June 1, 2022

SEC Proposes Changes to the Fund Names Rule

On May 25, 2022, the U.S. Securities and Exchange Commission (the "SEC") issued a release (the "Release")[1] containing proposed changes to the names rule, Rule 35d-1 under the Investment Company Act of 1940, as amended (the "1940 Act") (the "Rule"), and related form amendments (collectively, the "Proposals").[2] If adopted as proposed, the Proposals would substantially expand the Rule's applicability and require funds to amend their prospectus disclosure. Specifically, the Proposals would:

- Expand the Rule's 80% investment policy requirement to apply to any fund name containing terms that suggest the fund focuses in investments that have, or investments whose issuers have, particular characteristics (*e.g.,* "growth," "value" or terms indicating that the fund's investment decisions incorporate one or more ESG factors).

- Require funds to specify the particular circumstances under which they may depart from their 80% baskets, including specific time frames for getting back into compliance.

- Require funds to use a derivatives instrument's notional amount, rather than its market value, when determining the fund's compliance with its 80% investment policy and specifically address the derivatives instruments that a fund may include in this 80% basket.

- Amend funds' prospectus disclosure requirements by requiring a fund to define the terms used in its name, including the criteria employed to select the investments described by the term.

- Prohibit the use of ESG or similar factors in a fund's name if the factors do not play a central role in the fund's strategy (so-called "integration funds").[3]

These and other aspects of the Proposals are discussed in detail below.

I. New 80% Investment Policy Requirement – Names Suggesting an Investment Focus

The Proposals' Broad Scope. The Proposals would broaden the scope of the Rule's current 80% investment policy requirement to apply to fund names that "include terms suggesting that the fund focuses in investments that have, or whose issuers have, particular characteristics." This would include fund names with terms such as "growth" or "value," or terms indicating that the fund's investment decisions incorporate one or more ESG factors.[4] Therefore, as expanded, the Rule's 80% requirement would apply where a fund's name could be construed as referring to an investment strategy. The Rule's existing 80% investment policy requirement would continue to apply to funds with names that suggest a focus on a particular type of investment or industry, or in particular countries or geographic regions, or those that suggest certain tax treatment.

- The Proposals would capture other fund names that, until this point, may have not required an 80% investment policy (depending on the context), such as names that include terms like "global," "international," "income," or "intermediate term (or similar) bond."

- Where a fund's name suggests an investment focus that has multiple elements, the fund's 80% investment policy would have to address all of the elements in the name that suggest an investment focus.[5] The Release states that the Rule "permits the fund to take a reasonable approach in specifying how the fund's investments will incorporate each such element in the name." As an example, the Release states that the XYZ Environmental,

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Social, and Governance Fund "must adopt an 80% investment policy to address all three of those elements," and the SEC "recognize[s] that there are multiple reasonable ways the policy could address these elements."

- If a fund's name suggests an investment focus but also contains a term that does not suggest an investment focus, the Proposals would require the fund to adopt an 80% investment policy. As an example, the Release states that the XYZ Technology and Real Return Fund "would be required to adopt an 80% investment policy to invest 80% of the value of its assets in the technology sector despite the phrase 'real return' also appearing in the name."

- The Release states, in some cases, "what would be appropriate to include in the fund's 80% basket would be context-specific." As an example, the Release notes that funds currently do not include the value of short positions, including short-exposure derivatives, related to the investment focus suggested by a fund's name in their 80% baskets, absent some term in the fund's name – such as "inverse," "hedged" or "long/short" – that suggests to investors that short activity is or may be part of the fund's investment approach (*e.g.*, the XYZ Long/Short Equity Fund).

<u>Defining Terms in a Fund's Name</u>. Consistent with the Rule's current requirements, the Release states that funds would be able to define terms used in their names in a reasonable way. However, in a change from the current rule, the Proposals "would require that any terms used in the fund's name that suggest either an investment focus, or that the fund is a tax-exempt fund, must be consistent with those terms' plain English meaning or established industry use." According to the Release, what constitutes "reasonable" in this context could vary depending on the fund name, but "requires a meaningful nexus between the given investment and the focus suggested by the name." Here, the Release notes that, "when the investment focus relates to an industry, there are different approaches a fund could take to determine if a given security is tied to the economic fortunes and risks associated with the named industry."

<u>Treatment of a Fund of Funds</u>. The Release states that "it would generally be reasonable for a fund of funds or other acquiring fund to include the entire value of its investment in an appropriate acquired fund when calculating compliance with the 80% investment requirement without looking through to the acquired fund's underlying investments."[6]

<u>Funds Unaffected by the Proposals</u>. The Release notes that there will be fund names that would not require the fund to adopt an 80% investment policy because the names "would not connote an investment focus." This would include fund names that (i) reference characteristics of a fund's portfolio as a whole (such as a name indicating the fund seeks to achieve a certain portfolio "duration" or that the fund is "balanced"), (ii) reference elements of an investment thesis without specificity as to the particular characteristics of the component portfolio investments (such as "long/short"), (iii) suggest a possible result to be achieved (such as "real return") or (iv) refer to a retirement target date.[7]

II. Temporary Departures from the 80% Investment Requirement

The Proposals would permit a fund to temporarily depart from the 80% investment requirement under certain specific circumstances (i) as a result of market fluctuations or other circumstances where the temporary departure is not caused by the fund's purchase or sale of a security or the fund's entering into or exiting an investment, (ii) to address unusually large cash inflows or unusually large redemptions, (iii) to position the portfolio in cash and cash equivalents or government securities to avoid a 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 reorganization, to launch the fund or, following notice of a change in the fund's 80% investment policy, to fund shareholders at least 60 days before the change pursuant to the Rule.

Under each of these circumstances – except fund launches (where temporary departures may not exceed a period of 180 consecutive days),[8] reorganizations (for which the Proposals do not specify a required time frame) or where the 60-day notice has been provided to shareholders – the Proposals would require a fund to bring its portfolio back into compliance

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with the 80% investment requirement within 30 consecutive days or "as soon as reasonably practicable" (whichever period is shorter). The Release notes that "as soon as reasonably practicable" would not strictly mean "as soon as possible" in all instances, but is intended "to allow for consideration by the adviser of how to return to compliance in a manner that best serves the interest of the fund and its shareholders (but in no case longer than the proposed 30-day limit where applicable)."

III. Derivatives Instruments and Names Rule Compliance

The Proposals address both (i) the valuation of derivatives instruments for purposes of determining compliance with a fund's 80% investment policy and (ii) the derivatives instruments that a fund may include in its 80% investment requirement.

Use of Derivatives Instruments' Notional Amounts. The Proposals would require a fund, in calculating its assets for purposes of compliance with the Rule, to value each of its derivatives instruments using its notional amount (subject to adjustments discussed below) and to reduce the value of its assets by excluding cash and cash equivalents up to the notional amounts of the derivatives instrument(s).

- When calculating notional amounts for these purposes, the Proposals would require a fund to convert interest rate derivatives instruments to their 10-year bond equivalents and to delta adjust the notional amounts of options contracts.
- The Release states that (i) the requirement to convert interest rate derivatives instruments to 10-year bond equivalents "is designed to result in adjusted notional amounts that better represent a fund's exposure to interest rate changes" and (ii) the requirement to delta adjust options "is designed to provide for a more tailored notional amount that better reflects the exposure that an option creates to the underlying reference asset."

Derivatives Instruments Includes Liabilities. The Proposals' requirement to use notional amounts would apply to all of a fund's derivatives instruments. The requirement would apply to both the numerator and the denominator in the calculation that the fund would use to determine compliance with its 80% investment policy. Moreover, the Proposals requirement to value derivatives instruments using their notional amounts makes no distinction between derivatives instruments that are assets and derivatives instruments that are liabilities. Therefore, the Proposals would require funds, in measuring their assets when assessing compliance with its 80% investment policy, to include the notional amount of any derivatives instrument, regardless of whether the instrument is an asset or a liability.

Deduction of Cash and Cash Equivalents from Assets up to Notional Amounts. Funds that rely upon derivatives instruments to obtain exposure to the markets in which they invest may maintain portions of their assets in cash and cash equivalents.[9] Thus, when assessing compliance with a fund's 80% investment policy, the Proposals would require the deduction of cash and cash equivalents from assets (*i.e.*, the denominator in the 80% calculation) up to the notional amounts of the fund's derivatives instruments.

According to the Release, the approach is intended to remove from the compliance calculation cash and cash equivalents because they do not themselves provide market exposure and function as low-risk collateral for the derivatives instruments whose notional amounts already are included in the denominator. Thus, "including this collateral would effectively 'double-count' the fund's exposure" and including both the derivatives instruments' notional amounts and the value of the cash and cash equivalents "would overstate the scale of the fund's market exposure obtained through the derivatives instruments."

Derivatives Instruments Included in the 80% Basket. The Release acknowledges that, in addition to using derivatives instruments as direct substitutes for cash market investments, some funds use derivatives instruments to hedge exposures or to obtain exposure to market risk factors associated with the fund's investments (*e.g.,* interest rate risk, credit spread

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risk and foreign currency risk). The Release states that, if amended Rule 35d-1 "did not allow funds to treat the notional amounts of those derivatives instruments as investments that reflect the fund's investment focus, the notional amounts of those derivatives instruments could cause a fund to fall out of compliance with its 80% investment policy."

- Therefore, in addition to any derivatives instruments that a fund includes in its 80% basket because they provide investment exposure to the investments suggested by the fund's name, the Proposals would permit a fund to include in its 80% basket any 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.

- Consequently, the derivatives instruments included in a fund's 80% investment requirement basket must (i) function as a substitute for direct investments in the securities suggested by the fund's name or (ii) 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.

IV. Unlisted Closed-End Funds and BDCs

Some funds are either a registered closed-end investment company or a business development company (a "BDC") whose shares are not listed on a national securities exchange (together, "unlisted closed-end funds and BDCs"). The Proposals would require the 80% investment policy of unlisted closed-end funds and BDCs to be a fundamental investment policy.

- Under the Proposals, a "fundamental investment policy" is a policy adopted under Section 8(b)(3) of the 1940 Act or, if the fund is a BDC, a policy that is changeable only if authorized by the vote of a majority of the outstanding voting securities of the fund. As a result, unlisted closed-end funds and BDCs would not be permitted to change their 80% investment policies without shareholder approval.

- Under the current Rule, an unlisted closed-end fund's or BDC's 80% investment policy generally must either be a fundamental policy or subject to a requirement in the Rule to provide shareholders 60 days' advance notice of any change in the policy.

- Because unlisted closed-end funds and BDCs do not issue redeemable shares or list their shares on a national securities exchange – even if they provide 60 days' notice – shareholders in these funds generally lack 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.

- The Proposals address this concern by providing that investors in unlisted closed-end funds and BDCs must be able to vote on a change in investment policy or focus.

V. Effect of Compliance with an 80% Investment Policy

The Proposals would include a new provision in the Rule providing that a fund's name may be materially deceptive or misleading under Section 35(d) even if the fund adopts an 80% investment policy and otherwise complies with the Rule's requirement to adopt and implement the policy. The Release notes that the SEC has previously stated that the Rule's 80% investment policy requirement is not intended to create a safe harbor for fund names, and the Proposals, if adopted, would codify this view to make clear that a fund name may be materially deceptive or misleading even where the fund complies with its 80% investment policy.

The current Rule requires and, with the Proposals' amendments, would continue to require, a fund to invest at least 80% of its assets consistent with its name, but does not prescribe how the fund invests the remaining 20%. The Release notes that a fund's name could be materially deceptive or misleading for purposes of Section 35(d) if, for example, a fund

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complies with its 80% investment policy but makes a substantial investment that is antithetical to the fund's investment focus (*e.g.*, a "fossil fuel-free" fund making a substantial investment in an issuer with fossil fuel reserves). Similarly, a fund's name could be materially deceptive or misleading for purposes of Section 35(d) if the fund invests in a way such that the source of a substantial portion of the fund's risk or returns is different from those that an investor reasonably would expect based on the fund's name, regardless of the fund's compliance with the requirements of the Rule (*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).

VI. Prospectus Disclosure – Defining Terms Used in Fund Name

The Proposals include amendments to registration forms (Form N-1A, Form N-2, Form N-8B-2 and Form S-6) that would require any fund that is required to adopt and implement an 80% investment policy to include prospectus disclosure defining the terms used in the fund's name, including the specific criteria the fund uses to choose the investments described by the terms. In addition, funds would be required to tag this new information using a structured data language ("Inline XBRL").

- Under the proposed disclosure requirements, "terms" would mean any word or phrase used in a fund's name, other than any trade name of the fund or its adviser, related to the fund's investment focus or strategies. Words in a fund's name that do not describe an investment focus or strategy would not need to be defined (*e.g.*, "fund" or "portfolio").
- For fund names focusing on particular countries or geographic regions, the proposed disclosure requirements would replace the existing disclosure requirement with the general requirement to define terms used in the fund's name whenever the fund's name suggests an investment focus requiring an 80% investment policy.
- According to the Release, funds would have "flexibility to use reasonable definitions of the terms that their names use." However, a "fund's use of reasonable definitions of the terms used in the fund's name may not . . . otherwise change the meaning of these terms to be inconsistent with their plain English meaning or established industry use."

VII. Materially Deceptive and Misleading Use of ESG Terminology in Certain Fund Names

The Proposals specifically address what the Release calls "integration funds," which the Proposals describe as funds that consider one or more ESG factors alongside other, non-ESG factors in the fund's investment decisions but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio.

The Proposals would provide that the name of an "integration fund" is materially deceptive and misleading if the fund's name includes terms "suggesting that the fund's investment decisions incorporate one or more ESG factors." The Release states that this approach to integration funds makes clear that "it would be misleading for a fund for which ESG factors are generally no more significant than other factors in the investment selection process to include ESG terminology in its name, as this has the potential to overstate the importance of the ESG factors in the fund's selection of its portfolio investments." Therefore, a fund would be prohibited from using terms such as "ESG" or "sustainable" in its name where ESG inputs are merely one factor among many driving an investment decision. The inclusion of ESG terminology in a fund's name "would be materially deceptive and misleading unless a fund prioritizes those ESG considerations that their names suggest, as contrasted to funds that analyze ESG factors only as part of a broader investment selection process."

VIII. Modernizing the Rule's Notice Requirement

The Proposals would amend the Rule to include changes to the current notice requirement, which now requires 60 days' notice to fund shareholders of any change in the fund's 80% investment policy.

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- The Rule would specifically require, if the notice is delivered in paper form, that the notice may be provided in the same envelope as other written documents. This change is intended merely to clarify the current Rule's provisions that address when and how a notice can be provided with other written documents, but not to alter these current provisions substantively.

- The Rule would require that the notice contain the following prominent statement (or similar clear and understandable statement) in bold-face type: "**Important Notice Regarding Change in Investment Policy [and Name]**." The prominent statement would continue to alert shareholders that the notice contains information about a change in the fund's investment policy. In addition, the required prominent statement would have to highlight, where applicable, the fund's name change.

- For any notice under the Rule that is provided in paper form, the Rule would require that the prominent statement must also appear on the envelope in which the notice is delivered. This is an expansion of the Rule's existing requirement, which requires the statement to appear on the envelope only when the envelope includes other materials.

- For any electronic notice to shareholders under the Rule, the Rule would require the prominent statement to appear on the subject line of the email communication that includes the notice.

- In all cases, the Rule would require that the notice describe, as applicable, the fund's 80% investment policy, the nature of the change to the 80% investment policy, the fund's old and new names, and the effective date of any investment policy and/or name changes.

IX. N-PORT Reports

The Proposals would amend Form N-PORT to include a new reporting item requiring registered funds (other than money market funds and BDCs) that are required to adopt an 80% investment policy to report on Form N-PORT (i) the value of the fund's 80% basket, as a percentage of the value of the fund's assets and (ii) 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. Funds subject to this reporting would be required to provide this information as of the end of the reporting period, and the information would be publicly available for the third month of each of the fund's fiscal quarters.

The Proposals also would amend Form N-PORT to include a new reporting item requiring a registered fund that is subject to the 80% investment policy requirement to indicate, with respect to each portfolio investment, whether the investment is included in the fund's 80% basket. This information would be publicly available for the third month of each of the fund's fiscal quarters.

X. Recordkeeping

The Proposals would require funds to maintain certain records depending on whether the fund would be required to adopt an 80% investment policy.

Funds Required to Adopt an 80% Investment Policy. The Proposals would require a fund that is required to adopt an 80% investment policy to maintain written records of the following to document its compliance under the 80% investment policy provisions of the Rule.

- The fund's record of the investments included in the fund's 80% basket and the basis for including each such investment in the 80% basket;

- The value of the fund's 80% basket, as a percentage of the value of the fund's assets;

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- The reasons for any departures from the 80% investment policy;
- The dates of any departures from the 80% investment policy; and
- Any notice sent to the fund's shareholders pursuant to the Rule.

Funds That Do Not Adopt an 80% Investment Policy. The Proposals would require a fund that does not adopt an 80% investment policy to maintain a written record of the fund's analysis that such a policy is not required under the Rule.

XI. Unit Investment Trusts

The Proposals would include certain exceptions for unit investment trusts ("UITs") that have made their initial deposit of securities prior to the effective date of any amendments to the Rule that the SEC adopts. These UITs would be exempt from the requirements to adopt an 80% investment policy and the recordkeeping requirements, including recordkeeping for funds that do not adopt an 80% investment policy, unless the UIT has already adopted – or was required to adopt at the time of the initial deposit – an 80% investment policy under the now existing form of the Rule.

In addition, all UITs would be subject to the Proposals' other requirements. Consequently, UITs would be subject to the proposed plain English requirements, as well as the requirements to make prospectus disclosures that would be mandated by the Proposals and to tag newly required information in the prospectus using Inline XBRL.

XII. Comment Deadline

The Release states that comments on the Proposals should be received by the SEC no later than 60 days after publication of the Release in the *Federal Register*. As of the date of this Alert, the Release has not been published therein.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

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1. Investment Company Names, Rel. No. IC-34593 (May. 25, 2022).
2. On the same day, the SEC issued a separate release containing proposals to enhance disclosures by investment advisers and registered funds about their ESG investment practices. This separate release will be discussed in an upcoming Ropes & Gray Alert.
3. In general, the Release states that an integration fund considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, and the ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be dispositive with respect to any particular investment.
4. Under proposed Rule 35d-1(a)(2), the term "ESG" would encompass terms such as "socially responsible investing," "sustainable," "green," "ethical," "impact" or "good governance" to the extent they describe environmental, social, and/or governance factors that may be considered when making an investment decision.
5. As an example, the Release states that the investment policy of a fund named ABC Wind and Solar Power Fund could provide that each security included in the 80% basket must be in both the wind and solar industries or, instead, that 80% of the value of the fund's assets will be invested in a mix of investments, with some solar investments, some wind investments, and some investments in both industries. Similarly, the Release states that the XYZ Preferred Securities and Income Fund could have an investment policy to invest at least 80% of the value of its assets in preferred securities and securities that meet the fund's standards for being income-producing.

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6. The Release provides as an example a fund of funds with the name XYZ Industrials Fund that has an 80% investment policy to invest in the industrials sector. The Release states that the fund “could count the entire value of its investments in the ‘ABC Automotive Fund’ when calculating compliance with the 80% investment requirement, provided that the ABC Automotive Fund has an 80% investment policy to invest in its subsection of the industrials sector.”
7. The Release notes that while such names do not suggest that the fund focuses its investments in any of the ways covered under the proposed expanded scope, such names would continue to be subject to Section 35(d)’s prohibition on materially misleading or deceptive names, and funds with these names would continue to be subject to the anti-fraud provisions of the federal securities laws regarding disclosures to investors.
8. The Proposals would amend the Rule to define “launch” as a period, not to exceed 180 consecutive days, starting from the date the fund commences operations.
9. The Release cites the Rule 18f-4 adopting release, Rel. No. IC-34084 (Nov. 2, 2020), at text accompanying n.749 (stating that “[t]he Commission has also stated that items commonly considered to be cash equivalents include Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds”).

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