SEC Proposes Modernized Shareholder Reports and Other Disclosures

On August 5, 2020, the Securities and Exchange Commission ("SEC") proposed rule and form amendments that would modernize the disclosure framework for mutual funds and exchange-traded funds ("ETFs") to create a new layered disclosure approach (the "Proposals").[1] Comments on the Proposals are due 60 days after the Proposing Release is published in the Federal Register.

Overview

The modernized disclosure framework under the Proposals includes the following:

- Receipt of a concise annual and semi-annual shareholder report that would highlight key information of particular importance for retail investors to assess and monitor their fund investments. These shareholder reports would be the primary disclosure document for existing fund shareholders (new fund investors would continue to receive a fund prospectus upon their initial investment[2] in the fund). The Proposals also would replace the current expense example in shareholder reports with a more concise presentation.
- Certain information currently included in shareholder reports which may be of more interest to financial intermediaries and investors who desire more in-depth information would no longer be included in these reports, but would be available online and delivered free of charge upon request, and be filed semi-annually with the SEC on Form N-CSR.
- Amendments to open-end fund prospectus disclosures to provide more consistency and clarity with respect to fees, expenses and fund principal risks. This includes a new fee summary in a fund's summary prospectus (with the current fee table moving to the statutory prospectus) and a prohibition on including non-principal risks in a fund's prospectus.
- Amendments to investment company and business development company ("BDC") advertising rules.

In addition, the Proposals would rescind the ability for open-end funds and ETFs registered on Form N-1A to rely on Rule 30e-3 under the Investment Company Act of 1940, as amended (the "1940 Act"). If a fund chooses to rely on Rule 30e-3, beginning

[1] Release IC-33963, Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosures for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertising (August 5, 2020) at https://www.sec.gov/rules/proposed/2020/33-10814.pdf ("Proposing Release").

[2] While not entirely clear from the Proposing Release, it appears that a prospectus would no longer need to be sent for additional purchases in a fund as long as the investor meets the existing shareholder definition (defined below in "Proposed Rule 498B and Treatment of Annual Prospectus Updates").

as early as January 1, 2021, a shareholder who currently receives fund shareholder reports in the mail may begin receiving instead notices that a shareholder report is available at an identified website address, although the shareholder may request that they continue to receive paper reports. The Proposing Release notes that the staff of the SEC believes that the proposed disclosure approach included in the Proposals "represents a more-effective means of improving investors' ability to access and use fund information, and of reducing expenses associated with printing and mailing, than continuing to permit open-end funds to rely on [R]ule 30e-3".

Each of these Proposals is discussed below in more detail.

Annual Shareholder Reports

The Proposals would add new Item 27A to Form N-1A, which would specify the design and content of fund annual and semi-annual reports. Current provisions in Item 27 of Form N-1A that relate to fund annual and semi-annual reports would be rescinded.

Scope of Annual Report Disclosure

A separate annual report will be required for each series of a fund. While the content of a fund's annual report will be limited to the information specifically required or permitted by Item 27A to Form N-1A, the instructions will provide some flexibility so that a fund can tailor its presentation of information to match how the fund invests (including that in certain limited circumstances, additional information will be allowed to the extent needed to make the required disclosure items not misleading). A fund will also be allowed to omit an item if it is not applicable to that fund. Item 27A would not allow incorporation by reference of any information to an annual report for purposes of satisfying the annual report disclosure requirements.

Content of Proposed Annual Report

Below is a description of the information that would be required in a fund annual report under the Proposals. The design and content specifications required for funds' semi-annual reports will be similar.[3]

The following information would be required to be on the cover page or at the beginning of the annual report:

- **Fund/Class Name(s)**
- **Ticker Symbol(s)**
- **Principal U.S. Market(s) for ETFs**
- **Statement Identifying Document as "Annual Shareholder Report"**
- **Legend**

[3] The MDFP and Material Fund Changes sections would be optional for semi-annual reports. Additionally, the cover page statement and legend would be tailored for a semi-annual report rather than annual report.

- The following legend will be required:

  “This annual shareholder report contains important information about [the Fund] for the period of [beginning date] to [end date] [as well as certain changes to the Fund]. You can find additional information about the Fund at [Fund website address]. You can also request this information by contacting us at [toll-free telephone number and, as applicable, email address].”

  - The website address must be specific enough to lead shareholders directly to the information. Funds would also have discretion to include other ways to request or find information, such as a Quick Response Code or referring to mobile applications.

The following are the items to be required in the content of the annual report:

- **Expense Example**
  - The Proposals would have a simplified expense presentation in the annual report that would require a fund to provide expenses associated with a hypothetical $10,000 investment in the fund during the preceding reporting period. The proposed expense example would appear as follows:

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]	- $[X]	= $[X]		%

*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).

- If a fund incurred any extraordinary expenses during the reporting period, the fund would continue to be able to briefly describe in a footnote what the actual expenses would have been if those extraordinary expenses were not incurred.

- **Management's Discussion of Fund Performance**
    - The Proposals would generally keep the current requirements with respect to the management's discussion of fund performance ("MDFP") section of the annual report with a few changes.
        - The narrative discussion of the factors that materially affected the fund's performance during the most recently completed fiscal year would remain but the instructions would require that it be a brief summary of those factors. The instructions would also recommend the use of graphics, bullet point lists or tables.
        - The performance line graph currently required would remain but a fund would no longer be allowed to show periods longer than the most recent 10 fiscal years. The definition of an "appropriate broad-based securities market index" would be changed to be an index that represents the overall applicable domestic or international equity or debt markets[4]. Funds would be allowed to also include narrower indexes reflecting the market segments in which they invest and blended indexes would also be allowed.
        - The performance table would remain, however there would be three additional pieces of information required: (1) the average annual returns of an appropriate broad-based securities market index; (2) the fund's average annual total returns without sales charges (in addition to the current disclosure that must show returns that reflect any sales charges); and (3) average annual total returns for each class that the report covers. In addition, the Proposals would (i) permit funds to include returns for one or more other relevant indexes, including a more narrowly based index covering the market sectors in which the fund invests and (ii) replace the required statement accompanying the performance line graph and performance table with a simplified statement to the effect that the fund's past performance is not a good predictor of how the fund will perform in the future.

[4] This change in definition would also apply to the performance table in fund prospectuses.

        - For funds that have a stable distribution policy but were not able to maintain that stated level of distribution, that fact must be disclosed.

- **Fund Statistics**
    - Funds would be required to disclose certain fund statistics, including:
        - Net assets
        - Total number of portfolio holdings
        - Portfolio turnover rates
    - Funds would be permitted to include additional statistics that they believe would help shareholders better understanding the fund's activities and operation during the reporting period (such as tracking error, maturity, duration, average credit quality or yield). However, if these additional statistics are included, there are a number of additional instructions with which the fund must comply:
        - if a fund provides a statistic that is disclosed elsewhere on Form N-1A, the fund must follow any associated instructions describing the calculation method for the relevant statistic;
        - the instructions would encourage a fund to use tables, bullet lists, or other graphics or text features to disclose the statistics;
        - if a statistic is included in, or could be derived from, a fund's financial statements or financial highlights, the instructions would require a fund to use or derive such statistic from the fund's most recent financial statements or financial highlights;
        - the instructions would allow a fund to describe briefly the significance or limitations of any disclosed statistics in a parenthetical, footnote, or similar presentation; and
        - if a fund chooses to include additional statistics, the instructions would require additional statistics to be reasonably related to the fund's investment strategy.

- **Graphical Representation of Holdings**
    - The current requirements for the graphical representation of holdings that funds currently include in their annual reports will be retained with two changes.
        - First, while funds currently have the flexibility to base the tabular or graphic presentation of holdings on the fund's net asset value or total investments, the Proposals would also allow holdings to be shown based on the fund's net exposure or total exposure to particular categories of investments. This change could be particularly useful for funds that execute their strategy primarily through derivatives or for long/short funds.
        - Second, currently if a fund depicts portfolio holdings based on credit quality, that fund must describe how the credit quality of its holdings was determined and, if credit ratings are used, the fund must explain why it selected a particular credit rating. The

staff of the SEC has noted that there is a wide range of practices as to the level of detail provided for these descriptions and under the Proposals they would need to be brief and concise.

- **Material Fund Changes**
  - Under the Proposals, a new section would be added to annual reports to describe material changes in an enumerated list of items (as well as any other material change that the fund chooses to disclose) that has occurred since the beginning of the reporting period or that the fund plans to make in connection with its annual prospectus update. This item is intended to highlight for fund shareholders the most relevant information they typically receive through the annual prospectus updates and it will be tailored for the needs of existing shareholders. Material changes in any of the following items would be required to be disclosed even if they have previously been disclosed through a prospectus supplement:
    - Change in the fund name
    - Change in the fund's investment objectives or goals
    - An increase in the fund's ongoing annual fees, transaction fees or maximum account fee
    - A change in the fund's principal investment strategies
    - A change in the fund's principal risks
    - A change in the fund's investment adviser(s), including sub-adviser(s)
    - A change in the fund's portfolio managers
  - The following legend will be required to accompany the disclosure of these material fund changes:

    "This is a summary of certain changes [and planned changes] to the Fund since [date]. For more complete information, you may review the Fund's next prospectus, which we expect to be available by [date] at [website address] or upon request at [toll-free telephone number and, as applicable, email address]."

- **Changes in and Disagreements with Accountants**
  - Current shareholder report disclosures relating to changes in and disagreements with accountants would be moved to Form N-CSR. However, when a fund has a material disagreement with an accountant that has resigned or been dismissed, the fund would have to include in its annual report:
    - A statement of whether the former accountant resigned, declined to stand for re-election, or was dismissed and the date thereof

        - A brief, plain English description of disagreement(s) with the former accountant during the fund's two most recent fiscal years and any subsequent interim period that the fund discloses on Form N-CSR.

- **Statement Regarding Liquidity Risk Management Program**
    - The Proposals would replace the current requirement for disclosure of the operation of a fund's liquidity risk management program with a brief summary of:
        - The key factors or market events that materially affected the fund's liquidity risk during the reporting period
        - The key features of the fund's liquidity risk management program
        - The effectiveness of the fund's liquidity risk management program over the past year
    - The instructions to this item would require that the fund tailor its disclosure to the fund rather than rely on generic, standard disclosures recite all the elements of Rule 22e-4.
    - This item would be included in the annual or semi-annual report following the period when the fund performed its annual review of the liquidity risk management program.

- **Availability of Additional Information**
    - Funds would be required to include a statement in the annual report that informs investors about additional information that is available on the fund's website. Specifically, the statement would have to include plain English references, as applicable, to the fund's prospectus, financial information, holdings and proxy voting information. If the shareholder report is available on a fund's website or is otherwise provided electronically, the fund must provide a means of immediately accessing this additional information, such as through a hyperlink.

- **Householding Disclosure (optional)**
    - The Proposals would retain the provision that permits funds to explain how to revoke consent to the householding of the annual report.

New Form N-CSR and Website Availability Requirements

The Proposals would amend Form N-CSR and Rule 30e-1 under the 1940 Act. Certain information currently included in shareholder reports would instead be filed on Form N-CSR. Funds would have to make available on their website the information that would now be filed on Form N-CSR and would be required to provide such to shareholders free of charge upon request. The information being moved from shareholder reports to Form N-CSR include:

- Financial statements for funds, including schedule of portfolio holdings;

- Financial highlights;
- Renumeration paid to directors, officers and others;
- Changes in and disagreements with accountants;
- Matters submitted for shareholder vote;
- Statement regarding the basis for the board's approval of investment advisory agreements;
- Complete portfolio holdings as of the close of the most recent first and third fiscal quarters (this item would not be required for Form N-CSR as it is filed on Form N-PORT but it would have to be available on the fund's website).

Under the Proposals, the required information would have to be on the fund's website within 70 days after the end of the fiscal period until 70 days after the end of the next fiscal period, at which time it would be updated.

Disclosure Item Proposed to be Removed from Shareholder Report and Not Filed on Form N-CSR

The Proposals would result in the management information table being removed from a fund's annual report and from Form N-CSR. The Proposing Release notes that this information is also included in a fund's SAI and that it is not necessary to include it in multiple locations. The Proposing Release also notes that the staff of the SEC believes that this information is less pertinent to retail shareholders' understanding of the operations and performance of a fund and therefore shouldn't be included in the concise shareholder reports being proposed.

Proposed Rule 498B and Treatment of Annual Prospectus Updates

Scope of Proposed Rule 498B

Proposed Rule 498B under the Securities Act of 1933, as amended (the "Securities Act") would continue to require that a fund investor receive a prospectus along with their initial investment in a fund and the prospectus would continue being the principal selling document for potential investors. However, "existing shareholders"[5] would no longer be required to receive updated prospectuses; rather, they would be kept informed with respect to their funds through shareholder reports. Funds could however choose to not rely on Rule 498B and continue to deliver annual prospectus updates to existing shareholders.

[5] Proposed Rule 498B would define "existing shareholder" as a shareholder to whom a Summary Prospectus or Statutory Prospectus has been previously sent or given in order to satisfy any obligation under section 5(b)(2) of the Securities Act to have a Statutory Prospectus precede or accompany the carrying or delivery of fund shares and that has either continuously held fund shares or, if the fund is a money market fund as defined in Rule 2a-7 of the 1940 Act has continuously maintained or been a beneficial owner of a fund account, since that Summary Prospectus or Statutory Prospectus has been sent or given. This definition excludes investors that hold the fund through a separate account funding a variable annuity contract offered on Form N-4 or a variable life insurance contract offered on Form N-6.

Conditions to Rely on Proposed Rule 498B

In order to rely on Proposed Rule 498B, a fund would need to comply with the following conditions:

- Website Availability of Certain Fund Documents. Certain materials would have to be publicly available, free of charge, at the website address specified on the cover page or at the beginning of the fund's annual and semi-annual reports. Such materials would include: the current summary[6] and statutory prospectus, the SAI, and most recent annual and semi-annual shareholder reports (collectively, the "Rule 498B documents"). Proposed Rule 498B also includes conditions regarding the formats in which the Rule 498B documents are presented on the website; the ability to move within and between certain documents; and retention requirements.

  Additionally, Proposed Rule 498B would include a safe harbor in the event that a Rule 498B document was temporarily unavailable at the specified website as long as the following conditions are met:
  - the fund has reasonable procedures in place to ensure that the specified materials are available in the manner required by Proposed Rule 498B; and
  - the fund takes prompt action to ensure that the specified documents become available in the manner required by Proposed Rule 498B, as soon as practicable following the earlier of the time at which it knows or reasonably should have known that the documents are not available in the manner required.

- Notice of Materials Changes. Since existing shareholders would no longer receive an updated prospectus, if there is a material change with respect to certain topics, a fund relying on Proposed Rule 498B would have to send or give existing shareholders notice of the change. The proposed items that would require disclosure of any material change are the same as those which would be required to be disclosed in the shareholder report and are discussed above under "Annual Shareholder Reports – Content of Proposed Annual Reports – Material Fund Changes". Proposed Rule 498B does not prescribe the form that such notice must take, but if it is not in the format of a prospectus supplement, then such notice must also be filed with the SEC along with the prospectus supplement.

Other Requirements

[6] Under Proposed Rule 498B, a fund would be required to have a summary prospectus (although a fund could still decide to utilize a statutory prospectus for purposes of satisfying the prospectus delivery obligations under the Securities Act. In this regard, the Proposing Release notes that while it is currently optional for a fund to utilize a summary prospectus, it is estimated that 93% of funds use a summary prospectus.

If requested, a fund or financial intermediary must deliver the Rule 498B documents to a shareholder.

Proposed Amendments to Fund Prospectus Disclosure Requirements

Improved Prospectus Fee Disclosures

The Proposals include amendments to simplify the presentation of fees and expenses in the prospectus and would replace the current fee table in the summary section of the statutory prospectus with a "fee summary". The current fee table[7] would be moved to the statutory prospectus where it can be used by investors who want additional details about the fund's fees.

Below is a description of the proposed fee summary:

Your Investment Costs

These are the amounts that you could pay to buy, hold, and sell shares of the Fund. These costs reduce the value of your investment. You may pay other fees, such as brokerage commissions and other fees to financial intermediaries, which are not reflected in the table and example below.

Transaction Fees (fees paid each time you buy or sell)[8]	
Purchase Charge (as a percentage of your investment)[9]	[Up to] % (Or [up to] $___, if you invest $10,000)
Exit Charge (as a percentage of ______)[10]	[Up to] % (Or [up to] $___, if you invest $10,000)
Maximum Purchase Charge Imposed on Reinvested Dividends [and Other Distributions] (as a percentage of ______)	[Up to] _________% (Or [up to] $___ , if you invest $10,000)
Early Exit Fee (as a percentage of amount redeemed)[11]	[Up to] _________% (Or [up to] ____, if you invest $10,000)
Exchange Fee	[Up to] __________ % (Or [up to] ____, if you invest $10,000)

[7] Certain line item headers in the fee table will be renamed to what is shown below in the fee summary.

[8] Any line item in the transaction fees section that is not applicable to a fund would be omitted.

[9] Purchase Charge is the sales charge imposed on purchase.

[10] Exit Charge includes the total deferred sales charge payable upon redemption.

[11] Early Exit Fee is a fee charged for any redemption of the fund's shares.

Maximum Account Fee[12]	[Up to] _________% (Or [up to] ____, if you invest $10,000)
Ongoing Annual Fees (estimated expenses you pay each year as a percentage of the value of your investment)	
Ongoing Annual Fees	__________% (Or $___, if you invest $10,000)
Ongoing Annual Fees with Temporary Discount	(Or $___, if you invest $10,000)

*Discount expected to end on [date].

Example

This example may help you understand the costs of investing in the Fund. The example assumes that: (1) you invest $10,000 in the Fund; (2) your investment has a 5% return each year; and (3) the Fund's operating expenses are based on the table above.

	1 year	10 years
Although your actual costs may be higher or lower, based on these assumptions, your costs would be:	$___	$___
If you sold your shares at the end of the relevant period, your costs would be:	$___	$___

The example does not reflect purchase changes on reinvested dividends [and other distributions]. If these purchase charges were included, your costs would be higher.

Under the Proposals, the fee summary would not be permitted to include footnotes and other extraneous disclosure; however, an exception would be allowed if omitting a footnote would cause the disclosure to be materially misleading (for example if the fund charges a "fulcrum fee").

Additionally, the Proposals would permit funds that make limited investments (10% or less of their total assets) in other funds to disclose Acquired Fund Fees and Expenses ("AFFE") in a footnote to the fee table in the statutory prospectus instead of being reflected as a line item as is required currently.

The Proposals also would require portfolio turnover to be disclosed both in the fee summary and in the full fee table and would change the required disclosure to the following:

[12] Account fees that may be charged to a typical investor in the fund.

Proposed Portfolio Turnover Disclosure
Portfolio turnover measures how often a fund buys and sells its investments. A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes. The Fund's annual portfolio turnover rate is ____%.

Improved Prospectus Risk Disclosures

The Proposals would revise the current instructions in Form N-1A to prohibit funds from disclosing non-principal risks in the prospectus in order to streamline risk disclosure in the prospectus but such non-principal risks could continue to be disclosed in the SAI. With respect to the summary prospectus, the Proposals include several new requirements relating to principal risk disclosure, including:

- The term "briefly" will be inserted before the current requirement that the fund summarize its principal risks in order to emphasize that the summary prospectus risk disclosure should be concise with more detail being provided in the statutory prospectus.
- Funds would be required to list principal risks in the order of importance, with those most significant risks appearing first. The instructions would indicate that a fund may use any reasonable means of determining the significance of risks.
- Instructions will require, where appropriate, for a fund to tailor its risk disclosures as to how the fund operates rather than rely on generic risk disclosures.

The Proposals also add new instructions to Form N-1A relating to a fund's principal risk disclosures in the statutory prospectus, which would therefore also relate to the summary prospectus:

- In determining whether a risk is a principal risk, the fund should consider both whether the risk would place more than 10% of the fund's assets at risk ("10% standard") and whether it is reasonably likely that a risk will meet this 10% standard in the future.
- With respect fund of funds, risks should only be included if they are principal risks of the acquiring fund, and a principal risk of the acquired fund should not be included unless it is also a principal risk of the acquiring fund.
- With respect to "go anywhere" funds, if the 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.

Prospectuses and SAIs Transmitted under Rule 30e-1(d)

The Proposals would rescind Rule 30e-1(d), which permits a fund to transmit a copy of its prospectus or SAI in place of its shareholder report, if it includes all of the information that would otherwise be required to be contained in the shareholder report. The Proposing Release notes that the staff of the SEC does not believe many funds rely on this Rule and that continuing to allow it would not be consistent with the goals of the Proposals.

Investment Company and Business Development Company Advertising Rule Amendments

The Proposals would amend the SEC's investment company advertising rules (which include Rules 482, 156 and 433 under the Securities Act and Rule 34b-1 under the 1940 Act) to promote transparent and balanced presentations of fees and expenses in investment company advertisements. These amendments would apply to all investment companies, including mutual funds, ETFs, registered closed-end funds and BDCs. Specifically, the Proposals would require that presentations of investment company fees and expenses in advertisements and sales literature are consistent with relevant prospectus fee table presentations and are reasonably current. Also addressed in the Proposals are representations of fund fees and expenses that could be materially misleading.