SEC PROPOSES MAJOR CHANGES TO PROSPECTUS AND SHAREHOLDER REPORT DISCLOSURE SCHEME

Date: 19 August 2020

U.S. Asset Management and Investment Funds Alert

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I. INTRODUCTION AND SUMMARY

The Securities and Exchange Commission (SEC) has proposed a bold new approach to shareholder and investor communications by investment companies registered on Form N-1A under the Investment Company Act of 1940 (1940 Act). Dalia Blass, the director of the Division of Investment Management—the SEC office responsible for regulating investment companies—declared in a recent speech that it is time to treat "physical and electronic delivery as equals rather than measuring delivery against a paper standard."

The SEC is proposing the fourth major reform of investment company prospectus rules since 1933. In 1954, Section 24 of the 1940 Act was amended to permit mutual funds and unit investment trusts to offer securities under an "evergreen prospectus" that could be updated annually.[1] Until then, an open-end fund making a continuous public offering was required to file a new registration statement each year. In 1982, the SEC permitted all registered investment companies to move certain disclosures to a statement of additional information (SAI).[2] In 2009, the SEC adopted the summary prospectus rule.[3]

This alert summarizes the proposed changes in prospectus, SAI, shareholder report and advertising disclosure requirements (Proposed Rule), including the following:

Prospectuses and SAIs

- Fund prospectuses and SAIs would continue to be updated annually, with prospectus supplements filed with the SEC to incorporate material changes.
- Funds would no longer have to send existing shareholders updated prospectuses every year or at the time of purchase of additional shares.
- New investors would continue to receive a prospectus when they first purchase shares of a mutual fund.
- Existing shareholders would continue to receive notices of material changes, unless the changes are disclosed in a shareholder report.
- Information in mutual fund prospectuses would be substantially reduced, and the standardized formats applicable to certain types of information would be updated.
- The current prospectus fee table would be moved out of the summary prospectus and replaced by a new prospectus fee summary.

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- Existing shareholders could request delivery of paper or electronic copies of prospectuses and SAIs at no cost.

Shareholder Reports

- Shareholder reports would become the primary disclosure document for existing shareholders, and would be condensed into as few as three pages including only the information that the SEC deems most "important for retail shareholders to assess and monitor their fund investments."
- Most of the "less retail-focused" information now in prospectuses and shareholder reports would be required to be on mutual funds' websites and also filed with the SEC on Form N-CSR.
- Shareholders could request paper or electronic copies of the information moved to the website at no cost.
- Mutual funds would be subject to these rules and could no longer rely on new Rule 30e-3 to deliver shareholder reports electronically.

Advertisements

- Advertisements that include fee and expense information would have to include certain standardized figures and provide reasonably current information.
- Certain types of advertising statements that do not adequately describe fees and expenses would be deemed materially misleading.
- The proposed advertising rule amendments would generally apply to all investment companies, including mutual funds, exchange-traded funds (ETFs), registered closed-end funds, and business development companies (BDCs).

II. PROSPECTUS AND SAI PROPOSALS

The new disclosure framework makes the prospectus the primary document to inform new and potential investors about a fund, including its objectives and strategies. A shorter and more concise shareholder report would serve as the source of fund disclosure for existing mutual fund shareholders who purchase additional shares. This will eliminate the need for funds to send an annual update prospectus to all existing shareholders or those who made new investments.

In addition, the SEC is proposing Form N-1A revisions that it believes will simplify the presentation of fees and expenses and improve the presentation of risk disclosures.

Proposed Changes to Prospectus Fee Disclosures

The SEC is proposing amendments to Form N-1A fee disclosure that it believes will allow investors to more easily compare information across funds and make more informed investment decisions.

> Would focus on fees and expenses most relevant to potential investors.

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Fee Summary

The currently required fee table would be moved out of the summary portion of the prospectus and into the statutory section of the prospectus. The SEC is proposing to replace it in the summary prospectus with a simplified fee summary.

Narrative

The focus of the fee summary would be the "bottom line" costs of an investment in the fund. The fee summary would be preceded by a narrative explaining that:

- It shows amounts the investor could pay to buy, hold, and sell shares of the fund, and
- These costs reduce the value of the investment and that the investor may pay other fees, such as brokerage commissions and other fees to financial intermediaries, not reflected in the fee summary and example.

All figures in the summary fee table would be presented both as a percentage of the investment and as a dollar amount based on a hypothetical $10,000 initial investment.

Summary Fee Table

The summary fee table would be more concise than the current fee table and replaces current terminology with new plain English terms that the SEC believes investors will more readily understand. The new table would use the terms "transaction fees," "purchase charges," "exit charges" and "early exit fees," and drop current references to traditional industry terms "shareholder fees," "sales charges," "deferred sales charges" and "redemption fees." Any transaction fee equaling $0 would not be included in the summary fee table, and the applicable line item would be omitted. The "maximum account fee" figure would be retained, but moved to a standalone line item separate from the transaction fees. The annual fund operating expenses section of the current fee table would be replaced by one or two line items in the summary fee table: "ongoing annual fees" and, if applicable, "ongoing annual fees with temporary discount."

The proposed amendments to Form N-1A would permit only specified footnotes to be used to address the termination date of any discounts and acquired fund fees and expenses as discussed below. A fund would not be permitted to include footnotes or other extraneous disclosure in the fee summary unless omitting the footnote would cause the disclosure to be materially misleading such that the fees borne by investors would be materially higher than presented in the fee summary.

A sample summary fee table under these proposed amendments to Form N-1A is shown below.

Transaction Fees (fees paid each time you buy or sell)	
Purchase Charge (as a percentage of your investment)	[Up to] xx% (or up to $xx, if you invest $10,000)
Exit Charge (as a percentage of amount redeemed)	[Up to] xx% (or up to $xx, if you invest $10,000)

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Maximum Purchase Charge Imposed on Reinvested Dividends and Other Distributions (as a percentage of your investment)	[Up to] xx% (or up to $xx, if you invest $10,000)
Early Exit Fee (as a percentage of amount redeemed)	[Up to] xx% (or up to $xx, if you invest $10,000)
Exchange Fee	[Up to] xx% (or up to $xx, if you invest $10,000)
Maximum Account Fee	[Up to] xx% (or up to $xx, if you invest $10,000)
Ongoing Annual Fees (estimated expenses you pay each year as a percentage of the value of your investment)	
Ongoing Annual Fees	xx% (or up to $xx, if you invest $10,000)
Ongoing Annual Fees with Temporary Discount	xx% (or up to $xx, if you invest $10,000)

Expense Example

The fee summary would also include a modified expense example with an abbreviated narrative and costs shown over 1- and 10-year periods, rather than 1-, 3-, 5- and 10-year periods as currently required. New funds,[4] however would show costs over 1- and 3-year periods.

Statutory Prospectus Fee Table

The fees that appear in the fee table included in the statutory portion of the prospectus would correspond to fees in the fee summary, where applicable. The terminology changes discussed in connection with the fee summary also would be carried into the fee table in the statutory portion of the prospectus, as applicable. One additional change that would only be reflected in the statutory portion of the prospectus is that distribution fees and service fees under a Rule 12b-1 plan would be renamed “selling fees.” Portfolio turnover would be disclosed in both the fee summary and the statutory portion of the prospectus.

Acquired Fund Fees and Expenses

The proposed amendments to Form N-1A would also revise the treatment of funds with significant investments in other funds. A fund that invests 10% or less of its total assets in acquired funds would be permitted, but not required, to omit the acquired fund fees and expenses from the calculation of ongoing annual fees in the summary fee table and from the line item in the fee table in the statutory portion of the prospectus. Any omitted acquired

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fund fees and expenses would instead be disclosed in a footnote to the fee table and fee summary. The SEC believes this would provide for a more consistent treatment of acquired fund fees and expenses and other indirect costs. All investments in money market funds would be omitted from the calculation of whether a fund has 10% or more of its total assets invested in other funds.

Proposed Changes to Prospectus Risk Disclosure

The proposed Form N-1A amendments would also change the principal risk disclosure included in a fund's prospectus.

10% Standard

The "principal risks" in the summary and statutory prospectus sections would be limited to those risks that satisfy a new "10% standard." The SEC explains that the 10% standard is an effort to limit the often expansive risk disclosure currently presented in fund prospectuses. This new standard would require a fund to make two judgments regarding principal risks:

- Whether the risk would place more than 10% of the fund's assets at risk in the current environment; and
- Whether it is reasonably likely that a risk will meet the 10% standard and become a principal risk in the future due to changing conditions.

The proposed 10% standard would also apply to determining whether investing in a particular sector presents a principal risk.

> Would create new standard thresholds for determining what risks are principal, with a cascading impact on what is a principal strategy.

More volatile investments, such as short sales or derivatives, would satisfy the proposed 10% standard if such investments would subject a fund to a risk of loss with respect to more than 10% of its assets even if the fund uses a lower percentage of assets to make such investments. Additionally, a specific proposed new instruction to Form N-1A would require funds of funds to include only principal risks of the investing fund rather than disclose the principal risks of each underlying fund. Funds would remain free to disclose non-principal risks in the SAI.

Listing Risks in Order of Importance

A new instruction would be added requiring that funds list principal risks in the summary portion of the prospectus in the order of importance, with the most significant risks appearing first. The proposed amendment would specifically prohibit the listing of risks in alphabetical order. The proposed instruction would specifically permit the fund to make determinations regarding the relative importance of risks using any reasonable means.

> Would codify the position taken by the SEC staff in Accounting and Disclosure Information publication 2019-08 - Improving Principal Risks Disclosure.

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Concise Risk Disclosure

New instructions would be added to promote prospectus risk disclosure that is more concise. The proposed amendments to Item 4(b)(1)(i) of Form N-1A would insert the term "briefly" before the current requirement that the fund summarize the principal risks. The SEC is also proposing an instruction to Item 4(b)(1)(i) of Form N-1A that would direct a fund to, where appropriate, tailor its risk disclosures to how the fund operates rather than rely on generic, standard risk disclosures used for every fund in the same fund family. While the SEC acknowledges that certain risks, such as "market risk," are inherently generic, the SEC does not believe it is appropriate for a fund to include generic risk disclosure not applicable to a fund. The Proposed Rule release gives as an example generic below-investment-grade risk disclosure for all funds in a fund family regardless of each fund's exposure to such risk.

Proposed Rescission of Rule 30e-1(d)

The SEC is proposing to rescind Rule 30e-1(d), which currently permits a fund to transmit a copy of its prospectus and/or SAI in place of its shareholder report, if it includes all of the information required to be contained in the shareholder report. The Proposed Rule release states that rescission of this rule will foster the new disclosure framework in which the prospectus is primarily directed at new and potential investors and the shareholder report is primarily directed at existing shareholders. The SEC also believes rescission of Rule 30e-1(d) will reduce the volume of information in these documents and limit it to only what is specifically required.

III. ANNUAL AND SEMI-ANNUAL SHAREHOLDER REPORT PROPOSALS

The Proposed Rule is founded on the premise that new and existing shareholders require different information. The prospectus would remain the primary document to inform new investors regarding the aspects of a fund that generally do not change from year to year, such as the fund's objectives and strategies. A fund that chooses to rely on the Proposed Rule would no longer be required to deliver annual prospectus updates to existing shareholders. Instead, a fund could satisfy any applicable prospectus delivery requirements by providing existing shareholders with annual and semi-annual reports and notices of certain material changes to the fund that occur during the year and have not been reported in a shareholder report.

The Proposed Rule would add new Item 27A to Form N-1A (Proposed Item 27A) which would significantly change the content of mutual fund shareholder reports. The SEC envisions that the proposed new form of shareholder report would serve as the "central source" of information for existing shareholders, and would highlight key information for existing shareholders regarding their investment.

> Would focus on expense information, performance information, and material changes most relevant to existing shareholders, presented in a clear and concise manner.

Outlined below is the information that would be included in a shareholder report in the order in which it would be required.

Cover Page

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Proposed Item 27A would require the cover page to include fund and share class names, ticker symbols, a statement identifying the report as an “Annual Shareholder Report” or “Semi-Annual Shareholder Report,” and a legend stating the reporting period and how additional information can be obtained. For ETFs, the cover page also must include the principal U.S. market(s). While many funds currently include some or all of this information on the cover page, it is not currently required.

Expense Example

The Proposed Rule would replace the two current expense examples with one simplified expense table designed to align with the presentation of expenses in the prospectus and financial statements. Proposed Item 27A would require funds to provide for each share class the expenses, or “costs,” associated with a $10,000 investment rather than the current $1,000 investment amount. From this $10,000 beginning account value, the shareholder report would present:

- “Total return before costs paid”;
- Costs in dollars paid during the period, or “costs paid”;
- Ending account value in dollars based on net asset value return, or “ending account value”; and
- “Costs paid as a percentage of your investment.”

This last figure, “costs paid as a percentage of your investment,” would be the expense ratio of each class as it appears in the most recent audited financial statements or financial highlights. Feeder funds would be allowed to reflect the aggregate expenses of the feeder fund and the master fund in the expense table, with a footnote clearly stating that the expense table reflects the expenses of both funds.

ETFs would also be required to include the ending value of the account based on market value return in this expense table. Therefore, ETFs would be required to show two versions of the ending account value, one based on the ETF's net asset value return and one based on its market value return. This proposed requirement is to allow shareholders to understand any difference between the ETF's performance and market price, and to highlight for shareholders the indirect costs associated with investing in an ETF, including commissions and premium/discount costs.

Proposed Item 27A also would require the disclosure of other material costs included in the fund's total return, such as fund investment transaction costs, securities lending costs, or acquired fund fees and expenses, and that these costs materially reduced the fund's return. Footnotes to the “costs paid” and “costs paid as a percentage of your investment” figures would be required to disclose that the expense information does not reflect shareholder transaction costs associated with purchasing or selling fund shares.

Management's Discussion of Fund Performance (MDFP) (Permitted, but Not Required in Semi-Annual Report)

Narrative

Proposed Item 27A would maintain many of the current requirements for the MDFP section of the annual report, but would restrict the amount of discretionary additional information often included currently by funds. In order to prevent overly long narrative discussions, Proposed Item 27A would require funds to “briefly summarize” the “key”

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factors that materially affected the fund's performance during the reporting period. The SEC encourages the use of graphics or text features such as bullet lists, tables, or charts to show how the fund performed in comparison to its benchmark or to identify the significant contributors to or detractors from performance by holding, industry, geographic region, or other relevant category.

Line Graph

The currently required line graph showing performance of a $10,000 investment in the fund and as compared to an appropriate broad-based securities market index over a 10-year period would be retained, with certain amendments to include additional performance-related information that is available in fund prospectuses.

Under the proposed instructions, the fund could select the share class or classes reflected as long as the line graph includes:

- At least one share class with more than 10 years of annual returns;
- The class with the longest period of annual returns if no share classes have 10 years of annual returns; and
- Annual returns for the same share classes as the immediately preceding annual shareholder report or a brief explanation in a footnote of the reasons for selecting a different class.

Broad-Based Securities Market Index

Proposed Item 27A would revise the definition of an “appropriate broad-based securities market index” to reflect the SEC's view that funds should compare their returns to the overall applicable securities market. As proposed, an “appropriate broad-based securities market index” would be an index that represents the overall applicable domestic or international equity or debt markets, as appropriate, and is administered by an organization that is not an affiliated person of the fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used.

An instruction to Proposed Item 27A would permit funds to compare performance to other more narrowly based indexes that reflect the market sectors in which the fund invests. However, an index tied to a particular sector, industry, geographic location, asset class, or strategy, including commonly used “growth” and “value” indexes, would not be considered an appropriate broad-based securities market index for purposes of Proposed Item 27A.

Annual Total Return Table

The currently required average annual total return table for 1, 5-, and 10-year periods would also be retained, with certain amendments to include additional performance-related information that is available in fund prospectuses. The annual total return table would be required to include:

- The average annual total returns of an appropriate broad-based securities market index. Returns for one or more other relevant indexes would be permitted.
- Average annual total returns without sales charges in addition to the currently required returns reflecting applicable sales charges.
- The average annual total returns of each share class.
- A footnote describing any material change to the fund during the period that would affect performance.

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Availability of Additional Information

Funds that provide updated performance information through widely accessible mechanisms, such as fund websites, would be required to include a statement in the shareholder report directing shareholders to where they can find this information, which would include a hyperlink or other reasonable means of accessing the updated performance information.

Fund Statistics

Proposed Item 27A would include a new shareholder report requirement to disclose as of the end of a reporting period, a fund's

- Net assets;
- Total number of portfolio holdings; and
- Portfolio turnover rate.

While many funds currently elect to include some or all of these statistics in shareholder reports, the SEC believes the consistent inclusion of this information together with the below graphical representation of fund holdings information would help investors understand the fund's diversification and susceptibility to market fluctuations. Funds would be permitted to include additional statistics that the fund believes would help shareholders better understand the fund's activities and operation during the reporting period such as, for example, tracking error, maturity, duration, average credit quality, or yield.

Graphical Representation of Fund Holdings

Currently, funds are required to present portfolio holdings as of the end of the reporting period in a schedule of investments and in one or more tables, charts, or graphs by category (for example, type of security, industry sector, geographic region, credit quality, or maturity). Only the graphical representation of holdings would continue to be required under Proposed Item 27A.

Importantly, the SEC also is proposing to permit funds to show their holdings based on either net exposure or total exposure to particular categories of investments. This is intended to provide a more meaningful presentation for funds that use derivatives to obtain investment exposures or hold both long and short positions.

The complete list of fund portfolio holdings would be removed from the shareholder report but available to shareholders on the fund's website and upon request.

Material Changes (Permitted, but Not Required in Semi-Annual Report)

Proposed Item 27A would require that a shareholder report disclose material changes that have occurred since the beginning of the reporting period or that the fund plans to make in connection with its annual prospectus update:

- Name;
- Investment objective or goals;
- Ongoing annual fees, transaction fees, or maximum account fees, if there have been any material increases;

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- Principal investment strategies;
- Principal risks;
- Investment adviser(s); and
- Portfolio manager(s).

If a prospectus supplement informing shareholders of a change to any of the above items was sent to shareholders during the reporting period, disclosure of the change would be required in the annual report.

The shareholder report may include any additional changes that the fund believes are material that it would like to disclose to shareholders, such as, for example, changes to fundamental and nonfundamental policies, limitations, and restrictions.

Changes in and Disagreements with Accountants

Currently, if during the fund's two most recent fiscal years or any subsequent interim period an independent accountant has resigned or was dismissed, then the information concerning changes in and disagreements with accountants and on accounting and financial disclosure required by Item 304 of Regulation S-K is required to be included in the shareholder report.

If a fund is required to disclose this information, Proposed Item 27A would require the information to be disclosed in the Form N-CSR filing and the shareholder report would provide a more concise discussion of the matter. As proposed, the shareholder report would include:

- A statement of whether the former accountant resigned, declined to stand for reelection, or was dismissed and the date thereof; and
- A brief, plain-English description of any disagreement with the former accountant during the fund's two most recent fiscal years and any subsequent interim period that the fund discloses on Form N-CSR.

Statement Regarding Liquidity Risk Management Program

Proposed Item 27A would retain the requirement that a fund briefly disclose the operation and effectiveness of its liquidity risk management program if the fund's board of directors has reviewed the fund's liquidity risk management program during the most recent fiscal half-year. With the emphasis on brevity, the SEC noted that Proposed Item 27A would require that this disclosure briefly address the following focus points:

- Key factors or market events that materially affected the fund's liquidity risk during the reporting period;
- Key features of the fund's liquidity risk management program; and
- Effectiveness of the fund's liquidity risk management program over the past year.

Statement Regarding the Availability of Additional Information

Proposed Item 27A would require shareholder reports to include a brief, plain-English statement that certain additional fund information is available on the fund's website, including, as applicable, the fund's prospectus, financial information, holdings, and proxy voting information.

Shareholders Revocation of Consent to Householding

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As currently permitted, but not required, a fund may disclose in the shareholder report how shareholders may revoke their consent to householding.

Format and Filing

Proposed Item 27A would require every fund to produce a separate shareholder report; though, a fund could combine multiple share classes in the same shareholder report. Shareholder reports would be required to include only the information allowed or required by Item 27A and such other disclosure necessary to prevent the disclosure from being misleading. Additional information (e.g., president's letters and portfolio manager commentary), could be included alongside the shareholder report so long as the report is given greater prominence than these other materials.[5]

Proposed Item 27A would require the presentation of shareholder report information in a specific order. Incorporation by reference is not permitted. The use of plain-English, “everyday” words, active voice, short sentences and paragraphs, and descriptive headers and sub-headers would be required. Visually, design features such as white space, question-and-answer formats, charts, graphs, tables, bullet lists, and other graphics or text features are encouraged to make shareholder reports easy to read. Electronic shareholder reports should include online tools allowing shareholders to populate discrete sets of information: class-specific information, performance information over different time horizons, or the dollar value used to illustrate the expenses or performance.

Shareholder reports would continue to be filed within a larger Form N-CSR filing. Multiple fund shareholder reports would be permitted to be included in a single Form N-CSR filing.

Delivery of Shareholder Reports, New Form N-CSR Requirements, and Website Availability Requirements

Rules 30e-1 and 30b2-1 under the 1940 Act require a registered investment company to (1) transmit to shareholders an annual and semi-annual report no later than 60 days after the end of its fiscal year or fiscal half-year; and (2) file the shareholder report with the SEC on Form N-CSR no later than 10 days after the shareholder report is transmitted to shareholders.

> The SEC is embracing the approach of layered information across multiple locations.

Layered Disclosure Information

The Proposed Rule would require open-end funds to continue to comply with current requirements for the distribution and filing of shareholder reports. However, the Proposed Rule's layered disclosure framework would limit information required in shareholder reports. Certain disclosures currently included in shareholder reports that the SEC considers to be “less retail-focused” would no longer be disclosed in shareholder reports and would instead be available only in filings made on Form N-CSR. “Less retail-focused” information could be available online for a period 70 days after the end of the relevant fiscal period to 70 days following the next respective fiscal period. This timing would align with the availability of the information included in the fund's next Form N-CSR

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filing. A fund also would be required to provide this information to shareholders upon request. The “less retail-focused” disclosures identified in the Proposed Rule include the following:

- The fund's financial statements, including a statement of assets and liabilities, a schedule of investments, a statement of operations, and a statement of changes in net assets;
- The fund's financial highlights;
- Remuneration paid to directors, officers, their affiliated persons, and members of advisory boards;
- Disclosure regarding changes in and disagreements with fund accountants;
- Matters submitted to shareholders for a vote; and
- A statement regarding the basis for the board's approval of a fund's investment advisory agreement.

A fund's annual financial statements must be audited and accompanied by an accountant's report, while the semi-annual financial statements need not be audited. A fund would no longer be permitted to provide a “summary schedule” reflecting the fund's 50 largest issues and any other issue exceeding 1% of the fund's net asset value in lieu of the complete schedule of investments, as is currently permitted to be included in the schedule of investments that is included in shareholder reports.

The Proposed Rule would further require that an open-end fund, other than a money market fund, make available online its complete portfolio holdings as of the end of the fund's most recent first and third fiscal quarters. This information would need to be made available within 70 days after the close of each applicable fiscal quarter and remain publicly accessible online for a full year. In addition, the Proposed Rule would “conform the format and content of the portfolio holdings schedules for the first and third quarters to those schedules presented in the fund's financial statements for the second and fourth quarters.” Funds are currently required to file this portfolio holdings information with the SEC on Form N-PORT but otherwise are not currently required to make these portfolio holdings available to shareholders.

The Proposed Rule does not generally prescribe the format for the “less retail-focused” materials that would be required to be posted on a fund's website, and a fund may satisfy the website availability requirement by making its most recent report on Form N-CSR publicly available on a website. In addition, the Proposed Rule provides that the materials may be separately available for each series of a fund, grouped by types of materials, or both, so long as they are presented in a format designed to communicate the information effectively and provide a means of easily locating the information, such as a table of contents with hyperlinks to the specific materials. The proposed changes to Rule 30e-1 would require funds to present these materials in a format convenient for reading online and printing on paper and allow persons accessing them to permanently retain an electronic version of the materials.

Rule 30e-1 Safe Harbor

A safe harbor would be available in the event a fund fails to meet the posting requirements of Rule 30e-1 for a temporary period of time. In order to rely on the safe harbor, a fund must have reasonable procedures in place to help ensure that the materials are available in the manner required by Rule 30e-1 and must take prompt action to correct noncompliance with the website availability requirements after a fund knows, or reasonably should have known, that the required documents are not available in the manner required. Finally, funds would be required to

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send, free of charge, a paper or electronic copy of any of these materials upon request within three business days after receiving a request for such information.

Incorporation by Reference

As is the case under the current disclosure framework, once a fund has filed Form N-CSR on the SEC's EDGAR system, the fund may incorporate by reference into its registration statement information that is disclosed in the Form N-CSR filing, including the fund's financial statements, subject to certain limitations.[6] The Proposed Rule would continue to permit a fund to incorporate by reference into its prospectus its financial highlights, which would be incorporated by reference to Form N-CSR rather than its annual report. Consistent with current Form N-1A requirements, for new investors, a fund incorporating financial highlights would be required to provide the most recent annual report with the prospectus[7] and, for existing shareholders, would be required to include in its prospectus a legend stating that additional information about the fund's annual and semi-annual financial statements is available on Form N-CSR.

Directors and Officers

The Proposed Rule would eliminate the requirement that a fund include in its annual report certain information about a fund's directors and officers. Unlike other types of information that would be removed from shareholder reports, this information would not be required to be disclosed elsewhere, such as on Form N-CSR. The Proposed Rule release notes that information regarding a fund's directors and officers already is included in a fund's SAI and is required to be included in a proxy statement that solicits votes with respect to the election of directors.

Proposed Rule 498B and Treatment of Annual Prospectus Update

Section 5(b)(2) of the Securities Act of 1933 (Securities Act) requires that a fund or financial intermediary deliver a prospectus to an investor in connection with the purchase of fund shares. Section 10(a)(3) of the Securities Act provides that the audited financial information included in a fund's prospectus must be no more than 16 months old. In light of this requirement and related rules under the 1940 Act, mutual funds update their prospectus and SAI on an annual basis. The Proposed Rule release recognizes that, while there is no ongoing prospectus delivery requirement with respect to a fund's existing shareholders, many funds deliver an updated prospectus to existing shareholders annually to avoid the need to track each shareholder's additional purchase activity throughout the year. According to the Proposed Rule release, most funds send a summary prospectus, rather than the longer, more detailed, statutory prospectus, to shareholders, as permitted by Securities Act Rule 498.

Prospectus Delivery to Existing Shareholders

Once a fund has provided a summary or statutory prospectus in connection with an initial purchase of fund shares, Proposed Rule 498B would permit the fund to satisfy any future prospectus delivery obligation to existing shareholders[8] by transmitting only the fund's shareholder reports and notices of any material changes with respect to certain sections of the prospectus discussed below. As a condition to reliance on Proposed Rule 498B, a fund must: (1) make its current summary prospectus, statutory prospectus, SAI, and most recent shareholder reports publicly accessible on its website, free of charge; and (2) provide shareholders notice of the material changes within three business days of a post-effective amendment filing or the filing date of a prospectus supplement. Additionally, a fund or financial intermediary would be required to deliver a copy of these fund documents in an electronic or paper format at no cost to any person who requests a copy.

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The materials required by Proposed Rule 498B to be posted online are the same as those required to be posted online under Rule 498. In addition, Proposed Rule 498B would require those materials to be provided in the same format as currently required under Rule 498. The materials must be readable, printable, and capable of being retained permanently in an electronic format. In addition, the statutory prospectus and SAI must permit readers to move directly back and forth between the table of contents and the sections identified therein. Readers also must be able to move directly back and forth between: (1) a section of the summary prospectus and the corresponding section of the statutory prospectus or SAI, or (2) links located at the beginning and end of the summary prospectus, or that remain continuously visible to persons accessing the summary prospectus and tables of contents of the statutory prospectus and SAI.

Proposed Rule 498B provides the same safe harbor available under the proposed amendments to Rule 30e-1 with respect to the website posting of materials described above.

Prospectus Supplements

Funds generally maintain a current prospectus and SAI by supplementing the prospectus or SAI information to reflect any material changes to the information contained in those documents. Funds relying on the Proposed Rule to satisfy their prospectus delivery requirements with respect to existing shareholders would no longer be required to distribute prospectus supplements to existing shareholders. Instead, funds could deliver a shareholder report that describes any material changes. As discussed above, shareholder reports would be required to include a description of a material change that occurred since the beginning of the reporting period or that the fund intends to make in its annual prospectus update.

If a material change is not described in a shareholder report, a fund would be required to send shareholders a notice of any material changes. To satisfy this requirement, a fund could either deliver the prospectus supplement that describes the material change to existing shareholders or prepare a separate notice that contains substantially identical information as the prospectus supplement. If a fund uses a separate notice, it must file that notice on EDGAR as an attachment to the post-effective amendment or prospectus supplement.

> As certain changes to a registration statement, such as updates to existing risk disclosures, may be deemed not to be material under the Proposed Rule, shareholders may not be apprised of these changes. As a result, funds may elect not to rely on the Proposed Rule and instead continue to distribute prospectuses on an annual basis.

Proposed Rule 498B would not affect a fund's ability to satisfy its prospectus delivery obligations by delivering a copy of the summary prospectus and any supplements thereto to existing shareholders, either annually or after each subsequent purchase by an existing shareholder. Proposed Rule 498B also would not relieve funds of any legal responsibility for misleading disclosures with respect to fund documents that are posted online. Funds would remain subject to the same prospectus and registration statement liability and anti-fraud provisions as if the fund had given or sent those prospectuses to existing shareholders.

Exclusion of Open-End Funds from Rule 30e-3

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Rule 30e-3 under the 1940 Act permits funds to satisfy shareholder report transmission requirements by making shareholder reports and other materials available online and providing a notice of that availability to shareholders, rather than directly mailing the report or emailing the report to shareholders, unless a shareholder requests to continue receiving shareholder reports on paper. As a result, funds relying on Rule 30e-3 may be able to reduce printing and mailing expenses associated with shareholder reports. Although Rule 30e-3 is effective, funds are not permitted to begin relying on it until January 1, 2021, and then only if they have complied with certain conditions of the rule, including the use of a legend on the front covers of their summary prospectuses, statutory prospectuses, and shareholder reports.

The Proposed Rule would exclude open-end funds from the scope of Rule 30e-3 and, accordingly, would prohibit open-end funds from satisfying shareholder report transmission requirements by making shareholder reports available online. As a result, open-end funds would continue to be required to mail their shareholder reports to all shareholders, unless a shareholder affirmatively opts in to electronic delivery. The SEC's rationale is that open-end funds "would be sending tailored annual and semi-annual reports under the [Proposed Rule]," which the SEC "preliminarily believe[s] … represents a more-effective means of improving investors' ability to access and use fund information, and of reducing expenses associated with printing and mailing, than continuing to permit open-end funds to rely on Rule 30e-3."

> One step forward with emphasis on relevant disclosure. Two steps back on electronic delivery. While funds would no longer be required to deliver prospectus updates to existing shareholders, the initial prospectus, notices of changes, and annual and semi-annual shareholder reports would be required to be mailed unless there has been an affirmative election of the shareholder for electronic delivery.

IV. INVESTMENT COMPANY ADVERTISING RULES

As part of its proposed improvements to fund fee and expense information for investors, the SEC has proposed to amend the investment company advertising rules set forth in Securities Act Rules 482, 156, and 433 and 1940 Act Rule 34b-1.[9] The amendments would 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. The proposed advertising rule amendments would generally apply to all investment companies, including mutual funds, ETFs, registered closed-end funds, and BDCs, as further discussed below.

Proposed Amendments to Rule 482

Advertisements including fee and expense information must include standardized figures, including sales loads and gross expenses, and current information.

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Requirements for Presentation of Sales Loads and Gross Expenses

The Proposed Rule would 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 (collectively, the "required fee and expense figures").[10] An advertisement could also provide fund fee and expenses net of certain fee waivers and expense reimbursement arrangement amounts, provided that they comply with the prominence requirements discussed below. The proposed required fee and expense figures would be based on the methods of computation that the fund's 1940 Act or Securities Act registration statement form prescribes for a prospectus.[11]

Prominence Requirements

The advertisement would have to present the required fee and expense figures at least as prominently as any other fee and expense figures included in the advertisement. For example, the proposed amendments would permit an advertisement to include a fund's fees and expenses net of certain amounts, such as a fee waiver or expense reimbursement arrangement. However, an advertisement could not present the net figure more prominently than the required fee and expense figures. In addition to meeting the proposed content and presentation requirements, advertisements that include a fund's total annual expenses net of fee waiver or expense reimbursement arrangement amounts would also need to include the expected termination date of the arrangement.[12]

The proposed amendments would also include timeliness requirements for fee and expense information, which would apply to fee and expense figures as well as to related narrative information. The Proposed Rule would require fee and expense information to be as of 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. A fund would, however, be able to provide more current information, if available.

Fund registration statements on Form N-1A would need to provide a fund's maximum sales load (or other nonrecurring fee) and gross total annual expenses as of the date of the fund's most recent prospectus.

Closed-End Funds

A registered closed-end fund that includes fee and expense figures in a Rule 482 advertisement and that does not maintain an effective registration statement would need to provide its gross total annual expenses as of the date of the fund's most recent annual report. The registered closed-end fund would not have a maximum sales load to report in its advertisement because it does not have an effective Securities Act registration statement and cannot presently sell the fund's securities.[13]

Proposed Amendments to Rules 34b-1 and 433

The Proposed Rule would amend Rules 34b-1 and 433 to incorporate Rule 482's proposed fees and expenses content, presentation, and timeliness requirements. The proposed amendments to Rule 34b-1 would provide that any sales literature of a registered investment company or BDC would be deemed to have omitted a fact necessary to make the statements therein not materially misleading unless the sales literature meets Rule 482's proposed fees and expenses content, presentation, and timeliness requirements. The proposed amendments to Rule 34b-1 would, for example, apply to sales literature that is excluded from the definition of "prospectus" in section 2(a)(10) of the Securities Act and thus is not subject to Rule 482. Additionally, the Proposed Rule would amend Rule 433, which establishes conditions for the use of post-filing free writing prospectuses, to require a

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registered closed-end fund or BDC free writing prospectus to comply with the proposed fees and expenses content, presentation, and timeliness requirements of proposed amended Rule 482, if the free writing prospectus includes fee and expense information.

While the proposed amendments to Rules 482, 34b-1, and 433 are similar to requirements that currently apply to a subset of fund advertisements under FINRA Rule 2210 (i.e., certain non-money market fund open-end management investment company advertisements that provide performance information), the amendments would apply more broadly to all investment company advertisements and supplemental sales literature.

Implications for Open-End Funds

Supplemental sales literature subject to Rule 34b-1 that would not otherwise be subject to Rule 482 would have to meet Rule 482's fee and expense presentation requirements.

Implications for Closed-End Funds and BDCs

Regardless of whether a registered closed-end fund or BDC advertisement uses Rule 482 or Rule 433 (for free writing prospectuses), the advertisement would be subject to the same requirements regarding fee and expense information as prescribed in the proposed amended Rule 482.

Proposed Amendments to Rule 156

> Advertising statements that do not adequately describe the universe of relevant fees and expenses would be deemed materially misleading.

The Proposed Rule would amend Rule 156 to provide that representations about fees or expenses in investment company sales literature associated with an investment in the fund could be misleading because of statements or omissions involving a material fact. The Proposed Rule release gives examples of situations where portrayals of such fees and expenses omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading. The Proposed Rule release also notes that, consistent with the current Rule 156 framework, whether a particular description, representation, illustration, or other statement involving a fund's fees and expenses is materially misleading depends on evaluation of the context in which it is made. The SEC specifically noted in the Proposed Rule release that in order to avoid materially misleading statements, it would be appropriate for funds to avoid using lengthy and technical disclaimers in small font sizes.

This amendment reflects the SEC's concern that investment companies and intermediaries may understate or obscure the costs associated with a fund investment, particularly with respect to funds that market themselves as “zero expense” or “no expense” funds based solely on information in their prospectus fee tables and without also disclosing that investors or the fund may incur other costs (e.g., wrap fees or compensation to a securities lending agent).

Implications for Open-End Funds, Closed-End Funds, ETFs and BDCs

An advertisement 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 or recognize 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 fund's management fee, without stating that there are other costs associated with a fund investment or providing the total operating expense figure.
- It uses lengthy or technical disclaimers regarding fees and expenses in small font sizes.

V. CONCLUSIONS

The SEC has requested comments on the Proposed Rule and has also specifically asked whether industry stakeholders would prefer that the SEC limit these amendments to only ETF and mutual fund advertisements, noting that this limitation could lead to reduced comparability and distortions in investor choice across registered investment companies, including registered closed-end funds and BDCs.

Details of the comprehensive restructuring of the 1940 Act prospectus and shareholder report regulatory scheme are discussed in a 646 page SEC release that raises many questions. The short 60-day comment period suggests the SEC has a goal of adopting the proposals before Chair Jay Clayton leaves the SEC, which he has announced will be at the end of the year. In contrast, a 90-day comment period was set for the simpler Fair Value Rule 2a-5 proposal.

The proposals are complicated and will require significant time, money, and other resources to implement. It will be difficult to analyze the proposals and prepare comments in only 60 days.

FOOTNOTES

[1] Act of Aug. 10, 1954, Pub. L. No. 83-777, 68 Stat. 683.

[2] SEC, REGISTRATION FORM USED BY OPEN-END MANAGEMENT INVESTMENT COMPANIES, SEC Release No. 33-7512 (1998).

[3] SEC, ENHANCED DISCLOSURE AND NEW PROSPECTUS DELIVERY OPTION FOR REGISTERED OPEN-END INVESTMENT COMPANIES, SEC Release No. 33-8998 (2009).

[4] The Proposed Rule defines a “new fund” as a fund that does not include in Form N-1A financial statements reporting operating results or that includes financial statements for the fund's initial fiscal year reporting operating results for a period of 6 months or less.

[5] Generally, a fund will be considered to have satisfied the “greater prominence” requirement if the shareholder report is on top of a group of paper documents that are provided together or, in the case of an electronic transmission, the email or other message includes a direct link to the report or provides the report in full in the body of the message.

[6] Rule 0-4 under the 1940 Act, 17 C.F.R. § 270.0-4; Rule 411 under the Securities Act, 17 C.F.R. § 230.411; Rule 303 of Regulation S-T, 17 C.F.R. § 232.303; General Instruction D to Form N-1A.

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[7] However, unlike the current disclosure framework, the annual report provided with the prospectus would no longer itself include the financial highlights, which would instead be available in the Form N-CSR filing and online.

[8] Proposed Rule 498B defines "existing shareholder" as a shareholder to whom a summary or statutory prospectus was previously given that "has either continuously held [f]und shares or, if the [f]und is a money market fund … has continuously maintained or been a beneficial owner of a Fund Account" since the summary or statutory prospectus was previously given. This definition excludes any shareholders who purchased, subsequently sold, and later repurchased shares, except in the case of money market fund shareholders. Proposed Rule 498B also excludes from the definition of existing shareholders those that hold a fund through a separate account funding a variable annuity contract or variable life insurance contract.

[9] Although the SEC recently proposed rule amendments relating to investment adviser advertisements, that proposal did not address investment company advertising rules. *See* SEC, INVESTMENT ADVISER ADVERTISEMENTS; COMPENSATION FOR SOLICITATIONS, Investment Advisers Act Release No. 5407 (Nov. 4, 2019) [84 Fed. Reg. 67,518 (Dec. 10, 2019)].

[10] This proposed requirement would only apply if an investment company advertisement includes fee or expense figures. Therefore, an advertisement will not need to include the required fee and expense figures if it only includes general, narrative information about fee and expense considerations and does not include any numerical fee or expense amounts.

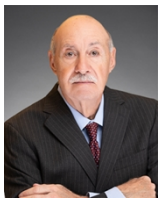
[11] Similar to associated prospectus requirements, if an advertisement covers only a subset of a fund's share classes, the advertisement could provide the required fee and expense information for those classes only.

[12] The SEC believes this proposed requirement would help investors better understand how a fee waiver or expense reimbursement arrangement may affect their investment costs by providing information about how long the arrangement would likely be in place (including that it may be terminated at any time).

[13] An exception to this would be for registered closed-end funds conducting ongoing shelf offerings, in which case sales loads would need to be disclosed, similar to open-end funds, for purposes of the Rule 482 amendments.

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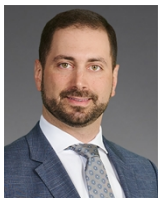
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