CARLTON FIELDS

SEC Proposes Changes to Fund Shareholder Reports, Prospectuses, SAIs, and Ads

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On August 5, the SEC proposed what it called "comprehensive modifications to the mutual fund … disclosure framework."

These modifications involve:

- Annual and semiannual shareholder reports;
- Form-N-CSR (certified shareholder report);
- Form N-1A registration statement (the prospectus and SAI);
- Fund advertising rules; and
- Rule 30e-3 regarding electronic delivery.

We discuss the proposal's implications for variable insurance products and separate accounts toward the end of this alert.

The SEC proposed the modifications in a 646-page release and summarized the changes in a press release.

The SEC provided for a 60-day comment period beginning with the publication of the release in the Federal Register. Commissioner Allison Lee, in public remarks, said that she thinks more time is going to be needed.

The proposal relies on what's now a familiar SEC regulatory approach:

- Layered disclosure; and
- Electronic delivery.

The proposal requires compliance 18 months after adoption.

Backstory

Jay Clayton, since he became SEC chairman on May 4, 2017, has focused on improving disclosure for what he calls "the Main Street investor."

The SEC announced its "investor experience initiative" on June 5, 2018, a little over two years ago. This proposal is a result of that initiative, as well as preexisting disclosure initiatives.

Clayton is reported to be leaving the SEC before the end of the year. So he'll probably want this proposal in place, or almost in place, before he leaves.

Shareholder Reports

The SEC proposes a new Rule 498B.

Shareholder reports would become what the SEC describes as the "central source of fund disclosure for existing shareholders."

Funds would no longer send annual updated prospectuses to shareholders.

Funds would have drastically shortened shareholder reports — three or so pages — that would be delivered electronically. Other information — layered disclosure — would be in the Form N-CSR. A fund would be required to deliver the report or N-CSR information on paper at no charge, if a shareholder requests.

The SEC proposes an amendment to Form N-1A, item 27A, to reflect new annual shareholder report contents.

Some information that's now in the shareholder report would be *moved* to Form N-CSR — for example, a fund's:

- Financial statements;
- Schedule of investments; and
- Financial highlights.

The schedule of investments would be shortened.

Some information that's in the shareholder report would be *deleted*. For example, information on directors and officers would be deleted because it's required to appear in the SAI.

The proposal imposes no page or word limits. However:

- A shareholder report could cover only a single *series* (although it could cover more than one share *class*); and
- Only required or permitted disclosure would be permitted (although a fund would be able to (i) link "certain additional website information" or (ii) provide additional information to shareholders in the same transmission as the annual report: for example, a fund president's letter explaining the fund's management philosophy or investment outlook).

The SEC's release includes a *specimen* shareholder report, in full color, that's very easy and quick to read. The specimen runs only three pages.

The first page has:

- A table of costs for the period, based on $10,000 worth of shares;
- Performance shown in a percentage figure and compared with the fund's benchmark index; and
- The top performance contributors and detractors in terms of asset classes and sectors.

The second page has:

- A 10-year performance line graph showing actual and benchmark performance; and
- Key statistics, such as fund size, number of investments, portfolio turnover, average credit quality, and 30-day yield.

The third page has:

- A list of investments by asset class, showing credit quality;
- A colorful pie chart showing sector investments by percentage of net assets;
- A narrative of how the fund has changed during the past year;
- Disclosure of the dismissal or resignation of an accountant and the existence of a material disagreement with that accountant;

- Disclosure regarding the fund's liquidity risk and management program;
- Disclosure of how the fund ensures that it has money to pay redemptions; and
- Disclosure of where the shareholder can find additional information, such as the fund's financial statements and proxy voting procedures — with hyperlinks.

The narrative of how the fund has changed during the year would involve two categories of changes:

- First, the narrative would set out changes that had been made in the fund's disclosure documents during the year. The report would be required to set out this disclosure, even if the fund previously provided the disclosure to shareholders by prospectus sticker.
- Second, the narrative would set out disclosure of "material changes that the fund plans to make" in its annual update prospectus. The shareholder report must be sent within 60 days after the first of the year, but the prospectus need not be updated until May 1. So the SEC wants the report to *anticipate* disclosure changes to be made in the prospectus.

Prospectus Disclosure

The SEC proposes to amend Form N-1A disclosure requirements.

Regarding *fee* disclosure, the proposal:

- Replaces the existing fee table in the summary section of the statutory prospectus with a simplified fee summary;
- Moves the existing fee table to the statutory prospectus; and
- Replaces certain terms in the current fee table with terms that the SEC thinks may be clearer to investors.

There's some controversy over the proposal regarding acquired fund fees and expenses. The proposal provides that funds that limit their investments in *other* funds to 10% or less of their total assets would be able to include the fee data in a *footnote* to the fee table rather than as a *line item* in the fee table itself. Commissioners Hester Peirce, Elad Roisman, and Allison Lee, in public remarks, have raised questions about this proposal.

Regarding *risk* disclosure, the proposal requires funds to disclose principal risks in order of *importance*, as opposed to alphabetically or otherwise, in order to reduce the chance that important risks may be obscured.

Regarding *performance* disclosure, the proposal requires funds, in their prospectuses and shareholder reports, to compare their performance to the overall applicable market rather than selecting a narrow index against which the fund may compare more favorably. In addition to required information about an appropriate broad-based securities market index's performance, a fund has the option to compare its performance to other indexes, including more narrowly based indexes that reflect the market sectors in which the fund invests.

Commissioner Elad Roisman, in public remarks, has raised questions about (i) the cost to the fund of licensing the use of any additional index and (ii) the fact that the SEC does not regulate these indexes.

Advertising Rules

The proposal amends Rules 482, 156, and 433 under the Securities Act of 1933 and 34b-1 under the Investment Company Act of 1940 ("1940 Act").

The SEC proposes to amend Rule 482 to require that investment company ads providing fee and expense *figures* include:

- The maximum amount of any sales load, or any other nonrecurring fee; and
- The total annual expenses without deducting any fee waiver or expense reimbursement.

The SEC also proposes to set out factors for investment companies to consider in advertising a fund as "zero expense" or "no expense," when shareholders are *actually* subject to:

- Intermediary costs, such as wrap fees;
- Securities lending fees; or
- Adviser fees that the adviser currently waives.

Implications for Variable Insurance Products and Separate Accounts

The SEC's proposed changes in fund prospectus and shareholder report *disclosure* apply the same way to all funds registered on Form N-1A. The amended Form N-1A does not distinguish between underlying funds selling shares to life insurance company separate accounts ("separate accounts") and retail funds selling shares to the public. Therefore, variable annuity and variable life insurance contract owners, as indirect owners of underlying fund shares, will receive (or have electronic access to) the same form of fund prospectus and shareholder report disclosure as shareholders of retail funds.

At the same time, the SEC's proposal does not supersede the SEC's recently adopted disclosure regime for variable annuity and variable life insurance contracts. This is particularly important for that regime's requirements for the delivery of underlying fund disclosure. For example, proposed new Rule 498B, regarding "delivery of prospectuses to existing shareholders of open-end management investment companies," expressly excludes "investors that hold the fund through a separate account funding a variable annuity contract offered on Form N-4 ... or a variable life insurance contract offered on Form N-6." Therefore, variable annuity and variable life insurance contract owners will receive (or have electronic access to) underlying fund disclosure pursuant to the SEC's recently adopted disclosure regime for variable insurance products and not the proposal.

The SEC does not propose to amend Rule 30e-2, which requires a unit investment trust separate account to transmit an underlying fund's shareholder report. The SEC does propose to amend Rule 30e-3 to exclude open-end funds, but not unit investment trusts. Thus, the terms of Rule 30e-3 would continue to permit a separate account to send only paper notice of internet availability of such report, when the requirements of Rule 30e-3 are satisfied. However, due to the importance of this subject to variable insurance product issuers, we expect commenters on the rule to seek further confirmation from the SEC that this understanding of the proposal is correct.

The SEC's proposal to change the advertising rules under the Securities Act of 1933 and the 1940 Act applies to separate accounts. For example, the release states that "[u]nder the current rules, if an advertisement provides performance data of an open-end management investment company or a separate account registered as a unit investment trust offering variable annuity contracts, it also must include the maximum amount of the fund's sales load (i.e., purchase charge or exit charge) or any other nonrecurring fee that it charges."

The SEC's proposed shareholder report amendments apply only to funds registered on Form N-1A. The proposed amendments do not apply to other registered management investment companies that transmit annual and semiannual reports pursuant to Rule 30e-1 under the 1940 Act, such as *management* insurance company separate accounts. The release points out that the SEC "could extend the shareholder report disclosure amendments to other registered management investment companies, including ... variable annuity separate accounts that register on Form N-3." The SEC states that, in light of recently adopted disclosure forms for variable insurance products, it prefers to "assess the impact of these changes prior to proposing additional disclosure changes for variable contracts or ... funds." The SEC invites comments on extending the shareholder report disclosure amendments to management separate accounts.

Looking Further Ahead

Commissioner Hester Peirce, in public comments, suggested that funds should be allowed to:

- Make electronic-only delivery for new investors; and

- Dispense with mailing paper copies of annual reports and other disclosures on request.

She said that funds would be free to provide information on paper as a business matter, but the government would not require it.

For more information regarding the SEC's fund disclosure reform proposal, please contact Gary Cohen, Richard Choi, Ann Furman, Chip Lunde, Thomas Lauerman, or Edmund Zaharewicz.

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