

TAILORING SHAREHOLDER REPORTS: SEC FINALIZES AMENDMENTS TO REGISTERED FUND SHAREHOLDER REPORTING REQUIREMENTS

November 2022

www.morganlewis.com

This report is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising. Links provided from outside sources are subject to expiration or change.

© 2022 Morgan, Lewis & Bockius LLP

TAILORING SHAREHOLDER REPORTS: SEC FINALIZES AMENDMENTS TO REGISTERED FUND SHAREHOLDER REPORTING REQUIREMENTS

The US Securities and Exchange Commission (SEC) recently finalized rule and form amendments (Adopted Rules) that require mutual funds and most exchange-traded funds¹ (ETFs) to provide shareholders with streamlined and “visually engaging” shareholder reports.² The Adopted Rules include significant changes to both the content and the presentation of information in shareholder reports, summarizing certain key information and moving other information that is currently included in shareholder reports to other SEC filings (e.g., Form N-CSR) and to fund websites. These changes are part of the SEC’s investor experience initiative and its effort to modernize shareholder disclosures and implement layered disclosure approaches.

KEY TAKEAWAYS

- The Adopted Rules further the SEC’s implementation of a “layered disclosure” approach, providing key information directly to investors, and allowing more detailed information to be accessed through fund websites or other SEC filings.
- The new shareholder reports, similar to summary prospectuses, are expected to be significantly shorter than current reports, with a focus on key information relevant to shareholders and provided in a “visually engaging” format.
- Shareholder reports will need to be specific to a shareholder’s fund and share class.
- Information contained in shareholder reports will be required to be tagged in Inline XBRL format.
- Rule 30e-3 (which permits funds to deliver shareholder reports through notice and access) will no longer be available for mutual funds and ETFs, which will reintroduce certain operational processes for funds.
- The Adopted Rules include a definition of “appropriate broad-based securities market index” and will require funds to include such an index in the performance line graph in both prospectuses and shareholder reports.
- Funds will be required to present fees and expenses in advertisements and sales literature consistent with relevant fee table presentations in fund prospectuses.
- The compliance period for almost all changes is 18 months after the effective date of the Adopted Rules.

¹ As used in this report, in regard to the streamlined shareholder report requirements, the term “ETF” refers only to ETFs registered on Form N-1A and does not include ETFs organized as unit investment trusts or exchange-traded products that are not registered under the Investment Company Act of 1940.

² See Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, Rel. No. IC-34731 (Oct. 26, 2022).

OVERVIEW OF ADOPTED RULES

The Adopted Rules are largely consistent with the amendments included in the original tailored shareholder reports proposal, which was released on August 5, 2020 (the Proposal).³ Like the framework described in the Proposal, the updated shareholder reports will use a layered approach to emphasize certain information that is intended to allow retail investors to better assess and monitor fund investments, while making other information available through fund website disclosure and other SEC filings.

The Adopted Rules do not include all elements that were included in the Proposal. First, the SEC did not adopt proposed Rule 498B, which would have provided an alternative for funds to satisfy the annual prospectus delivery requirement through delivery of shareholder reports. Second, the amendments to the ordering of prospectus risk disclosure that were included in the Proposal were similarly not adopted. In each of these cases, the SEC cited issues raised by commenters that warranted further consideration, indicating that they may be revisited by the SEC in future rulemaking proposals.

The Adopted Rules did, however, exclude mutual funds and ETFs from the scope of Rule 30e-3, as proposed. This exclusion eliminates the ability for these funds to satisfy the requirement to deliver a shareholder report by providing notice that the report is available online. Mutual funds and ETFs currently relying on Rule 30e-3 will once again be required to deliver paper copies of new, streamlined shareholder reports. The SEC notes that increased costs associated with this change should be “small.”

The Adopted Rules also include amendments to rules regarding investment company advertisements applicable to registered funds, including mutual funds, ETFs, closed-end funds, interval funds, unit investment trusts, and business development companies. Specifically, the Adopted Rules will require the presentation of fee and expense information in advertisements to be consistent with prospectus fee table presentations, reasonably current, and not misleading.

The Adopted Rules will become effective 60 days after publication in the *Federal Register*, and include an 18-month transition period after the effective date to allow mutual funds and ETFs to implement necessary changes required by the Adopted Rules. However, registered funds will have to comply with the Adopted Rules that address representations of fee and expense information that could be materially misleading as of the effective date.

STREAMLINED SHAREHOLDER REPORTS

Scope

The Adopted Rules, with respect to annual report disclosure, apply to shareholder reports for investment companies registered on Form N-1A (funds). They do not apply to any investment companies that are not registered on Form N-1A, such as closed-end funds, unit investment trusts, and open-end managed investment companies not registered on Form N-1A, (i.e., issuers of variable annuity contracts registered on Form S-3). The SEC states in the adopting release for the Adopted Rules that despite this, it will continue to consider consistency across informational disclosure among different investment entities.

³ See 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, Rel. No. IC-33963 (Aug. 5, 2020).

Morgan Lewis

Separate Shareholder Report Requirements

The Adopted Rules require a separate annual report prepared for each fund and class of a registrant, so that, according to the SEC, shareholders can more easily navigate and read information that applies to them. To ensure shareholders can still obtain information about other share classes, funds must post all fund documents on their websites in a structured, machine-readable data format.

Content

While the SEC was focused on promoting concise shareholder report disclosure, there will not be a page or word limit to the annual report. There are, however, specific content requirements aimed to ensure that the disclosure included in shareholder reports is simple and accessible.

As a general matter, funds will not be permitted to include any information that is not specifically required or permitted under Item 27A of Form N-1A, nor will funds be permitted to incorporate information by reference—all content requirements must be met within the annual report. However, 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 also may not include supplemental information beyond the requirements and permitted adjustments in the body of the shareholder report, but they may include additional information alongside the report, provided the shareholder report is given greater prominence than the other materials (other than prospectuses, notices of online proxy materials, and other shareholder reports). The shareholder report must also refer shareholders to additional website information.

Shareholder reports must contain, or, in some instances indicated below, are permitted to contain, the following information:

Cover Page or Beginning of Shareholder Report

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 ETF), a statement identifying the document as either an "annual shareholder report" or a semi-annual report, and two specific legends regarding the content of the report and how to access additional information.

In a departure from the Proposal, funds are not required to describe material changes on the cover page, but funds are permitted to do so. In the event the report does contain such disclosure, an additional legend (or a similar statement) would be required.

Expense Example

The Adopted Rules require 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 semi-annual 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, which is a change from the Proposal. If a fund incurred any extraordinary expenses during the

Morgan Lewis

reporting period, a footnote may briefly describe what the expenses would have been without the extraordinary expenses. Feeder funds must reflect the aggregate expenses of both the feeder and master fund in the table and state this in a footnote.

Lastly, if a shareholder report covers less than a full reporting period, the fund must include a footnote to note and explain that expenses would be higher for a full reporting period.

Management's Discussion of Fund Performance

The Adopted Rules make the Management's Discussion of Fund Performance (MDFP) section more concise. The narrative discussion of factors that materially impacted performance is required to be brief and to summarize only key factors. Funds must include additional performance-related information and comparative returns of relevant benchmarks, including a 10-year performance line graph for the relevant class.

Money market funds will be permitted, but not required, to include an MDFP in shareholder reports. Funds are not required to, but are permitted to, include MDFP in their semi-annual reports.

Fund Statistics

Funds are required to disclose certain general statistics, including net assets, total number of portfolio holdings, portfolio turnover rate (except for money market funds), and 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.

Funds may also disclose additional statistics that would help shareholders better understand a fund's activities and operations after the required statistics, so 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 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 largest 10 portfolio holdings and the respective net asset value, total investment, or total exposure of each holding.

Material Fund Changes

Material fund changes that occurred during the reporting period must be described in the annual report, which include changes to a fund's name, investment objectives or goals, annual operating expenses, shareholder fees, maximum account fee, principal investment strategies, principal risks of investing, the fund's investment advisers or sub-advisers, and any other material fund change the fund wants to disclose.

A fund can also disclose material planned changes, as well as a concise description to ensure shareholders understand the change. If there has been a material disagreement with an accountant that has resigned or been removed, the annual report must include whether the accountant resigned or was dismissed, and a brief description of any disagreements with such accountant within the last two fiscal years. More detailed information must be filed on Form N-CSR.

Morgan Lewis

Availability of Additional Information

Finally, shareholder reports are now required to have a statement that includes plain English references to the fund's prospectus, financial information, holdings, and proxy voting information, as applicable. If the shareholder report appears online, the fund must provide a link or other means of immediate access to the additional information.

Householding

Any funds that household based on implied consent must send notice to each investor that the household will receive only one report unless the fund receives instruction otherwise. Funds may explain in the annual report how to revoke consent to annual report householding, but must explain such process in some form once per year.

Broad-Based Securities Indices

Funds must include a comparison between their performance and an appropriate broad-based securities market index in both annual reports and prospectus performance tables.

As in the Proposal, the definition of an "appropriate broad-based securities market index" has been amended in the Adopted Rules to clarify that the term refers to an index that tracks the overall applicable domestic or international equity or debt securities market. Indices that are more narrowly tailored to specific sectors or industries, or that include characteristics such as "growth," "value," "ESG," or "small- or mid-cap," will not be considered to be appropriate broad-based securities market indices under the Adopted Rules, and such indices may only be included as secondary indices.

Funds that do not invest within a single overall market may include more than one appropriate broad-based securities market index (e.g., equity and debt indices), or they may include a blended index that combines the performance of more than one index (but only as a secondary index).

The adopting release includes several pages of guidance regarding how funds should approach the selection of an appropriate index for performance comparison purposes. For instance, the release clarifies 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) to the fund's investments such that they provide an appropriate point of comparison.

Given the wide range of indices currently used by funds, the new definition of "appropriate broad-based securities market index" could prove costly and cumbersome for funds to implement.

Format and Presentation

Information provided in annual shareholder reports must appear in the order required under the amendments to Form N-1A and must be in plain English. Funds are also encouraged to use investor-friendly formatting, such as charts, graphs, tables, bulleted lists, graphics, and question-and-answer formats. Shareholder reports must also be legible, and all required information must be presented "in a format that promotes effective communication."

Electronic Annual Reports

The SEC recognizes that shareholders may access annual reports online, and the Adopted Rules contain instructions to promote user-friendly electronic annual reports. These instructions include ordering and presentation requirements for electronic reports, flexibility for funds to add interactive tools and features

Morgan Lewis

to electronic reports and instructions on their use, and required links for direct immediate access to referenced information available online.

Any of the information provided in these tools or other additional information provided online is subject to record retention requirements. Funds are also required to comply with all applicable accessibility-related requirements under the Americans with Disabilities Act for online information.

iXBRL

In a departure from the Proposal, the Adopted Rules require funds to tag disclosures in new streamlined shareholder reports in Inline XBRL (iXBRL), in accordance with Rule 405 of Regulation S-T. Funds are currently required to tag other disclosures in iXBRL, such as the risk/return summary in prospectuses. The SEC states that iXBRL will allow the extraction of information using automated tools to help facilitate shareholders' comparison, filtering, and other analysis of information presented in shareholder reports.

Although the Proposal did not include this requirement, the Proposal did request comment on the potential benefits of requiring information filed on Form N-CSR, including the streamlined shareholder report, to be tagged in iXBRL format. This aspect of the Adopted Rules will have significant operational effects on the transmission of shareholder reports.

AVAILABILITY OF OTHER INFORMATION

Form N-CSR and Website Disclosure Requirements

The Adopted Rules require information that is currently presented in shareholder reports but is less retail-focused to be moved to Form N-CSR. The changes also necessitate that funds make available on their websites, and deliver upon request and at no cost, all information being moved from the shareholder report to Form N-CSR.

Unlike the annual and semi-annual shareholder reports discussed above, the information provided on Form N-CSR and on a fund's website may include information for multiple funds and classes.

Form N-CSR will continue to require the following information:

- Financial statements
- Financial highlights
- Remuneration paid to directors, officers, and others
- Changes in and disagreements with accountants
- Matters submitted to fund shareholders for a vote
- A statement regarding the basis for the board's approval of the investment advisory contract
- Complete portfolio holdings as of the close of the most recent first and third fiscal quarters

Information Removed from Shareholder Reports

As part of the Adopted Rules, the SEC removed 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's rationale for removing the management information table from shareholder reports is that identical information is available in a fund's statement of additional information, and it is duplicative to include the same information in multiple regulatory documents.

Morgan Lewis

The removal of the statement regarding a fund's LRMP is a departure from the Proposal. As proposed, a fund would be required to include a concise statement regarding its LRMP and a summary of the LRMP's effectiveness, in place of the currently required LRMP disclosure. In the Adopted Rules, however, the SEC eliminated a requirement to include any information regarding a fund's LRMP in shareholder reports.

In the adopting release for the Adopted Rules, the SEC acknowledges that this type of disclosure does not pertain to a retail shareholder's understanding of the operations and performance of a fund, and it is 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. The SEC does state, however, that helping retail shareholders better understand how funds manage liquidity risk merits further consideration.

TRANSMISSION OF SHAREHOLDER REPORTS: AMENDMENT TO RULE 30E-3

As proposed, the Adopted Rules narrow the scope of Rule 30e-3 to exclude investment companies registered on Form N-1A. These funds will no longer be permitted to rely on Rule 30e-3 to mail a notice of internet availability of annual and semi-annual reports to shareholders and will be required instead to mail such documents (if shareholders have not opted into another delivery method such as electronic delivery).

In the adopting release for the Adopted Rules, the SEC acknowledges that many commenters opposed this aspect of the Proposal. But nevertheless, the SEC believes mailing the new streamlined shareholder reports to shareholders is the best way to provide investors with the disclosure they need in order to understand a fund's operations and performance.

The Adopted Rules also make one technical change from the Proposal to clarify that the scope of the rule is narrowed with respect to all funds registered on Form N-1A, including funds that serve as underlying funds of insurance company separate accounts.

The SEC also discusses comments received on the Proposal regarding delivery of shareholder reports and other regulatory documents generally. Many commenters advocated for the SEC to modernize their guidance surrounding electronic delivery. Other commenters suggested that the posting of materials to fund websites should satisfy delivery requirements (i.e., "access equals delivery"). The SEC stated that although it is not adopting changes in response to these comments, it will continue to consider these issues. The Adopted Rules, similarly, do not adopt any changes to the required delivery of semi-annual shareholder reports to investors.

INVESTMENT COMPANY ADVERTISEMENT AMENDMENTS

In an effort to promote more consistent and transparent presentations of investment costs in advertisements, the Adopted Rules also include amendments to the investment company advertising rules under the Securities Act of 1933 (the 1933 Act) and the Investment Company Act of 1940 (the 1940 Act).⁴ The Adopted Rules will apply to fund advertisements and sales literature that include fee and expense figures.

⁴ See Rules 156, 433, and 482 under the 1933 Act and Rule 34b-1 under the 1940 Act.

Morgan Lewis

The Adopted Rules will 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 fee, 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 Adopted 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.⁵

The SEC expressed concern that because funds are increasingly marketed based on costs, advertisements and sales literature may present fees and expenses in a way that misleads investors into concluding that the costs of investing in a fund are lower than they actually are. To address that concern, the Adopted Rules clarify that when a fund considers whether a particular statement of material fact could be misleading under Rule 156 under the 1933 Act, the fund should consider whether its representation of fund fees and expenses could be misleading because of statements or omissions involving a material fact. Pursuant to the amendments to Rule 156, a fund should consider whether an omission of an explanation, qualification, limitation, or other statement might make the presentation of the fund's fees and expenses misleading.

The SEC noted that changes to the fee table in open-end funds' prospectuses will continue to be considered. This focus on transparency of investment costs, particularly for retail investors, is also a priority of William Birdthistle, the director of the SEC's Division of Investment Management, who has discussed this topic in recent speeches.⁶ Given this continued focus, we may see additional changes to prospectus disclosure requirements for fund fees and expenses.

IMPLICATIONS

Funds should review the new specific requirements for shareholder reports and determine what modifications may be required to ensure that both content and format are in line with the requirements included in the Adopted Rules.

Fund fulfillment and investor relations teams will need to design processes to address customer questions and complaints in response to the substantial changes in information they receive, and also to deliver hardcopy materials upon request.

Funds should review their benchmark indices to ensure that they comply with the amended definition of "broad-based securities market index," as some funds will likely have to change their benchmark index for performance comparison purposes.

New iXBRL tagging requirements are likely to significantly impact printing timelines going forward.

Due to the transformational nature of the changes in the Adopted Rules, funds should expect to incur significant implementation costs. Despite these implementation costs, funds and shareholders likely will benefit from reduced printing and mailing expenses over time.

⁵ 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 Adopted Rules also permit funds to provide more current fee and expense information, if available.

⁶ See [Remarks at PLI: Investment Management 2022](#) (July 26, 2022) and [Remarks at the ICI Investment Management Conference](#) (Mar. 28, 2022).

Morgan Lewis

CONTACTS

If you have any questions or would like more information on the issues discussed in this report, please contact any of the following:

Boston

Lea Anne Copenhefer	+1.617.951.8515	leanne.copenhefer@morganlewis.com
Lance C. Dial	+1.617.341.7727	lance.dial@morganlewis.com
Barry N. Hurwitz	+1.617.951.8267	barry.hurwitz@morganlewis.com
Roger P. Joseph	+1.617.951.8247	roger.joseph@morganlewis.com
Jeremy B. Kantrowitz	+1.617.951.8458	jeremy.kantrowitz@morganlewis.com
Toby R. Serkin	+1.617.951.8760	toby.serkin@morganlewis.com
Mari Wilson	+1.617.951.8381	mari.wilson@morganlewis.com
Ellen Blanchard	+1.617.341.7505	ellen.blanchard@morganlewis.com
Lauren A. Fenningdorf	+1.617.341.7883	lauren.fenningdorf@morganlewis.com
Amy C. McDonald	+1.617.341.7810	amy.mcdonald@morganlewis.com

New York

Elizabeth L. Belanger	+1.212.309.6353	elizabeth.belanger@morganlewis.com
-----------------------	-----------------	--

Orange County

Laurie A. Dee	+1.714.830.0679	laurie.dee@morganlewis.com
Jonathan J. Nowakowski	+1.714.830.0640	jonathan.nowakowski@morganlewis.com

Philadelphia

David W. Freese	+1.215.963.5862	david.freese@morganlewis.com
Sean Graber	+1.215.963.5598	sean.graber@morganlewis.com
Timothy W. Levin	+1.216.963.5037	timothy.levin@morganlewis.com
John J. O'Brien	+1.215.963.4969	john.obrien@morganlewis.com

Washington, DC

Mana Behbin	+1.202.373.6599	mbehbin@morganlewis.com
Laura E. Flores	+1.202.373.6101	laura.flores@morganlewis.com
Thomas S. Harman	+1.202.373.6725	thomas.harman@morganlewis.com
W. John McGuire	+1.202.373.6799	john.mcguire@morganlewis.com
Christopher D. Menconi	+1.202.373.6173	christopher.menconi@morganlewis.com
Beau Yanoshik	+1.202.373.6133	beau.yanoshik@morganlewis.com
Abigail Bertumen	+1.202.739.5988	abigail.bertumen@morganlewis.com
Kathleen M. Macpeak	+1.202.373.6149	kathleen.macpeak@morganlewis.com
Monica Lea Parry	+1.202.373.6179	monica.parry@morganlewis.com
Magda El Guindi-Rosenbaum	+1.202.373.6091	magda.elguindi-rosenbaum@morganlewis.com
Matthew Wolock	+1.202.739.5322	matthew.wolock@morganlewis.com

ABOUT US

Morgan Lewis is recognized for exceptional client service, legal innovation, and commitment to its communities. Our global depth reaches across North America, Asia, Europe, and the Middle East with the collaboration of more than 2,200 lawyers and specialists who provide elite legal services across industry sectors for multinational corporations to startups around the world. For more information about us, please visit www.morganlewis.com.