

THE AMERICAN LAW INSTITUTE
Continuing Legal Education

Life Insurance Company Products 2023:
*Featuring Current SEC, FINRA, Insurance, Tax,
and ERISA Regulatory and Compliance Issues*

November 2-3, 2023
Washington, D.C.

**Variable Annuity Product and Related Disclosure, Regulatory, and
Accounting Pronouncement Developments**

By
W. Thomas Conner
Carlton Fields
Washington, D.C.

A Bird’s Eye View of the SEC’s New Tailored Shareholder Reports Rule

W. Thomas Conner

The Securities and Exchange Commission (the “SEC” or “Commission”) recently adopted rule and form amendments that require mutual funds and exchange-traded funds (together, “funds”) to transmit concise and visually engaging shareholder reports that highlight key information that is particularly important for retail investors to assess and monitor their investments.¹ The rule amendments employ a “layered” disclosure approach by requiring funds to make certain other detailed information that may be more relevant to investors and financial professionals who desire in-depth information, available online, delivered free of charge upon request, and to file such information on a semi-annual basis on Form N-CSR. The Commission also adopted amendments to advertising rules applicable to funds and business development companies to promote more transparent and balanced statements about investment costs.

The Commission prefaced its adoption of the tailored shareholder report amendments by noting that for more than a decade, the agency has engaged in extensive investor research and has proposed and adopted new rules to address concerns regarding the increasing length, complexity and availability of investment company disclosure documents. For example, the Commission adopted Rule 498, the fund summary prospectus rule; Rule 30e-3, which provides optional Internet availability of shareholder reports (but which will soon no longer be available for funds); and Rule 498A, the variable contract summary prospectus rule.

¹ See “Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements,” Investment Company Act Release No. 34731 (Oct. 26, 2022), available here.

Each of these rules were constructed around a “layered” approach to disclosure. Regrettably, though, as discussed below the Commission did not adopt a proposed rule that would have improved the prospectus “evergreening” process for providing existing shareholders with updated information about their funds on an ongoing basis.

This outline was submitted for inclusion in the conference materials for the ALI-CLE Insurance Products Conference 2023. The author’s co-panelists at the conference will discuss in some detail implementation questions that have arisen since the adoption of the tailored shareholder report amendments. The following summary of the amendments is presented to provide background for that discussion.

Tailored Shareholder Reports

When in 2018 the SEC adopted Rule 30e-3 under the Investment Company Act of 1940 (the “Investment Company Act”) to permit shareholder reports to be delivered online through “notice-and-access,” the agency also published a request for comment seeking feedback on retail investors’ experience with fund disclosure and on ways to improve fund disclosure.² The feedback the SEC received in response to this request for comment showed that retail investors prefer concise, layered disclosure and feel overwhelmed by the volume of fund information they currently receive.

The new rules reflect this feedback by requiring funds to transmit to shareholders concise and visually engaging annual and semiannual reports that highlight key information for investors. The focused content requirements are expected to reduce the length of shareholder

² See “Request for Comment on Fund Retail Investor Experience and Disclosure,” Investment Company Act Release No. 33113 (June 5, 2018), available here.

reports to a few pages. The new rules will also give funds the ability 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 by using structured data language, which will allow investors and other interested parties to use automated analytical tools to readily extract information from within a filing.

Under the new streamlined shareholder report disclosure requirements, shareholder reports are only permitted to include information that is specifically permitted or required by new Item 27A to Form N-1A, with limited exceptions. Incorporation by reference is not be allowed. Notably, the amendments eliminate other information, such a fund’s president letter, interviews or commentary from portfolio managers, and general market and similar commentary.³ A separate shareholder report must be prepared for each series of a fund, and if a series has multiple classes, a separate report must be prepared for each such class within the series. Shareholder reports that currently cover multiple funds, series or classes, which are sometimes hundreds of pages long, will need to be broken up. In this regard, Commission staff and industry participants have discussed preparing individual shareholder reports that may be three pages long in a “tri-fold” format.

Shareholder reports must now focus on several principal areas of information: (1) fund expenses, (2) management’s discussion of fund performance; (3) fund statistics, such as net assets, total number of portfolio holdings, total advisory fees, and portfolio turnover rate; (4) graphical illustrations of fund holdings; and (5) material fund changes occurring during the

³ Such additional information could, however, *accompany* the shareholder report provided that it meets the prominence requirements for materials that accompany the report. *See* Instruction 12 to Item 27A(a) of amended Form N-1A.

reporting period. The summary of material changes must briefly describe changes with respect to the fund's name; investment objective or goals; principal investment strategies; principal risks; investment adviser; certain fee and expense charges; and other material changes. As noted above, for funds that post or deliver shareholder reports electronically, the SEC is strongly encouraging the use of modern technology to provide investors with visually stimulating, interactive shareholder reports.

Availability of Additional Information

The new rules require that more in-depth information, such as a fund's schedule of investments and other financial statement elements, be made available to shareholders online. This information will have to be filed with the SEC on a semiannual basis on Form N-CSR and will also have to be delivered free of charge in paper or electronically upon request.

Diminished Scope of Rule 30e-3

As an alternative to delivering shareholder reports in paper, current Rule 30e-3 generally permits investment companies to meet shareholder report transmission requirements by making these reports and other materials available online and providing a notice of the reports' online availability. This method of transmitting shareholder reports has been available to funds since January 1, 2021.

Because of the prominent role that new streamlined shareholder reports will play, the Commission amended Rule 30e-3 so that funds may no longer rely on the rule to send notices of the availability of shareholder reports and then post the shareholder reports and other required documents online. Instead, funds are required to deliver shareholder reports in accordance with

preferences of shareholders, that is, on paper or electronically. Some funds, including funds offered as investment options in variable contracts and the issuers of those contracts that bear responsibility for delivering underlying fund shareholder reports under Rule 30e-2 of the Investment Company Act, have not been keen on this rule change, especially those that now needlessly have spent time and resources altering their existing shareholder report delivery systems to avail themselves of the rule's optional delivery framework.

Amendments to Investment Company Advertising Rules

The new rules require that presentations of investment company fees and expenses in advertisements and sales literature be consistent with relevant prospectus fee table presentations and be reasonably current. These rule amendments will affect all registered investment company and business development company (“BDC”) advertisements that include fee and expense figures. The new rules also address presentations of fees and expenses that could be materially misleading. Importantly, though, with respect to variable contract advertisements, the adopting release accompanying the rule and form amendments noted that “the registration statement forms for variable insurance contract separate accounts do not require that total annual expense figures be presented, and therefore, we understand that total annual expense figures are not presented in variable insurance contract prospectuses) (footnote omitted).”

Proposed Rule 498B Missing in Action

The tailored shareholder report rule amendments were initially proposed in 2020 as part of a package of disclosure reforms for mutual funds and exchange-traded funds.⁴ A primary

⁴ 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,” Investment Company Act Release No. 33963 (Aug. 5, 2020), available here.

aspect of the proposed amendments at that time was that the more concise shareholder reports the Commission was proposing also would serve as the central source of fund disclosure for existing shareholders under a new Rule 498B.

Instead of delivering prospectus updates to existing shareholders each year, funds would have had an alternative way to keep shareholders informed. This framework would have relied on the shareholder report (which would include a summary of material fund changes), along with timely notifications to shareholders about material fund changes as they occur and continued availability of the fund's prospectus. Focused tailored shareholder reports, together with notices of prospectus supplements provided to shareholders throughout the year, would have served as the primary fund disclosure that existing shareholders receive each year. Statutory and summary prospectuses would have continued to be updated each year, but would have only been required to be provided to new investors.

Rule 498B was noticeably absent when the final tailored shareholder report rule amendments were adopted. This approach to providing existing fund shareholders with updated information about their funds as necessary not only would have been welcome by at least some industry participants, it would have taken some of the sting out of funds' losing the ability under Rule 30e-3 to transmit shareholder reports by posting the reports online and mailing shareholders a notice of the reports' availability online.

Compliance Dates

The new rules had an effective date on January 24, 2023. The Commission provided an 18-month transition period to allow funds time to adjust their shareholder reports and comply

with the Rule 30e-3 changes. Investment companies and BDCs also have an 18-month transition period to comply with the new advertising rules.

Conclusion

The tailored shareholder report amendments are requiring funds to make significant revisions to their shareholder reports and other disclosure documents and the transmission systems for delivery of fund documents. While the amendments primarily impact the fund industry, because insurance dedicated funds are equally impacted, variable contract issuers are wrestling with implementation issues. This outline was designed to provide a high-level summary of the amendments as a predicate for discussions regarding those implementation challenges.

W.T.C.