THE SEC'S NEW RULE DEMONSTRATES THAT IT BELIEVES SHAREHOLDER REPORTS, LIKE CLOTHES, SHOULD BE TAILORED TO YOU

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U.S. Asset Management and Investment Funds Alert

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On 26 October 2022, the Securities and Exchange Commission (SEC) adopted final rules and form amendments (the Final Rules) representing significant reforms to the content and delivery of shareholder reports for open-end mutual funds and exchange-traded funds (ETFs) registered on Form N-1A, among other reforms such as amendments to the advertising rules for all registered investment companies and business development companies. See the 27 October 2022 K&L Gates client alert providing a high-level summary of the key aspects of the Final Rules.

Many aspects of the Final Rules closely follow elements of the SEC's originally proposed changes from August 2020 (the Proposed Rules), particularly with respect to the content and transmittal of shareholder reports and the advertising rules. However, several major changes in the Proposed Rules relating to prospectus disclosure and delivery obligations, including proposed Rule 498B, proposing a new prospectus fee summary table, and establishing a 10% standard for principal risk disclosure, were not adopted in the Final Rules.

Given the complexities of the Final Rules and the significance of these changes, K&L Gates plans to publish a series of supplemental alerts focused on specific provisions of the Final Rules and their respective impacts, and to host a series of webinars in the coming weeks to discuss the elements of the Final Rules in depth. These alerts will focus on the various components of the layered disclosure approach contemplated by the SEC in adopting the Final Rules. This alert will focus on the content of shareholder reports, in particular the “tailored shareholder report” and the repeal of Rule 30e-3 relating to the transmittal of shareholder reports. The second alert will focus on fund prospectus disclosures and transmittals, as well as advertising rules requiring the presentation of fees and expenses in advertisements and sales literature to be consistent with relevant prospectus presentations. The third and final alert will focus on the third layer of disclosures, which include the continued communication of certain information currently included in a fund's shareholder reports that will now be included as part of its Form N-CSR filing, as well as other materials available on the website.

AMENDMENTS TO ITEM 27 OF FORM N-1A AND THE REPEAL OF RULE 30E-3

Tailored Shareholder Reports

In an effort to establish a “layered” disclosure framework for shareholder reports, the SEC amended Item 27 to Form N-1A, creating a new “concise and visually engaging” form of shareholder report focusing on information the SEC believes is particularly important for retail shareholders to assess and monitor their fund investments on an ongoing basis, namely fund expenses, performance, and portfolio holdings.

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Other information that was previously included in the shareholder report that is considered to be “less retail-focused” and more relevant to financial professionals and investors who desire more in-depth information, will instead be made available on Form N-CSR, which will be: (i) filed with the SEC on EDGAR; (ii) made available on the fund's website, as described in the shareholder report; and (iii) available to be delivered to investors upon request, free of charge.

Funds will have the flexibility to make electronic versions of their shareholder reports more user-friendly and interactive. In addition, funds will be required to tag the information in their shareholder reports using Inline XBRL structured data language.

Series and Class Specific

Every fund will be required to produce an individual shareholder report separate from other series of the same registrant, as was proposed in the Proposed Rules. However, in a significant change from the Proposed Rules, the Final Rules also require a separate shareholder report to be produced for each share class of a multi-class fund, resulting in shareholders only receiving reports applicable to the particular share class in which they invest. The SEC requested comment on whether a shareholder report should be limited to a single class. After considering the comments received, the SEC determined that shareholders only receiving reports applicable to their share class would make it easier for such shareholders to navigate the shareholder report disclosure and understand how it applies to their own interests in the fund.

The SEC considered adopting an approach whereby all share classes could be included in a shareholder report if the fund were to provide additional disclosure regarding share class availability and eligibility to assist shareholders in understanding the various available share classes, however, the length and complexity associated with shareholder reports that include multiple series and/or classes was determined to be inconsistent with the Final Rules' goal of creating a clear and concise shareholder report. Further, the length and complexity of a shareholder report including all share classes of a multiple share class fund would make it more difficult for shareholders to identify information pertaining to their investment, which may differ depending on which share class the shareholder is invested. The SEC recognizes that while different share classes of a fund hold an interest in the same portfolio and certain disclosure would be identical for all classes, significant disclosure will vary among the various share classes. Accordingly, the SEC concludes that limiting shareholder reports to one class of a multiple class fund is appropriate in order to ensure shareholders can easily assess and monitor their ongoing investments.

Content of the Tailored Shareholder Report

An example of the streamlined shareholder report, updated from what was published with the Proposed Rules, is included at the end of this alert.

Cover Page or Beginning of the Report

In a change from the current shareholder report requirements, the Final Rules require each shareholder report to contain administrative information on the cover or beginning of a report including:

- Fund/Class Name;
- Ticker Symbol;

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- Principal U.S. Market(s) for ETFs;
- A statement identifying the report as either an annual or semi-annual report;
- A legend that states:

> "This annual shareholder report contains important information about [the Fund] for the period of [beginning date] to [end date]. You can find additional information about the Fund at [Fund website address]. You can also request this information by contacting us at [toll-free telephone number and, as applicable, email address]"; and

- If an annual report describes material fund changes, the following bold face type statement must be included:

> "This report describes changes to the Fund that occurred during the reporting period."

Expenses

In accordance with the Final Rules, shareholder reports will be required to include a simplified expense table, as compared to the table included in the Proposed Rules, showing certain "costs" associated with a hypothetical $10,000 investment, both as a percent of a shareholder's investment in the fund (i.e., the expense ratio), and as a dollar amount. The Final Rules do not include the proposed requirements that the expense table include the fund's total return during the period nor the inclusion of an explanation that expense information does not reflect shareholder transaction costs associated with purchasing or selling fund shares. In addition to instructions as to how to the calculate the amounts included in the expense table, the Final Rules provide instructions related to the permitted types of footnotes to the expense table, each as described below:

- Extraordinary Expenses – If a fund incurred "extraordinary expenses" during the reporting period, a fund may briefly describe what the expenses would have been if the extraordinary expenses had not been incurred.
- Feeder Fund – If a fund is a feeder fund, the fund must reflect the aggregate expenses of the feeder fund and the master fund in an expense table and can include a footnote stating the expense table includes the expenses of both the master and feeder fund.
- Shareholder Report Covering Less than a Full Reporting Period – A fund must include a footnote to the table noting the report covers less than full reporting period and explain that the expenses for a full reporting period would have been higher than the figures shown.

Management's Discussion of Fund Performance

The Final Rules retain the management's discussion of fund performance (MDFP) section that typically appears in annual shareholder reports but condense the section to include only specified disclosure and information. The

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narrative disclosure that is required to be included in the MDFP section of the annual report will contain disclosure that “must 'briefly summarize' the 'key' factors that materially affected the fund's performance during the last fiscal year.” The adopting release provides examples as to what these factors may be, namely, relevant market conditions and the investment strategies and techniques utilized by the adviser. Further, the Final Rules incorporate an instruction related to this section that encourages the inclusion of charts, graphs, bulleted lists or tables to indicate how a fund has performed instead of lengthy discussions that may be generic or too broad.

The Final Rules also retain the requirement to include a performance line graph, updated from the format included in the Proposed Rules to reflect the shift from a multiple-class to a single share class report. The line graph will show performance of a $10,000 investment into the relevant share class of the fund, as well as an appropriate broad-based securities market index, over a ten-year period. The Final Rules also permit the inclusion of additional more narrowly-based indexes that reflect the fund's relevant market sectors. The adopting release notes that the Final Rules will limit the time frame for the line graph to a ten-year period so as to avoid unrealistic investor performance-related expectations and allow investors to easily identify volatility. Additionally, the Final Rules include an instruction that defines a “broad-based” securities market index, which will be discussed in detail later in this alert.

Further, the Final Rules retain the current requirement to include a table presenting average annual total returns of a fund in the relevant annual report. This table will include the average annual total returns for the past 1-, 5- and 10-year periods for the fund's relevant share class, the average annual total returns of an appropriate broad-based securities market index and the fund's average annual total returns without sales charges for the fund's relevant share class. Additionally, the Final Rules allow for the fund to include a legend or footnote to describe any material change that occurred during the relevant period.

Finally, with respect to any fund that has a policy or practice of maintaining a specified level of distribution to shareholders, the Final Rules require that a fund unable to maintain such a policy or practice must disclose this in the MDFP section of their annual report, along with any instances where distributions result in returns of capital.

Fund Statistics

Certain fund statistics are also required to be included in a fund's shareholder report per the Final Rules. The enumerated list of statistics that are required to be included within the shareholder report include:

- Net assets;
- Total number of portfolio holdings;
- Portfolio turnover rate (excluding money market funds); and
- Total advisory fees paid by the fund during the reporting period.

Funds are also permitted to disclose further statistics that it believes would help shareholders understand a fund's activities and operations during the reporting period so long as any additional statistics that are included are reasonably related to the fund's investment strategy. In a change from the Proposed Rules, the Final Rules mandate that the required statistics be presented prior to any additional statistics so as to enhance the comparability of fund statistics across various funds. The statistics must abide by the following guidelines: if a statistic is also required under Form N-1A, the Form N-1A instructions describing the calculation method must be followed; statistics included in or derived from fund financial statements or financial highlights must be sourced

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from the most recent financial statements or financial highlights; and any description of the significance or limitation of any disclosed statistics may be included in a parenthetical or similar presentation but not as a footnote as a footnote was thought to diminish the effectiveness of the disclosed information and run counter to the SEC's goals of clear and concise shareholder reports.

Graphical Representations of Holdings

The Final Rules retain the current requirements related to the graphical representation of holdings with certain revisions. Funds will be required to include one or more tables, charts or graphs within their shareholder report illustrating the fund's portfolio holdings by categories as of the end of the reporting period. Funds are permitted to show holdings based on a fund's net exposure to a particular category of investments, but only if a fund's holdings are depicted based on total exposure to a particular category of investments. Additionally, the Final Rules updated the current instructions related to the depiction of portfolio holdings according to credit quality requiring any disclosures to be brief and concise, and requiring the inclusion of a statement as to why a particular credit rating was selected.

In addition to the graphical representation of holdings and fund statistics required by the Final Rules, the Final Rules permit a fund to disclose, in a table or chart that appears near the fund's graphical representation of holdings, a fund's largest 10 portfolio holdings, along with the percentage of the fund's net asset value, total investments, or total exposure attributable to each holding.

Material Fund Changes Section

The adopting release includes a list of changes that the SEC considers to be “material fund changes” that a fund must disclose in its annual report. Such material fund changes must have occurred since the beginning of the reporting period and include a change in a fund's:

- Name;
- Investment objective or goals;
- Annual operating expenses, shareholder fees, or maximum account fees, including the introduction or termination of an expense reimbursement or fee waiver arrangement (whether or not they result in increases in fees);
- Principal investment strategies;
- Principal risks; and
- Investment adviser(s) or subadviser(s).

The Final Rules also permit a fund to describe other material changes that it wishes to disclose to its shareholders, including other changes that may be helpful to investors in understanding the operations and/or performance of the fund over the reporting period. The Final Rules do not define a material change as a change that would require a fund to file an amendment to a fund's registration statement under Rule 485(a) under the Securities Act of 1933 (the Securities Act) as some commenters had requested. The SEC did, however, note that materiality is and has been a “bedrock” principle in the securities laws and cited to the *Basic v. Levinson* standard instead.[1] The adopting release highlights the importance of examining the facts and circumstances in determining whether a change is material and provides certain considerations in making that determination.

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The SEC notes that funds may wish to consider the following items when determining whether such a change would likely be considered a material change: the nature of the change; whether it reflects a material change in a fund's risk profile or the way the fund is currently being managed; which sections of the prospectus the change affects; and how likely the change would be to influence a shareholder's decision to continue to invest in the fund. Further, the Final Rules do not require but permit disclosure of changes that the fund plans to make in connection with its next annual prospectus update if such changes are considered to be material.

Changes in and Disagreements with Accountants

Per the Final Rules, funds will be required to include a discussion of certain disagreements with accountants that have resigned or have been dismissed. In such an instance, the Final Rules require a concise statement discussing whether the former accountant resigned, declined to stand for re-election, or was dismissed, including the date of such occurrence, as well as a high-level plain-English description of any disagreement with the former accountant during the fund's two most recent fiscal year ends and any subsequent interim period, as applicable. Funds will not be required to include a statement indicating the absence of changes in or disagreements with accountants. Furthermore, the Final Rules require that a more detailed and fulsome description of changes in and disagreements with accountants, which mirrors the current requirements, be included on Form N-CSR.

Statement Regarding the Availability of Certain Other Information

The Final Rules require funds to include at the end of the report, a brief plain-English statement providing investors with direction to the availability of certain additional information located on the fund's website. The Final Rules require references to the fund's prospectus, financial information, holdings and proxy voting information, as applicable and must incorporate a means of immediately accessing this additional information such as the inclusion of a QR code or hyperlink.

Householding Disclosure

The Final Rules retain the current provision with respect to householding, whereby funds will include disclosure in their annual report indicating how a shareholder may revoke consent to householding of an annual report. Including such disclosure in the annual report satisfies the annual notice requirement, whereby funds must explain to investors who provided implied or written consent to householding how they can revoke their consent.

Format and Presentation of Shareholder Reports

The adopting release discusses the adoption of general instructions related to the format and presentation of shareholder report. Under the general instruction, shareholder reports must use plain-English and investor-friendly principles, its contents must appear in the order as is required by Item 27A of Form N-1A, and the report must include legibility requirements applicable to printed documents in a format that promotes effective communication as described in Instruction 8 of Item 27A(a).

Electronic Shareholder Reports

The SEC is adopting general instructions describing requirements for any electronic shareholder reports including ordering and presentation requirements, flexibility to provide additional tools and features, and links for immediate access to information. Funds will have the flexibility to make electronic versions of their shareholder reports more user-friendly and interactive. With respect to added tools and features that would appear on a website or would otherwise be provided electronically, funds are permitted to include any instructions necessary for the use and

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interpretation of interactive graphics or tools. Further, any tools or features included electronically or on the website must adhere to any requirement of Item 27A of Form N-1A.

Differences between Annual and Semi-Annual Reports

The Final Rules contain nearly identical requirements for annual and semi-annual reports. Unlike annual reports, semi-annual shareholder reports are not required to include the items discussed above with respect to the "Management's Discussion of Fund Performance" or disclosure of material changes sections. The Final Rules do not require the noted disclosures but funds are given the option to include these items in semi-annual reports. Any voluntary disclosure must comply with the requirements of Item 27A of Form N-1A.

Furthermore, the adopting release approved three additional annual report only provisions, as proposed. First, funds may include disclosure not enumerated in Item 27A if the information is necessary so as to make the required disclosure not misleading. Second, a required disclosure may be omitted if it is inapplicable and a required legend or narrative may be modified if comparable information is included. Finally, no information may be incorporated by reference into the shareholder report.

Definition of a Broad-Based Index

The Final Rules define a "broad-based" securities market index as an index that represents the overall applicable domestic or international equity or debt markets, as applicable. The SEC notes in the adopting release that they believe that including a broad-based securities market index in performance disclosure provides investors with readily-accessible contextual information regarding market performance. The SEC further notes that inclusion of such a broad-based securities market index provides investors in a sector-specific fund with the ability to determine how the fund is performing in comparison to its peers, as well as the market as a whole. As noted above, the Final Rules allow for funds to use more narrowly based indexes that reflect market sectors, industries, geographic locations, asset classes, or strategies in which a fund invests, including commonly used "growth" and "value" indexes, only as secondary indexes.

To assist funds in the selection of their indexes, within the adopting release, the SEC discusses general guidelines and examples of indexes that would be applicable and meet the requirements of the Final Rules. The example included in the adopting release describes a fund that invests primarily in the equity securities of a subset of the U.S. market, such as healthcare companies, the appropriate broad-based securities market index in this case would be an index reflecting the U.S. equity market overall, rather than an index reflecting the overall market related to healthcare companies. However, the adopting release notes that such a fund would be permitted to include a more narrowly tailored healthcare company index as a secondary index in addition to the broad-based securities market index. The adopting release further notes that the "appropriate" broad-based securities market index selected may include components that do not overlap with the fund's investments, such as is the case with multi-asset and alternative strategy funds that do not invest in a single overall debt or equity market. Such a fund would be permitted under the Final Rules to select an index that shares other economic characteristics with the fund, such as volatility. Additionally, the adopting release states that in the event a fund invests in both equity and debt securities, it may include more than one appropriate broad-based securities market index, including a blended index.

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

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As foreshadowed by the Proposed Rules, the Final Rules amend the scope of rule 30e-3 (Rule 30e-3) of the Investment Company Act of 1940, as amended (1940 Act), by eliminating the ability of all funds registered on Form N-1A to rely on the rule to satisfy shareholder report transmission requirements by making shareholder reports available online and mailing a notice indicating the availability of the reports. Instead, these funds once again will be required to mail shareholder reports to all shareholders, unless a shareholder affirmatively confirms their request to receive their shareholder reports via electronic delivery. Although, Rule 30e-3 was recently adopted in 2018 with funds being able to rely upon the Rule 30e-3 beginning January 2021, the SEC concluded that investors will benefit from receiving streamlined information delivered directly to them, rather than receiving a notice with no substantive content and thereafter having to locate the information electronically.

The SEC remarks on their belief that the new disclosure approach for shareholder reports is a more-effective means of improving investor access and use of fund information while also preserving the expected cost savings that would be experienced by choosing to rely on Rule 30e 3. The Final Rules would provide a reduction of costs of transmitting a shareholder report by a larger per-fund amount for funds that do not rely on Rule 30e-3 as compared to those that rely on Rule 30e-3. The SEC further clarifies that variable contract unit investment trusts (UITs) may no longer rely on Rule 30e 3 to satisfy shareholder report transmission requirements with respect to underlying funds registered on Form N-1A despite the fact that UITs currently may rely on Rule 30e-3 to satisfy their shareholder report transmission requirements under Rule 30e-2 of the 1940 Act.

Additionally, the Final Rules rescind Rule 30e-1(d) of the 1940 Act (Rule 30e-1(d)), which allows for a copy of a fund's prospectus or statement of additional information to be transmitted in place of the shareholder report if it includes all of the information required to be included in the shareholder report. According to the adopting release, Rule 30e-1(d) is rescinded as it was rarely utilized and is inconsistent with the SEC's layered disclosure framework adopted through the Final Rules.

Further, the Final Rules will permit the shareholder report to be transmitted with additional information so long as the shareholder report is given “greater prominence.” Materials that are considered exempt from the “greater prominence” requirement include summary prospectuses, statutory prospectuses (both as defined in rule 498 under the Securities Act), or notices of the online availability of proxy materials under rule 14a-6 under the Securities Exchange Act of 1934, and other shareholder reports.

Items Omitted from the Tailored Shareholder Reports

The SEC's “layered” disclosure framework provides for a significant shift of information being relocated out of the shareholder report and into the Form N-CSR filing or omitted from the requirements of both the reports and the filings. Specifically, the Final Rules require funds to shift the following items so that they are filed on Form N-CSR, posted on a fund's website, and available in paper form upon request by a shareholder:

- Detailed discussion of changes in and disagreement with accountants, while a summary will be retained in the annual shareholder report;
- Complete list of fund portfolio holdings;
- Financial statements;
- Financial highlights, while certain data points will be retained in the shareholder reports;

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- Results of any shareholder votes;
- Remuneration paid to directors, officers and others; and
- Statement regarding the basis for the board's approval of any investment advisory contract.

Further, the Final Rules eliminate the disclosure previously required in Item 27 of Form N-1A regarding information on management and fund directors, as well as statements regarding the liquidity risk management program. These items are not relocated to Form N-CSR but rather removed entirely as the information is required to be included in the fund's registration statement or other filings. The adopting release provides that the SEC determined that it was unnecessary to include management information in both an annual report or Form N-CSR and a fund's statement of additional information, and that the currently-required liquidity risk management narrative disclosure does not meaningfully augment existing liquidity risk management disclosure or reporting requirements.

The tailored shareholder report amendments and the amendments to the scope of Rule 30e-3 will become effective 60 days' after publication in the Federal Register. However, the Final Rules including both the tailored shareholder reporting and Rule 30e-3 amendments for registered investment companies under the 1940 Act, provide an 18-month transition period after publication in the Federal Register to provide time for fund complexes to design and implement the website availability requirements for the new Form N-CSR items, as well as to allow time for fund complexes that rely on Rule 30e-3 to transition to the proposed disclosure framework.

For an example of a streamlined shareholder report based on the model included in the Proposed Release, click here.

FOOTNOTES

[1] *See Basic v. Levinson*, 485 U.S. 224, 231 (1988) (To fulfill the materiality requirement there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.)

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