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SEC MODERNIZES CONTENT AND DELIVERY REQUIREMENTS
FOR MUTUAL FUND SHAREHOLDER REPORTS

This article discusses the SEC's newly adopted requirements for mutual fund shareholder reports. It outlines the context in which the new requirements were adopted and provides a detailed description of what has changed, both with respect to the reports themselves and the requirements for how these reports will be delivered. The article concludes with a brief discussion of the implications for funds and their service providers and suggests potential next steps.

By Lance C. Dial, Amy McDonald, and Jonathan Nowakowski *

Mutual fund annual shareholder reports do not typically top the must-read list of even the most avid mutual fund investor. No doubt this is due, at least in part, to the fact that these reports, in their current incarnation, are long (the average report weighing in at 134 pages, with some exceeding 1,000 pages), dense, and challenging to navigate — at least according to the investors who responded to the 2018 Securities and Exchange Commission (“SEC”) request for comments on the retail fund investor experience.

Faced with such feedback, the SEC has taken action. On October 26, 2022, the SEC issued revised requirements for mutual fund shareholder reports (the “New Rules”). These New Rules will streamline the information included in shareholder reports, extend the SEC’s use of “layered disclosure” by requiring concise shareholder report disclosure, and move some information out of shareholder reports entirely. In sum, the SEC expects that shareholder reports issued under these New Rules will be significantly shorter, weighing in at three or four pages; clearer, owing to the use of

enhanced visuals and required plain-English disclosure; and easier to navigate, by tailoring the reports to the specific funds and share classes relevant to the investor. While it remains unlikely that even these revised shareholder reports will find places on bestseller lists, these changes represent the most significant revisions to these documents since the adoption of Form N-CSR back in 2003.

In addition to the modifications to content and presentation of shareholder reports, the New Rules include some other important revisions. First, the New Rules eliminate the ability for mutual funds to rely on SEC Rule 30e-3 for shareholder reports, which allowed for electronic delivery of reports via a notice-and-access model. In addition, the New Rules include a new requirement that funds compare their performance to an “appropriate broad-based index,” and place new limitations on how fees and expenses can be presented in fund sales literature.

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The New Rules officially go into effect on July 24, 2024, following an 18-month transition period after their effective date (January 24, 2023), and apply to shareholder reports for investment companies registered on Form N-1A (i.e., substantially all mutual funds, including exchange-traded funds and money market funds).

I. BACKGROUND

The quality and accessibility of mutual fund disclosure has long been a concern of the SEC. In 2006, the SEC hosted an “Interactive Data Roundtable,” with the very first session focusing on the quality of mutual fund disclosures.¹ These discussions ultimately led to the 2009 adoption of the new summary prospectus, which introduced the “layered disclosure” approach in which key information is provided initially, followed by more detailed information later in the document or elsewhere.²

The SEC’s attention to quality of disclosure continued in 2018 with a public request for comment on the “Fund Retail Investor Experience” (the “Investor Experience RFC”), which asked retail investors to provide feedback on mutual fund disclosures.³ In addition to requesting generalized feedback, the SEC also included a standardized feedback flyer that included 14 specific questions concerning various aspects of fund disclosure. The feedback from the Investor Experience RFC validated that retail investors preferred layered disclosure and felt overwhelmed by the amount of fund information they received.

Informed by this feedback, the SEC sought to extend the layered disclosure approach to shareholder reports

and, in 2020, proposed amendments⁴ that would ultimately become the New Rules.⁵

II. REVISIONS TO STRUCTURE, FORMAT, AND PRESENTATION OF SHAREHOLDER REPORTS

A. Tailored Shareholder Reports

Currently, shareholder reports for mutual funds are often bundled together with other funds in a fund family and cover multiple share classes. This bundling can result in lengthy and complex reports that can be overwhelming to shareholders. In an effort to make shareholder reports easier to navigate and understand, the New Rules require that shareholder reports be prepared as separate reports for each fund and for each class of fund. As a result, shareholders will receive a shareholder report tailored to their specific investments, making the disclosure more accessible and relevant. That said, the SEC recognized that investors may find certain information relating to other funds and classes valuable, so, consistent with the layered disclosure approach, the New Rules also require that funds post all fund documents on their websites in a structured, machine-readable data format.

For large fund families that currently bundle multiple funds and classes into the same shareholder report, this new requirement represents a significant change that could result in the organization being required to maintain dozens or even hundreds of new individual shareholder reports. The SEC did not indicate that this separation would be an outsized burden because, as it noted, funds, intermediaries, and service providers already have processes in place to transmit series-specific regulatory materials such as summary

¹ Transcript of U.S. Securities and Exchange Commission Interactive Data Roundtable, at 69 (June 12, 2006), <http://www.sec.gov/spotlight/xbrl/xbrlofficialtranscript0606.pdf>.

² Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, SEC Rel. No. IC-28584 (Jan. 13, 2009).

³ Request for Comment on Fund Retail Investor Experience and Disclosure, SEC Rel. No. IC-33113 (June 5, 2018).

⁴ Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, SEC Rel. No. IC-33963 (Aug. 5, 2020).

⁵ Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, SEC Rel. No. IC-34731 (Oct. 26, 2022) (the “Adopting Release”).

prospectuses.⁶ The SEC reasoned that fund sponsors could utilize the processes developed in connection with the creation and delivery of those materials in order to address the multiplication of shareholder reports.

B. Shareholder Report Content Requirements

In addition to ensuring that the shareholder reports are tailored to the specific funds and classes in which shareholders are invested, the New Rules also include certain content requirements aimed to ensure that shareholder reports remain concise and easy to digest. While the New Rules do not include a specific page or word limit, the SEC noted its expectation that the revised fund- and class-specific shareholder report would cover three or four pages.⁷

The first key limitation in the New Rules is a specific prohibition on including any information other than that which is specifically required or permitted in the shareholder report. In addition, the information provided in annual shareholder reports is required to appear in the order set forth in Form N-1A, and funds are not permitted to incorporate information into the shareholder report by reference. These requirements are intended to ensure that shareholder reports include all key information within the report itself, focus on the information most pertinent to shareholders, and promote consistency of information presented to shareholders in shareholder reports across funds.

The New Rules provide certain exceptions to the above requirements. First, if the required disclosures, without more information, would be misleading in light of a fund's particular circumstances, a fund may include brief additional information necessary to make the required disclosures not misleading. In addition, if a required disclosure is inapplicable, the fund may omit the disclosure or modify required language as long as the modified language contains comparable information. Funds may include additional information alongside the report, provided that the shareholder report is given greater prominence than the other materials (other than prospectuses, notices of online proxy materials, and other shareholder reports).

C. Format and Presentation Requirements and Electronic Shareholder Reports

The New Rules also include specific requirements regarding how shareholder reports are formatted and

presented. Specifically, the New Rules require that shareholder reports be drafted using “plain English” principles for their organization, wording, and design. In addition to the “plain English” requirement, the New Rules also include instructions that encourage funds to use investor-friendly formatting such as charts, graphs, tables, bulleted lists, graphics, and question-and-answer formats. Shareholder reports under the New Rules must also meet the legibility requirement applicable to printed documents, and all required information must be presented “in a format that promotes effective communication.”

The New Rules include provisions applicable to shareholder reports that are accessed online in order to promote the use of interactive, user-friendly electronic design features with respect to these reports. For example, the New Rules note that an annual shareholder report appearing on a website must “organize the information in a manner that gives each item similar prominence as that provided by the order prescribed [for paper shareholder reports].”

D. Inline XBRL Requirements

Also recognizing the utility of electronic disclosures, the New Rules include requirements intended to ensure that the data in shareholder reports is readily accessible by automated tools. To that end, the New Rules require funds to tag disclosures in new streamlined shareholder reports in Inline XBRL, a structured, machine-readable language.

This requirement is an extension of efforts on the part of the SEC to implement structured data requirements for fund disclosures dating to 2009.⁸ The requirements in the New Rules apply only to the information included in the streamlined shareholder reports and not to all the information filed in Form N-CSR. The SEC believes that Inline XBRL tagging will help investors, as well as other market participants, understand funds' performance and operations.

While this requirement may improve the machine-readability of shareholder report disclosure, it will also create new operational considerations and costs, as funds determine how to best implement the Inline XBRL requirements.

⁶ Adopting Release at 251.

⁷ Adopting Release at 121, n.368.

⁸ Interactive Data to Improve Financial Reporting, SEC Rel. No. 33-9002 (Jan. 30, 2009); Interactive Data for Mutual Fund Risk/Return Summary, SEC Rel. No. IC-28617 (Feb. 11, 2009) [74 FR 7748] (Feb. 19, 2009).

III. THE STREAMLINED SHAREHOLDER REPORT

A. *Implementation of Layered Disclosure*

As noted above, and consistent with the approach taken with respect to mutual fund prospectus disclosure, the New Rules implement a layered disclosure approach for mutual fund shareholder reports, offering easy access to key and summary information while ensuring that other, more detailed information is available through other filings. As implemented with respect to shareholder reports, certain information is moved out of the shareholder report but retained in the fund's filing with the SEC on Form N-CSR, while other information is removed entirely. In addition, funds are required to note that certain additional information is made available on the fund's website.

1. Information Moved to Form N-CSR and Made Available Online

Shareholder reports are filed with the SEC as part of Form N-CSR along with other information, such as the information relating to the fund's adoption of a code of ethics and the board's appointment of an audit committee financial expert. While shareholder reports are required to be delivered to shareholders, a fund's filing on Form N-CSR is not.⁹ As a result, Form N-CSR provides an ideal location for the more detailed disclosure under a layered disclosure approach.

To that end, under the New Rules, the following information is moved from the shareholder report to Form N-CSR and is therefore not required to be delivered to shareholders as part of the shareholder report:

- financial statements, including the schedule of investments;
- financial highlights, but certain data points (e.g., expense ratio, net assets, portfolio turnover rate) are retained in the shareholder report;
- disclosure of remuneration paid to directors, officers, and others;
- disclosure of changes in and disagreements with accountants, with a concise summary retained in the annual report;

⁹ Form N-CSR is used by funds to file reports (and other information) with the SEC not later than 10 days after the transmission to shareholder reports. Form N-CSR General Instruction A.

- a listing of matters submitted to fund shareholders for a vote; and
- a statement regarding the basis for the board's approval of the investment advisory contract.

In addition to being filed on Form N-CSR, the New Rules require funds to make the above information available on their websites for investors who are interested in obtaining the additional details.

2. Removed Information

Consistent with the goal of streamlining disclosures, the New Rules also remove two currently required disclosure items from shareholder reports altogether. The management information table and the statement regarding a fund's liquidity risk management program ("LRMP") will not be required in streamlined shareholder reports or in Form N-CSR going forward.

The SEC noted that, with respect to the management information table, identical information is available in a fund's statement of additional information, so inclusion in the shareholder report would be duplicative. With respect to the statement regarding the fund's LRMP, the SEC reasoned that the disclosure was unnecessary in a shareholder report because it does not pertain to a retail shareholder's understanding of the operations and performance of a fund, and it is therefore not the type of focused information that the new streamlined shareholder report is designed to include. The SEC also acknowledges that other LRMP information is still required in other regulatory documents, including Form N-PORT, Form N-CEN, and fund registration statements.

3. Availability of Additional Information on Website

As a further implementation of layered disclosure, the New Rules require shareholder reports to include, near the end of the report, a reference to availability of certain additional website information, such as the fund's prospectus, financial information, holdings, and proxy voting information. In addition, if the shareholder report appears on a fund's website or is otherwise provided electronically, the fund must provide a means of immediately accessing this additional information (such as a hyperlink or QR code).

B. *Cover Page or Beginning of Shareholder Report*

The shareholder report must have a cover page (or, if presented electronically, a beginning) that meets certain requirements. Specifically, funds must provide the name

of the fund, the class to which the annual report relates, the exchange ticker symbol of the fund's shares or class, the principal US market(s) on which the fund's shares are traded (if an exchange-traded fund), a statement identifying the document as either an "annual shareholder report" or a "semiannual report," and two specific legends regarding the content of the report and how to access additional information. In addition, the cover page may, but is not required to, include a description of material changes.

C. Expense Example

The New Rules include provisions to simplify the disclosure of fund expenses. Specifically, shareholder reports must include a simplified \$10,000 expense table example with expenses presented as both a dollar amount and a percentage of a shareholder's investment in the fund. This table replaces the current two-table expense example and preamble that reflect expenses associated with a \$1,000 investment. The table must also reference expenses from "the past year" or "the past six months" for annual and semiannual reports, respectively.

The table is not required to include information about the fund's total return during the period or a footnote explanation that the table does not reflect transaction costs associated with purchasing or selling shares. If a fund incurred any extraordinary expenses during the reporting period, a footnote may briefly describe what the expenses would have been without the extraordinary expenses. Finally, if a shareholder report covers less than a full reporting period, the fund must include a footnote to explain that expenses would be higher for a full reporting period.

D. Management's Discussion of Fund Performance

Shareholder reports are required to include a Management's Discussion of Fund Performance ("MDFP"), which is where fund management addresses the fund's performance over the prior period. The New Rules retain this section but include requirements intended to make it more concise and clarify that money market funds are permitted, but not required, to include an MDFP. Specifically, the narrative discussion of factors that materially impacted performance is required to be brief and summarize only key factors, and the New Rules specifically instruct against lengthy, generic, or overly broad discussions of these factors. The New Rules also encourage the use of graphics and text features to ease readability. This focus on language may require fund service providers to supply a more tailored

discussion of key factors and may require some investment in drafting and publishing existing processes to ensure that the narratives are specifically targeted to the reporting fund.

E. Fund Statistics

In keeping with the goal to provide shareholders with critical key data and characteristics, the New Rules require shareholder reports to include certain general fund statistics, including net assets, total number of portfolio holdings, portfolio turnover rate (except for money market funds), and a new statistic related to the total advisory fees paid during the reporting period. Shareholder reports must also include, if applicable, a description of distribution policies when a fund is unable to meet a specified level of distribution within a stable distribution policy, or when a fund has distributions that result in a return of capital.

In one of the few areas in which shareholder reports may include additional information beyond that which is required, funds are permitted to disclose, after the required statistics, additional statistics that would help shareholders better understand a fund's activities and operations as long as they are reasonably related to the fund's investment strategy. Any statistics that are included in or pulled from financial statements must be from the most recent statements. Funds are still required to disclose one or more tables, charts, or graphs showing the fund's portfolio holdings by category, but they must now use a format and categories that are "reasonably designed to depict clearly the types of investments made by the fund, given its investment objectives."

Funds may now show holdings based on *total* exposure to certain categories of investments, as well as a list of the fund's 10 largest portfolio holdings and the respective net asset value, total investment, or total exposure of each holding.

F. Material Fund Changes

The New Rules also adopt changes designed to provide more effective disclosure of material changes to funds occurring during the reporting period. Noting that, under current rules, shareholders receive notice of material changes from prospectus updates that may or may not specifically identify what has changed, the SEC believes that creating a consolidated discussion of material changes in the shareholder reports would increase the salience of the disclosure.

The New Rules provide a list of specific items that must be included as material changes, specifically:

- a change to the fund’s name;
- changes to the fund’s investment objectives or goals;
- changes in the fund’s annual operating expenses, shareholder fees, or maximum account fee (even if such changes do not result in increased fees paid by shareholders);¹⁰
- changes to the fund’s principal investment strategies;
- changes to the principal risks of investing in the fund; and
- changes to the fund’s investment advisers or sub-advisers.

The SEC noted its preference for a list-based approach (as opposed to a more general principles-based approach) to provide certainty to funds on what should be disclosed and to promote consistency of disclosure of these events across funds. That said, the New Rules will permit funds to include other material fund changes as well as to changes regarding the listed items. In addition to the enumerated list and additional material changes, the New Rules also permit, but do not require, disclosure of material planned changes.

IV. RULE 30E-3 AND ELECTRONIC DELIVERY

The New Rules extend beyond the content and structure of shareholder reports and also address how shareholder reports are to be delivered. One of the more controversial aspects of the New Rules is the revision that narrows the scope of Rule 30e-3 to exclude investment companies registered on Form N-1A, i.e., mutual funds. Rule 30e-3, adopted in 2018 and effective as of January 1, 2021, allowed mutual funds to satisfy shareholder report transmission requirements by making these reports and other materials available online and providing a notice of that availability instead of directly mailing the report to shareholders.¹¹

Given the changes made to shareholder reports under the New Rules, the SEC believes that mailing the new streamlined shareholder reports to shareholders is the best way to provide investors with the disclosure they need to understand a fund’s operations and performance. The SEC also noted that, given the anticipated brevity of the streamlined shareholder reports, funds should still be

able to retain the cost savings that Rule 30e-3 was intended to provide.¹² Rule 30e-3 required paper delivery of a notice informing shareholders that an electronic shareholder report was available; under the New Rules, the more streamlined shareholder report should be able to fit on only a few pages, perhaps even a “trifold self-mailer.” The SEC reasons that the transmission of such a short document should not be significantly more expensive than the transmission of the Rule 30e-3 notice. In addition, shareholders may still request delivery of their shareholder reports, which would also serve to limit the impact of the change on costs.

While the SEC’s estimations that direct expenses may not be increased as a result of the rescission of Rule 30e-3, funds and their service providers have expended considerable resources developing processes for a rule that was effectively rescinded for open-end funds only one year after its effective date (January 1, 2021). These efforts will need to be renewed in connection with operational implementation of new and revised processes relating to these new delivery requirements.

V. OTHER CHANGES

A. Broad-Based Securities Market Index

The New Rules also address certain issues relating to the content of shareholder reports or the information contained therein. Perhaps most significantly, the New Rules include new requirements with respect to funds’ presentation of their performance as compared to an index. Specifically, the New Rules include a new definition of the “appropriate broad-based securities market index” that funds must use in shareholder report performance tables. This definition also applies to the presentation of performance in a fund’s prospectus performance tables.

This new definition is a significant change from current fund practice with respect to performance comparison tables. The new definition makes clear that an index used for performance comparison must track the overall applicable domestic or international equity, or debt securities market. The New Rules specify that indices that are more narrowly tailored to specific

¹⁰ Adopting Release at 106.

¹¹ Optional Internet Availability of Investment Company Shareholder Reports, SEC Rel. No. IC-33115 (June 5, 2018).

¹² The SEC noted that funds may be able to transmit the streamlined shareholder reports as a trifold mailing, which will only incrementally increase the printing and mailing costs of a Rule 30e-3 notice. The SEC also noted one commenter’s estimation that a concise shareholder report would cost only \$0.01 more than a Rule 30e-3 notice. Adopting Release at 246.

sectors or industries, or that include characteristics such as “growth,” “value,” “ESG,” or “small- or mid-cap,” are sufficiently broad-based to be used as a primary comparison; however, such indices may be included as secondary indices.

The New Rules include several pages of guidance regarding how funds should approach the selection of an appropriate index for performance-comparison purposes. For instance, the New Rules note that a fund may select an appropriate broad-based securities market index that includes components that do not directly overlap with the fund’s investments as long as the index’s components share similar economic characteristics (e.g., volatility) so as to provide an appropriate point of comparison.

Funds and their advisers will need to carefully assess whether changes are required to their selection of indices for performance comparison, as many funds are benchmarked against indices that would likely be impermissible under the New Rules.

B. Investment Company Advertisement Amendments

The New Rules also include provisions that extend beyond shareholder reports. In an effort to promote more consistent and transparent presentations of investment costs in advertisements, the New Rules also include amendments to investment company advertising rules.¹³ The New Rules will apply to fund advertisements and sales literature that include fee and expense figures. Specifically, the New Rules require investment company advertisements and sales literature to provide, at least as prominently as other fee and expense figures, (1) the maximum amount of any sales load or any other nonrecurring fees and (2) the total annual expenses without any fee waiver or expense-reimbursement arrangement, in each case based on the computation methods prescribed for such figures in the fund’s registration statement form. For advertisements and sales literature that include total annual expenses presented net of a fee waiver or expense-reimbursement arrangement, the New Rules will also require disclosure of the expected termination date of the arrangement.

The required fee and expense information will also have to be reasonably current.¹⁴

The SEC also noted that funds are increasingly marketed based on costs, and that advertisements and sales literature may present fees and expenses in a way that misleads investors (e.g., advertising a “zero-fee fund” without also noting that investors will pay other expenses). To address that concern, the New Rules specifically note that representation of fund fees and expenses could be misleading if a pertinent explanation, qualification, limitation, or other statement is omitted.

VI. IMPLICATIONS

The New Rules are intended to increase the utility of shareholder reports for end investors without significantly increasing their cost of delivery to funds. By streamlining the shareholder reports to require only information that can potentially fit on a few pages, shareholders may find these reports more useful. That said, the New Rules most certainly will require fund service providers to review and assess their existing shareholder report processes, especially those funds that currently bundle shareholder reports together. For example, fund fulfillment and investor relations teams will need to design processes to address customer questions in response to the substantial changes in information they receive. In addition, the new Inline XBRL requirement will necessitate meaningful investments and technology and may impact filing timeframes.

Finally, the new requirements with respect to performance comparisons against a “broad-based securities market index” will require funds to review their existing performance comparisons, and many funds will presumably be required to make changes to their represented indices.

In the end, while the New Rules are not likely to result in shareholder reports that break new ground on the literary front, shareholders should expect to receive shareholder reports that are both more tailored to their investments and more useful to their evaluations of their investments. ■

¹³ Rules 156, 433, and 482 under the Securities Act of 1933 (“1933 Act”) and Rule 34b-1 under the Investment Company Act of 1940.

¹⁴ Specifically, fee and expense information will need to be as of the date of the fund’s most recent prospectus or, if the fund no longer has an effective registration statement under the 1933 Act (e.g., a registered closed-end fund), as of the fund’s most recent annual report. The New Rules also permit funds to provide more current fee and expense information, if available.