

SEC ADOPTS AMENDMENTS TO FUND SHAREHOLDER REPORTS AND FEE- AND EXPENSE-RELATED DISCLOSURE IN FUND ADVERTISING

On October 26, 2022, the U.S. Securities and Exchange Commission (the "SEC") unanimously voted to adopt Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements (the "Adopting Release") which is designed to provide mutual fund and exchange-traded fund ("ETF" or "ETFs") investors with clear and concise information in shareholder reports. According to the Adopting Release, the new requirements will require layered disclosure in shareholder reports, with a summary highlighting important information, such as expenses, performance and portfolio holdings, with more detailed disclosures to be provided either online or in physical form, as requested by shareholders, and filed with the SEC on a semi-annual basis on Form N-CSR. The Adopting Release also excludes mutual funds and ETFs from Rule 30e-3 under the Investment Company Act of 1940, as amended (the "Investment Company Act"), requiring paper delivery of shareholder reports in order to satisfy delivery requirements.

In addition, the SEC decided to amend certain fund advertising rules to require that investment company advertisements and sales materials include fees and expenses in a manner consistent with the applicable prospectus.

This Client Alert provides details regarding the Adopting Release, including how it will impact the information mutual funds and

ETFs must provide to current and prospective shareholders in reports and advertising materials.

The rule amendments were adopted largely as proposed, however, the proposed new Rule 498B¹ and the proposed amendments to funds' prospectus fee and risk disclosure were not adopted. The SEC remarked that they will continue to consider these proposals.

AMENDMENTS TO FUND SHAREHOLDER REPORTS

Shareholder Reports Tailored to the Needs of Retail Shareholders

The Adopting Release adopted final annual report disclosure rules that apply only to shareholder reports for investment companies required to file on Form N-1A. The amendments do not extend to other investment companies such as closed-end funds, unit investment trusts, or open-end managed investment companies not required to file on Form N-1A (i.e., issuers of variable annuity contracts registered on Form N-3).

- **Series Scope:** Currently, fund registrants that are set up as series trusts may prepare a single shareholder report covering multiple series in a trust, a presentation which the SEC believes contributes to the length and complexity of shareholder reports. The Adopting Release requires funds to prepare separate annual reports for each series of a trust, thus allowing a shareholder to only receive the annual report(s) that addresses the series in which that shareholder is invested.
- **Class Scope:** The Adopting Release also permits a shareholder report for a multi-class fund to cover a single class of shares in which a shareholder receiving the report has invested. Commissioner Peirce noted this change will not allow fund investors to see cheaper class options available to them, cutting against the intention of providing an improved shareholder experience.²
- **Content of Shareholder Reports:** The Adopting Release adds new Item 27A of Form N-1A which amends the information contained in and presentation of shareholder reports³ to provide information most relevant to shareholders, including fund expenses, performance, statistics, a graphical representation of holdings and material⁴ fund changes.

¹ 17 CFR230.498B under the Securities Act of 1933, as amended (the "Securities Act"). The proposed Rule 498B, if adopted, would have included changes to prospectus delivery requirements and certain fee and risk disclosure, including allowing funds that invest no more than 10% of their total assets in acquired fund fees and expenses ("AFFE") to omit the AFFE line item from their fee and expenses table.

² See Hester M. Peirce, Commissioner, U.S. Sec. & Exch. Comm'n, One Good Step, More to Go: Statement on Final Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements (October 26, 2022), <https://www.sec.gov/news/statement/peirce-statement-shareholder-reports-102622>

³ See Instruction 3 to Item 27A(a) of amended Form N-1A which prohibits information be contained in annual or semi-annual shareholder reports other than the disclosure that Item 27A and its instructions require or permit.

⁴ Item 27A will require funds to describe material changes to the fund in the annual report, including changes to the fund's name, investment objective or goals, annual operating expenses, shareholder fees, maximum account fee including termination or introduction of expense reimbursement or fee waiver arrangements, principal investment strategies, principal risks or investment advisers or sub-advisers.

- **Layered Disclosure:** The layered disclosure approach requires that certain information be available directly in the report and additional detail, which may be more valuable to only certain investors or investment professionals, be available online at a website specified in the report and delivered to shareholders in paper or electronically upon request. In the Adopting Release, the SEC stated that the layered disclosure would improve the usefulness of shareholder reports by taking into account investors' varying preferences for information.
- **Definition of "Broad-Based Securities Market Index":** All funds are required to compare their performance to an appropriate broad-based securities market index for purposes of both fund annual reports and prospectuses. A "broad-based" index is defined as an index that represents the overall applicable domestic or international equity or debt markets, as appropriate. Commenters on the rule proposal expressed concern with the requirement to compare a fund's performance to an index that is both broad-based and appropriate. Commissioner Peirce echoed this concern, noting the requirement may conflict in cases where a fund's investments are focused on a particular segment of the market.
- **Electronic Annual Reports:** In an effort to make electronic versions of funds' shareholder reports more user-friendly and interactive, the Adopting Release provides:
 - ordering and presentation requirements for reports that appear on a website or are otherwise provided electronically;
 - instructions offering additional flexibility for funds to add tools and features to reports that appear on a website or are otherwise provided electronically; and
 - linking requirements or other means for immediately accessing information referenced in reports available online.

Availability of Additional Information on Form N-CSR and Online

Pursuant to the Adopting Release, certain information will be excluded from the tailored shareholder reports, such as: financial statements; financial highlights; and remuneration paid to fund directors, officers, and certain affiliates. Pursuant to the new requirements, funds will be required to include the information excluded in the summary shareholder reports on Form N-CSR, to post it on the fund's website and make it available upon request in paper form. The Adopting Release also requires funds to tag shareholder report contents in a structured, machine-readable data language (Inline XBRL).

Amendments to the Scope of Rule 30e-3 to Exclude Open-End Funds

Open-end funds and ETFs will no longer be permitted to rely on Rule 30e-3 after the effective date of the amendments discussed herein. These funds will be

required to mail shareholder reports to all shareholders unless a shareholder requests electronic delivery. The Adopting Release states that the SEC believes the delivery requirement will improve investors' ability to access and use relevant fund information while "preserving much of the expected cost savings to funds and investors that the fund would experience by choosing to rely on Rule 30e-3" due to the shorter, streamlined form that shareholder reports will take. Commissioner Peirce questioned the elimination of electronic delivery and noted that paper delivery requirements belong in the SEC archives.

AMENDMENTS TO ADVERTISING RULES

The Adopting Release includes amendments to Rules 156, 433 and 482 under the Securities Act, and Rule 34b-1 under the Investment Company Act. The amendments will apply generally to any investment company (or company that elects to be regulated under the Investment Company Act), including mutual funds, ETFs, registered closed-end funds and business development companies ("BDCs"). According to the SEC, the amendments to the advertising rules are intended to promote more transparent and balanced statements about a fund's investment costs. They also noted that fund advertisements are often designed for prospective investors, which amplifies the importance of transparency. The amendments will require that investment company advertisements that contain fee or expense figures include certain standardized fee and expense information and comply with prominence and timeliness requirements. The Adopting Release notes that the SEC declined to include proposed changes to AFEE disclosure in fund advertisements because it is still considering the adoption of proposed Rule 498B, including the proposed changes to the AFEE disclosure contained therein.

Presentation of Fee and Expense Figures

The amendments to Rules 433 and 482 under the Securities Act and Rule 34b-1 under the Investment Company Act address the presentation of fee and expense information in investment company advertisements. The Adopting Release requires that investment company advertisements that present 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 (collectively, the "required fee and expense figures") based on the methods of computation for a prospectus that the fund's Investment Company Act or Securities Act registration statement form prescribes for those figures. If an investment company does not present total annual expense figures in its prospectus or the advertisement in question includes only narrative information about fee and expense considerations, the advertisement would not need to include the required fee and expense figures.

The Adopting Release also provides that the required fee and expense figures must be presented at least as prominently as any other fee and expense figures included in investment company advertisements. For example, fund advertisements may include fees and expenses net of a fee waiver or expense reimbursement arrangement, however, the net figures may not be displayed more prominently than the required fee and expense figures. Additionally, if advertisements include a fund's total annual expenses net of fee waiver or expense reimbursement amounts, the expected termination date of such arrangements must also be included.

Finally, the required fee and expense figures included in investment company advertisements must be provided as of the date of the fund's most recent prospectus or, if the fund no longer has an effective registration statement under the Securities Act, as of the most recent annual report.

Materially Misleading Statements about Fees and Expenses in Sales Literature

The final amendments to Rule 156 of the Securities Act are, according to the SEC, designed to protect investors by preventing investment companies from providing materially misleading representations about applicable fees and expenses. The amendments provide factors an investment company should consider in determining whether representations about fees and expenses associated with an investment in the fund could be materially misleading. Specifically, the investment company should consider whether the portrayal of fees omits explanations, qualifications, limitations or other statements necessary or appropriate to make the portrayals not misleading.

COMPLIANCE DATE

The rules and amendments contained in the Adopting Release will be effective sixty days after the date of publication in the federal register. There will be a transition period of eighteen months after the effective date of the final rules, however there is no transition period provided for compliance with the amendments to Rule 156 of the Securities Act.

CONTACTS

Vadim Avdeychik
Partner

T +1 212 878 3055
E vadim.avdeychik
@cliffordchance.com

Jeff Berman
Partner

T +1 212 878 3460
E jeffrey.berman
@cliffordchance.com

Cliff Cone
Partner

T +1 212 878 3180
E clifford.cone
@cliffordchance.com

Jefferey LeMaster
Partner

T + 1 212 878 3206
E jefferey.lemaster
@cliffordchance.com

Eric Bernstein
Associate

T +1 212 878 3411
E eric.bernstein
@cliffordchance.com

Andrew Nelson
Associate

T +1 212 878 8284
E andrew.nelson
@cliffordchance.com

Emily Picard
Associate

T +1 212 878 3495
E emily.picard
@cliffordchance.com

Michelle Mount
Law Clerk

T +1 212 878 8091
E michelle.mount
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

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