



SEC Issues Guidance Update Regarding Enhanced Mutual Fund Disclosure

BY THE INVESTMENT MANAGEMENT PRACTICE

On January 13, 2009, the U.S. Securities and Exchange Commission (the "Commission") adopted a number of new rules and rule amendments (collectively, the "Summary Prospectus Rules")¹ designed to simplify mutual fund prospectus disclosure and to provide funds with the option to sell shares by means of a short (3-4 page) summary document ("Summary Prospectus")². In June 2014, the Commission's Division of Investment Management issued a Guidance Update³ in light of comments the Commission's staff has provided to a number of funds and their counsel related to the Summary Prospectus Rules.

The Guidance Update reports that the staff has observed a trend in which a significant number of prospectuses include complex, technical, and duplicative disclosure that is inconsistent with the objective of the Summary Prospectus Rules. The Guidance Update is intended to further the Commission's goal of clear and concise, user-friendly disclosure by focusing funds on the following requirements set forth in Form N-1A⁴ and the Summary Prospectus Rules:

- *Summarize the Principal Investment Strategies and Risks*

Form N-1A provides that the principal investment strategies and risks, which are required to be set forth in the Summary Section, should be a summary of the information provided later on in the body of the prospectus.⁵ The Guidance Update reminds issuers that information included in the Summary Section need not be repeated elsewhere in the prospectus. The Guidance Update also notes that the staff often observes that the Summary Section sometimes contains 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 that appears later in the prospectus. In fact, the staff often sees prospectuses that substantially, and often times identically, repeat the same principal investment strategies and risks disclosure in the Summary Section and in the body of the prospectus. The Guidance Update notes that this undermines the Commission's layered disclosure regime, in which investors are sent or given key information contained in the Summary Prospectus, coupled with more detailed information that is provided online and, upon request, is sent in paper or by e-mail. The layered format is 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. Furthermore, the unnecessary duplication of information increases the length of the prospectus.

According to the Guidance Update, 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 investment 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*

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.” As such, the Summary Section must be written in plain English⁶ and the information must be presented in a clear, concise, and understandable manner.⁷

Notwithstanding these requirements, the Guidance Update reports that the staff continues to observe the use of technical terms that are not explained in plain English and the use of unnecessary defined terms, long, compound sentences, and long, dense paragraphs that the staff believes may be difficult for investors to read. Failure to follow the plain English requirements undermines the usefulness of the Summary Section, and, thus, the Summary Prospectus. The Guidance Update reminds funds 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 may not include disclosure other than that required or permitted by the Form.⁸ The Guidance Update reports that the staff closely scrutinizes the disclosure in the Summary Section and will comment that information included, but not required or permitted, should be moved out of the Summary Section. As an example, to streamline the disclosure and foster comparison between funds, the staff 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 to appear in the Summary Section, 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. The Guidance Update reminds funds to include only information in the Summary Section that is either permitted or required by Form N-1A.

- *Inclusion of Non-Principal Investment Strategies and Risks in the Prospectus*

Form N-1A requires a fund to disclose its principal investment strategies and risks in its prospectus. Any non-principal investment strategies and risks should be disclosed in the SAI. 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. The Guidance Update reports that many funds include in their prospectus additional information related to non-principal investment strategies and risks; however, they often do not clearly indicate which of the strategies and risks are principal and which are non-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 investment strategies and risks are principal and which are non-principal.

- *Avoid Cross-References*

Form N-1A provides that in providing the required information in the prospectus funds should avoid cross-references to the SAI or shareholder reports. The Guidance Update reports that the staff

frequently observes funds with numerous cross-references in the Summary Section, which the staff believes can add unnecessary complexity. When appropriate, the staff suggests that the cross-references be deleted to streamline the Summary Section.



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- ¹ See SEC Release No. 33-8998, Enhanced Disclosure and New Prospectus Delivery Option For Registered Open-End Management Investment Companies, <http://www.sec.gov/rules/final/2009/33-8998.pdf> (the "Adopting Release"). The Adopting Release also included amendments pertaining to Rule 498 under the Securities Act of 1933, as amended (the "Securities Act"), with respect to a new option for satisfying prospectus delivery obligations for mutual fund securities. The Guidance Update does not specifically relate to compliance with Rule 498. For more information on the Adopting Release, see Paul Hastings LLP Client Alert, "SEC Adopts 'Summary Prospectus' and Related Rules Designed to Improve Mutual Fund Prospectus Disclosure" (Jan. 29, 2009), available at: <http://www.paulhastings.com/publications-items/details/?id=d466de69-2334-6428-811c-ff00004cbded>.
- ² The Summary Prospectus is identical to the summary section of the statutory prospectus (*i.e.*, the "Summary Section"), except that a fund may omit from the Summary Prospectus the explanation required in the statutory prospectus of the reasons for any change in the comparative securities market index used by the fund for performance purposes. 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).
- ³ IM Guidance Update (Guidance Regarding Mutual Fund Enhanced Disclosure) (June 26, 2014), available at: <http://www.sec.gov/investment/im-guidance-2014-08.pdf>.
- ⁴ Form N-1A is the form used by mutual funds to register under the Investment Company Act of 1940 and to offer their securities under the Securities Act. Form N-1A is available at: <http://www.sec.gov/about/forms/formn-1a.pdf>. Form N-1A consists of three parts. 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.
- ⁵ 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.
- ⁶ 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.
- ⁷ 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.
- ⁸ A fund may, however, include information elsewhere in the prospectus or in the SAI that is not otherwise required by Form N-1A.