WHAT'S IN A FUND NAME? SEC APPROVES CHANGES TO THE FUND NAMES RULE

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US Asset Management and Investment Funds Alert

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On 20 September 2023, the US Securities and Exchange Commission (the SEC) adopted amendments to Rule 35d-1 (the Names Rule or Rule) under the Investment Company Act of 1940, as amended (the 1940 Act), and made related form amendments (collectively, the Amendments). The Amendments substantially expand the Names Rule's application and related disclosures by including within the scope of the Rule names that suggest a registered investment company (fund) focuses on strategies with "particular characteristics" in addition to the prior focus on investment in particular types of securities. Among other things, this makes terms that historically have been viewed as related to a fund's strategy, such as "growth" and "value," as well as many others, now subject to the Names Rule. The Amendments also change how funds are required to address deviations from the Rule through establishment of minimum standards for compliance testing and setting of timeframes for variance from compliance. In addition, the Amendments change how derivatives exposure is measured under the Rule for compliance testing, alter investor notice requirements, and add significant recordkeeping requirements. The Amendments will have a significant impact and necessitate that the majority of existing funds consider whether changes are required to current names, 80% investment policies, and registration statement disclosures. Sponsors also will need to consider how to name new funds in light of the Amendments as overall industry impact is absorbed. The Amendments overall create material uncertainty and suggest a large amount of SEC staff discretion in interpretation.

EXPANSION OF NAMES RULE SCOPE

The Amendments expand the scope of terms under the Names Rule that would require a fund to adopt a policy to invest at least 80% of the fund's assets in the manner suggested by the fund's name (an 80% Policy). Currently, the Names Rule applies to fund names that suggest a focus on a particular type of investment, industry, countries or geographic regions, or those that suggest certain tax treatment. The Amendments expand the application of the Names Rule to fund names containing terms that suggest that the fund focuses on investments that have, or investments whose issuers have, "particular characteristics." This expanded scope would apply irrespective of whether those characteristics describe an investment security or an investment strategy.

Notably, the SEC does not define the term "particular characteristics," and instead includes a nonexclusive list of examples of "particular characteristics." The adopting release for the Amendments (the Adopting Release) highlights the SEC's view that "particular characteristics" will be recognized as any feature, quality, or attribute that suggests an investment focus. According to the Adopting Release, specific terms that have "particular characteristics" include:

- Growth;

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- Value;
- Environmental, social, governance (ESG) factors/terms; and
- “Thematic” funds.

In addition, if a fund's name suggests multiple elements of investment focus, then the Amendments require that the fund's 80% Policy address all of the elements in the name suggesting an investment focus. Fund managers are permitted to take a reasonable approach in specifying how the fund's investments will incorporate each such element in the name and, importantly, the Adopting Release makes clear that each element of focus need not independently meet the 80% threshold included in such policies. Further, a fund of funds is permitted to include the entire value of investment in an acquired fund when calculating compliance with its 80% Policy as long as the acquired fund has an 80% Policy that is consistent with the investment focus of the fund of funds. The Amendments do not directly address index funds, but the Adopting Release clarifies that an index fund is not subject to an additional 80% Policy for other terms in an index fund's name apart from an 80% Policy to invest in its underlying index. However, the Adopting Release indicates that index funds should adopt policies and procedures under its Rule 38a-1 compliance program around the name of its underlying index to ensure the name of the index itself is not materially deceptive or misleading.

Certain terms continue to be excluded from the Names Rule, including names that reference:

- Characteristics of a fund's portfolio as a whole, without an additional term suggesting an investment focus, such as:
  - Duration, intermediate-term, balanced, global, or international;
- Elements of an investment thesis to be achieved or a particular investment technique to be utilized without specificity as to the particular characteristics of the component portfolio investments, such as:
  - Real return, managed risk, long/short, and hedged;
- Negative or exclusionary screening processes for investments, such as:
  - Fossil fuel free;
- A specific population of investors, well-known organizations or affinity groups, such as:
  - Generation Z; and
- Asset allocation determinations that evolve over time, such as:
  - Target date funds and sector rotation funds.

Importantly, in the Adopting Release, the SEC reiterated that funds that are not subject to Rule 35d-1 will continue to be subject to Section 35(d)'s prohibition on materially misleading or deceptive names and that such funds likewise will continue to be subject to the anti-fraud provisions of the federal securities laws regarding disclosures to investors. Similarly, the SEC stated its belief that a fund's name could be materially deceptive or misleading for purposes of Section 35(d) even if that fund has complied with the Names Rule's 80% investment policy requirement. For example, the SEC stated that, if a fund that is subject to Rule 35d-1 uses its 20% basket to

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invest in assets that are materially inconsistent with the investment focus or risk profile reflected by the fund's name, the fund's name "would be" materially deceptive or misleading under Section 35(d).

These Amendments have broad implications for all funds. Funds with an 80% Policy will need to review their current names and 80% Policies, as well as their other permissible investments (e.g., the 20% basket) to analyze whether changes are required. Funds without an 80% Policy will need to review their current fund names to analyze whether they now require an 80% Policy or if a change in the fund's name is necessary.

REGISTRATION STATEMENT DISCLOSURE CHANGES

In addition to adopting an 80% Policy, fund names that fall under the Names Rule are required to define in their prospectuses the terms used in their names, including the criteria the fund uses to select the investments that the term describes. A fund with an existing 80% policy should review whether the policy requires definitions or definitional edits, and funds that become subject to the 80% policy requirement may need to define or edit terms.

Terms are supposed to be defined consistent with their "plain English" meaning or established industry use. The Adopting Release states that funds will have the flexibility to use a "reasonable" definition of the terms in their names and flexibility to determine the specific criteria used to select investments. Whether a term should be defined consistent with its plain English meaning or established industry use will be a context-based analysis.

Importantly, the SEC acknowledged in the Adopting Release that different portfolio managers or third-party data providers may use different definitions for the same term as long as it is not inconsistent with a term's plain English meaning or established industry use. As a result, what is reasonable will vary with a fund's name and will depend on the nexus established between the fund's name and the definition of the fund's investment focus. The SEC added that, similar to other prospectus disclosures, this disclosure should follow the general instructions of Form N-1A, which requires funds to avoid "excess detail, technical or legal terminology, and complex language."

Notably, the ability of funds to ascribe reasonable definitions is not in the actual text of the Names Rule and appears only in the discussion in the Adopting Release. This could result in practice in a large amount of discretion in interpretation by the SEC staff.

Changing a Fund's Name in Response to a Names Rule Determination

The Adopting Release does not directly address the process by which an existing fund should reflect in its registration statement and other disclosures any changes to its name or principal investment strategies in response to a determination that its name now requires the adoption of an 80% Policy under the Amendments, including whether such changes would require such a fund that is an open-end fund to file a post-effective amendment pursuant to paragraph (a) of Rule 485 under the Securities Act of 1933. The Amendments are likely to impact a significant number of funds, which could potentially create a substantial burden for registrants, as well as the SEC staff. This is particularly true in light of the interpretive challenges presented by the scope of the phrase "investments that have, or whose issuers have, particular characteristics" under the amended Rule. Accordingly, registrants will need to carefully consider the materiality of any changes to existing funds' disclosure for purposes of Rule 485(a) as a result of the Amendments.

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DEVIATIONS FROM 80% POLICY

In a departure from the rule proposal, which would have required daily compliance monitoring, funds will continue to be able to determine whether an investment falls under a fund's 80% Policy at the time of investment. However, in a potentially significant change from current practices, a fund will also be required to conduct at least quarterly reviews of its holdings to reassess compliance with its 80% Policy at the applicable quarter end.

A fund's 80% Policy will continue to apply “under normal circumstances” and funds will retain the discretion to determine what is not a “normal circumstance.” Of note, the Adopting Release states that frequent or serial departures in other-than-normal circumstances may call into question a fund's determination of what circumstance is normal.

In addition, if a fund's assets deviate from its 80% Policy, the Amendments require a fund to come back into compliance with its 80% Policy as soon as reasonably practicable and in all circumstances within 90 days of the date of departure from compliance. As noted above, this is a significant change from current practice and, notably, this requirement cannot be waived by a fund's board. The only remedy under the Amendments is to seek exemptive relief from the SEC if a fund believes it would be appropriate and consistent with the protection of investors for the fund to depart from its 80% Policy for a period beyond 90 days. As with current practice, any future investments after the deviation must be made in a manner that will bring the fund into compliance with its 80% Policy.
Funds may also temporarily depart from their 80% Policies in connection with:

- Reorganizations (no required time frame to come back into compliance);
- Fund launches (180 days to come into compliance); or
- After notice of a change in fund policy is provided to shareholders (no required time frame to come back into compliance).

COUNTING SHORTS AND DERIVATIVES UNDER AN 80% POLICY

In another significant change from current practice, the Amendments require funds to use a derivatives instrument's notional amount (subject to adjustments described below), rather than its market value, when determining the value of a fund's assets for purposes of its 80% Policy. Physical short positions must be valued using the value of the asset sold short.

Under the Amendments, required adjustments to the use of a derivative notional amount are as follows:

- Funds must convert interest rate derivatives to their 10-year bond equivalents;
- Funds must delta-adjust the notional amount of options;
- Funds must exclude derivatives used to hedge currency risk associated with a fund's foreign currency denominated investments if the notional amounts of the derivatives do not exceed the value of the hedged investments by more than 10%; and
- Funds must value each physical short position using the value of the asset sold short.

In addition, funds may make the following adjustments to a notional amount:

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- Funds may deduct cash and cash equivalents and US Treasury securities with remaining maturities of one year or less from assets, up to the notional amounts of the fund's derivatives instruments and the value of the asset sold short; and
- Funds may exclude any closed-out derivatives positions when calculating assets for purposes of determining compliance with its 80% Policy when those positions result in no credit or market exposure to the fund;
    - The Amendments do not require closed-out positions be closed out with the same counterparty in order for a fund to exclude them from the calculation of its assets, which is a significant departure from Rule 18f-4 of the 1940 Act.

The Amendments adopt, substantially as proposed, the derivatives instruments that a fund may include in its 80% Policy. In particular, the Amendments require the inclusion of any derivative instruments that provide investment exposure to investments suggested by the fund's name. In addition, a fund may include in its 80% Policy a derivative instrument that provides investment exposure to one or more of the market risk factors associated with the investments suggested by the fund's name. As a result, derivative instruments included in a fund's 80% Policy basket must either function as a substitute for direct investments in the securities suggested by the fund's name or be used to facilitate the fund's investment in those securities by increasing or decreasing the fund's exposure to risk factors associated with those securities.

NO ABSOLUTE PROHIBITION ON THE USE OF ESG TERMS IN NAMES FOR "INTEGRATION FUNDS"

In a departure from the proposed rule, the Amendments do not take action regarding so-called "integration funds," which are funds that include ESG terms in their names but consider ESG factors alongside other non-ESG factors in investment decisions where none is more significant than another. The Adopting Release noted that the description of integration funds in the Names Rule proposal mirrored the definition of integration funds in the SEC's ESG Disclosure Proposal,[1] and determined that they are continuing to consider comments on that proposal and are not adopting the proposed change at this time. Of note and as described above, fund names with terms suggesting a fund focuses on ESG factors, including integration funds, must adopt an 80% Policy and comply with the Amendments.

NEW FORM N-PORT REPORTING AND RECORDKEEPING REQUIREMENTS

The Amendments expand materially record-keeping and reporting requirements. Specifically, the Amendments require funds having 80% Policies, other than money market funds and business development companies (BDCs), to report the following information on their Form N-PORT for the third month of each quarter:

- Whether an investment is in a fund's 80% Policy basket;
- The value of the fund's 80% Policy basket, as a percentage of the value of fund assets; and
- The definitions of terms used in the fund's name, including the specific criteria the fund uses to select the investments that the term describes.

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The Amendments also require funds with 80% Policies to maintain written records of the following to demonstrate compliance with the Amendments:

- Record of investments included in the 80% Policy basket and basis for inclusion at the time the fund invested in the asset;
- The value of the 80% Policy basket, as a percentage of value of the funds' assets at the time the fund invested in the asset;
- Quarterly review and records of investments included in the 80% Policy basket and basis for inclusion;
- If drift has caused the fund to no longer meet the 80% requirement, record of the date this was identified and the reason for departure;
- Reasons for any departures, including why the fund departed if it did so for circumstances that are other-than-normal;
- Dates of departures from the 80% Policy requirement in other-than-normal circumstances; and
- Notices sent to shareholders.

These records are required to be maintained for at least six years following the creation of the records, the first two years of which must be in an easily accessible place.

CHANGE TO NOTICE REQUIREMENTS

The Amendments retain the existing requirement either that an 80% policy be a fundamental policy or the fund has adopted a policy to provide the fund's shareholders with at least 60 days' prior notice of any change in the policy. The Amendments, however, change the notice requirements to be more prescriptive and add that shareholders be informed of the change in the name of a fund along with change in the 80% Policy. Other aspects of the notice requirements remain similar to the current Names Rule with some modification for electronic delivery. In particular, the prominent notice currently required in written notices must be in the subject line of communications for electronic transmittal.

The notice must include, as applicable:

- A description of the fund's 80% Policy;
- The nature of the change to the 80% Policy;
- The fund's old and new names; and
- The effective date of any investment policy or name changes.

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NEW LIMITS FOR CHANGES BY UNLISTED CLOSED-END FUNDS AND BUSINESS DEVELOPMENT COMPANIES

Unlisted closed-end funds (CEFs) and BDCs are subject to the Names Rule like other funds. However, they are subject to special rules related to changing their 80% Policies. Unlisted CEFs and BDCs are prohibited from changing their 80% Policy without a shareholder vote, unless:

- The fund conducts a tender or repurchase offer in advance of the change to the 80% Policy;
- The fund provides at least 60 days' prior notice to shareholders of the change to the 80% Policy in advance of that offer;
- The offer is not oversubscribed; and
- The fund purchases shares at their net asset value.

Because such funds frequently invest in illiquid assets and conduct limited tender offers for liquidity purposes, the conduct of a tender offer for a potentially larger than normal amount may not be practical, which could in effect result in a requirement for a shareholder vote.

COMPLIANCE DATES

Fund groups with net assets of US $1 billion or more would have 24 months to comply with the Amendments, and fund groups with net assets of less than US $1 billion would have 30 months to comply.

Of note, certain unit investment trusts are exempt from the new requirements, including the monitoring and recordkeeping requirements, unless an 80% Policy was adopted or was required to be adopted at the time of initial deposit.

FOOTNOTES

[1] *See* Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, Investment Company Act Release No. 34594 (May 25, 2022) [87 FR 36654 (June 17, 2022)].

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KEY CONTACTS



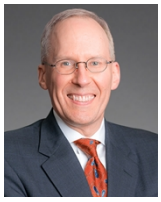
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