

GUIDANCE REGARDING MUTUAL FUND ENHANCED DISCLOSURE

To further the Commission's goal of clear and concise, user-friendly disclosure, the staff is providing this guidance related to the Commission's enhanced mutual fund disclosure amendments adopted in 2009.¹ This guidance is based on comments the staff of the Division of Investment Management has provided to a number of funds and their counsel related to these amendments, and is intended to focus funds on certain form and rule requirements to provide investors with improved disclosure.

Background

On January 13, 2009, the Commission issued amendments to Form N-1A, the registration form used by mutual funds, in order to enhance the disclosures that are provided to mutual fund investors.² Noting that mutual fund prospectuses were often long and too frequently the language was complex and legalistic, the Commission adopted, among other things, amendments to Form N-1A to provide investors with information that is easier to use and more readily accessible.³ The foundation of the improved disclosure framework was the provision to all investors of streamlined and user-friendly information that is key to an investment decision.⁴ The amendments required the information to appear in plain English in a standardized order at the beginning (*i.e.*, the "Summary Section") of the mutual fund statutory prospectus.⁵ The key information in the Summary Section includes investment objectives and strategies, risks, costs and performance.⁶ The Commission stated that it intended this information be presented succinctly, in three or four pages, at the front of the prospectus.⁷

In addition to the amendments to Form N-1A, the Commission also adopted amendments to Rule 498 under the Securities Act, providing a new option for satisfying prospectus delivery obligations with respect to mutual fund securities under the Securities Act.⁸ Under this option, the key information that is included in the Summary Section of the statutory prospectus is sent or given to investors in the form of a Summary Prospectus. The statutory prospectus is provided on an Internet Web site and funds are required to send it by paper or email upon an investor's request. The Commission's framework



provides for a layered approach to disclosure in which key information is sent or given to the investor and access to more detailed information is provided.⁹ While use of the Summary Prospectus is optional, it has been widely adopted. In the staff's estimate, based on the number of Summary Prospectuses filed with the Commission as of March 31, 2014, well in excess of 80% of mutual funds offer investors Summary Prospectuses.

The staff has now reviewed disclosures related to these amendments for several years, and the staff continues to provide registrants with comments concerning these amendments. This guidance is intended to further the Commission's goal of clear and concise, user-friendly disclosure. While this guidance does not specifically relate to compliance with Rule 498, it does relate to the content of Summary Prospectuses, through the disclosures contained in the Summary Section of the statutory prospectus.

Staff Observations

The staff has observed that funds often provide clear and concise disclosure in response to the specific Summary Section requirements of Form N-1A. There are a significant number of prospectuses, however, in which disclosure remains complex, technical and duplicative. Further, the staff continues to see what it believes are unnecessarily long Summary Sections. In the Adopting Release, the Commission explicitly noted that it shares the concerns of some commenters that, over time, Summary Sections could get longer, undermining the usefulness of the summary.¹⁰ While the Commission did not impose page limits on the Summary Section, stating that doing so could constrain appropriate disclosure, the Commission emphasized its intent that funds prepare a concise summary (on the order of three or four pages) that will provide key information.¹¹ Notwithstanding the Commission's expressed intent, it is not unusual for the staff to review filings with Summary Sections that are longer than ten pages for a single mutual fund and sometimes almost twenty pages in length.

Based on comments the staff has provided, the staff highlights below certain rule and form requirements that, while not exhaustive of the disclosure requirements, are intended to focus funds on providing investors clear and concise disclosure:

- *Summarize the Principal Investment Strategies and Risks:* Form N-1A provides that the principal investment strategies and risks, required by Item 4 in the Summary Section, should be based on the information given in response to Item 9 of the Form, and should be a *summary* of that information.¹² The Form also provides that information included in response to Items 2 through 8 need not be repeated elsewhere in the prospectus.¹³ Instead of a concise summary, however, the staff often observes in Item 4 of the Summary Section long, complex and detailed descriptions

of principal investment strategies and risks that are dense, are not user-friendly, and do not appear to be summaries of the information in Item 9 later in the prospectus. The staff also often reviews prospectuses that substantially repeat the same principal investment strategies and risks disclosure in response to Item 4 and in response to Item 9. Indeed, many times this disclosure is identical.

The layered disclosure regime adopted by the Commission may be undermined by Summary Sections that do not, in fact, summarize the information available elsewhere. In the staff's view, the repetition of substantially the same—or identical—information in response to both Items 4 and 9 often highlights that a fund has not provided a summary in response to Item 4. In addition, the unnecessary duplication of information increases the length of the prospectus. When the staff observes a Summary Section that is long, dense and complex and does not, in fact, appear to summarize a fund's principal strategies and risks, the staff will remind the fund that the Summary Section is intended to summarize the key information that is important to an investment decision, with more detailed information presented elsewhere. Further, when a fund substantially duplicates its disclosure, the staff will remind the fund that information need not be duplicated.

- *Plain English Requirements:* Form N-1A provides that the Summary Section must be provided in plain English under Rule 421(d) under the Securities Act.¹⁴ In addition, the prospectus, in its entirety, is subject to the requirement that the information be presented in a clear, concise, and understandable manner.¹⁵ Similarly, Form N-1A also provides that the prospectus disclosure requirements “are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters.”¹⁶

Notwithstanding these requirements, the staff continues to observe the use of technical terms that are not explained in plain English. Funds also often use unnecessary defined terms, long, compound sentences, and long, dense paragraphs that the staff believes may be difficult for investors to read. The use of plain English principles in the Summary Section is intended to further the Commission's goal of encouraging funds to create useable summaries at the front of their prospectuses.¹⁷ Failure to follow the plain English requirements undermines the usefulness of the Summary Section, and, thus, the Summary Prospectus. Funds are reminded to revisit their disclosures in light of these requirements.

- *Summary Section Must Only Include Required or Permitted Information:* Form N-1A provides that the Summary Section of the prospectus “may not include disclosure other than that required or permitted by [Items 2 through 8].”¹⁸ A fund may, how-

ever, include information elsewhere in the prospectus or in the SAI that is not otherwise required by Form N-1A.¹⁹

The staff closely scrutinizes the disclosure in the Summary Section, and when information is included that is not required or permitted, comments that the information should be moved out of the Summary Section. For example, to streamline the disclosure and foster comparison between funds, the staff, in particular, assesses whether information in the footnotes to the Fee Table is permitted or required. As another example, the staff often comments about the inclusion of purchase and sale information that is neither permitted nor required by Item 6 (“Purchase and Sale of Fund Shares”), which generally requires a fund to disclose its minimum initial or subsequent investment requirements, that the fund’s shares are redeemable, and briefly identify the procedures for redeeming shares. Funds are reminded to include only information in the Summary Section that is either permitted or required by Form N-1A.

- *Inclusion of Non-Principal Strategies and Risks in the Prospectus:* As noted above, Form N-1A requires a fund to disclose its principal investment strategies and risks in its prospectus.²⁰ The Form provides that a fund should describe any investment strategies and risks that are not principal in the SAI.²¹ Form N-1A, however, also provides that a fund may include (except in the Summary Section) information in the prospectus that is not otherwise required.²² Many funds include in their prospectus additional information related to strategies and risks that are not principal. In the view of the staff, however, funds that include this additional information often do not clearly indicate which of the strategies and risks are principal and which are not principal. The staff believes that this can result in prospectus disclosure that does not clearly and concisely inform investors about how the fund principally intends to invest and the related risks. In such cases, the staff will comment that funds should distinguish which of the strategies and risks are principal and which are not principal.
- *Avoid Cross-References:* Form N-1A provides that, in responding to the required information in the prospectus, funds should avoid cross-references to the SAI or shareholder reports.²³ The Form further provides that “[c]ross references within the prospectus are most useful when their use assists investors in understanding the information presented and does not add complexity to the prospectus.”²⁴ The staff frequently observes funds with numerous cross-references in the Summary Section, which the staff believes can add complexity. When appropriate, the staff suggests that the cross-references be deleted to streamline the Summary Section.

Conclusion

In the staff's view, if the 2009 amendments are to have their intended effect of providing investors with clear and concise, user-friendly disclosure, funds and their service providers must act diligently to focus on the established framework. The staff encourages funds to revisit their disclosure in light of this guidance.

Endnotes

- 1 See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28584 (Jan. 13, 2009) [74 FR 4546 (Jan. 26, 2009)] ("Adopting Release"), available at: <http://www.sec.gov/rules/final/2009/33-8998.pdf>.
- 2 Form N-1A is the form used by mutual funds to register under the Investment Company Act of 1940 ("1940 Act") and to offer their securities under the Securities Act of 1933 ("Securities Act"). Form N-1A consists of three parts. Form N-1A is available at: <http://www.sec.gov/about/forms/formn-1a.pdf>. Part A includes the information required in a fund's prospectus under Section 10(a) of the Securities Act. Part B, called the Statement of Additional Information ("SAI"), includes additional information about the fund that the Commission has concluded is not necessary or appropriate in the public interest or for the protection of investors to be in the prospectus, but that some investors may find useful. Part C includes other information required in a fund's registration statement, primarily exhibits.
- 3 Adopting Release, 74 FR at 4546-47.
- 4 *Id.* at 74 FR at 4546. The Commission noted that it "is committed to encouraging statutory prospectuses that are simpler, clearer, and more useful to investors. The prospectus summary section is intended to provide investors with streamlined disclosure of key mutual fund information at the front of the statutory prospectus, in a standardized order that facilitates comparisons across funds." *Id.* at 74 FR at 4549.
- 5 *Id.* at 74 FR at 4546.
- 6 *Id.* Specifically, the "Summary Section" consists of Items 2 through 8 of Form N-1A, as follows: investment objectives (Item 2), costs (Item 3), a summary of principal investment strategies and risks and the fund's performance (Item 4), investment advisers and portfolio managers (Item 5), brief purchase and sale and tax information (Items 6 and 7), and a statement regarding financial intermediary compensation (Item 8).

- 7 *Id.* at 74 FR at 4548.
- 8 17 CFR 230.498.
- 9 Adopting Release, 74 FR at 4560. The form and rule amendments were intended to create a disclosure regime tailored to the unique needs of mutual fund investors in a manner that provides ready access to the information that investors need, want, and choose to review. *Id.* The Summary Prospectus, containing key information about the fund, coupled with online provision of more detailed information, was intended to aid investors in comparing funds and to provide investors with more useable information in a format that investors are more likely to use. *Id.*
- 10 *Id.* at 74 FR at 4551.
- 11 *Id.*
- 12 Form N-1A requires a fund to disclose its principal investment strategies, including the type or types of securities in which the fund principally invests or will invest. See Items 4(a) and 9(b) of Form N-1A. Whether a particular strategy, including a strategy to invest in a particular type of security, is a principal investment strategy depends on the strategy's anticipated importance in achieving the fund's investment objectives, and how the strategy affects the fund's potential risks and returns. See Instr. 2 to Item 9(b) of Form N-1A. In assessing what is a principal investment strategy, a fund should consider, among other things, the amount of the fund's assets expected to be committed to the strategy, the amount of the fund's assets expected to be placed at risk by the strategy, and the likelihood of the fund losing some or all of those assets from implementing the strategy. *Id.* Further, Form N-1A requires a mutual fund to disclose the principal risks of investing in the fund, including the risks to which the fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the fund's net asset value, yield, or total return. See Items 4(b) and 9(c) of Form N-1A.
- 13 General Instruction C.3.(a) of Form N-1A.
- 14 See General Instruction B.4.(c) of Form N-1A. Rule 421(d) [17 CFR 230.421(d)] requires an issuer to use plain English principles in the organization, language, and design of the front and back cover pages, the summary, and the risk factors sections of its prospectus. Specifically, Rule 421(d) lists the following plain English principles: (1) short sentences; (2) definite, concrete, everyday words; (3) active voice; (4) tabular presentation or bullet lists for complex material, wherever possible; (5) no legal jargon or highly technical business terms; and (6) no multiple negatives.

- 15 Pursuant to Rule 421(b) [17 CFR 230.421(b)], the following standards must be used when preparing prospectuses: (1) present information in clear, concise sections, paragraphs, and sentences; (2) use descriptive headings and subheadings; (3) avoid frequent reliance on glossaries or defined terms as the primary means of explaining information in the prospectus; and (4) avoid legal and highly technical business terminology.
- 16 General Instruction 3.C.1.(b) of Form N-1A. Form N-1A also provides that responses to the Items in the Form: (1) “should be as simple and direct as reasonably possible and should include only as much information as is necessary to enable an average or typical investor to understand the particular characteristics of the Fund”; (2) should avoid: “including lengthy and technical discussions; simply restating legal or regulatory requirements to which Funds generally are subject; and disproportionately emphasizing possible investments or activities of the Fund that are not a significant part of the Fund’s investment operations”; (3) should “[a]void excessive detail, technical or legal terminology, and complex language”; and (4) should “avoid lengthy sentences and paragraphs that make the prospectus difficult for many investors to understand and detract from its usefulness.” General Instruction 3.C.1.(c) of Form N-1A.
- 17 Adopting Release, 74 FR at 4549.
- 18 General Instruction C.2.(b) of Form N-1A.
- 19 *Id.*
- 20 *See supra* note 12.
- 21 Item 16(b) of Form N-1A.
- 22 General Instruction C.3.(b) of Form N-1A. Such information may be included so long as the information is not incomplete, inaccurate, or misleading and does not, because of its nature, quantity, or manner of presentation, obscure or impede understanding of the information that is required to be included. *Id.*
- 23 General Instruction C.3.(a) of Form N-1A.
- 24 *Id.*

This *IM Guidance Update* summarizes the views of the Division of Investment Management regarding various requirements of the federal securities laws. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This *IM Guidance Update* is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this *IM Guidance Update*.

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- ▲ protect investors
- ▲ promote informed investment decisions and
- ▲ facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

If you have any questions about this IM Guidance Update, please contact:

Disclosure Review Office

Phone: 202.551.6921

Email: IMOCC@sec.gov