Chapter 2A

Fund Names

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§ 2A:1 Introduction

Section 35(d) of the Investment Company Act of 1940, as amended (the "Investment Company Act") makes it unlawful for "any registered investment company to adopt as a part of the name or title of such company, or of any securities of which it is the issuer, any word or words that the SEC finds are materially deceptive or misleading."[1] The

1. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 840; 15 U.S.C. § 80a-34(d). Whether a name is materially deceptive or misleading for the purposes of the Investment Company Act is determined by the likely effect of the name's connotations on the reader; the intent of the persons choosing the words of the name is not relevant. A fund name will be materially deceptive or misleading if there is objectively "a substantial

section also authorizes the Securities and Exchange Commission (SEC) to define "by rule, regulation or order" such names or titles as are materially deceptive or misleading.[2] Pursuant to section 35(d), the SEC adopted Rule 35d-1 under the Investment Company Act ("Rule 35d-1" or the "Names Rule"). The Names Rule states that a materially deceptive and misleading name includes certain specific names. The Names Rule also states that funds with certain types of names operating under the Names Rule must adopt investment policies with respect to 80% of the fund's net assets to avoid violating section 35(d) of the Investment Company Act.

Like many rules promulgated pursuant to the Investment Company Act, the Names Rule prescribes certain behavior and actions that registered investment companies must take. Unlike some rules, however, the vast majority of SEC regulation under Rule 35d-1 is conducted through the disclosure and comment process with the SEC staff (the "Staff"). The Names Rule is applicable to most registered investment companies. As such, the Names Rule is one of the rules with which the SEC is regularly involved on a near-continuous basis. The relative importance of the comment process in the administration of Rule 35d-1 has led to inconsistent application of the Names Rule as compared to other rules under the Investment Company Act.

This chapter looks at the legislative and regulatory background for section 35(d) and Rule 35d-1 thereunder, examines the text of the section 35(d) and Rule 35d-1, discusses the administration of the Names Rule, and discusses compliance with the Names Rule. The compliance section includes discussion of regulation as applied to a number of similarly named fund types, including somewhat unsettled issues such as SEC regulation of the Names Rule pertaining to fund names suggesting a geographic focus and regulation regarding fund names for funds that invest substantially in derivatives.

§ 2A:2 Legislative and Regulatory Background

§ 2A:2.1 Legislative Basis

Section 35(d) does not receive significant attention in the legislative history of the Investment Company Act. Congress seemed to view the purpose of the provision as intuitively consistent with the broader purpose of the Investment Company Act—investor protection. As the

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likelihood that a reasonable [investor] would consider it important in deciding" to invest in the fund or whether the name would give a false impression about the investments of the fund. *Cf.* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

2. 15 U.S.C. § 80a-34(d).

SEC explained in its adopting release for Rule 35d-1 (the "Adopting Release"), while sophisticated investors understand that a name never tells the whole story about a fund, all types of investors often rely on investment company names when making investment decisions.[3] One Investment Company Act scholar has shown that empirical studies have borne out the SEC's intuition.[4] One study found that when researchers studied fund names expressing either a value or growth orientation to equities, or a focus on either *large-cap* or *small-cap* issuers, name changes tended to follow shifts into or out of the investment styles under investigation.[5] When trends shifted, investment company names followed, and investors rewarded these types of name changes by abnormal inflows, whether or not the portfolio holdings of the funds conformed to their new names.[6]

There are few criticisms of section 35(d) in its legislative history. During Senate hearings in 1940, one critic noted that the provision could have a deleterious effect on the goodwill associated with the names of long-standing investment companies. As an investment company changes in character over time, its name may remain the same, though the character of its investments may undergo material changes. Changing the name under such circumstances, he argued, would destroy the goodwill associated with the company's historical name.[7] Other than this narrow critique, the section was subject to little debate or discussion.

§ 2A:2.2 Early Operation of Section 35(d)

As originally adopted, the Investment Company Act conferred a more limited authority on the SEC to regulate names than what currently exists under the act today. The original language of section 35(d) required the SEC, upon a finding that a fund name was materially deceptive or misleading, to issue an order declaring the name to be in

3. Investment Company Names, Investment Company Act Release No. 24,828 (Jan 17, 2001), 66 Fed. Reg. 8509–10 (Feb. 1, 2001) [hereinafter Adopting Release].
4. Larry D. Barnett, *The Regulation of Mutual Fund Names and the Societal Role of Trust: An Exploration of Section 35(d) of the Investment Company Act*, 3 DEPAUL BUS. & COMM. L.J. 345 (2005) [hereinafter Barnett], at 352.
5. *Id.*
6. *Id.* at 352–53.
7. *A Bill to Provide for the Registration and Regulation of Investment Companies and Investment Advisers, and for Other Purposes: Hearing on S. 3580 Before a S. Comm. of the Comm. on Banking and Currency*, 76th Cong. 631, Part 2 (1940) (statement of James H. Orr, President, Railway and Light Securities Co., Boston, MA).

violation of the paragraph. If the party responsible for the violation refused to comply with the order, the SEC would be forced to seek a court injunction enforcing it.[8]

The early policy of the Division of Investment Management under section 35(d) was expressed not through rulemaking, but through the guidelines accompanying Form N-8B-1, a predecessor to Form N-1A. The guidelines required a fund to invest at least 80% of its assets in the type of investment indicated by its name.[9] This policy was modified in 1983 with the adoption of Form N-1A, which instituted a 65% investment requirement to give funds greater flexibility with respect to their names and investments.[10]

Congress amended section 35(d) as part of the National Securities Market Improvement Act of 1996 (NSMIA).[11] The act granted the SEC broader authority to promulgate rules prohibiting deceptive names. As the House Report explained, the amendments were motivated by a concern that the process contemplated by the framers of the Investment Company Act—SEC order followed by judicial injunction—was "rarely used" and considered "extremely cumbersome."[12] The 1996 amendments gave the SEC rulemaking authority to define investment company names it finds materially deceptive or misleading.

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8. The enacted language read: "It shall be unlawful for any registered investment company hereafter to adopt as part of the name or title of such company, or of any security of which it is the issuer, any word or words which the [SEC] finds and by order declares to be deceptive or misleading. The [SEC] is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States alleging that the name or title of any registered investment company, or of any security which it has issued, is materially deceptive or misleading. If the court finds that the [SEC]'s allegations in this respect, taking into consideration the history of the investment company and the length of time which it may have used any such name or title, are established, the court shall enjoin such investment company from continuing to use any such name or title." Investment Company Act of 1940, Pub. L. No. 76-768, § 35(d), 54 Stat. 840.
9. Investment Company Names, Investment Company Act Release No. 7221 (June 9, 1972), 37 Fed. Reg. 12,790 (June 29, 1972), *cited in* Investment Company Names, Investment Company Act Release No. 22,530 (Feb. 27, 1997), 62 Fed. Reg. 10,955, 10,956 n.8 (Mar. 10, 1997) [hereinafter Proposing Release].
10. Investment Company Names, Investment Company Act Release No. 13436 (Aug. 12, 1983), 48 Fed. Reg. 37,928 (Aug. 22, 1983), *cited in* Proposing Release, *supra* note 9, at 10,956 n.9.
11. Investment Company Act § 35(d).
12. H.R. REP. No. 104-622, at 50 (1996).

§ 2A:2.3 SEC Rule 35d-1

In 1997, the SEC first exercised the authority granted to it by NSMIA by proposing Rule 35d-1. The proposed rule generally reverted to the 80% test of the 1970s.[13] The rule was adopted, with some significant changes, in 2001. The text of the Final Rule reads as follows:

(a) For purposes of section 35(d) of the Act (15 U.S.C. 80a-34(d)), a materially deceptive and misleading name of a Fund includes:

(1) Names suggesting guarantee or approval by the United States government. A name suggesting that the Fund or the securities issued by it are guaranteed, sponsored, recommended, or approved by the United States government or any United States government agency or instrumentality, including any name that uses the words "guaranteed" or "insured" or similar terms in conjunction with the words "United States" or "U.S. government."

(2) Names suggesting investment in certain investments or industries. A name suggesting that the Fund focuses its investments in a particular type of investment or investments, or in investments in a particular industry or group of industries, unless:

(i) The Fund has adopted a policy to invest, under normal circumstances, at least 80% of the value of its Assets in the particular type of investments, or in investments in the particular industry or industries, suggested by the Fund's name; and

(ii) Either the policy described in paragraph (a)(2)(i) of this section is a fundamental policy under section 8(b)(3) of the Act (15 U.S.C. 80a-8(b)(3)), 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 described in paragraph (a)(2)(i) of this section that meets the requirements of paragraph (c) of this section.

(3) Names suggesting investment in certain countries or geographic regions. A name suggesting that the Fund focuses its investments in a particular country or geographic region, unless:

13. *See* Proposing Release, *supra* note 9, at 10,955.

(i) The Fund has adopted a policy to invest, under normal circumstances, at least 80% of the value of its Assets in investments that are tied economically to the particular country or geographic region suggested by its name;

(ii) The Fund discloses in its prospectus the specific criteria used by the Fund to select these investments; and

(iii) Either the policy described in paragraph (a)(3)(i) of this section is a fundamental policy under section 8(b)(3) of the Act (15 U.S.C. 80a-8(b)(3)), 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 described in paragraph (a)(3)(i) of this section that meets the requirements of paragraph (c) of this section.

(4) Tax-exempt Funds. A name suggesting that the Fund's distributions are exempt from federal income tax or from both federal and state income tax, unless the Fund has adopted a fundamental policy under section 8(b)(3) of the Act (15 U.S.C. 80a–8(b)(3)):

(i) To invest, under normal circumstances, at least 80% of the value of its Assets in investments the income from which is exempt, as applicable, from federal income tax or from both federal and state income tax; or

(ii) To invest, under normal circumstances, its Assets so that at least 80% of the income that it distributes will be exempt, as applicable, from federal income tax or from both federal and state income tax.

(b) The requirements of paragraphs (a)(2) through (a)(4) of this section apply at the time a Fund invests its Assets, except that these requirements shall not apply to any unit investment trust (as defined in section 4(2) of the Act (15 U.S.C. 80a-4(2))) that has made an initial deposit of securities prior to July 31, 2002. If, subsequent to an investment, these requirements are no longer met, the Fund's future investments must be made in a manner that will bring the Fund into compliance with those paragraphs.

(c) A policy to provide a Fund's shareholders with notice of a change in a Fund's investment policy as described in paragraphs (a)(2)(ii) and (a)(3)(iii) of this section must provide that:

(1) The notice will be provided in plain English in a separate written document;

(2) The notice will contain the following prominent statement, or similar clear and understandable statement, in bold-face type: "Important Notice Regarding Change in Investment Policy"; and

(3) The statement contained in paragraph (c)(2) of this section also will appear on the envelope in which the notice is delivered or, if the notice is delivered separately from other communications to investors, that the statement will appear either on the notice or on the envelope in which the notice is delivered.

(d) For purposes of this section:

(1) Fund means a registered investment company and any series of the investment company.

(2) Assets means net assets, plus the amount of any borrowings for investment purposes.

In the Proposing Release to the Names Rule (the "Proposing Release"), the SEC explained that the 80% test "could help reduce confusion when an investor selects an investment company for specific investment needs and asset allocation goals."[14] More specifically, the SEC pointed to the increasing number of investors who were investing to meet specific retirement goals as evidence that more investors place "emphasis on allocating their investment company holdings in well-defined types of investments such as stocks, bonds, and money market instruments."[15] The SEC explained that allowing 20% in assets not indicated by the fund name would give a fund the flexibility to hold cash and other liquid securities necessary to meet investor redemptions.[16]

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14. *Id.* at 10,957.
15. *Id.*
16. *Id.*

§ 2A:2.4 Rule 35d-1: Key Differences between Proposal and Adoption

In the Adopting Release, the SEC noted three major differences between Rule 35d-1 as proposed and as adopted. First, for all but investment companies that primarily invest in tax-exempt bonds, the final rule dropped the requirement that an investment company adopt the 80% test as a "fundamental policy." Under a fundamental policy approach, any departure from the 80% allocation policy would require shareholder approval.[17] In lieu of this requirement, the final rule requires an investment company to provide notice to shareholders at least sixty days prior to any change to its 80% investment policy and to change its name in light of its new investment policy.[18] The 80% test remains a required fundamental policy for tax-exempt investment companies.

Second, the Adopting Release modified the two-part test for investment companies with names that suggest that they focus their investments in a particular geographic region.[19] As proposed, the Names Rule would have required investment companies with names that suggest that the funds focus their investments in a particular country or geographic region to meet a two-part test. They would have to invest at least 80% of their assets in securities of issuers that are tied economically to that country or region, and the securities would have to meet one of three criteria: (i) securities of issuers that are organized under the laws of the country or of a country within the geographic region suggested by the company's name or that maintain their principal place of business in that country or region; (ii) securities that are traded principally in the country or region suggested by the company's name; or (iii) securities of issuers that, during the issuer's most recent fiscal year, derived at least 50% of their revenues or profits from goods produced or sold, investments made, or services performed in the country or region suggested by the company's name or that have at least 50% of their assets in that country or region.[20]

Instead of requiring these investment companies to invest in securities that meet one of the three criteria specified in the proposed rule, the final rule simply requires these companies to adopt a policy to invest at least 80% of their assets in investments that are tied economically to the particular country or geographic

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17. *See* Investment Company Act § 8(b)(3).
18. *See* Adopting Release, *supra* note 3, at 8511.
19. *See also infra* section 2A:5.3.
20. *See* Proposing Release, *supra* note 9, at 10,961–62.

region suggested by their names and to disclose in their prospectuses the specific criteria that are used to select investments that meet this standard.[21]

Third, the proposed rule would have allowed an investment company to depart from the 80% requirement only to take a "temporary defensive position."[22] The rule as adopted broadens this exception by making the 80% applicable only "under normal circumstances."[23]

§ 2A:2.5 Names Not Included Under Rule 35d-1

The SEC states explicitly in the Adopting Release that Rule 35d-1 does not codify positions of the Division of Investment Management with respect to investment company names including the terms "balanced," "index," "small, mid, or large capitalization," "international," and "global."[24] Nor does the Names Rule apply to fund names that incorporate terms such as "growth" and "value," since these terms "connote types of investment strategies as opposed to types of investments."[25] The Adopting Release states that the standard for names not covered by the Names Rule will continue to be "whether the name would lead a reasonable investor to conclude that the company invests in a manner that is inconsistent with the company's intended investments or the risks of those investments."[26]

§ 2A:3 Administration of Section 35(d) and the Names Rule

§ 2A:3.1 SEC Administration

The SEC "is authorized, by rule, regulation, or order, to *define* such names or titles as are materially deceptive or misleading" (emphasis added).[27] Under that authority as discussed above, the SEC has promulgated Rule 35d-1 to prescribe and proscribe certain conventions with respect to particular fund names.

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21. *See* Adopting Release, *supra* note 3, at 8512.
22. Proposing Release, *supra* note 9, at 10,962.
23. Adopting Release, *supra* note 3, at 8513. For discussion of this change, see *infra* section 2A:4.4.
24. Adopting Release, *supra* note 3, at 8513.
25. *Id.* at 8514.
26. *Id.*
27. 15 U.S.C. § 80a-34(d) (1996); *see, e.g.*, SEC Investment Company Names Rule, 17 C.F.R. § 270 (2009).

§ 2A:3.2 Private Right of Action Under Section 35(d)

[A] Generally

Unlike section 36(b) of the Investment Company Act,[28] the explicit text of section 35(d) of the Investment Company Act does not provide for a private right of action. Based on current judicial trends, it appears unlikely that courts would find a private right of action under section 35(d) of the Investment Company Act.

Courts in the 1960s and 1970s were more likely than modern courts to find an implied private right of action under section 35(d). In *Taussig v. Wellington Fund, Inc.*,[29] for example, stockholders of Wellington Fund, Inc. alleged that the adoption of a nearly identical fund name by Wellington Equity Fund constituted both a violation of section 35(d) of the Investment Company Act and common law principles of unfair competition. The issue before the court was whether the federal district court had jurisdiction over both claims based on an alleged violation of the federal statute, and the Third Circuit Court of Appeals held the district court had federal question jurisdiction over the section 35(d) claim and pendent jurisdiction over the remaining state common-law claims.[30] Subsequently, in *Monheit v. Carter*, a district court also concluded that a private right of action likely exists under section 35(d) since "it is clear that [a stockholder] is a member of the class which the statute was designed to protect"; therefore, the court held that a private right of action secured effective enforcement of the statute.[31]

More recent jurisprudence surrounding private rights of action, however, indicates that a private right of action is unlikely to be found for section 35(d). While a U.S. Supreme Court decision has not

28. "An action may be brought under this subsection . . . by a security holder of such registered investment company on behalf of such company . . . for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person." 15 U.S.C. § 80a-35(b) (1996).

29. Taussig v. Wellington Fund, Inc., 313 F.2d 472 (3d Cir. 1963).

30. *See id.* at 476; *see also* Monheit v. Carter, 376 F. Supp. 334 (S.D.N.Y. 1974) (finding a private right of action exists under section 35(d)); *In re* Alliance N. Am. Gov't Income Trust, Inc. Secs. Litig., 95 Civ. 0330 (LMM), 1996 U.S. Dist. LEXIS 14209 (S.D.N.Y. Sept. 27, 1996) (implying that a private right of action exists under Section 35(d) by finding that the fund name was not deceptive or misleading); *cf.* Krome v. Merrill Lynch & Co., 637 F. Supp. 910 (S.D.N.Y. 1986) (holding that private right of action exists under section 35(a), but implying that private right of action exists for all subsections of section 35).

31. *Monheit v. Carter*, 376 F. Supp. at 340.

expressly foreclosed the possibility of a private right of action under section 35(d), a series of decisions, beginning with *Alexander v. Sandoval*,[32] has led to resistance by courts to imply new private rights of action where one has not explicitly been created by Congress.[33] Also, notably, at least one district court has specifically held that no private right of action exists under section 35(d).[34] Further, many decisions have held that similar provisions of the Investment Company Act do not provide private rights of action.[35] Therefore, while no definitive precedent exists on the issue, section 35(d) likely does not give rise to an implied private right of action by shareholders of a fund.

[B] Alternative Legal Theories—Section 10 of the Exchange Act

While a court may not find a private right of action exists under section 35(d) of the Investment Company Act, this does not necessarily lead to the conclusion that a defendant fund can escape private liability completely for a misleading name. Many private plaintiff cases that make section 35(d) claims also make similar claims under other anti-fraud provisions.[36] Section 10 of the Securities Exchange Act of 1934 (the "Exchange Act") is the most common anti-fraud

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32. Alexander v. Sandoval, 532 U.S. 275 (2001).
33. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (declining to extend the implied right of action in Section 10(b) of the Exchange Act to aiders and abettors because of concerns with judicial creation of private causes of action); Gonzaga Univ. v. Doe, 536 U.S. 273 (2002) (rejecting that a private right of action exists under the Family Educational Rights and Privacy Act of 1974 since the provisions at issue contained no rights-creating language, had an aggregate rather than individual focus and served primarily to direct the United States Secretary of Education's distribution of public funds to educational institutions).
34. *See* Young v. Nationwide Life Ins. Co., 2 F. Supp. 2d 914 (S.D. Tex. 1998) (holding no private right of action exists under section 35(d)).
35. *See* Olmsted v. Pruco Life Ins. Co. of N.J., 283 F.3d 429 (2d Cir. 2002) (holding no private right of action under Investment Company Act sections 26(f) and 27(i), 15 U.S.C. §§ 80a-26(f), 27(i)); *see also* Bellikoff v. Eaton Vance Corp., 481 F.3d 110 (2d Cir. 2007) (holding no private right of action under Investment Company Act Sections 34(b), 36(a) and 48(a), 15 U.S.C. §§ 80a-34(b), 36(a), 48(a)); Stegall v. Ladner, 394 F. Supp. 2d 358 (D. Mass. 2005) (holding no private right of action under Investment Company Act Section 36(a), 15 U.S.C. § 80a-35(a)); Hamilton v. Allen, 396 F. Supp. 2d 545 (E.D. Penn. 2005) (same).
36. *In re* Alliance N. Am. Gov't Income Trust, Inc. Secs. Litig., 95 Civ. 0330 (LMM), 1996 U.S. Dist. LEXIS 14209 (S.D.N.Y. Sept. 27, 1996) (alleging both violations under Rule 10b-5 and section 35(d) under common set of facts); Monheit v. Carter, 376 F. Supp. 334 (S.D.N.Y. 1974) (same); *see also*

provision of the federal securities laws typically used in such cases.[37] A plaintiff with a colorable claim that a fund name is misleading may well have a claim with respect to other statements within a fund's prospectus.[38] Thus, while an investment company with an arguably misleading name will likely not be held liable in a private suit brought under section 35(d), that company may still face liability under other anti-fraud provisions under federal securities laws.

§ 2A:4 Compliance with the Names Rule—Generally

§ 2A:4.1 Shareholder Communication

[A] Approval

Rule 35d-1 does not generally require that funds adopt the Names Rule's 80% investment requirement as a fundamental policy unless they have a name suggesting primary investment in tax-exempt bonds. The Investment Company Act does not require that a fund obtain shareholder approval for adoptions of new fundamental policies unless they deviate from an existing policy.[39] Shareholder approval is also not needed for any changes to non-fundamental policies. Therefore, a fund could change a non-fundamental 65% investment policy to a fundamental 80% investment policy without approval, unless the new policy deviates from another existing fundamental policy. Similarly,

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Bellikoff, 481 F.3d 110 (noting that company had previously been charged with violating Section 17 of the 1933 Act for actions that arose out of the same set of facts, but declining to find a private right of action exists under ICA §§ 80a-34(b), 36(a) or 48(a)); *Young*, 2 F. Supp. 2d 914 (denying defendant's motion to dismiss 10b-5 claims, but dismissing section 35(d) claim based on finding that no private right of action exists); Krome v. Merrill Lynch & Co., 637 F. Supp. 910 (S.D.N.Y. 1986) (alleging violations of both section 17 of the Securities Act of 1933 and Rule 10b-5).

37. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding private right of action exist under Rule 10b-5 (an SEC Rule pursuant to section 10 of the Exchange Act), but limiting its scope by requiring the element of scienter to be satisfied).

38. *See* Rule 10b-5, 17 C.F.R. § 240.10b-5 (1975) ("It shall be unlawful for any person . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .").

39. *See* 15 U.S.C.A. § 80a-13 (requiring shareholder approval to deviate from a fundamental policy); Proposing Release, *supra* note 9, at 10,960–61 n.49, correction 62 Fed. Reg. 24,161 (May 2, 1997) (discussing whether funds need shareholder approval to adopt a fundamental 80% investment policy), *available at* www.gpo.gov/fdsys/pkg/FR-1997-05-02/pdf/X97-70502.pdf.

a fund could change a fundamental 65% investment policy to that of a fundamental 80% policy without approval, unless the new policy deviates from either the current or another existing fundamental policy. Many funds made such changes without shareholder approval after the implementation of the Names Rule, as the Names Rule raised the investment requirement from 65% to 80%, following SEC guidance that said such changes did not require shareholder approval.[40] Many funds that previously had fundamental 65% investment policies adopted non-fundamental 80% investment policies following the adoption of the Names Rule. Such funds remain subject to their earlier fundamental 65% investment policy unless and until shareholders approve a change to or elimination of such policy.

Shareholder approval is also required if any newly adopted or changed fundamental policy deviates or conflicts with existing fundamental policies. For example, a fund with a fundamental policy to invest at least 65% but no more than 75% in equity securities could not adopt a new fundamental policy to invest at least 80% of assets in equity securities without shareholder approval.

[B] Notice

If adopted as originally proposed, the Names Rule would have required the 80% investment requirement to be a fundamental policy of the investment company, thus requiring shareholder approval for change. Commenters were worried that this requirement would reduce the flexibility of investment companies to respond efficiently to market events or new regulatory requirements, and discourage investment companies from using descriptive names altogether. In the face of this concern, the SEC modified the final adopted Names Rule to include an alternative to making the 80% investment requirement a fundamental policy. A fund with a descriptive name has the alternative compliance option of adopting a policy requiring sixty days' prior notice to shareholders for changes to the 80% investment policy. The SEC stated that it believed the notice alternative would allow shareholders who purchased shares in an investment company based on its name sufficient time to redeem their shares should the company change its investment policy. However, this second option is only available to funds that do not suggest tax-exempt status with their names.[41]

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40. *See* U.S. Securities and Exchange Commission, Frequently Asked Questions about Rule 35d-1 (Investment Company Names) [hereinafter FAQs], at Question 1, *available at* www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm.
41. *See* Adopting Release, *supra* note 3, at 8511.

While the Names Rule does not prescribe the contents of a notice to shareholders for a change in a fund's investment policy, the Staff provided insight in question 14 of the Frequently Asked Questions about Rule 35d-1 (the "FAQs"). The notice for a change in a fund's 80% investment policy should describe the 80% investment policy, the nature of the change to the investment policy, the fund's new name, and the effective date of the investment policy and name changes. [42] Additionally, Rule 35d-1(c) requires the notice to be written in plain English, be in a separate written document and contain a statement substantially similar to "Important Notice Regarding Change in Investment Policy" in bold face-type. The statement must also appear on the envelope if delivered with other communications to investors. If the notice is delivered separately, the statement must appear on either the notice or on the envelope.[43] The SEC anticipates the notice will typically be a short, one-page document enclosed with other written materials sent to shareholders.[44]

§ 2A:4.2 Assets to Which 80% Requirement Applies

The Names Rule 80% requirement is based on a fund's net assets plus any borrowings for investment purposes.[45] The Adopting Release explained that the use of net assets (as opposed to total assets) was intended to reflect more closely an investment company's portfolio investments.[46] The 80% requirement includes any borrowings for investment purposes, as opposed to the proposed inclusion of any borrowings that are senior securities under section 18 of the Investment Company Act, in order to prevent an investment company from circumventing the 80% requirement by investing borrowed funds in investments that are not consistent with its name.[47]

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42. *See* FAQs, *supra* note 40, at Question 14.
43. Adopting Release, *supra* note 3, at 8519.
44. When a fund changes its name, often it will also change other aspects of its investment objectives and strategies. Thus, the fund could either supplement the prospectus in a Rule 35d-1 notice or provide the notice along with a prospectus describing those changes. If it chooses to do the latter, and relies on Rule 498 under the Securities Act of 1933 to send a summary prospectus, the fund should be mindful that the prospectus be placed on top of the Rule 35d-1 notice to satisfy the "greater prominence" requirement of Rule 498. The fund should also stamp the required Rule 35d-1 language on the envelope, because the notice will not be the only document in the mailing.
45. 17 C.F.R. § 270.35d-1(d)(2) (2013).
46. *See* Adopting Release, *supra* note 3, at 8513.
47. *Id.*

§ 2A:4.3 Avoiding Confusion Because of Similarly Named Funds

A fund's name may be materially misleading and, therefore, violate section 35(d) of the Investment Company Act if it has the same or similar name to that of a different fund, as the similarity may cause investor confusion. Names that would likely cause investors to believe two funds are associated are also misleading. However, a fund may distinguish itself by including the name of the fund family. For example, ABC could offer the "ABC Short-Term Corporate Bond Fund," which would be different than XYZ's "XYZ Short-Term Corporate Bond Fund."[48] Further, in a no-action letter issued in 1975, the Staff explained that funds can "use the same generic terms in their names . . . provided that the words in the names appear in different order or . . . there are other distinguishing words in the names."[49] Examples of allowed and disallowed pairs of names from various no-action letters are below:

- "Minnesota Tax-Exempt Income Trust" and "Minnesota Tax-Exempt Bond Fund" are too similar and imply association, though "Tax Exempt Bond Fund for Minnesotans" would be different and allowed.[50]
- "Fund for U.S. Government Securities" and "Fund for Government Investors" are substantially different because the SEC felt investors would not confuse them.[51]
- "Capital Liquidity" and "Liquid Capital Income" are substantially different from one another as the generic terms appear in a different order.[52]
- "Kemper Income and Capital Preservation Fund" differs from "Capital Preservation Fund" through the employ of "Kemper Income and."[53]

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48. Barnett, *supra* note 4, at 362.
49. Capital Liquidity, SEC No-Action letter, 1975 SEC No-Act. Lexis 628, at *1 (Mar. 28, 1975).
50. Minnesota Fund Management, Inc., SEC No-Action letter, 1978 SEC No-Act. LEXIS 885 (Mar. 12, 1978).
51. Fund for U.S. Government Securities, Inc., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 803 (Apr. 27, 1975).
52. Capital Liquidity, SEC No-Action letter, 1975 SEC No-Act. Lexis 628, at *1 (Mar. 28, 1975).
53. Bayrock and Kemper Funds, SEC No-Action Letter, 1974 SEC No-Act. LEXIS 847 (Nov. 21, 1974).

§ 2A:4.4 "Under Normal Circumstances"/"Temporary Defensive Positions"

Investment companies must comply with the 80% investment requirement "under normal circumstances."[54] The original proposed rule allowed investment companies to depart from the 80% requirement to take a "temporary defensive position" to avoid losses in response to adverse market, economic, political, or other conditions. However, the SEC determined, based on comments to the proposed rule, that the "temporary defensive position" exception was too narrow and limited flexibility. The revised approach allows reprieve from the 80% requirement when there is the need to take a temporary defensive position as well as in other limited circumstances, such as in the case of unusually large cash inflows or redemptions. The SEC has also noted that new funds should generally be invested at the normal 80% level within six months, with the expectation that relatively liquid assets would generally be fully invested towards compliance with the normally required 80% level in a much shorter period than relatively illiquid investments.[55]

Another example of permitted deviation from an 80% investment policy due to abnormal circumstances is when the opportunity for suitable investments temporarily dries up. In the final rule, the SEC recognized that the supply of tax-free instruments eligible for purchase by money market funds can be severely limited in some states. At times, some of these funds may not be able to meet the 80% requirement. The SEC wrote that such a fund might be allowed to dip below the 80% requirement when there is a temporary shortage of securities of appropriate quality that distribute tax-exempt income in the particular state. However, the SEC further emphasized the need for this condition to be temporary. If the supply were perpetually limited, the fund should not use a suggestive name instead of relying on the "under normal circumstances" exception.[56]

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54. *See* 17 C.F.R. § 270.35d-1(a)(2)(i)(2013); *see also* Investment Company Act Release No. 13,436 (Aug. 12, 1983), 48 Fed. Reg. 37,928 (Aug. 22, 1983) [hereinafter N-1A Guidelines Release] (rescinded by Investment Company Act Release No. 23,064 (Mar. 13, 1998), 63 Fed. Reg. 13,916 (Mar. 23, 1998), at 13,940 n.214 ("N-1A Amendments")) (from Investment Company Names, Investment Company Act Release No. 24,828 (Jan. 17, 2001), 66 Fed. Reg. 8509, 8511 n.15 (Feb. 1, 2001)); former Guide 1 in the N-1A Guidelines Release, *supra* (applying 65% investment requirement "under normal circumstances").
55. Adopting Release, *supra* note 3, at 8513.
56. *See id.*

§ 2A:5 Compliance with the Names Rule—Specific Topics and Issues

§ 2A:5.1 Index Funds

Rule 35d-1 does not codify a position of the SEC regarding the term "index" used within a fund name.[57] However, funds that use this term are subjected to the 80% investment requirement since the term "index" "suggest[s] a focus on a particular type of investment."[58] The Adopting Release suggested that "[i]ndex funds . . . generally would be expected to invest more than 80 percent of their assets in investments connoted by the applicable index."[59] Further, the SEC has stated that this requirement is not intended as a safe harbor provision; a fund name may still be interpreted as deceptive or misleading even if the fund were in compliance with the 80% investment requirement.[60]

§ 2A:5.2 "Global" and "International"

[A] Generally

Similar to index funds, fund names including the terms "global" or "international" are also not subject to Rule 35d-1.[61] In the past, the SEC has differentiated between the terms "global" and "international"—requiring that a fund using the term "global" normally hold securities of issuers located in at least three countries including the United States, while funds using the term "international" normally hold securities of issuers located in at least three countries not including the United States.[62] While the SEC has indicated it no longer makes this distinction, it appears, in the context of Staff comments, that some distinction may remain.[63]

The Adopting Release provides "that investment companies using these terms in their names . . . [are expected to] invest their assets in investments that are tied economically to a number of countries throughout the world."[64] This broad guidance has been applied somewhat inconsistently. The Proposing Release, however, provides some instruction on this issue:

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57. *Id.* at 8513–14.
58. *Id.* at 8513–14 n.42.
59. *Id.* at 8511; *see also* Barnett, *supra* note 4, at 367.
60. *See* Adopting Release, *supra* note 3, at 8511.
61. *Id.* at 8513–14.
62. *See* Proposing Release, *supra* note 9, at 10,960 n.38.
63. *See* Alyssa Albertelli, Rajib Chanda & Jessica Riley Hale, *Rule 35d-1: What's In a Name?*, 18 THE INV. LAW. 1, 14 (2011) [hereinafter Albertelli, Chanda & Hale].
64. Adopting Release, *supra* note 3, at 8514 n.42.

> [W]hile an investment company with a name that includes the words "international" or "global" generally suggests that the company invests in more than one country, these terms may describe a number of investment companies that have significantly different investment portfolios. Among other things, the number of countries in which an "international" or "global" investment company may invest at any one time may appropriately differ from company to company.[65]

The key issue for the Staff in determining whether a name of this type is deceptive or misleading is if "the name would lead a reasonable investor to conclude that the company invests in a manner that is inconsistent with the company's intended investments or the risks of those investments."[66] Typically, the Staff has asked for a combination of both a requirement as to the number of non-U.S. companies and a percentage of the fund's net assets in the comment process, such as:

> (1) Adopt a policy that the fund will invest, under normal market conditions, at least 40% of its assets outside the United States, or if market conditions are not favorable, at least 30% of its assets outside the United States, and (2) [d]isclose in the prospectus for the fund that the fund will normally hold securities of issuers located in at least three countries.[67]

The Staff, however, has recently clarified that it does not believe that the above approach is compulsory. Statements to the effect that the fund will invest "primarily" or "a majority of assets" in non-U.S. securities are also acceptable.[68] If alternative language is proposed (for example, that a fund will invest "to approximately the same extent as the fund's benchmark index" in non-U.S. securities), Staff reviewers are expected to consider whether such formulations effectively reflect the appropriate level of investment outside of the United States.[69]

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65. Proposing Release, *supra* note 9, at 10,960.
66. *Id.* (noting that the Staff would continue to provide guidance on the terms not covered by Rule 35d-1).
67. *See* Alyssa Albertelli, Chanda & Hale, *supra* note 63, at 14. For funds using the term "international," the Staff will occasionally request for the United States to be excluded from the number of countries.
68. Memorandum from Investment Company Institute to SEC Rules Members No. 47-12 et al. (June 4, 2012), *available at* http://ici.org/my_ici/memorandum/ci.memo26215.print.
69. *Id.* As with other funds under Rule 35d-1, a global/international fund may still take a "temporary defensive position" in response to adverse market, economic, political or other conditions. *Id.*

[B] "Go Anywhere" Funds

Increasingly, many funds style themselves as "go anywhere" funds, which are funds that provide managers significant latitude in making their investment decisions, both geographically and stylistically. Such funds provide managers the opportunity to move investments to meet their views of global market prospects. However, "go anywhere" funds that also include the term "global" or "international" must still comply with guidance, discussed above, concerning these terms.[70] Such "go anywhere" strategies may lead to increased SEC scrutiny as they may conflict to some degree with the SEC's approach to "global" or "international" funds, but some funds have taken the position that this strategy is consistent with the language of the Adopting Release, which only requires investment in assets that are "tied economically to a number of countries throughout the world."[71]

§ 2A:5.3 Geographic Regions

[A] Generally

Rule 35d-1 covers fund names that relate to investment interests in certain countries or geographic regions.[72] The Names Rule requires such a company to "adopt a policy to invest at least 80% of its assets in investments that are tied economically to the particular country or geographic region suggested by its name. The investment company also must disclose in its prospectus the specific criteria that are used to select investments that meet this standard."[73] Significantly, Rule 35d-1, as adopted, embodies a much more flexible structure than the proposed rule, which included a list of three criteria to use in considering whether an investment is tied economically to a particular country or region (only one of which would have been needed to be satisfied).[74] The adopted rule does not provide any definition of the phrase "tied economically," and instead requires that the fund clearly

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70. Adopting Release, *supra* note 3, at 8514 n.42 ("[I]nvestment companies using ["global" or "international"] . . . in their names . . . [are expected to] invest their assets in investments that are tied economically to a number of countries throughout the world.").
71. *See supra* note 64.
72. *See* Adopting Release, *supra* note 3, at 8512 n.22 ("We do not intend that rule 35d-1 would require an investment company to change its name . . . where the connotation of the name is clear through long-standing usage and there is no risk of investor confusion.").
73. Adopting Release, *supra* note 3, at 8517.
74. Proposing Release, *supra* note 9, at 10,961–62; *see also* Adopting Release, *supra* note 3, at 8512 (noting that specific criteria approach was not adopted because the Staff believed it would be too restrictive).

state how the fund will make this determination.[75] However, the Adopting Release provides some guidance on this issue:

> We note, however, that if an investment company uses a criterion that requires qualifying investments to be in issuers that derive a specified proportion of their revenues or profits from goods produced or sold, investments made, or services performed in the applicable country or region, or that have a specified proportion of their assets in that country or region, the Division, consistent with its current position, would expect the proportion used to be at least 50%, in order for the investments to be deemed to be tied economically to the country or region.[76]

[B] "Non-U.S. Companies"

For certain funds, such as those which incorporate "U.S." or other geographical terms in its name, the determination of what constitutes a "non-U.S. company" is significant for compliance with the Names Rule. However, Rule 35d-1 does not provide a definition of the term "non-U.S. companies." The SEC decided that setting forth strict criteria would hinder investment companies.[77] Thus, the Staff decided that the adopted approach "will allow an investment company the flexibility to invest in additional types of investments that are not addressed by the three proposed criteria, but expose the company's assets to the economic fortunes and risks of the country or geographic region indicated by its name."[78] Given this flexibility, general practice varies substantially to determine whether a company qualifies as "non-U.S. company." While many investment companies use a company's place of organization or headquarters, others use the location of a majority of the company's assets, the place in which a majority of its revenues are collected, or a combination of these factors.[79] However, guidance from the Adopting Release suggests

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75. A key feature of the adopted rule structure is its flexibility. *See* Adopting Release, *supra* note 3, at 8512 n.26 ("For example, an investment company may invest in a foreign stock index futures contract traded on a U.S. commodities exchange, which may not meet any of the three proposed criteria but could expose the investment company to the economic fortunes and risks of the geographic region covered by the index.").
76. *Id.*
77. *Id.* at 8512.
78. *Id.*
79. *See, e.g.*, Albertelli, Chanda & Hale, *supra* note 63, at 15 ("Through the comment process, the Staff has suggested that the definition of 'non-US companies,' for example, should include that such companies derive 50 percent or more of their revenue from activities conducted outside of the US or have 50 percent or more of their assets located outside of the US.").

that if a company sets criteria based on revenues or profits from goods produced or sold, investments made, or services performed in a geographic region, or require a certain portion of the company's assets in that geographic region, "the Division . . . would expect the proportion used to be at least 50% . . . ."[80]

§ 2A:5.4 Tax-Exempt Funds

[A] Generally

Under Rule 35d-1(a)(4), a fund with a name that suggests its distributions are tax-exempt may satisfy the Names Rule only by adopting one of two fundamental policies. First, the fund may adopt a policy that, under normal circumstances, it must invest at least 80% of the value of its assets in investments that produce income exempt from both federal income tax and the income tax of the named state. Second, the fund may adopt a policy that the fund must invest its assets such that at least 80% of the income distributed will be exempt from both the federal income tax and the income tax of the named state.

[B] Single State Tax-Exempt Funds

Single state tax-exempt funds (for example, the "Massachusetts Tax-Exempt Fund") are not limited by section (a)(3) of the Names Rule, which relates to funds suggesting investment in a specific geographic region (see above). As such, the 80% basket for a single-state tax-exempt fund may include a security of an issuer from outside of the state referenced in the fund's name if the security pays interest exempt from both federal income tax and tax of the named state. In this case, the fund must disclose in its prospectus that it may invest in securities from outside of the named state. If the fund does not disclose in its prospectus that the fund may invest in securities from outside of the named state, all the securities that count towards the 80% test of the Names Rule must be from the named state.[81]

[C] "Municipal"/"Municipal Bond"

The SEC stated in the FAQs that it believes a fund's use of the terms "municipal" and "municipal bond" in its name suggests the fund's distributions are exempt from income tax.[82] Further, the SEC in a no-action letter agreed that the term "Muni" was commonly understood to mean the same as "Municipal." As such, these fund names

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80. Adopting Release, *supra* note 3, at 8512 n.26.
81. *See* FAQs, *supra* note 40, at Question 3.
82. *See id.* at Question 4.

fall into the purview of rule 35d-1(a)(4), and the funds must adopt one of the two allowable "tax-exempt" fundamental policies. However, the SEC will allow these municipal and municipal bond funds to include securities that generate income subject to the alternative minimum tax towards the 80% test, unlike general "tax-exempt" funds.[83]

§ 2A:5.5 "Tax Sensitive" Funds

The use of the term "tax-sensitive" in a fund's name does not in itself force the fund to comply with the 80% investment requirement, as the term describes an investment strategy rather than an investment type.[84]

§ 2A:5.6 "Small-cap"/"Mid-cap"/"Large-cap Funds"

While the Names Rule does not specifically use the terms "small-, mid-, and large-capitalization," the Adopting Release explained such terms "suggest a focus on a particular type of investment, and investment companies that use these terms will be subject to the 80% investment requirement of the rule."[85] In determining the universe of investments for a fund with a capitalization range in its name, a fund may use "any reasonable definition" of these terms for determining which investments count for a given size of capitalization.[86] The FAQs state that "i[n] developing a definition of the terms 'small-, mid-, or large-capitalization,' registrants should consider all pertinent references, including, for example, industry indices, classifications used by mutual fund rating organizations, and definitions used in financial publications."[87] The SEC considers deviations from common usage inappropriate and misleading. The chosen definition must be included in the fund's investment objectives and strategies within its prospectus.[88]

Generally, for "small-," "mid-," and "large-capitalization" funds, there has been wide variance in disclosure language and SEC comments regarding the ranges used for Names Rule compliance. Registrants often respond to Staff comments disputing the fund's choice of range by comparing the chosen range to those of other similarly

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83. *See id.*
84. *Id.* at Question 8. The SEC has noted that "tax-sensitive" as a descriptor would still be subject to the other antifraud provisions of the federal securities laws. *See id.*
85. Adopting Release, *supra* note 3, at 8513 n.42.
86. FAQs, *supra* note 40, at Question 6.
87. *Id.*
88. *See id.*

named funds.[89] In the years since the Adopting Release and the FAQs, Staff comments have narrowed the scope of what constitutes a "reasonable definition" for defining small-, mid-, and large-capitalization ranges. We are familiar with comments that have precluded the use of an index holding itself out as a small-cap index as the basis for a range of investments made by a fund with "small-cap" in its name, for example.[90]

Another Staff concern with regard to defining capitalization ranges relates to the date as of which a firm can look to an index to define its range. Staff comments have generally asked registrants to use indexes as reference points only on index reconstitution dates, rather than other dates (such as calendar year-end, fund fiscal year-end, or the date of investment by a fund). An issue for a fund with a capitalization range in its name arises when the fund had made an investment that was within the named capitalization range on the date of investment, but has grown or shrunk in value out of range by the time of a subsequent index reconstitution date. Most funds consider that a purchase made in compliance with the Names Rule 80% requirement as of the time of purchase (in other words, a purchase made within the capitalization range on the date of purchase) remains within compliance with the 80% requirement until the fund has sold that investment.[91] This approach is consistent with the Adopting Release, which states that "[t]he 80% investment requirement generally applies . . . at the time when an investment company invests its assets"[92] and "an investment company subject to the [80%] requirement would not have to sell portfolio holdings that have increased in value"[93] in order to meet the requirement.

§ 2A:5.7 "High-Yield" Funds

The SEC believes the term "high-yield" in a fund name particularly describes corporate bonds that are below investment grade. The SEC explains that investors equate "high-yield" with "junk bonds" or bonds receiving a Standard & Poor's rating below BBB or a Moody's rating below Baa. As such, any fund using "high-yield" in its name must

89. *See* Albertelli, Chanda & Hale, *supra* note 63, at 16–17.
90. For some time, registrants' written responses to Staff comments in the registration process have been publicly available, although not in every case. Examples referred to in this chapter come from either publicly available comments or from comment letters produced by Ropes & Gray LLP on behalf of its clients, without attribution to the client to protect competitive secrets.
91. *See* Albertelli, Chanda & Hale, *supra* note 63, at 16.
92. Adopting Release, *supra* note 3, at 8513.
93. *Id.* at n.32.

adopt a policy to invest at least 80% of assets in bonds that are below investment grade.[94] However, in response to Staff comments, some funds have disputed the SEC interpretation of "high-yield," stating that a reasonable interpretation of "high-yield" may also include high-yielding foreign corporate and government bonds, as well as high-yielding asset-backed securities, whether or not the securities are rated below investment grade, and may also include income-producing convertible securities and preferred stock that are rated below-investment grade or are not rated.

The SEC accepts that a fund using "high-yield" in conjunction with "municipal" or "tax-exempt" does not require an 80% investment in BBB or Baa, or lower-rated bonds. The market for below-grade municipal bonds is smaller and relatively illiquid, meaning investment companies typically have invested in higher grade bonds than taxable "high-yield" funds. Thus, if a fund combines "high-yield" and "municipal" or "tax-exempt" in its name, it does not suggest an 80% investment in junk bonds, but instead suggests a focus on pursuing higher yields than other municipal or tax-exempt bond funds.[95]

§ 2A:5.8 "Income" Funds

"Income" in a fund name can signify a type of investment (subjecting it to the 80% investment requirement) or merely depict an investment objective (which does not subject it to the 80% test). The categorization depends upon other words coupled with the term "income." When used alone, "income" generally means a strategy aimed at current income. When used with "growth," the term means an investment strategy to achieve growth of capital and current income.[96] Neither of these names triggers the 80% requirement of Rule 35d-1.[97] In the FAQs, the SEC stated that the term "equity income" would mean the fund focuses on equity investments with the objective of obtaining current income and, therefore, an "equity income" fund also does not trigger 35d-1 with respect to the word "income."[98] Contrary to the SEC's position in its FAQs, a number of comment letters reveal the Staff occasionally takes issue with the term "equity income" without an accompanying 35d-1 policy. It appears that a majority of "equity income" funds do not have an

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94. FAQs, *supra* note 40, at Question 7.
95. *Id.*
96. *Id.* at Question 9.
97. Relatedly, "high income" does not trigger the 80% test, unlike "high yield" (discussed *supra*).
98. FAQs, *supra* note 40, at Question 9. Note that the 80% requirement would be triggered for the word "equity," as equity is a type of investment.

80% policy with respect to the word "income," presumably in reliance on the FAQs.

The term "fixed income," however, indicates investment in a specific investment type and is subject to the Names Rule 80% investment policy requirement.[99]

§ 2A:5.9 Money Market Funds

A fund with the term "money market" in its name triggers the requirement of Rule 35d-1. However, such a fund must already follow Investment Company Act Rule 2a-7, which requires the fund to invest solely in eligible securities. As a generic money market fund must invest 100% of its assets in general money market securities, Rule 35d-1 becomes superfluous for funds with generic "money market" names (for example, the "ABC Money Market Fund"). Thus, the 80% rule only adds additional requirements when the fund name suggests investment in a specific type of money market instruments. For example, if the fund were called the "ABC U.S. Treasury Money Market Fund," Rule 35d-1 requires the fund to adopt a policy to invest at least 80% of its assets in U.S. Treasury securities.[100]

§ 2A:5.10 "Commodity Strategy"

The SEC generally does not subject "commodity strategy" funds to a literal interpretation of the 80% requirement of the Names Rule. While it may appear that a fund with such a name need make 80% of its investments directly in commodities, the Staff has informally indicated that these funds are not required to make such direct commodity investments because a registered fund typically cannot invest 80% of its assets in commodities while remaining an investment company under the Investment Company Act.[101] Instead, "commodity strategy" funds typically invest in commodity-linked

99. *See id.*

100. *Id.* at Question 13. There are several funds that are named, *e.g.*, "ABC 100% U.S. Treasury Money Market Fund." Such funds typically have policies to invest exclusively in obligations of the U.S. Treasury under normal conditions.

101. Since an investment company is defined to be an issuer that, inter alia, "is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in *securities* . . . ." 15 U.S.C. § 80a-3 (emphasis added), a company that primarily invests directly in commodities might not be an investment company for the purposes of the Investment Company Act. In addition, tax considerations also constrain such investment by registered funds seeking to rely on Subchapter M of the Internal Revenue Code.

derivatives that provide exposure to the investment returns of commodities and commodity markets rather than making commodity investments directly. While "commodity strategy" funds are not required to make direct investments in commodities, funds should not view the Staff's apparent interpretation of the Names Rule with respect to "commodity strategy" funds as an opportunity to use the word "strategy" in a fund name to avoid the 80% test of Rule 35d-1. A fund called the "Large-Cap Strategy Fund" would, for example, still be required to directly invest 80% of its assets in large-cap stocks under the Names Rule. The SEC appears to view the situation of "commodity strategy" funds as unique for the purposes of the Names Rule, given the limits on the ability of investment companies to make direct investments in commodities.[102]

§ 2A:5.11 "Short-term"/"Intermediate-term"/ "Long-term"

Funds that use terms that indicate a temporal limitation to the maturities of instruments are subject to Rule 35d-1. The Adopting Release notes that investment companies investing in debt may seek to distinguish themselves by limiting the maturity of instruments they hold and calling themselves "short-term," "intermediate-term," or "long-term" bond or debt funds. The Adopting Release notes that:

> Historically, the Division of Investment Management [of the SEC] has required investment companies with these types of names to have average weighted portfolio maturities of specified lengths. In particular, the Division has required an investment company that included the words 'short-term,' 'intermediate-term,' or 'long-term' in its name to have a dollar-weighted average maturity of, respectively, no more than 3 years, more than 3 years but no less than 10 years, or more than 10 years. . . . The Division has concluded that it will continue to apply these maturity criteria to investment companies that call themselves 'short-term,' 'intermediate-term,' or long-term' because they provide reasonable constraints on the use of these terms.[103]

The SEC notes, however, that "there may be instances where the average weighted maturity of an investment company's portfolio securities may not accurately reflect the sensitivity of the company's share prices to changes in interest rates" and, therefore, the maturity guidelines are not intended to be a safe harbor.[104] The FAQs clarify

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102. *See* Albertelli, Chanda & Hale, *supra* note 63, at 17.
103. Adopting Release, *supra* note 3, at 8514.
104. *Id.*

that a fund with the name "Intermediate-Term Bond Fund," for example, would not be required to invest 80% of its assets in intermediate-term bonds; rather, the fund would have to invest at least 80% of its assets in bonds and have a dollar-weighted average maturity following the maturity guidelines established by the Adopting Release, so long as using the guidelines is not misleading (3–10 years in the case of the "Intermediate-Term Bond Fund").[105] Some funds have used different maturity terms than those laid out in the Adopting Release, stating in response to Staff comments that the different categorizations used by those funds provide a more accurate maturity range for investors.

§ 2A:5.12 *"Duration"*

Similar to the "short-, intermediate-, long-term" fund names outlined above, funds that use "duration" in their names to describe temporal characteristics of their bond portfolios are also subject to the Names Rule. Duration is a measure of a bond's price sensitivity to interest rate risk.[106] The duration of a bond will always be less than or equal to its maturity. In the Adopting Release, after laying out the terms of average weighted portfolio maturities for "short-/intermediate-/long-term" funds, the SEC noted that the maturity guidelines are not intended as a safe harbor and cited to an example where "an investment company's name was consistent with the Division's maturity guidelines, but the 'duration' of the company's portfolio was inconsistent with the sensitivity to interest rates suggested by the company's name." There, the SEC found the name misleading and in violation of Rule 35d-1.[107] In a footnote to the Adopting Release, the SEC noted that "investment companies and investment professionals increasingly evaluate bond portfolios based on 'duration'. . . Whether a name was misleading in the circumstances outlined above would depend on all the facts and circumstances, including other disclosures to investors."[108] The FAQs note that, unlike the "short-/intermediate-/long-term" funds, "[t]he Division has not developed specific guidelines regarding a fund's use of a name . . . suggesting that its bond portfolio has a specific duration."[109] A fund that uses such a name may use "any reasonable definition of the terms used, and should explain its definition in its discussion of its investment objectives and strategies in the

105. *See* FAQs, *supra* note 40, at Question 11.
106. *See* Adopting Release, *supra* note 3, at 8514 n.47.
107. *See id.* at 8514.
108. *Id.* at 8514 n.47.
109. FAQs, *supra* note 40, at Question 12.

fund's prospectus."[110] Registrants were further instructed to consider "all pertinent references," including classifications used by mutual fund rating organizations, definitions used in financial publications, and industry indices.[111]

Like the short-/intermediate-/long-term bond funds, a fund that uses a name suggesting that its bond portfolio has a particular duration is not required to invest 80% of assets in bonds of that duration; rather, the fund must invest at least 80% of its assets in bonds and the duration described must not be misleading.[112]

§ 2A:5.13 Made-Up Words

One way for funds to avoid being subject to the 80% requirement of Rule 35d-1 is to have a fund name without any particular connotation to an investment category. A fund name with words lacking any objective connotation would not normally be expected to be materially deceptive or misleading (and therefore should not run afoul of section 35(d) or Rule 35d-1), as a reasonable investor would not likely form any objective expectation of a particular investment strategy associated with the fund name. However, particular seemingly "made-up" words or combinations of words have been found to have certain connotations and, therefore, are subject to section 35(d). For example, the Staff refused to grant no-action relief to a fund seeking to use the word "savest" (a blend of "safe" and "invest") in its name. The Staff took the view that the word signified "safest" and therefore connoted a government-protected savings account.[113] Additionally, funds that use the word "SMID" in their names are subject to the 80% requirement of Rule 35d-1, as "SMID" is a commonly used abbreviation among investors for "small- and mid-capitalization,"[114] names that, as noted above, are subject to Rule 35d-1.

§ 2A:5.14 "Cute and Catchy" Names

Section 35(d) is designed to prevent investors from being harmed by the use of materially misleading or deceptive names. Section 35(d) does not, however, necessarily prohibit fund names that have the power to influence investors through the names' ability to be easily remembered or to evoke imagery favorably. These names, which one

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110. *Id.*
111. *Id.*
112. *See id.*
113. Nat'l Secs. & Research Corp., SEC No-Action Letter, 1974 SEC No-Act. LEXIS 1331 (Jan. 21, 1974).
114. *See* Albertelli, Chanda & Hale, *supra* note 63, at 17.

scholar refers to as "cute and catchy,"[115] could be expected to fall outside the scope of section 35(d) because they do not distort or misrepresent their fund's investment strategies or portfolios. The scholar cites four examples of such names that funds have used: (1) "Global Interactive Couch Potato Fund," which invested primarily in entertainment and publishing securities;[116] (2) "Nifty Fifty Fund," composed of roughly fifty "growth" issuers chosen on the basis of their prospects for long-term capital appreciation;[117] (3) "Thermostat Fund," which alters its mix of stocks and bonds according to a formula linked to the performance of the S&P 500 index;[118] and (4) "Vice Fund," which invests primarily in equities of businesses that sell products or services considered socially irresponsible (liquor, tobacco, and gambling).[119] The scholar further explains that these "cute and catchy" names likely had a direct and significant impact on investor interest in the funds. The Vice Fund, for example, received significant media attention in its launch year, 2002, despite investor disenchantment with both equities and mutual funds in 2002.[120]

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115. Barnett, *supra* note 4, at 372.

116. *See, e.g.*, Gabelli Global Series Funds, Inc. The Gabelli Global Interactive Couch Potato Fund Semi-Annual Report (June 30, 1997), *available at* www.gabelli.com/Gab_pdf/QRep/1997q2/442.pdf.

117. *See, e.g.*, Phoenix All-Cap Growth Fund, Phoenix Balanced Return Fund, Phoenix Nifty Fifty Fund, Phoenix Small-Cap Growth Fund, each a series of the Phoenix-Engemann Funds (Supplement dated April 12, 2006 to the Prospectus dated May 1, 2005, as supplemented June 17, 2005, October 31, 2005, January 11, 2006, February 17, 2006, March 15, 2006 and March 29, 2006); Phoenix Balanced Fund, Phoenix Capital Growth Fund, Phoenix Mid-Cap Growth Fund, each a series of Phoenix Series Fund, (Supplement dated April 12, 2006 to the Prospectus dated February 15, 2006, as supplemented March 29, 2006); Phoenix Growth & Income Fund, a series of Phoenix Equity Series Fund (Supplement dated April 12, 2006 to the Prospectus dated December 31, 2005, as supplemented January 11, 2006 and February 17, 2006); Phoenix Income & Growth Fund, a series of Phoenix Investment Series Fund (Supplement dated April 12, 2006 to the Prospectus dated August 28, 2005, as supplemented January 11, 2006 and February 17, 2006); Phoenix Worldwide Strategies Fund, a series of Phoenix Equity Trust (Supplement dated April 12, 2006 to the Prospectus dated October 31, 2005, as supplemented January 11, 2006, February 17, 2006 and March 16, 2006), *available at* www.sec.gov/Archives/edgar/data/796298/000094937706000290/pisf76114-497.txt.

118. COLUMBIA MANAGEMENT, COLUMBIA THERMOSTAT FUND SECOND QUARTER 2013 INVESTMENT COMMENTARY (July 2013), *available at* www.columbiamanagement.com/content/columbia/pdf/LIT_DOC_218D023A.pdf.

119. *See* USAMUTUALS, THE BIG IDEA BEHIND THE VICE FUND, *available at* www.usamutuals.com/vicefund/phil.aspx (last accessed Aug. 1, 2013); *see also* Barnett, *supra* note 4, at 372.

120. *See* Barnett, *supra* note 4, at 374.

§ 2A:5.15 Target Date Funds

Target date funds have also been a focus of SEC regulatory attention. Target date funds are offered as retirement savings vehicles through many defined contribution pension plans, and operate by adjusting the mix of assets in the fund as the "target date" (the expected retirement date of the fund's investors) approaches. As the fund nears its target date, the assets of the fund are generally adjusted toward a more conservative mix, for example, toward a greater proportion of bonds to stocks.[121] This continuous adjustment toward less risky assets is known as the target date fund's "glide path."[122]

On June 16, 2010, the SEC proposed amendments to Rule 34b-1 under the Investment Company Act, which would require a target date retirement fund that includes the target date in its name to disclose the fund's asset allocation at the target date immediately adjacent to the first use of the fund's name in marketing materials.[123] The SEC explained that the proposal was motivated by the dramatic growth of target date funds over the past five years,[124] their increasing prominence in the retirement plans of Americans,[125] and the dramatic losses suffered by many target date funds, even many nearing their target dates with relatively conservative portfolios, due to heavy market losses incurred in 2008.[126] Of special concern was the high volatility of investment losses in 2008 and 2009 among target date funds with the same target dates. The SEC explained that this volatility could be explained by the use of different allocation models by different funds. Though target date funds are designed to move toward a less risky mix of assets as they approach their target date, target date funds sharing the same target date may have significantly different degrees of exposure to more volatile asset classes depending on the model under which they are managed.

The SEC noted that a target date fund's name may contribute to investor misunderstanding about the risk characteristics of the fund.[127] Target date fund names generally include a year, which is intended to approximate the retirement year for investors in the fund. However, the SEC noted that a single glide path is not appropriate for

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121. Investment Company Advertising: Target Date Retirement Fund Names and Marketing, Investment Company Act Release No. 339126 (June 16, 2010), 75 Fed. Reg. 35,921–22 (June 23, 2010).
122. *Id.* at 35,921.
123. *See id.*
124. *Id.*
125. *Id.* at 35,920.
126. *Id.* at 35,921.
127. *Id.* at 35,922.

all investors with the same expected retirement year, and investors may mistakenly assume that all funds that have the same date in their name are managed according to an identical asset allocation strategy.[128]

In response to concerns that investors may not adequately understand the risks of target date funds or be able to easily compare the risks of one fund to another, the SEC proposal would, among other things, require a target date fund that includes the target date in its name to disclose the fund's asset allocation at the target date immediately adjacent to the first use of the fund's name in marketing materials.[129] Though the requirement would formally be contained in a provision of Rule 34b-1, the rule would have implications for Rule 35d-1, because the marketing restriction is implicated only when a fund uses a name that includes the target date. Additionally, in its request for comments, the SEC asked for comment on several alternative courses of action that would have a direct impact on Rule 35d-1.[130] The SEC asked whether it should consider amending Rule 35d-1 to provide that a target date fund must include its asset allocation as part of its name, so that it would appear every time the name is used.[131] It also asked if Rule 35d-1 should be amended to prohibit the use of a date in target date fund names, or to include only the "landing point" (the date at which the fund reaches its lowest equity allocation) and not the target date.[132] The SEC has not, as of the publication of this chapter, adopted a final rule or updated Rule 35d-1 with respect to target date funds.

§ 2A:5.16 Derivatives

[A] Background

A derivative is a financial contract whose value depends on the value of an underlying or "reference" asset. While the reference asset is generally not bought or sold at the initiation of the contract, derivatives often operate by granting their holders rights to certain payment streams related to that asset. Common derivative contracts include swaps, options, futures, forwards, and repurchase agreements. Mutual funds use derivatives for a variety of purposes, including to hedge interest rate, credit, and other risks; gain access to certain markets;

128. *Id*. at 35,922–23.
129. *Id.* at 35,923.
130. *Id.* at 35,927.
131. *Id.* at 35,921.
132. *Id.*

achieve greater transaction efficiency; or increase leverage to augment returns.[133] Though the use of derivatives is widespread within the mutual fund industry,[134] the application of the Names Rule to derivative instruments consists primarily of informal Staff guidance.

[B] Formal SEC Guidance

In the Adopting Release, the SEC noted that it considered but did not adopt proposed language that would have required an investment company to invest at least 80% of its assets in the type of *security* indicated by its name. Instead, the language of the rule as adopted was modified to require that an investment company with a name suggesting that the company focuses on a particular type of investment invest at least 80% of its assets in the indicated *investments*. The Adopting Release notes that this change in language "would permit an investment company to include a synthetic instrument in the 80% basket if it has economic characteristics similar to the securities included in that basket."[135] Exposure obtained through derivative contacts (a type of synthetic instrument) is, thus, an acceptable means of satisfying the 80% requirement under Rule 35d-1.

However, the Adopting Release did not provide guidance on how exactly derivatives would be treated under the 80% test. Derivatives may be broadly categorized as either exchange-traded or over-the-counter (OTC). Exchange-traded derivatives—such as futures and certain options—are standardized contracts traded on regulated exchanges with readily available market quotations and, thus, values. OTC derivatives, which include most swaps, are bespoke contracts whose terms are individually negotiated based on the investment objectives of the parties to the contract. OTC derivatives are generally more difficult to value for the purposes of the Names Rule than exchange-traded derivatives as the OTC derivatives are less standardized.[136] For the purposes of determining a fund's compliance with

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133. Use of Derivatives by Investment Company Under the Investment Company Act of 1940, Release No. 28,776 (Aug. 31, 2011), 76 Fed. Reg. 55,237, 55,238 (Sept. 7, 2011).

134. *Id.*

135. Adopting Release, *supra* note 3, at 8510 n.13.

136. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1979 (2010), information regarding the terms of all OTC derivatives is required to be reported to swap data repositories, which make such information available to the public shortly after execution of the transaction. Such information may make it easier to value OTC derivatives transactions. Also, many swaps will now be required to be cleared, and such cleared swaps are likely to become more standardized with a more easily calculable market value.

the 80% test under the Names Rule, OTC derivatives raise two important and interrelated questions: (1) how to value a derivative contract when making the 80% calculation, and (2) whether to consider the issuer of the derivative instrument or the issuer of the reference asset when determining to which party the instrument creates exposure.

On August 31, 2011, the SEC issued a concept release (the "Derivatives Concept Release"), seeking public comment on a number of issues related to funds' use of derivatives, including leverage, diversification, exposure to securities-related issuers, concentration, and valuation.[137] While the Derivatives Concept Release mentioned the Names Rule only in passing,[138] much of the analysis related to valuation, diversification, and concentration should apply with equal force to the 80% analysis under Rule 35d-1. For example, if a total return swap is treated as creating exposure to the equity securities of ABC pharmaceutical company, that exposure should count both as exposure to the pharmaceutical industry for the purposes of a fund's concentration policy pursuant to section 8(b)(1)(E) and as exposure to equities for the purposes of the 80% test under Rule 35d-1. Likewise, where it is appropriate to look to the notional size of a derivative position in meeting the valuation requirements under section 2(a)(41) and Rule 22c-1 thereunder for purposes of valuation, it appears that using the same approach may also be appropriate for complying with the 80% test under Rule 35(d)(1).

The Derivatives Concept Release, however, did little more than flag important derivatives-related issues and seek public comment. The SEC has provided scant formal guidance on accounting for derivatives under Rule 35d-1. Instead, industry practice has been shaped by informal guidance from the Staff, obtained in this regard at least partially through the comment-response process. The Staff comment-response process reveals that the SEC has not developed a consistent approach to the key questions of derivative valuation and issuer identification, though funds generally argue for a common-sense treatment of both issues.

[C] Value

In general, fund practice has been to value derivatives based on their economic characteristics. However, one report suggests the Staff has increasingly encouraged funds to avoid using notional values for the

137. *See* Release No. 28,776, 76 Fed. Reg. 55,237, *supra* note 133.

138. *Id.* at 55,239 n.16 (noting that a fund's use of derivatives may raise issues "under applicable disclosure provisions" including "Investment Company Act provisions relating to . . . fund names (section 35(d) and rule 35d-1)").

purpose of meeting an 80% asset policy.[139] In some circumstances, fund complexes are comfortable accounting for derivative positions solely by reference to their market value. However, funds often disclose that they may depart from this methodology in special cases. For example, where two derivative positions based on two different reference assets are combined to create synthetic exposure that has economic characteristics similar to a direct investment in a third asset, a fund may use a different methodology that seeks to capture the fund's synthetic exposure for purposes of its 35d-1 policy.

Many funds have successfully resisted SEC pressure to consider only the market value of their derivatives, explaining, in response to SEC comments, that notional values will be used whenever notional value is a more appropriate measure of the fund's real economic exposure than market value.[140] Some funds have argued to the Staff that if a derivative creates an investment exposure to an issuer in an amount equal to the mark-to-market value of the derivative, the Fund would typically expect to use that mark-to-market value for purposes of the 80% test. On the other hand, if the derivative creates an exposure equivalent to a cash investment in the underlying issuer equal to the derivative's notional amount, the Fund would typically expect to use that notional amount for purposes of the 80% test. This is consistent with the view of some commentators, who have pointed out that valuation of derivatives under the 80% test should be tailored to the type and purpose of the derivative in question.[141] For example, according to those commentators, while credit default swaps might generally be valued according to their mark-to-market value, they might be valued according to their notional amount when they are used as a proxy to gain exposure to a certain asset class (that is, as a proxy for changes in value of the underlying asset).[142]

[D] Determination of the Issuer

The Task Force on Investment Company Use of Derivatives and Leverage, a task force of investment company lawyers formed for the

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139. Greg Saitz, *To Pass this Test, SEC Wants to Ensure Funds Keep it Real*, BOARD IQ (July 16, 2013).

140. *Id.* (quoting a comment response letter stating that "for the purposes of determining compliance with a policy adopted in accordance with Rule 35d-1, the funds may use a derivative contract's notional value when it determines that notional value is an appropriate measure of the fund's exposure to investments that are consistent with its 35d-1 policy").

141. *See* Albertelli, Chanda & Hale, *supra* note 63, at 18 ("Different categories of derivatives should . . . be treated differently, in a functional way, in the context of both the derivative and the investment strategy.").

142. *See id.*

purpose of assisting the SEC's Division of Investment Management with regard to regulation of the use of derivatives by investment companies, recommended that the SEC clarify that Rule 35d-1 should be interpreted in the same manner as section 5(b) of the Investment Company Act; that is, it would be appropriate for a registered investment company to consider the reference asset, rather than the counterparty, as the relevant basis for determining whether a fund invests in a manner that is consistent with its name.[143] As noted above, the SEC's Derivatives Concept Release, published after the task force's publication, did not discuss the subject in detail.

143. ABA Comm. on Fed. Regulations of Secs., Report of the Task Force on Investment Company Use of Derivatives and Leverage, at 39 (July 6, 2010).