A FUND BY ANY OTHER NAME: SEC PROPOSES NAMES RULE AMENDMENTS

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U.S. Asset Management and Investment Funds Alert

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UPDATE: Since this alert was published, the proposals have been printed in the Federal Register, and the comment period will close on 16 August 2022.

SUMMARY

On 25 May 2022, the U.S. Securities and Exchange Commission (the SEC) proposed amendments (the Proposed Amendments) to Rule 35d-1 (the Names Rule) under the Investment Company Act of 1940, as amended in its release entitled "Investment Company Names"[1] (the Proposing Release). The Proposed Amendments would significantly expand the scope of terms that the SEC considers materially deceptive and misleading in a registered investment company's (a fund) name without a corresponding policy to invest at least 80% of the value of the fund's net assets, plus the amount of any borrowings for investment purposes, in the manner suggested by the fund's name (an 80% Policy). Triggered in part by the rise of environmental, social, and governance (ESG) investing and concerns that investors may rely inordinately on a fund's name to understand its investments and risks, the Proposed Amendments are aimed at addressing perceived gaps in the Names Rule.

While the SEC is clearly motivated by concerns over "greenwashing," where disclosure of ESG considerations in fund offering materials does not align with actual investment practices, the Proposed Amendments would also capture other terms that historically have been considered investment strategy terminology outside the scope of the rule. This approach represents a significant departure from the SEC's long-standing position on the use of fund names by expanding the scope of the Names Rule to apply to fund names that include terms suggesting that the fund focuses in "investments that have, or whose issuers have, particular characteristics."

Consequently, the Proposing Release states an 80% Policy would be required for funds with names that include "growth" or "value" or terms indicating that the fund's investment decisions incorporate one or more ESG factors. Further, the Proposed Amendments would define as materially deceptive or misleading the use of ESG or similar terminology in a fund's name by "integration funds" where the identified ESG factors are considered to the same extent as other screening factors in the fund's investment decision-making process.

The Proposed Amendments include enhanced disclosure requirements for how a fund defines the terms in its name and selects investments for its 80% basket. The Proposed Amendments also go beyond enhancing disclosure requirements by limiting when funds may deviate from an 80% Policy, mandating how the Names Rule will be applied to derivatives exposure calculations, imposing specific requirements on unlisted closed-end funds and business development companies (BDCs), and requiring new or expanded notice, recordkeeping, and reporting requirements. The comment period for the Proposed Amendments is 60 days after publication in the

Federal Register.[2] If adopted, compliance with all elements of the Proposed Amendments will be required following a one-year transition period.

EXPANSION OF SCOPE AND INTERPRETATION OF MATERIALLY DECEPTIVE AND MISLEADING NAMES

> If adopted as proposed, the expansion of the Names Rule would require all funds currently without an 80% Policy to review and consider whether they must now implement an 80% Policy.

As adopted in 2001, the Names Rule requires a fund with a name that suggests investment in certain types of investments, industries, countries, or geographical regions to adopt an 80% Policy to invest, under normal circumstances, at least 80% of the value of its net assets, plus the amount of any borrowings for investment purposes, in holdings aligned with the fund's name. Historically, the SEC has not applied the Names Rule to names that correspond to a particular investment focus or strategy. Unlike traditional Names Rule terms such as “real estate” or “large capitalization” that are broadly understood and easily quantified, strategies are frequently a subjective aspect of a fund's investment policies.

The Proposed Amendments would expand the scope of the Names Rule to cover fund names that describe investment strategies as well as investment types or industries. This represents a significant departure from how the SEC has regulated fund names for two decades. The Names Rule would be expanded to apply to terms suggesting the fund focuses in investments that have, or whose issuers have, particular characteristics, including such terms as “growth,” “value,” and terms indicating that the fund's investment decisions incorporate one or more ESG factors. The SEC believes terms like “growth,” “value,” and “sustainable” communicate to investors that a fund will concentrate in investments that the fund believes have those particular characteristics.

> Under the Proposed Amendments, a fund cannot include ESG in its name if ESG factors are not the determinative consideration in investment decisions or if the fund makes substantial investments that are contrary to its ESG factors, even when those investments are within the other 20% basket under an 80% Policy.

Notably, the Proposed Amendments would prohibit so-called “integration funds” from using ESG-related terms in their names. As defined in the Proposing Release, an integration fund is a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions but does not consider such ESG factors as determinative or more significant than other factors in the investment selection process.

The Proposed Amendments codify the SEC position from the original Names Rule adopting release that technical compliance with the Names Rule is not a safe harbor, and a fund name may be materially deceptive or misleading even where the fund complies with its 80% Policy. In particular, the SEC cites this codification in their restriction on ESG integration funds, as discussed above. Further, the Proposing Release explains that a fund's name could be materially deceptive or misleading if the fund makes a substantial investment that is antithetical to the fund's

investment focus or invests in a way such that the source of a substantial portion of the fund's risk or returns is different from that which an investor reasonably would expect based on the fund's name, regardless of the fund's compliance with the requirements of the Names Rule.[3]

The Proposing Release also notes that the Names Rule application could extend to terms like “global,” “international,” “income,” or “intermediate term (or similar) bond” depending on the context. However, the Proposed Amendments are not meant to expand the Names Rule to names that do not otherwise specify the fund's investments, such as names that suggest characteristics of the fund's overall portfolio (e.g., duration or balanced), particular investment techniques (e.g., long/short), or possible results to be achieved (e.g., real return).

DEPARTURES FROM 80% POLICY

> The Proposed Amendments would limit funds' ability to depart from an 80% Policy and require funds to quickly come back into compliance. This could require daily compliance tracking and could be particularly burdensome for funds taking temporary defensive positions due to market conditions or other reasons if those market conditions still exist after the 30-day period.

Whereas the Names Rule currently only applies “under normal circumstances” and at the time of investment, the SEC specifies in the Proposed Amendments the particular circumstances under which a fund may depart from its 80% Policy, including specific timeframes for coming back into compliance (as soon as reasonably practicable but in any event within 30 consecutive days, except as specifically noted below). Such circumstances permitting an 80% Policy departure include (i) market fluctuations or other circumstances not caused by the fund's purchase or sale of a security or entering or exiting an investment; (ii) to address unusually large cash inflows or redemptions; (iii) to take a position in cash and cash equivalents or government securities to avoid loss in response to adverse market, economic, political, or other conditions; or (iv) to reposition or liquidate a fund's assets in connection with a fund launch (within 180 consecutive days), reorganization (no specific time period required), or when at least 60 days notice of a change to the fund's 80% Policy has been provided to shareholders under the Names Rule (time period to be driven by the length of notice).

DERIVATIVES

> The Proposed Amendments’ definitive approach of requiring funds to use the notional value of derivatives instruments, rather than market value, when calculating compliance with an 80% Policy contrasts with past views of the Division of Investment Management’s disclosure review staff, who have regularly requested in the comment process that registrants confirm and disclose that they use a derivatives investment’s market value for purposes of compliance with their 80% Policies.

The SEC stated that in order to more accurately reflect the investment exposure derivatives investments create, the Proposed Amendments would require funds to use a derivatives instrument's notional amount, rather than its market value, for the purpose of determining the fund's compliance with its 80% Policy. Specifically, the Proposed

Amendments would require a fund to value each derivatives instrument using its notional amount, with certain adjustments.[4] When calculating a fund's net assets for the "denominator" to test compliance with the 80% Policy, a fund would be required to reduce the value of its assets by excluding cash and cash equivalents up to the notional amounts of its derivatives investments. The SEC explains that a market value approach may not accurately capture the investment exposure a fund may have to derivatives used in furtherance of an 80% Policy, where a notional value approach would, and the SEC notes that their proposed approach would help to align derivatives use with investor expectations.

Further, the Proposed Amendments also specify that a fund may include in its 80% basket derivatives instruments that provide investment exposure to either (i) investments suggested by the fund's name or (ii) one or more of the market risk factors associated with the investments suggested by the fund's name (e.g., interest rate risk, credit spread risk, and foreign currency risk). The SEC specifically is concerned that investors could be misled or deceived if a fund gains significant exposure through a derivatives instrument to a particular asset class but uses a name that reflects exposure to a different asset class, and thus these proposed derivatives valuation requirements apply to all derivatives instruments.

UNLISTED CLOSED-END FUNDS AND BDCS

> Requiring unlisted closed-end funds and BDCs to adopt fundamental policies tied to their names will significantly inhibit the boards of these types of funds from being able make a determination as to whether maintaining an 80% Policy is in the best interest of the fund. In addition, it puts these types of funds on an uneven playing field with other registered investment companies, potentially disadvantaging them in the marketplace.

The Proposed Amendments require that a fund's 80% Policy must always be a fundamental investment policy if the fund is a registered closed-end fund or BDC whose shares are not listed on a national securities exchange. As a result, these funds would not be permitted to change a Names Rule 80% Policy without a shareholder vote. This proposed change reflects the SEC's concern that a shareholder in an unlisted closed-end fund or BDC generally will have no ready recourse, such as the ability to redeem or quickly sell their shares, if the fund were to change its investment policy and the investment focus that the fund's name indicates.

DISCLOSURE REQUIREMENTS

To deepen investor understanding and clearly communicate these enhanced Names Rule requirements, the SEC is also proposing amendments to fund registration statement forms. The Proposed Amendments would require a fund with an 80% Policy to include disclosure in its prospectus that defines the terms in its name that are related to the fund's investment focus or strategies, including any specific criteria the fund uses to select the investments the term describes.[5] Further, where a fund's name suggests an investment focus in multiple types of investments or investment strategies, the fund's 80% Policy must address all elements in the name. In particular, the Proposing Release states that funds that include "ESG" in their names must adopt 80% Policies to address environmental, social, and governance investments (rather than a single element of the "ESG" term).

> The Proposed Amendments assume that there are standardized terms for the strategies potentially covered by the expanded scope of the rule. However, different funds implement particular strategies in very different ways, and standardization to "plain English" meaning and conventional industry use fails to recognize that one manager might implement a strategy differently than another.

The SEC also is targeting a certain degree of industry standardization relating to fund naming practices with the Proposed Amendments.[6] Consistent with the current Names Rule, a fund must define a term used in its name reasonably. However, in a change from the current rule, a fund using a name that suggests an investment focus, or a tax-exempt fund, would be required to use a term consistent with the term's "plain English" meaning or established industry use. Fund issuers would be prohibited from using fund naming terminology that differs from the plain English meaning or industry-established use in an effort to more closely align fund naming terminology with investor expectations. Further, while the Proposing Release notes that funds could use compliance policies and procedures to address how to allocate portfolio companies in its 80% basket consistent with such requirements, the SEC cautions funds from simply relying on textual characterizations in issuer public disclosure documents without further analysis.

RECORDKEEPING AND REPORTING

> The proposed recordkeeping requirements would impose significant new compliance burdens for funds, whether or not they are subject to an 80% Policy. For example, while funds typically have in place mechanisms for monitoring compliance with 80% Policies, funds may not formally maintain records of the reasons for and the dates of departures from such policies (since the Names Rule requirement currently applies "under normal circumstances" and "at the time of investment"), nor do funds typically formally document the determination that an 80% Policy is not required.

If the Proposed Amendments are adopted, funds that are subject to the amended Names Rule would be required to maintain certain records documenting their compliance with the rule, such as recording which investments are counted towards the fund's 80% Policy and the basis for their inclusion towards the 80% Policy, as well as the reasons for any departures from the 80% Policy, dates of such departure, and any related shareholder communications. While many of these records may be automated, they likely would need to be maintained on a daily basis for most funds with ongoing investment activity. All funds will be affected by the amended Names Rule, as funds that do not adopt an 80% Policy would be required to maintain a written record of their analysis that such a Policy is not required under the Names Rule in light of the fund's name.

The SEC also is proposing amendments to Form N-PORT to require greater transparency on how fund investment selection methods match the investment focus that the fund's name suggests. Such reporting would represent an additional data category that the SEC can aggregate and analyze across registrants, potentially subjecting funds whose investment selections for a particular 80% basket are "outliers" to greater regulatory scrutiny. These new reporting items would disclose (i) the value of the fund's 80% basket, as a percentage of the value of the fund's assets; (ii) with respect to each portfolio investment, whether the investment is included in the

fund's 80% basket at the end of the period; and (iii) if applicable, the number of days that the value of the fund's 80% basket fell below 80% of the value of the fund's assets during the reporting period. These proposed N-PORT requirements would not be applicable to money market funds.

MODERNIZING NAMES RULE NOTICE REQUIREMENTS

The Proposed Amendments would update the notice requirements under the Names Rule for providing notice to shareholders when a fund makes any change to its 80% Policy by specifying the form and requirements for electronic as well as written notices. The notice period remains "at least 60 days prior notice," and the notice must describe the nature of the change to the 80% policy as well as the fund's old and new names and the effective date of the changes. If the notice is provided electronically, the Proposed Amendments would require a statement to appear on the subject line of the email communication that includes the notice stating: "Important Notice Regarding Change in Investment Policy [and Name]." The Proposed Amendments, as in the current rule, also would require the notice to be provided in plain English and separately from any other documents.

CONCLUSION

The Proposed Amendments, as well as other ESG-related rules applicable to investment advisers and investment companies that were proposed on the same day, demonstrate the SEC's intention to regulate in an area that previously had few rules specifically addressing this area of the securities industry.

For additional information and guidance on the SEC's proposed ESG rules and amendments, please refer to our 27 May 2022 client alert, SEC Takes First Step Toward Standardized ESG Disclosures for Funds and Investment Advisers.

Terms such as "ESG," "growth," and "value" will continue to mean different things to different people. Regardless of how the Names Rule ultimately may be amended, the focus for funds and their sponsors should be on providing clear and accessible disclosure to help investors understand how investment strategies are applied, supporting them with well-organized and documented compliance procedures. While the parameters under the Names Rule will drive the industry towards consistent and comparable disclosure structures, funds will be challenged to differentiate themselves by providing the clarity and detail necessary to inform investors about how the fund lives up to its name.

FOOTNOTES

[1] *See* U.S. SEC. & EXCH. COMM'N, INVESTMENT COMPANY NAMES (May 25, 2022), https://www.sec.gov/rules/proposed/2022/ic-34593.pdf.

[2] As of the date of this alert, the Proposed Amendments have not been published in the Federal Register.

[3] The Proposing Release provided several examples of scenarios where a fund could be in violation of the Names Rule despite technical compliance with its 80% Policy. For example, (i) a "fossil fuel-free" fund complies with its 80% investment policy but makes a substantial investment in an issuer with fossil fuel reserves; (ii) the fund invests in a way such that the source of a substantial portion of the fund's risk or returns is different from that which an investor reasonably would expect based on the fund's name (e.g., a short-term bond fund using the 20%

basket to invest in highly volatile equity securities that introduce significant volatility into a fund that investors would expect to have lower levels of volatility associated with short-term bonds); (iii) an index tracking fund invests 80% or more in an index included in the fund's name, but that underlying index has components that are contradictory to the index's name; or (iv) a fund is perpetually out of compliance with the 80% investment requirement on account of temporary departures even if each temporary departure is permissible under the Names Rule.

[4] In calculating notional amounts for purposes of meeting an 80% Policy, a fund would be required to convert interest rate derivatives to their 10-year bond equivalents and to delta adjust the notional amounts of options contracts. These adjustments are consistent with those used when calculating a fund's “derivatives exposure” under Rule 18f-4 under the Investment Company Act of 1940, as amended (the Derivatives Rule).

[5] For registration forms, the SEC is proposing to amend Form N-1A, Form N-2, Form N-8B-2 and Form S-6. The SEC is also proposing to amend Form N-PORT.

[6] The Proposed Amendments also include a requirement for funds to tag certain disclosures using Inline XBRL, including the defined terms required for funds with strategy names.

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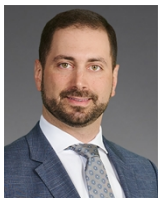

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