# REGISTERED FUNDS AND THE NEW NAMES RULE PROPOSALS: WHAT YOU NEED TO KNOW AND WHY YOU NEED TO COMMENT NOW

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**U.S. Asset Management and Investment 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 (the 1940 Act).[1] 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 fund's assets in the manner suggested by the fund's name (an 80% Policy).

The Proposed Amendments:

- Expand the scope of the Names Rule to encompass certain terms denoting an investment strategy that have historically been considered beyond the scope of the Names Rule;
- Require additional disclosures regarding how a fund selects investments that fit the terms used in its name;
- Limit the types of investments a fund can make outside of its 80% Policy;
- Narrow the length of time and circumstances in which a fund may depart from its 80% Policy;
- Impose strict standards for how a fund must calculate the value of derivatives exposures;
- Impose new requirements on unlisted closed-end funds and business development companies (BDCs); and
- Modify the Names Rule's notice, recordkeeping, and reporting requirements.

We previously summarized the Proposed Amendments in our 26 May 2022 client alert, "A Fund By Any Other Name: SEC Proposes Names Rule Amendments."

This client alert focuses on potential areas for comment on the Proposed Amendments to the Names Rule where they may present difficulties or uncertainty for funds.[2]

The comment period for the Proposed Amendments is 60 days after publication in the Federal Register.[3] If adopted, a one-year transition period is proposed for compliance with all elements of the Proposed Amendments.

## EXPANSION OF SCOPE

The current Names Rule requires a fund with a name that suggests investment in certain types of investments, industries, countries, or geographical regions, or that suggests the fund's distributions are tax-exempt, to adopt a corresponding 80% Policy. In a significant departure from past practice, the Proposed Amendments would expand the scope of the Names Rule to also include fund names that include terms suggesting that a fund focuses in "investments that have, or whose issuers have, particular characteristics." In addition to easily quantified terms such as "real estate" or "large capitalization," terms that historically connoted a specific strategy, such as "growth," "value," "income," "global," "international," and "intermediate term (or similar) bond" would now be subject to the requirements of the Names Rule.

It would not however apply to names that suggest characteristics of the fund's overall portfolio, such as a name indicating the fund seeks to achieve a certain objective or portfolio "duration" or that the fund is "balanced." It would also not apply to names that suggest a possible result to be achieved (real return) or a particular investment technique (long/short).

### Deviations From Historical Uses

Unlike security types that generally reflect static characteristics, fund names connected to strategies may present issues with compliance with 80% Policies over time. As discussed in greater detail below under "DEPARTURES FROM 80% POLICY," the SEC has proposed a shift in 80% Policy compliance from a time-of-purchase test to a daily compliance test in an attempt to reduce "drift" as the nature of certain securities changes over time. Applying an 80% Policy to certain terms that have historically been connected to investment strategies could be incongruent with the strategies themselves, requiring funds to materially alter their strategies to meet these new requirements.

For example, the Proposed Amendments could prove problematic for funds with "value" or "growth" in their names seeking to execute a "buy and hold" strategy. Indeed, portfolio managers could be challenged in managing such a fund in accordance with its 80% Policy as the securities grow in capitalization, increase in value, or when other particular characteristics change following their initial purchase. This could also artificially increase portfolio turnover and potential tax consequences to investors by forcing these funds to sell the securities that best demonstrated their investment theses rather than providing investors with the benefit of long-term investment in these positions.

### Investment Focus – A Security's Particular Characteristics v. Characteristics of the Fund's Overall Portfolio

While the SEC in the Proposing Release states that "[d]istinguishing whether a term connotes a 'strategy' versus a 'type of investment' can be a subjective determination, prone to second guessing," the lack of a definition or clarity regarding the meaning of "particular characteristics" further presents an interpretational challenge for funds. Rather than assessing whether terminology addresses a strategy or an investment type, funds would be required to assess every strategy term to determine how "focused" it is. The Adopting Release distinguishes a fund name that references characteristics of a fund's portfolio as a whole, such as "duration," versus a fund name that references particular characteristics of the component portfolio investments, noting that the former would not require an 80% Policy, whereas the latter would. This distinction may present practical challenges for funds seeking to clearly distinguish between the two, such as where the intent is to focus on the portfolio as a whole, but the implementation reflects portfolio investments with particular characteristics. For example, it may be difficult to differentiate where an overall portfolio duration target reflects the average duration of every individual portfolio security.

Contrary to the original release in which the Names Rule was adopted in 2001, which states an 80% Policy is not required for the terms “international” and “global,” as these terms connote diversification among investments in a number of different countries throughout the world or based on other characteristics, the Proposed Amendments would consider this to generally constitute an investment focus which would now require an 80% Policy.[4]

Although the Proposing Release clarifies whether certain terms would be covered under the Proposed Amendments, many naming conventions for commonly used investment strategies would need to be revisited by fund sponsors. In certain cases, over twenty years of application of the existing Names Rule structure has contributed to the development of “plain English” meanings and established industry uses for strategy terms that reflect qualitative features that exist alongside and above more numerical investment policies and restrictions. Without clarity on what constitutes a “particular characteristic,” fund sponsors may opt to adopt generic fund names that do not describe fund strategies at all, and avoid second guessing on terminology.

The SEC also requested comments from the industry regarding whether the Names Rule should apply to terms suggesting a fund engages in short sales and whether, where a fund's name includes multiple elements, specific minimum requirements (e.g., 5%, 10%, 25%) should be applied to each term in a fund's name that triggers the Names Rule. Currently, funds are not limited in this manner unless they elect to include specific minimums in the strategy, and portfolio managers typically have flexibility to invest more in such strategies favored by current market conditions.

## INTERPRETATION OF MATERIALLY DECEPTIVE OR MISLEADING NAMES

The Proposed Amendments would codify the SEC position from the original Names Rule adopting release that no safe harbor exists for technical compliance with the Names Rule, such that a fund name may be materially deceptive or misleading even where the fund complies with its 80% Policy.

The current rule does not prescribe how a fund invests its remaining 20% of assets. However, the Proposed Amendments make clear that a fund name may be materially deceptive or misleading where a 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 does not align with what an investor would reasonably expect based on the fund's name, regardless of technical compliance with the 80% Policy.[5]

This interpretation of materially deceptive or misleading would apply unnecessary additional qualitative determinations under the Names Rule. Form N-1A already requires funds to disclose principal investment strategies and principal risks in their summary prospectuses. The Names Rule protects investors by requiring an 80% Policy in line with the investments an investor would expect based on the fund's name. Any substantial investments or risk exposures in the 20% basket should already be sufficiently disclosed in the fund's summary prospectus without the need to add another undefined qualifying term such as “substantial” into the existing considerations of principal investment strategies and risks. This has the potential to encourage greater than 80% compliance and discourage investments that may still be in the best interests of shareholders.

Funds are subject to various risks, and the extent to which a risk applies to a fund may not be identified until after it has had a negative impact on performance. Measuring risks necessitates forecasting, and thus cannot be quantified in the same manner as many categories historically covered by the Names Rule. This could subject funds to potential enforcement or litigation actions based on hindsight of how a risk impacted a fund in scenarios when it could not be accurately projected in advance.

## DEPARTURES FROM 80% POLICY

The Proposed Amendments greatly reduce the ability of a fund to depart from its 80% Policy by prescribing a limited set of circumstances and timeframes (as soon as reasonably practicable but in any event within 30 consecutive days) during which such a departure is permitted. A fund would only be permitted to depart from its 80% Policy: (i) as a result of 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) during certain fund events.[6]

### Issues with the 30-Day Limit

Setting a strict limit of no more than 30 consecutive days for a fund to return to compliance with an 80% Policy during adverse market, economic, political, or other conditions may not be in the best interests of shareholders. Enforcing this requirement on Eastern Europe-focused funds during the currently ongoing confrontation between Russia and Ukraine, for example, may have caused such funds to endure significant losses. Although the Proposing Release acknowledges that some investors would likely prefer their fund to continue to depart from its 80% Policy rather than incur losses to come back into compliance, the SEC remains concerned that extended departures would undermine investor expectations created by the fund's name. As a result, the Proposed Amendments could challenge investor expectations that the fund will act in their best interests at all times.

### No Longer “Under Normal Circumstances”

Rather than limiting investor protections in this manner, the current Names Rule requires the 80% Policy to be met “under normal circumstances,” providing funds with broad flexibility to react to unexpected occurrences or market turmoil to protect investors. Where such market turmoil is focused in a particular investment type or industry that is tied to a fund's 80% Policy, a fund would be further limited by the Proposed Amendments if temporary defensive investments could only be made in cash and cash equivalents or government securities without access to other types of investments that could be held when taking a defensive position.

### Time of Investment v. Daily Compliance

The Proposed Amendments also move away from applying 80% Policies at the time of investment. Instead, in order to comply with the 30-day limit on departures, funds will be required to track compliance with 80% Policies at least daily, with detailed records demonstrating the assessment of each security position counted towards the 80% basket. While this process lends itself to automation for tracking easily quantifiable characteristics such as types of investments, industries, and geographic regions that have historically been covered by the Names Rule, it could place a heavy burden on portfolio managers to continually confirm and reconfirm that qualitative terms such as “value” continue to apply to every security they hold.

## DERIVATIVES

Under the Proposed Amendments, the Names Rule would require funds to use the notional value of derivatives instruments, rather than market value, when calculating compliance with the 80% Policy.

### Notional Value

As adopted in 2001, the Names Rule defines “assets” as a fund's net assets, plus the amount of any borrowings for investment purposes. This definition has provided clear guidance for over two decades on how to measure compliance with an 80% Policy, but neither the 2001 adopting release nor contemporaneous “Frequently Asked Questions” guidance published by the SEC staff addressed the appropriate treatment of derivatives. The SEC staff through the registration statement comment process has often asked funds whether derivatives are included in the fund's 80% Policy, and, if so, how they are valued. Over the years, the SEC staff has at times taken the position during the comment process that derivatives included in an 80% Policy should be calculated using market value and not notional value, although many fund families do use the notional value of derivatives for Names Rule compliance.

Under the Proposed Amendments, the definition of “assets” would be expanded to require a fund to value each derivatives instrument using the instrument's notional amount and reduce the value of its assets by excluding any cash and cash equivalents up to the notional amount of the derivatives instrument(s). Notional amounts must be converted to 10-year bond equivalents for interest rate derivatives and delta adjusted for options contracts, and the change to the definition of assets would have the effect of changing the Names Rule compliance calculations for both the “numerator” and “denominator” of the 80% Policy.

In theory, the SEC believes notional value would better reflect the investment exposure connected to individual derivatives instruments, and in many cases, such as a total return swap on a security or an index, this is likely the case. But in practice, notional value may overstate the economic exposure associated with the position for certain types of derivatives instruments. For example, because currencies tend to move against one another in small increments, currency forwards and other currency derivatives generally will not introduce investment risk to a fund's investment portfolio that corresponds to those large notional amounts. By contrast, a derivative with a volatile reference asset, such as the CBOE Volatility Index (VIX), could introduce enormous risk at relatively low notional amounts. Credit default swaps and more complex instruments may also introduce asymmetric risks that are not properly reflected in a derivatives instrument's notional value.

In the adopting release for Rule 18f-4 under the 1940 Act (the Derivatives Rule), the SEC specifically stated that “[u]sing gross notional amounts to measure market exposure could be viewed as a relatively blunt measurement” that would not be suited for calculating precise measurements of a fund's exposure to derivatives or the level of risk posed by such investments, adopting instead a value-at-risk compliance testing regime.[7] Commenters may consider whether the SEC's assessment of notional value as a “blunt measurement” for purposes of the Derivatives Rule is also an apt characterization for purposes of the Names Rule.

### Potential for Manipulation and Confusion

 

For certain funds, the notional value of derivatives instruments could far exceed the net assets of the directly held securities, skewing the calculation of the 80% Policy to overly account for derivatives exposures. This could encourage increased usage of derivatives to replace direct securities investments as a mean to achieve compliance with an 80% Policy, and could even be subject to manipulation by funds struggling to otherwise maintain their 80% Policies during volatile or adverse market conditions. The Proposed Amendments also specify that a fund may include in its 80% basket derivatives instruments that provide investment exposure to one or more of the market risk factors associated with the investments suggested by the fund's name (i.e., hedges). The inclusion of hedge positions will have the effect of increasing the notional value of the 80% basket in most cases, but it could also provide opportunities to manipulate the calculation by treating derivative positions as hedging risks of positions in the 80% basket even when the hedge is imperfect or only loosely correlated to the 80% basket positions.

Requiring funds to use the notional value for derivatives investments under the Names Rule could also create confusion for shareholders by disconnecting calculations for purposes of compliance with an 80% Policy from a fund's other policies and restrictions, such as the valuation procedures the fund uses to calculate its net asset value. Further, the use of disparate calculation practices, taken together, imposes a significant compliance burden on a fund to calculate each individual derivatives position using multiple different methods in order to comply with the various rules that have been in place for years, that the SEC has recently promulgated, and that it has proposed amending.

## UNLISTED CLOSED-END FUNDS AND BDCS

For registered closed-end funds or BDCs whose shares are not listed on a national exchange, the Proposed Amendments require that the fund's 80% Policy must always be a fundamental investment policy due to the limited liquidity that may be available to shareholders in these structures. If implemented as proposed, these funds would be prohibited from changing an 80% Policy under the Names Rule without a shareholder vote.

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. It is also possible this segment of the industry may move towards generic names that would provide investors with less of an understanding about how these funds invest in reaction to the imposition of these disadvantages.

## KEY TAKEAWAYS AND REQUESTS FOR COMMENTS

The comment period for the Proposed Amendments is 60 days after their publication in the Federal Register. This client alert summarizes a number of areas that may warrant industry comments, but the combination of broad scope and open-ended statutory terminology create many questions that remain to be analyzed and addressed.

The following key areas are likely to affect registered fund complexes and industry participants and are ripe for comments:

- Without definitions or additional guidance from the SEC as to their meaning, how can funds reasonably distinguish between a name that references characteristics of a fund's portfolio as a whole versus a name that references particular characteristics of the component portfolio investments?

 

- How should terms such as “particular characteristics,” “antithetical,” and “substantial investment” be defined for purposes of the Names Rule?
- Should funds with an 80% Policy have more rather than less flexibility with respect to the 20% of assets not committed to the 80% Policy with appropriate disclosure?
- With respect to the Proposed Amendments related to departures from the 80% Policy, should the focus be on investor expectations for protection of assets or on preventing extended departures that would undermine investor expectations created by the fund's name?
- Does the departure from a “time of investment” 80% Policy to one where funds are required to continually monitor a particular investment make sense for qualitative fund names?
- Would the use of notional value for derivatives cause current fund portfolios to depart from their existing 80% Policies?

Please see below a summary of the terms the Proposing Release specifically noted would be covered or not covered by the Proposed Amendments. However, note that these are only examples and the universe of names potentially impacted is far broader.

| Terms Covered by Proposed Expanded Scope of the Names Rule | Terms That Would Continue to be Excluded from the Names Rule |
|---|---|
| ▪ Growth<br>▪ Value<br>▪ ESG Factors<br>▪ Global<br>▪ International<br>▪ Income<br>▪ Intermediate Term (or similar) Bond | Names that reference:<br>▪ Characteristics of a fund's objective or portfolio as a whole<br>  ▪ Duration<br>  ▪ Balanced<br>▪ Elements of an investment thesis or technique without specificity as to the particular characteristics of the component portfolio investments<br>  ▪ Long/Short<br>▪ A possible result to be achieved<br>  ▪ Real Return<br>▪ A retirement target date |

## FOOTNOTES

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

[2] While this client alert does not address environmental, social, and governance (ESG) considerations under the Names Rule, please refer to our 8 June 2022 client alert, *"Registered Funds and the New ESG Rule Proposals: Everything You Wanted to Know (But Were Afraid to Ask),"* for a detailed discussion on the impact of the Proposed Amendments and other proposed rulemakings regarding ESG funds.

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

[4] *See U.S. SEC. & EXCH. COMM'N, INVESTMENT COMPANY NAMES* (Jan. 17, 2001),https://www.sec.gov/rules/final/ic-24828.htm, at n.42.

[5] 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.

[6] Such fund events include: *(i)* to reposition or liquidate a fund's assets in connection with a fund launch (within 180 consecutive days); *(ii)* in advance of a reorganization (no specific time period required); or *(iii)* 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).

[7] *See U.S. SEC. & EXCH. COMM'N, USE OF DERIVATIVES BY REGISTERED INVESTMENT COMPANIES AND BUSINESS DEVELOPMENT COMPANIES* (Feb. 19, 2021), https://www.sec.gov/rules/final/2020/ic-34084.pdf.

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