

SEC Proposes to Transform and Modernize Mutual Fund and ETF Disclosure Framework

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On August 5, 2020, the Securities and Exchange Commission (SEC) unanimously approved the release of a proposal (the proposing release) to adopt new Rule 498B under the Securities Act of 1933, as amended, and other corresponding proposed rule amendments and related changes to Forms N-1A and N-CSR. The proposal is primarily designed to (i) streamline the content of shareholder reports, (ii) change certain prospectus and advertising disclosures and (iii) change prospectus and shareholder report delivery requirements of open-end investment companies registered on Form N-1A, that are known as mutual funds and exchange-traded funds (ETFs).

The proposal is largely the result of feedback the SEC received from its 2018 survey of retail investors' experience with fund disclosure. The results of that survey generally showed that retail investors prefer concise, layered and more understandable disclosure and are overwhelmed by the volume and frequency of the fund information that they currently receive.

The proposed changes would substantially modernize the disclosures to open-end fund shareholders by applying a multi-layered framework that directly delivers important information to investors in significantly revised and shortened shareholder reports for each series of a fund complex, while making more detailed information available online, delivered free of charge on request. In the proposing release, the SEC explained that the proposed changes will help ensure that disclosures in shareholder reports are more concise, visually engaging and accessible for retail investors to make informed investment decisions and monitor their investments. There are also proposed changes to prospectus and fund advertising disclosures. Key provisions of the proposed rule and form amendments are summarized below.

Modernized Shareholder Reports

The primary focus of the proposal is to substantially modernize annual and semi-annual shareholder reports so that they become the primary source of information and updates for mutual fund and ETF shareholders. The proposing release contains a useful chart comparing the current required content

of annual and semiannual reports to the proposed new disclosure framework and is available [here](#). These changes are summarized below.

Importantly, some of the substantive information currently required in shareholder reports would remain, but the reports would be significantly shorter, formatted differently and the information would appear in a prescribed order. For example, information such as fund expenses, performance, graphical list of holdings and, for the annual report, the discussion of the matters that materially affected fund performance would remain, but funds would be encouraged to display this information through graphics, tables, and bullets in order to highlight the information that the SEC considers critical for retail investors to focus on in a more concise, visually engaging and understandable form. A fund would be required to prepare a separate shareholder report for each of its series. As a result, shareholders would receive reports that address only the series in which they are invested.

Additionally, the annual report would now include a new section regarding material fund changes that have occurred since the beginning of the reporting period and that the fund expects to make in its upcoming annual prospectus update. The SEC believes that this would help to ensure that material changes are readily apparent to shareholders and achieve its goal of making the shareholder report the primary source of information and updates to existing mutual fund and ETF shareholders. Under the proposal, the fund would be required to briefly describe a material change with respect to any of the following items: the fund's name; investment objective or goals; increase in fund ongoing annual fees, transaction fees or maximum account fee; principal investment strategies; principal risks; investment adviser or sub-adviser; portfolio manager; and any other material changes. Material changes would be disclosed to shareholders in each annual report and also in timely notifications to shareholders as they occur through a prospectus sticker, a notice required by the proposed rule, or the annual prospectus update (which would no longer be mailed to existing shareholders annually, as more fully described below).

Although the proposal requires that the management discussion of fund performance information be retained in the annual report, this information would only briefly summarize the key factors that materially affected the fund's performance. The proposed rule would eliminate the fund's president's letter, interviews with portfolio managers, general market commentary and other similar information that some funds normally include with the annual report. This additional information may be sent separately to shareholders in the same transmission as the annual report, provided that the annual report is given greater prominence.

Further, the proposal would, among other things, change the shareholder expense presentation in the annual and semi-annual report by requiring a fund to provide the expenses associated with a \$10,000 investment, rather than a \$1,000 investment; include expense information as a percentage of a shareholder's investment, in addition to as a dollar amount; and eliminate the hypothetical return information for the period. Instead, funds would provide only expense information based on actual returns, with certain presentation changes, as applicable, to show investors the actual costs associated with investing in the fund. ETFs would also disclose the ending value of the account based on market value return.

The proposal also addresses the use of market indices in presenting comparative performance information. The proposal would clarify the definition of a "broad-based index" as an index that represents the overall applicable securities market. Funds are also encouraged to include additional narrower indices that better reflect the market segments in which the fund invests. A fund that invests in both equities and bonds would also be permitted to continue utilizing a blended index as a supplement to the appropriate broad-based index. This clarification applies to the index presentation

in both shareholder reports as well as prospectuses.

Certain information, such as financial statements (including the schedule of investments, financial highlights table, fees paid to directors and officers and board considerations on approval of advisory contracts), would be removed from shareholder reports and contained instead in reports on Form N-CSR and N-CSRS, which would be available online or delivered free of charge upon request. The proposing release maintains that this information is less relevant for retail investors, but may still be of interest to financial and other professionals.

The SEC has released a hypothetical streamlined annual report based on the proposal that is available [here](#).

Changes to Prospectus and Shareholder Report Delivery

The proposal would eliminate the delivery of annual prospectus updates, unless requested, but require delivery of the streamlined shareholder reports.

Prospectus Delivery Changes

Under the present rules, investors receive a current prospectus in connection with their initial purchase of fund shares and thereafter generally receive an updated prospectus each year. The proposal would substantially change this practice. Under the proposal, new investors would still receive a fund prospectus with their initial investment, but mutual funds and ETFs would no longer deliver annual prospectus updates to existing shareholders. Instead, shareholders would be kept informed of any material changes through the newly streamlined shareholder reports and through timely notifications regarding material fund changes as they occur throughout the year. The current prospectus would be available online, delivered free of charge upon request.

Proposed Amendments to Rule 30e-3 to Exclude Open-End Funds

Currently, Rule 30e-3 under the Investment Company Act of 1940, as amended, will allow all registered investment companies to make shareholder reports available online as early as January 1, 2021, by providing a notice of their availability, instead of transmitting the reports directly to shareholders, unless requested. The proposal would narrow the scope of Rule 30e-3 to exclude mutual funds and ETFs registered on Form N-1A, so that they would be required to continue to deliver these reports to shareholders by mail or if the shareholder requests, electronically. The SEC stated in the proposing release that this change allows for a more accessible and effective means to ensure all such open-end fund shareholders receive the benefit of the new disclosure framework.

Prospectus Disclosure Updates

Additionally, the proposal would change certain prospectus disclosures required by Form N-1A, including altering the disclosure of fund fees and risks. Specifically, the current fee table in the summary section of a fund's prospectus would be replaced with a less detailed fee summary with more plain-English descriptions of the types of fees and a simplified version of the expense example. Among other proposed changes, funds would be permitted to disclose "acquired fund fees and expenses" associated with their investments in other funds in a footnote to the fee table, instead of as a fee table line item if such fees exceed 0.01% of average net assets. In addition, the full fee table would be modified and moved to the statutory prospectus for investors seeking additional information regarding fees and expenses. This is an extension of the SEC's layered disclosure framework

applicable to prospectuses, where key information is disclosed in a summary fashion, with access to more detailed information elsewhere.

With regard to prospectus risk disclosure, the proposal would permit funds to disclose only principal risks in the fund's prospectus. In addition, funds would be required to disclose principal risks in order of importance, fortifying the [SEC staff guidance issued in 2019](#) that merely recommended such ordering, instead of the commonly used alphabetical approach. The proposed amendments to Form N-1A also encourage funds to tailor risk disclosures by specifying how the fund operates rather than including generic, standardized risk disclosure.

Fund Advertisement Fee and Expense Information

Finally, the proposal would require advertisements that include fund fees and expenses to present that information consistent with the relevant prospectus fee table presentations and be reasonably current. The proposal also includes new factors to consider whether representations in advertisements about fees and expenses could be deemed misleading. The proposed advertising rule amendments would affect all registered investment companies, including closed-end funds and business development companies.

Compliance Period and Compliance Date

The proposing release includes numerous questions for public comment on the proposed amendments. The public comment period will remain open 60 days after publication in the Federal Register.

The SEC proposed an 18-month transition period after the effective date of the amendments for funds to come into compliance with the rule and form amendments. However, a fund could rely on new Rule 498B to eliminate annual prospectus delivery to existing shareholders beginning on the effective date, provided that the fund is also in compliance with the amendments relating to the shareholder reports, Form N-CSR and reliance on Rule 30e-1.

Conclusion

If adopted as proposed, the amendments will radically change and reduce the content of mutual fund and ETF shareholder reports; however, funds will be required to deliver the streamlined shareholder reports to shareholders semi-annually, instead of making them available online as anticipated starting as early as 2021. Funds would also no longer deliver annual prospectus updates to existing shareholders, unless requested. As noted above, after the amendments are effective, funds would not have to wait until the end of the 18-month transition period to implement these changes, but could do so earlier.

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