

SEC Finalizes Major Changes to Shareholder Report Disclosure Scheme and Investment Company Advertisement Rules

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On 26 October 2022, the Securities and Exchange Commission (SEC) adopted final rule and form amendments (the Final Rules) representing major reforms to: 1) shareholder reports for open-end mutual funds and exchange-traded funds (ETFs) registered on Form N-1A; and 2) advertisement rules for all registered investment companies, including closed-end funds and business development companies (BDCs). The Final Rules fundamentally transform shareholder reports, turning them into condensed documents that may be as short as three pages in length.

Significantly, the Final Rules also exclude open-end mutual funds and ETFs from the scope of Rule 30e-3, thereby again mandating paper delivery of shareholder reports and barring such funds from satisfying shareholder report transmission requirements by making reports available exclusively online and providing a notice of online availability to shareholders. In addition, the Final Rules amend the definition of “broad-based securities market index” in Form N-1A as discussed further herein.

While many aspects of the Final Rules closely follow elements of the SEC’s originally proposed changes from August 2020 (the Proposed Rules), further refinements clarify or expand the applicability of certain requirements. In addition, several major changes in the Proposed Rules relating to prospectus disclosure and delivery obligations, such as proposed Rule 498B, creating a new prospectus fee summary table, and establishing a 10% standard for principal risk disclosure, were not adopted in the Final Rules.

The amendments will become effective 60 days after publication in the Federal Register. The compliance date for the Final Rules will be 18 months after publication in the Federal Register, except that investment companies will be required to comply with amendments addressing representations of fees and expenses that could be materially misleading as of the effective date.

While this alert provides a high-level summary of the key aspects of the Final Rules, K&L Gates will be publishing additional alerts and hosting webinars in the coming weeks which will cover individual elements of the Final Rules in more depth.

TAILORED SHAREHOLDER REPORTS (OPEN-END MUTUAL FUNDS AND ETFS ONLY)

The Final Rules add new Item 27A to Form N-1A which significantly changes the content and structure of shareholder reports. Funds must provide “concise and visually engaging” reports focusing on information the SEC believes is particularly important for retail shareholders to assess and monitor their fund investments on an ongoing basis, namely fund expenses, performance, and portfolio holdings. The new form of shareholder report will be condensed into as few as three pages, removing “less retail-focused” information that will instead be available in filings made on Form N-CSR, posted on a fund’s website, and in paper form upon request by a shareholder. The SEC believes that this division of the delivery method based upon the level of detail of the corresponding information will help establish a “layered” disclosure framework with respect to shareholder reports.

As adopted, every fund will be required to produce an individual shareholder report separate from other series of the same registrant. In addition, in a significant change from the Proposed Rules, a separate shareholder report is required for each class of a multi-class fund. Shareholders will only receive reports applicable to the particular share class in which they invest.

Shareholder report information must appear in the order the requirements appear in Item 27A, required items may not be addressed by incorporation by reference, and if the shareholder report references other information that is available online, the report must include a link or some other means of immediately accessing that information. Funds will also be required to tag the information in shareholder reports using Inline XBRL.

Expenses

Shareholder reports will be required to include one expense table showing certain enumerated “costs” associated with a hypothetical US\$10,000 investment, both as a percent of a shareholder’s investment in the fund (i.e., the expense ratio), and as a dollar amount. Item 27A also outlines various instructions for clarifying footnotes relating to extraordinary expenses, master/feeder fund structures, and short reporting periods. In a change from the Proposed Rules, the expense presentation under the Final Rules will not require information about the fund’s total return during the period.

Performance and Fund Characteristics

The Final Rules retain the current requirement for fund annual reports to include a narrative discussion of factors that materially affected a fund’s performance during the most recent fiscal year. In order to prevent overly long narrative discussions, Item 27A restricts the amount of discretionary additional information permitted under “Management’s Discussion of Fund Performance,” and states that a fund must “briefly summarize” the “key” factors that materially affected the fund’s performance during the last fiscal year, including relevant market conditions and the investment strategies and techniques utilized. The Final Rules encourage the use of graphics or text features such as bullet lists, tables, or charts to show how the fund performed.

Funds will continue to be required to include a line graph and average annual total return table in

their annual shareholder report. However, in light of the new requirement that each class of a multi-class fund must have a separate shareholder report, these performance disclosures will only include the specific class covered in the individual annual shareholder report.

The SEC has also revised the definition of “appropriate broad-based securities market index” to require funds to compare their returns to an index that represents the overall applicable domestic or international equity or debt markets in both shareholder reports and prospectuses. More narrowly based indexes that reflect market sectors, industries, geographic locations, asset classes, or strategies, including commonly used “growth” and “value” indexes, can be used only as secondary indexes.

Item 27A also requires funds to disclose, as of the end of a reporting period: net assets, total number of portfolio holdings, portfolio turnover rate, and total advisory fees paid by the fund during the reporting period. However, the complete list of fund portfolio holdings and other financial statements, financial highlights, and associated information will be removed from the shareholder report. This information will instead be available in filings made on Form N-CSR, posted on a fund’s website, and in paper form upon request by a shareholder.

Material Changes

Shareholder reports will be required to disclose certain enumerated material changes that have occurred since the beginning of the reporting period impacting:

- Name;
- Investment objective or goals;
- Annual operating expenses, shareholder fees, or maximum account fees, whether or not they result in increases in fees;
- Principal investment strategies;
- Principal risks; and
- Investment adviser(s) or subadviser(s).

In a change from the Proposed Rules, the Final Rules do not require disclosure of changes the fund plans to make in connection with its next annual prospectus update. However, if a prospectus supplement covering any of the above items was sent to shareholders during the reporting period, disclosure of the change would still be required in the annual report. If a shareholder report includes a discussion of material fund changes, the cover page must include a prominent statement, in bold-face type, explaining that the report describes certain changes to the fund that occurred during the reporting period.

The shareholder report may include any additional changes that the fund believes are material information for shareholders.

Item 27A will not require semi-annual shareholder reports to contain items covered under “Management’s Discussion of Fund Performance” or disclosure of material changes. Funds may

voluntarily include these items in semi-annual shareholder reports as long as the disclosure complies with the requirements of Item 27A.

Changes to Rules 30e-3 and 30e-1(d)

The Final Rules exclude open-end funds and ETFs from the scope of Rule 30e-3 and, accordingly, such funds will no longer be permitted to satisfy shareholder report transmission requirements by making shareholder reports available online. Instead, these funds once again will be required to mail shareholder reports to all shareholders, unless a shareholder affirmatively opts in to electronic delivery.

The Final Rules also rescind Rule 30e-1(d), which currently permits a fund to transmit a copy of its prospectus or statement of additional information in place of its shareholder report, if it includes all of the information required to be contained in the shareholder report. The SEC stated in the adopting release that it believes allowing reliance on Rule 30e-1(d) would be inconsistent with the layered disclosure framework outlined by the Final Rules.

INVESTMENT COMPANY ADVERTISING RULES (ALL REGISTERED INVESTMENT COMPANIES AND BDCS)

The SEC also amended the investment company advertising rules set forth in Rules 482, 156, and 433 under the Securities Act of 1933 (the Securities Act) and Rule 34b-1 under the Investment Company Act of 1940. The amendments require investment company advertisements to include certain standardized figures and provide reasonably current information, reflecting the SEC's desire to promote transparent and balanced presentations of fees and expenses, and are applicable to open-end mutual funds, ETFs, registered closed-end funds, and BDCs.

The Final Rules amend Rule 482 to require that investment company advertisements providing fee and expense figures include: 1) the maximum amount of any sales load or any other nonrecurring fee; and 2) the total annual expenses without any fee waiver or expense reimbursement arrangement. An advertisement could also provide fund fee and expenses net of certain fee waivers and expense reimbursement arrangement amounts, provided that they are presented at least as prominently as any other fee and expense figures included in the advertisement and include the expected termination date of the arrangement. Fee and expense information will also be required to be at least as current as the date of the fund's most recent prospectus or, if the fund no longer has an effective Securities Act registration statement, as of its most recent annual report. However, an advertisement would not need to include the required fee and expense figures if it only included general, narrative information about fee and expense considerations and did not include any numerical fee or expense amounts.

These same fee and expense content, presentation, and timeliness requirements are applied to Rules 34b-1 and 433 by the Final Rules. Amendments to Rule 34b-1 provide that any sales literature would be deemed to have omitted a fact necessary to make the statements therein not materially misleading unless the sales literature meets these requirements. The amendments to Rule 433 apply these requirements to post-filing free writing prospectuses used by registered closed-end funds or business development companies that include fee and expense information.

The Final Rules amend Rule 156 to provide that representations about fees or expenses in investment company sales literature may be deemed materially misleading if:

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- It advertises low investment fees and expenses, based solely on a fund's prospectus fee table, and does not reflect other categories of costs that may be supplementing or replacing a more traditional management fee (e.g., intermediary costs, securities lending costs);
 - It presents one component of a fund's total operating expenses, such as the management fee, without stating that there are other costs associated with a fund investment or providing the total operating expense figure; or
 - It uses lengthy or technical disclaimers regarding fees and expenses in small font sizes.

Whether information about a fund's fees and expenses is materially misleading depends on an evaluation of the context in which it is made, and the SEC noted specifically in the adopting release that a fund could "determine not to include certain information regarding fees and charges from sales literature if, based on an evaluation of the context of the fees and charges presentation, the omission of that information would not be materially misleading."

What's Not Here?

The Final Rules focus on fund shareholder reports and advertisements, while largely leaving registration statements untouched.

The Proposed Rules would have rewritten fee disclosures in open-end mutual fund and ETF prospectuses to move the current fee table out of the summary prospectus and replace it with a fee summary that would have disclosed the "bottom line" costs of an investment using new terminology. The Proposed Rules also contemplated changes to the presentation of acquired fund fees and expenses and the creation of a 10% of assets standard for determining principal risks in a prospectus.

While Chairman Gensler has instructed the SEC staff to continue reviewing these items, it is likely any further action in these areas would differ from the Proposed Rules, and this process may include additional proposals subject to industry review and comment before any final changes are adopted.

The SEC also chose not to adopt proposed Rule 498B, which would have permitted funds to satisfy prospectus delivery obligations to existing shareholders by transmitting only the fund's shareholder reports and notices of any material changes. Accordingly, open-end mutual funds and ETFs that deliver an updated prospectus to existing shareholders annually to avoid the need to track each shareholder's additional purchase activity throughout the year will need to continue this practice.

While the Final Rules adopt a "layering" approach to the disclosures required in shareholder reports designed to meet the different informational needs of different investors, the SEC chose not to bifurcate fund disclosures with shareholder reports as the primary communication with existing investors and prospectuses as the primary communication with new investors as originally proposed.

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