include a new summary fee table, rather than the current, lengthier fee table. The summary fee table would show a subset of the information historically included in the fee table, namely: transaction fees; the maximum account fee; and ongoing annual fees (before and after any waivers and/or reimbursements). Each line item in the summary fee table would show the cost to investors assuming an initial investment of \$10,000.²¹ A new narrative also would precede the summary fee table.

The SEC noted that, at this time, it is not proposing to modify fund prospectus disclosure to address performance expenses, such as securities lending costs, brokerage commissions and transaction costs. The SEC also noted, however, that the proposed modifications to the expense presentation in the shareholder reports are designed to reflect fixed fees and certain material performance expenses.

Expense Example

The Proposed Rule would: simplify the narrative statement immediately preceding the expense example; and simplify the example itself, by requiring funds to show expenses over only two periods (in the case of a fund with 10 or more years of performance, one year and 10 years; in the case of a new fund, one year and three years). The Proposing Release notes that the SEC considered incorporating elements of the proposed shareholder report expense presentation into the prospectus, but ultimately decided against doing so because, in the SEC's view, the prospectus expense example is forward-looking while the shareholder report presentation of expenses is retrospective.

Acquired Fund Fees and Expenses

The proposed amendments would allow a fund that invests 10 percent or less of its total assets in acquired funds²² to disclose AFFE in a footnote rather than as a separate line item in the fee table. Funds investing more than 10 percent of total assets in acquired funds would be required to include this information as a separate line item in the fee table. A fund would determine whether it meets the 10 percent threshold based on an average of month-end investments in acquired funds (excluding investments in money market funds) divided by the fund's total assets of each of the 12 months that make up the prior fiscal year (or fewer if the fund has not been in operation for a full fiscal year). A fund would be permitted to disclose AFFE in the fee table, even if the fund did not meet the 10 percent threshold. For example, a fund could include an AFFE line item where its investments in acquired funds hovered near 10 percent and the fund did not want to monitor closely the threshold for inclusion in, or exclusion from, the fee table. The Proposing Release explicitly notes that, although the 10 percent threshold calculation is based on monthly data, the Proposed Rule would not require a fund to assess whether it may disclose AFFE in a footnote on a monthly basis or update its prospectus based solely on such monthly assessments. However, the Proposing Release also reminds funds that the SEC would expect a fund to update its prospectus to reflect material changes in the amount a fund invests in other funds or its AFFE, just as it would for any other material changes to its annual total operating expenses.

²¹ Under the Proposed Rule, the full fee table currently required in the summary prospectus would be moved to the statutory portion of the prospectus.

²² An "acquired fund" is any company in which a fund invests that is an investment company or a private fund that would be an investment company but for Sections 3(c)(1) or 3(c)(7) of the 1940 Act. See Instruction 3(f)(i) to Item 3 of Form N-1A.

The SEC also is proposing two technical amendments, to: correct the manner in which a fund in operation for under one year calculates AFFE;²³ and amend an optional footnote instruction regarding total ongoing fees.²⁴ The SEC is requesting comment on whether the proposed amendments would address concerns about the impact of AFFE disclosure on BDCs, and if not, how the SEC could address these concerns.

Portfolio Turnover

The SEC is proposing to include disclosure regarding portfolio turnover in the new fee summary and in the full fee table in the prospectus, as such disclosure provides helpful context for fund fees. The SEC also is proposing to reduce the length of the disclosure surrounding portfolio turnover, in order to enhance investor comprehension.

Formatting, Terminology, and XBRL

As part of the Proposed Rule, the SEC would require that funds eliminate footnotes in the fee summary, in order to provide the clearest presentation of fee information to investors. The Proposed Rule contains an exception to allow footnotes where a statement otherwise would be materially misleading.

In addition, certain terms used in the current fee table would be changed to plain-English terms in the fee summary, in order to bolster retail investor comprehension. For example, the proposed summary fee table would change the current fee table heading “Shareholder Fees” to “Transaction Fees,” and would change the current fee table heading “Annual Fund Operating Expenses” to “Ongoing Annual Fees.”

Key areas in which the SEC is seeking comment include: whether the display of a fund’s transaction fees, maximum account fee, and ongoing annual fees is appropriate in the new fee summary; whether the terminology changes made in the Proposed Rule are helpful to shareholders; whether investors need additional information to compare costs of investing in certain funds; whether the simplified expense example is useful to investors; and whether funds investing 10 percent or less of their assets in AFFE should be permitted to omit this information from the fee table.

Prospectus Risk Disclosures

The Proposing Release indicates that, in the SEC’s view, prospectus risk disclosures are too long and therefore are confusing for investors. To address this concern, the SEC is proposing an Instruction to Form N-1A that would prohibit a fund from including non-principal risks in the prospectus. Funds could still disclose additional risks in the SAI.

The SEC is proposing to require that funds “briefly” summarize the principal risks of the fund in the summary prospectus. The Proposed Rule also would require a fund’s summary prospectus to list risks in order of importance,

²³ See Instruction 4(f)(ii) to Proposed Item 8A of Form N-1A. The amendment would require a fund in operation for under one year to calculate AFFE by using the number of days since the date the fund made its first investment, rather than the number of days in the fund’s fiscal year. This would modify the calculation so that both the numerator and denominator would be based on the same period of time.

²⁴ See Instruction 4(f)(viii) to Proposed Item 8A of Form N-1A. The amendment would permit funds to explain in the new shareholder reports, not in the financial highlights, that the total ongoing annual fees in the fee table do not correlate to the expense presentation. However, a fund may still reference the financial highlights in this optional footnote if it chooses to do so.

and would explicitly prohibit listing the risks in alphabetical order.²⁵ The Proposed Rule would include an instruction that funds must tailor risk disclosures to align with how funds actually operate, instead of including generic risks across all funds in the fund complex.

The SEC is proposing to add three new instructions to Item 9(c) of Form N-1A, regarding principal risks in the statutory prospectus. These instructions also would affect the summary prospectus principal risk disclosure. First, the SEC is proposing to add an instruction that, in determining whether a risk is a “principal” risk, a fund should consider both whether the risk would place more than 10 percent of the fund’s assets at risk (10 percent standard) and whether it is reasonably likely that a risk will meet this 10 percent standard in the future. Second, the SEC is proposing to add an instruction targeted at funds of funds, that in the case of acquiring funds, risks should be included only if they are principal risks of the acquiring fund, and that a principal risk of an acquired fund should not be included unless it is a principal risk of the acquiring fund. Third, the SEC is proposing to add an instruction targeted at “go anywhere” funds that allow portfolio managers to change the fund’s strategy. The instruction would provide that if the fund’s strategy permits the manager discretion to invest in different types of assets, such fund must 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.

Key areas in which the SEC is seeking comment include: whether the proposed preclusion of non-principal risks from the statutory prospectus is appropriate; whether the instruction to display risks in order of importance is appropriate; whether any additional changes should be made to ensure risk disclosure is digestible for investors; and whether any of the risk-related reforms in the Proposed Rule should be extended to closed-end funds.

Investment Company and BDC Advertising Rule Amendments

The SEC is proposing to amend Rules 482, 156 and 433 under the 1933 Act and Rule 34b-1 under the 1940 Act, “to promote transparent and balanced presentations of fees and expenses in investment company advertisements.” These proposed amendments would apply to all registered investment companies, including closed-end funds and BDCs (for the purposes of this section, closed-end funds, BDCs, mutual funds and ETFs are referred to as “funds”).

The proposed amendments to Rules 482, 433, and 34b-1 would require funds using advertisements that provide fee or expense figures to include standardized fee and expense figures in such advertisements. The proposed amendments to Rule 482 would require that applicable fee and expense figures include the maximum sales load or any other nonrecurring fee, as well as total annual expenses without fee waiver or expense reimbursement. The methods of computing these fees and expenses would be based on those prescribed on the applicable registration statement form, and the required fee and expense figures would need to be presented at least as prominently as other fee and expense figures the fund might choose to include. The Proposed Rule also would require fee and expense information to be accurate as of the fund’s most recent prospectus, or, if the fund does not have an effective registration statement, as of its most recent annual report. Under the Proposed Rule, similar requirements for content, presentation and timeliness of fee and expense information would apply under Rule 34b-1 under the 1940 Act and Rule 433 under the 1933 Act.

The SEC noted in the Proposing Release that it is particularly concerned about funds marketing their products as “zero-expense” funds, even when investors in such funds must bear the costs of securities lending, wrap programs

²⁵ In the Proposing Release, the SEC stated that a fund may use any reasonable means of determining the significance of risks. As an example, the SEC stated that a fund could order its principal risks in a way that considers the likelihood and possible severity of any loss resulting from each risk.

and other costs that may not be apparent or otherwise disclosed in fund advertising materials. To address concerns that funds might be misleading investors by showing lower fees and expenses than the fund actually has (or showing no fees or expenses at all), the SEC is proposing amendments to Rule 156, to “provide that representations about the fees or expenses associated with an investment in [a] fund could be misleading because of statements or omissions involving a material fact, including situations where portrayals of such fees and expenses omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading.”

Key areas in which the SEC is seeking comment include: whether the revised advertising rules should apply to all funds, as proposed; whether it is appropriate to require funds, as proposed, to use computational methods prescribed in their prospectus forms; whether the scope of the required fee and expense information is appropriate; and whether the content requirements of the revised rules should apply differently based on the advertisement’s audience.

Assessment of Potential Liability and Litigation Concerns

Certain aspects of the Proposed Rule, if adopted, could pose liability and litigation risks to funds, their advisers and their boards of directors. These concerns may arise due to the subjective nature of defining “principal” and “non-principal” risks. For example, once a fund has conformed its disclosure to the requirements under the Proposed Rule (if adopted), shareholders of such fund that otherwise suffered the type of losses that would draw the interest of the plaintiffs’ bar could try to bring a claim against a fund and other parties if a risk that was not listed in the prospectus as a principal risk plausibly could be alleged to be the primary reason for the fund’s loss of value. Moreover, if a principal risk is determined by the fund to be less significant and the realization of that risk plausibly could be alleged to cause an investment in the fund to lose value, shareholders also might attempt to claim that such risk actually should have been determined to have greater importance and placed earlier in the disclosures of the fund’s risks.

In addition, although funds may choose not to deliver prospectuses to existing shareholders on an annual basis pursuant to the Proposed Rule, the Proposed Rule would not relieve funds of legal responsibilities and potential liability for misleading disclosure. The Proposing Release states that a fund that relies upon proposed Rule 498B “would be subject to the same prospectus and registration statement liability and anti-fraud provisions as if the fund had sent or given those prospectuses to existing shareholders.”²⁶ Those liability standards would apply to the summary and statutory prospectuses that are required by the Proposed Rule to appear online, along with any information incorporated by reference in such prospectuses.

Conforming Form and Rule Amendments

The Proposed Rule would revise Form N-1A and Rule 498 under the 1933 Act to remove legends required by, and references to, the requirements of Rule 30e-3 that were enacted in connection with the adoption of Rule 30e-3; the Rule 30e-3 requirements are scheduled to become effective on January 1, 2021. In addition, the Proposed Rule would make certain amendments to Form N-1A’s terminology to reflect modern usage and presentation, as well as to remove references to collect phone calls.

Also, since the Proposed Rule would move the current full fee table included under Item 3 of Form N-1A to Item 8, the Proposed Rule would update Schedule 14A and Form N-14 to ensure that cross-references to the fee table in Form N-1A continue to reference the same table.

²⁶ For example, such liability may arise under sections 11, 12(a)(2) and 17(a)(2) of the 1933 Act.

Further, the Proposed Rule would amend Form N-1A to allow funds to disclose for each officer and director the birth year and the year their service began, in lieu of their age and length of service. Similarly, the Proposed Rule permits funds to disclose the year a portfolio manager's service began instead of his or her length of service. The Proposing Release indicates that the SEC believes that these amendments would relieve funds of the burden of continually updating a previously disclosed age.

Compliance Period

Funds generally would have 18 months from the Proposed Rule's effective date (Effective Date) to comply with the requirements: Accordingly:

- Shareholder reports delivered to shareholders more than 18 months after the Effective Date would be required to comply with Item 27A of Form N-1A, as well as the amendments to Rule 30e-1 and Form N-CSR, no later than 18 months after the Effective Date.
- Funds relying on Rule 30e-3 would have 18 months after the Effective Date to comply with the proposed disclosure framework.
- Funds could rely on Rule 498B on the Effective Date to satisfy prospectus delivery requirements for existing shareholders, provided the fund is in compliance with all other final rule amendments.
- Funds would have 18 months after the Effective Date to modify prospectus disclosures to conform with the amendments to Form N-1A (including the fee summary, revised fee table and revised principal risk disclosure).
- Registered investment companies and BDCs would have 18 months after the Effective Date to modify advertisements to comply with the amendments to Rules 482, 433, and 34b-1. Compliance with the amendments to Rule 156 would be required immediately upon the Effective Date.

Comment Period

As noted above, the comment period for the Proposed Rule will expire 60 days following the publication of the Proposed Rule in the Federal Register (as of September 1, 2020, the Proposing Release had not been published in the Federal Register).

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