SEC Adopts Amendments to Expand the Scope of the “Names Rule”

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On September 20, 2023, the SEC voted to adopt final amendments to Rule 35d-1 (the so-called “Names Rule”) under the Investment Company Act of 1940, as amended (the “Investment Company Act”) (the “Amendments”). The Amendments increase the number of registered investment companies and business development companies (“BDCs”) (together, “funds”) that are subject to the Names Rule, including registered funds with names indicating a focus on environmental, social and governance (“ESG”) factors in connection with their investment practices, and seek to enhance transparency into funds’ compliance with the Names Rule. The final Amendments depart from the proposed amendments (which we discuss here) in certain key respects, as described below.

Originally adopted in 2001, the Names Rule currently requires a fund with a name that suggests a focus in a specific type of investment, industry (or group of industries), or geography to adopt an investment policy requiring investment of at least 80% of the value of its assets in the suggested focus areas (the “80% Policy”). The Amendments are designed to further modernize and enhance the Names Rule, and the intended investor protections thereof, in light of market and other industry developments since the Names Rule was adopted (e.g., growth in ESG and similar products and the increased use of derivatives and similar financial instruments).

This *Alert* covers:

- the expanded scope of the Names Rule to fund names suggesting a focus in investments or issuers with “particular characteristics,” including the terms “growth,” “value,” “sustainable,” “green,” or “socially responsible,” which are *not* currently covered by the Names Rule;

- the requirement that, for funds required to adopt an 80% Policy, any terms used in the fund's name that suggest either an investment focus or that such fund is a tax-exempt fund must be consistent with those terms' plain English meaning or established industry use;
- the circumstances under, and the time periods (generally 90 days) during, which funds may deviate from their 80% Policy, including a new requirement to review portfolio investments included in the "80% bucket" at least quarterly to ensure compliance with the 80% Policy;
- the methodologies for valuing derivatives under an 80% Policy, including the mandate to use notional value — rather than market value — to compute compliance;
- the requirement, subject to exception, that registered closed-end funds and BDCs whose shares are not listed on a national securities exchange must obtain investor approval to change an 80% Policy;
- the enhanced disclosure requirements applicable to fund prospectuses and SEC filings; and
- the updated notice and recordkeeping requirements imposed under the Amendments.

The Amendments were approved by the SEC in a 4-1 vote, with Commissioner Uyeda dissenting, noting in particular his belief that the SEC has overemphasized the importance of a fund's name. The Amendments will become effective 60 days after publication in the Federal Register. From the effective date, fund groups with net assets of $1 billion or more will have 24 months to comply with the Amendments, and fund groups with net assets of less than $1 billion will have 30 months to comply with the Amendments.

80% Investment Policy Requirement

Expanded Scope

The Names Rule currently requires a fund to adopt an 80% Policy if its name suggests a focus in a particular type of investment, industry (or group of industries) or geography. As a result, funds with names that suggest a particular investment strategy (such as a growth or value strategy) have not been required to adopt an 80% Policy.

As adopted, the Amendments will expand the Names Rule to apply to any fund name with terms suggesting that the fund focuses in investments that have, or investments whose issuers have, "particular characteristics." The SEC declined to define the term "particular characteristics," noting its belief that the term will be adequately understood to mean any feature, quality or attribute. This expanded scope will include fund names that suggest an investment focus — for example, fund names with terms such as "growth," "value" or "income,"[1] as well as terms that reference a thematic investment focus, including investment decisions that incorporate one or more ESG factors. In discussing its particular focus on enhancing investor protections as respects the use of ESG or similar terminology in a fund's name, the SEC noted that evolving investor expectations around terms such as "sustainable," "green," or "socially responsible" "compound the possibility of investor confusion and potential 'greenwashing' in fund names" and, therefore, should fall within the scope of the Names Rule.

In a departure from the proposed amendments, names including the terms "global" and "international," without an additional term that suggests an investment focus such as "fixed income" or "growth," will not require an 80% Policy.

Exceptions to the Expanded Scope

Names that do not suggest an investment focus will continue to be outside the scope of the Names Rule. These include names that (i) suggest a portfolio-wide result to be achieved (e.g., "real return," "balanced," or "managed risk"), (ii) reference a particular investment technique (e.g., "long/short" or "hedged") and (iii) reference asset allocation determinations that evolve over time (e.g., retirement target date or "sector rotation" funds).

ESG Integration Funds

In another departure from the proposed amendments, the SEC determined not to adopt amendments that would have prohibited ESG integration funds, as defined in a separate SEC proposal regarding enhanced ESG disclosures, from using ESG terminology in their names. Integration funds are described by the SEC 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. Under the previously proposed approach, such fund names would have been defined as materially deceptive and misleading given the potential for the names to overstate the importance of ESG factors in the ESG integration fund's investment selection process. The SEC noted, however, that it is continuing to consider comments on ESG integration funds in connection with the separate pending proposal.

Parameters of an 80% Policy

The amended Names Rule requires that any terms used in a fund's name that suggest either an investment focus or that such fund is a tax-exempt fund must be "consistent" with the plain English meaning or established industry use of such terms. Whether a fund is using a term consistent with its plain English meaning or established industry use could be derived from a variety of sources, including the dictionary, prior public disclosures, industry codes or classifications and/or a colloquial understanding of the term. In addition, the Amendments seek to provide funds with certain flexibility:

- *Definitions of Terms*: Funds will have flexibility to use "reasonable definitions" of the terms in their names so long as such terms are consistent with their plain English meaning or established industry use. The SEC acknowledges that what constitutes "reasonable" in context could vary depending on the fund name, but requires that the definition have a "meaningful nexus between the term used in the fund's name and the fund's investment focus." Since funds may use multiple reasonable definitions of the same term in their names, each fund required to adopt an 80% Policy must disclose in their prospectuses how it interprets these terms.
- *80% Basket*: Funds also will have flexibility to reasonably determine which investments to include in their 80% baskets in accordance with the investment focus the name conveys, which can be dependent on the context of the terms in a name.

The SEC stated that if a fund's name suggests an investment focus with multiple elements, the 80% Policy must address each of the elements. For example, the XYZ Technology and Growth Fund could adopt an 80% Policy that provides that (i) each security included in the 80% basket must be in *both* the technology sector and meet the fund's growth criteria, or (ii) the fund's assets will be invested in a mix of technology and growth investments. Notably, such an 80% Policy would not be required to specify minimum or maximum investment requirements for either category.

The SEC also provided helpful guidance that a fund of funds or other "acquiring fund" may include the entire value of its investment in an underlying fund when calculating compliance with its 80% Policy without looking through to the underlying fund's investments, provided that the underlying fund itself has an 80% Policy. For example, the XYZ Industrials Fund, which has an 80% Policy to invest in the industrials sector, could count the entire value of its investments in ABC Automotive Fund when calculating compliance with its 80% Policy, provided that ABC Automotive Fund has an 80% Policy to invest in its subsection of the industrials sector. If, however, an "acquiring fund" knows that an underlying fund is not investing in a manner consistent with the acquiring fund's investment focus, the acquiring fund should take action to address the departure as it otherwise would to resolve a temporary departure from its 80% Policy under the Amendments.

The Amendments make clear that adopting an 80% Policy consistent with the Names Rule is not a "safe harbor" against claims of a misleading fund name — that is, a fund's name could nevertheless be materially deceptive or misleading even if the fund has complied with its 80% Policy. The SEC cited as an example of a fund with a materially deceptive or misleading name a "conservative income bond" fund that uses its 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 lower-yielding bonds."

Temporary Departures from the 80% Policy Requirement

In a reconsideration of the approach to temporary departures in the proposed amendments, the Amendments retain the current requirements of the Names Rule that a fund invest in accordance with its 80% Policy "under normal circumstances" (which, while not defined by the rule, gives funds the discretion to determine what constitutes something other than a normal circumstance), and that compliance with the 80% Policy must be tested at the time of an investment. The Amendments include a new requirement, in a change from the proposed amendments, that a fund must review its 80% basket, at least quarterly, to determine whether its investments continue to be consistent with its 80% Policy.

In the case of a departure from an 80% Policy, the Amendments require that funds come back into compliance "as soon as reasonably practicable" — generally, within 90 consecutive days, either from the time the fund identifies an unintentional departure from its 80% Policy or from an intended departure in the case of an other-than-normal

circumstance. The Amendments, however, provide exceptions from the 90-consecutive-day requirement in connection with reorganizations and fund launches:

- **Fund Launches**. New funds are permitted up to 180 consecutive days from their commencement of operations to come into compliance with an 80% Policy.
- **Planned Reorganizations**. The Amendments do not set forth a specified time limit for departures associated with planned reorganizations. The SEC acknowledged that an express time limit would be unnecessary as a reorganization is likely to result in a permanent change to the nature of the investor's investment, about which investors will already be notified.

Treatment of Derivatives

Scope

In addition to any derivatives instrument[2] that a fund includes in its 80% basket because the derivatives instrument provides investment exposure to investments suggested by the fund's name, the Amendments permit a fund to include, in its 80% basket, a derivatives instrument that provides investment exposure to one or more of the market risk factors associated with the investment focus suggested by the fund's name. The SEC noted that, in addition to using derivatives as direct substitutes for cash market investments, funds also use derivatives instruments to hedge exposures or to obtain exposure to market risk factors associated with the fund's investments (such as interest rate risk and credit spread risk). In connection with determining whether a derivatives instrument provides investment exposure to one or more of the market risk factors associated with the investments in a fund's 80% basket (i.e., a fund's so-called "name assets"), a fund generally should consider whether the derivative provides investment exposure to any explicit input that the fund uses to value its "name assets", where a change in that input would change the value of a security.

Valuation

In a departure from general industry practice, but as proposed, the Amendments require a fund to use a derivative's notational value, rather than market value, for purposes of assessing compliance with an 80% Policy. In calculating notional

amounts, the Amendments require a fund to convert interest rate derivatives to their 10-year bond equivalents and to delta adjust the notional amounts of options contracts. In addition, in a departure from the proposed amendments, the Amendments also:

- require a fund to exclude from its 80% Policy calculations certain derivatives that hedge the currency risk associated with a fund's foreign-currency denominated investments if: (i) the derivative is entered into and maintained by the fund for hedging purposes; and (ii) the notional amounts of the derivatives do not exceed the value of the hedged investments (or the par value thereof, in the case of fixed-income investments) by more than 10%;
- permit — rather than require, as originally proposed — a fund to deduct cash and cash equivalents and U.S. Treasury securities with remaining maturities of one year or less from its assets (i.e., the denominator in the 80% calculation), up to the notional amounts of the fund's derivatives instruments and the value of assets sold short; and
- provide that a fund is permitted to exclude any closed-out derivatives positions when calculating assets for purposes of determining compliance with its 80% Policy, if those positions result in no credit or market exposure to the fund.

Short Sales

As adopted, if a fund were to use derivatives instruments to obtain exposure to short positions in one or more reference assets, the fund would be required to use the notional amounts of such derivatives for purposes of determining compliance with its 80% Policy. As such, these investments would be valued at their notional amounts in the denominator in all cases, and at their notional amounts in the numerator where the fund includes investments that provide short exposure in the numerator. The Amendments also specify that a fund must value each physical short position using the value of the asset sold short.

Unlisted Registered Closed-End Funds and BDCs

The Amendments generally prohibit any registered closed-end fund or BDC whose shares are not listed on a national securities exchange, that is subject to an 80% Policy, from changing its 80% Policy unless authorized by a vote of the majority of the outstanding voting securities of the fund.[3] In the proposal, the SEC cited the limited

liquidity of investors in these funds as the impetus for the change — that is, it would provide investors an opportunity to vote on a change in the fund's investment policy, as such investors cannot "vote with their feet" by redeeming fund shares at net asset value (for mutual funds) or selling their shares in the secondary market (for listed funds) at a current market price. Unlisted registered closed-end funds and BDCs, however, will be permitted to change their 80% Policies without an investor vote if (i) a tender or repurchase offer is conducted with at least 60 days' prior notice of the policy change; (ii) that offer is not oversubscribed; and (iii) shares are repurchased at their net asset value.[4]

Additional Elements of the Amendments

Changes to Prospectus Disclosure Requirements

The SEC adopted additional disclosure requirements to funds' registration statement forms — specifically to Forms N-1A, N-2, N-8B-2 and S-6. Funds subject to the Names Rule must disclose in their prospectuses (and tag using Inline XBRL): (i) the definitions of any terms used in the fund's name related to its investment focus; and (ii) the specific criteria used to select the investments that such terms describe.

With respect to open-end funds, the SEC is modifying the proposed disclosure requirement to provide that the aforementioned definitions of terms must be summarized in the summary section of the prospectus and disclosed in the statutory prospectus.

Changes to Form N-PORT Reporting

Funds that are required to adopt an 80% Policy must report on Form N-PORT[5]: (i) whether each investment in the fund's portfolio is included in its 80% basket; (ii) the value of the fund's 80% basket, as a percentage of the value of the fund's assets and (iii) the definitions of any terms used in the fund's name, including the specific criteria used to select the investments that such terms describe.[6]

Notice Requirements

Unless a fund's 80% Policy is a fundamental investment policy, 60 days' notice must be provided to investors of any change in the fund's 80% Policy, or a change to the fund's name. The Amendments set forth certain requirements regarding the notice and the content thereof, including that the form be delivered "separately from other documents" (i.e., it cannot be built into the fund's prospectus or into other required investors communications), and updates the notice requirement, as proposed, to permit funds to use electronic delivery methods.

Recordkeeping Requirements

As proposed, funds subject to an 80% Policy will be required to maintain certain written records documenting their compliance with the Names Rule, as amended, including changes that reflect the rule's revised approach to temporary departures. In a departure from the proposed amendments, funds that do not adopt an 80% Policy will not be required to maintain a written record of their analysis regarding why an 80% Policy is not required.

Compliance with the Names Rule

The SEC's Division of Investment Management staff are reviewing its no-action letters and other statements addressing compliance with the Names Rule to determine which letters and other staff statements, or portions thereof, should be withdrawn in connection with the Amendments. Some of these letters and other staff statements, or portions thereof, may be moot, superseded, or otherwise inconsistent with the Amendments and, therefore, may be withdrawn by the staff.[7]

Takeaways

Evaluation of Fund Names

For more than 20 years, funds have relied on the SEC's position, as supplemented by its staff, that intentionally excluded types of investment strategies, as contrasted to actual investments, from the requirement to adopt an 80% Policy. Funds that use words like "growth", "value," or "income" should start to consider their ability to adopt and comply with an 80% Policy, notwithstanding the 24-30 month compliance period

following the effectiveness of the Amendments. In addition, funds, including closed-end funds and BDCs, that invest in illiquid securities and underlying private funds, should start to assess whether it may be advisable to remove certain words from their names to simplify compliance with the Names Rule, especially since rebalancing their portfolios could prove challenging. Doing so, however, may ironically provide investors with reduced information about such funds' investments and investment strategies.

ESG Considerations

- While terms used in a fund's name that suggest an investment focus must be "consistent" with the plain English meaning or established industry use of such terms, the SEC acknowledges, as noted above, that terms like, "ESG," "sustainable," "green," and "socially responsible" are confusing because they do not have widely accepted meanings. The SEC also acknowledges that certain terms may be defined in multiple reasonable ways. The Amendments could help accelerate established industry definitions given that funds that use ESG terms in their names will be required to define those terms more clearly, which would result in funds that use ESG terms in their names inconsistent with such definitions having to change their names or approaches to ESG. Further, although the Amendments do not apply to private funds, to the extent the Amendments accelerate the coalescence noted above, that coalescence could influence limited partner expectations for private funds.
- The use of ESG terms in a fund's name may not require adoption of an 80% Policy in all cases. One commenter focused on ESG "uplift" funds, which start with a universe of investments that are not selected on the basis of ESG criteria and then adjust the weight of those investments based on ESG factors. The SEC acknowledged that an 80% Policy would not be required in an instance where the ESG "uplift" fund's strategy is executed on a relative basis at the portfolio level and the fund's name is intended to communicate this approach to investors (such as ESG "Aware").
- There is existing and proposed ESG regulation in other jurisdictions related to fund naming and disclosure — such as the European Union's Sustainable Finance Disclosure Regulation, the European Securities and Markets Authority's draft guidelines on the use of ESG- or sustainability-related terms in fund names, and the United Kingdom's forthcoming Sustainability Disclosure Requirements. Funds subject to the Amendments should consider evaluating all other existing and potential regulatory requirements at the same time, to help inform the development of comprehensive compliance procedures as well as consistent disclosures to all investors and regulators.

- As illustrated by the recent $19 million penalty levied against DWS Investment Management Americas, the SEC remains focused on misstatements regarding ESG investment processes. A fund's name is just one aspect of ESG compliance and disclosure, and accordingly, in connection with drafting their 80% Policy, fund managers may wish to carefully review their ESG investment practices and compliance and recordkeeping procedures to ensure they are consistent with the 80% Policy as well as any other ESG disclosures to investors. Fund managers should also keep in mind that the SEC is expected to finalize in the coming months its separate proposal relating to enhanced ESG disclosures for registered investment advisers and funds, which will likely increase the importance of having robust compliance and recordkeeping procedures relating to ESG.

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1. While the final Amendments, unlike the proposal, do not explicitly address funds with names that include "income," we believe that the Amendments could pick up fund names that include "income" based on their "particular characteristics." ↩

2. A *derivatives instrument* means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument. ↩

3. This approach has the same practical effect as under the proposed amendments, which would have required such funds and BDCs to adopt their 80% Policies as fundamental investment policies (i.e., policies that cannot be changed unless authorized by a vote of a majority of outstanding voting securities). ↩

4. Unlike registered closed-end funds and BDCs, unit investment trusts ("UITs") that have names that are implicated by the Amendments, and whose initial deposit occurs after the compliance date of the Amendments, will need to adopt an appropriate 80% Policy and will be subject to the applicable provisions of the Names Rule. Such UITs, however, will not be required to engage in the monitoring and other requirements associated with the Amendments' temporary departure requirements nor will they be required to keep records under the Amendments beyond the initial deposit. ↩

5. As BDCs are not subject to Form N-PORT reporting requirements generally, they will not be subject to the Form N-PORT amendments. ↩

6. The SEC did not adopt the proposed requirement that a fund report the number of days that the value of the assets in its 80% basket fell below the required 80% threshold during the reporting period, as it would require daily monitoring and, therefore, be inconsistent with the revised approach of a quarterly review of the investments in the fund's portfolio. ↩

7. The staff's review of no-action letters and other statements includes, but is not limited to: Frequently Asked Questions about Rule 35d-1; Disclosure by Funds Investing in Government Sponsored Enterprises (staff letter to the ICI, Oct. 17, 2003); and IM Guidance Update, No. 2013-12, Fund Names Suggesting Protection from Loss (Nov. 2013). ↩

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Related Services

Practices

- Investment Funds
- ESG & Impact

Suggested Reading

- 30 November 2023 Sponsored Event Women's Private Capital Summit 2023
- 06 November 2023 - 07 November 2023 Sponsored Event SuperReturn North America 2023
- 24 October 2023 Sponsored Event Private Equity Wire’s European ESG Summit

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