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SEC Adopts Modernized Framework for Open-End Fund Shareholder Reports and Disclosures

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On October 26, the U.S. Securities and Exchange Commission (SEC) adopted amendments to the existing disclosure framework for open-end funds (e.g., mutual funds and exchange-traded funds) intended to represent a comprehensive reworking of the current requirements. The SEC under current Chairman Gary Gensler and its Division of Investment Management have prioritized improved quality of fund disclosures and the promotion of transparent and balanced fees and expenses presentations. The adopted requirements summarized below are substantially similar as were proposed in August 2020[1], but contain a few key differences as noted.

Shareholder Reports (Annual and Semi-annual):

- Under the final rule, shareholder reports must be concise, visually engaging, and designed to highlight, among other information, fund expenses, performance, and portfolio holdings.
- Under the final rule, funds organized as single registrants with several series must prepare separate annual reports for each series. As a result, a fund shareholder will receive an annual report that addresses only the series in which that shareholder is invested. Similarly, and in a change from the proposal, under the final rule, a fund must prepare a shareholder report that covers only the single class of a multiple-class fund in which the shareholder is invested.
- The final rule contains several amendments to the scope of annual report disclosure and the contents, format, and presentation of the annual report. A fund will no longer be permitted to incorporate by reference any information into its annual report.
- Funds will be required to tag the information in their shareholder reports using Inline XBRL structured data language, which is consistent with the SEC's recent initiatives requiring the use of Inline XBRL to improve the quality and usability of data for investors.

Availability of Additional Information on Form N-CSR and Online:

- Under the final rule, in-depth information that may be more relevant to financial professionals, such as the schedule of investments and other financial statement elements, must be made available online and delivered free of charge in paper or electronically upon request. Such information must also be filed on a semi-annual basis with the SEC on Form N-CSR.

Elimination of "Notice and Access" Delivery Option Under Rule 30e-3 for Open-End Funds:

- Rule 30e-3 under the Investment Company Act of 1940, as amended (1940 Act),^[2] has been amended to exclude open-end funds so that shareholders will directly receive annual and semi-annual reports, either in paper or electronically (if the shareholder has so elected).

Advertising Rule Amendments:

- The final rule requires that presentations of investment company fees and expenses in advertisements and sales literature be reasonably current and consistent with prospectus requirements. The amendments affect all registered investment company and BDC advertisements that include fee and expense figures and are therefore not limited to open-end fund advertisements.

Proposed Rules That Were Not Adopted:

Proposed Rule 498B:

- In a departure from the proposal, the SEC did not adopt proposed Rule 498B, which would have provided an alternative approach to keep investors informed about updates to their funds that occur year after year in lieu of providing an annual prospectus updated to existing fund investors.
- The SEC noted that most commenters expressed concern about the proposed rule, including concern about the proposed requirement to deliver notices of material fund changes and the increased possibility of shareholder litigation.

Proposed Amendments to Funds' Prospectus Fee Disclosure

- In a departure from the proposal, the SEC did not adopt proposed amendments to funds' prospectus disclosure requirements that would have, among other things, replaced the existing fee table in the summary section of funds' statutory prospectus with a simplified fee summary and moved the full, existing fee table to the statutory prospectus.
- The SEC noted that several commenters opposed the proposed prospectus disclosures due to concerns centered on investor confusion and an increased burden for funds.
- The final rule also omitted proposed changes to the disclosure of acquired fund fee and expenses (AFFE), which shows an investing fund's pro rata share of the fees and expenses of any underlying funds in which it invests (including BDCs and private funds). Under the proposal, a fund that invests less than 10% of the value of its total fund assets in other funds could disclose AFFE in a footnote to the fee table, instead of including AFFE as a fee table line item.
- The SEC noted that some commenters expressed concern that the approach would decrease transparency of funds' AFFE, while some commenters requested that the proposal be significantly broadened, including suggestions to carve out BDCs from the definition of "acquired fund" altogether.

Proposed Amendments to Funds' Prospectus Risk Disclosure:

- In another departure from the proposal, the final rule omitted proposed amendments to funds' prospectus disclosure requirements that would have added specificity to the existing requirement that funds must disclose principal risks in their prospectuses. The proposed amendments provided that a "principal" risk is one that would place more than 10% of the fund's assets at risk and is reasonably likely to occur in the future. The

proposal also would have required that funds' description of risks be brief and organized in order of importance.

- The SEC noted that most commenters generally opposed the proposals, expressing concern about the perceived difficulty and subjectivity of determining which risks currently or in the future will place more than 10% of the fund's assets at risk, and the potential of increased liability in connection with such determination.

The final rule amendments will become effective 60 days after publication in the *Federal Register*. The SEC is providing an 18-month transition period after the effective date of the final rule amendments to allow open-end funds time to adjust their shareholder reports and comply with the Rule 30e-3 changes. The 18-month transition period also applies to the amended advertising rules.

The SEC's final rule is available at <https://www.sec.gov/rules/final/2022/33-11125.pdf>.

[1] The modernized framework was proposed on August 5, 2020, as described in our *Investment Management Update* titled, "SEC Proposes to Improve the Retail Investor Experience Through Modernized Fund Shareholder Reports and Disclosures"

(<https://www.troutman.com/insights/sec-improve-the-retail-investor-experience-through-better-fund-shareholder-reports-and-disclosures.html>).

[2] Rule 30e-3 under the 1940 Act allows funds to use a "notice and access" method for the delivery of shareholder reports.

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