Investment Management Update

October 2023

SEC Adopts New Names Rule Under the Investment Company Act

Key Notes:

- Expands scope of 80% investment policy requirement to any fund name that suggests a particular type of investment, industry, country or region, or whose issuers have particular characteristics (e.g., thematic funds, "growth" or "value" funds).
- Allows for temporary departures from 80% investment policy requirement provided fund comes into compliance within 90 days.
- Permits new funds 180 days to comply with 80% investment policy.
- Requires that notional value of derivatives be used for the purposes of complying with an 80% investment policy.

On September 20, 2023, the Securities and Exchange Commission (SEC) adopted amendments to Rule 35d-1 under the Investment Company Act of 1940 (Investment Company Act). The amendments were approved to "modernize and enhance" Rule 35d-1 (Names Rule) and to "help ensure that a fund's portfolio aligns with a fund's name." The amendments will increase the scope of the Names Rule to include any fund name that suggests a fund focuses on investments with specific characteristics rather than differentiating between fund names that reference a strategy. One notable difference between the adopted amendments and those proposed in May 2022 is that the SEC did not adopt the proposed amendments related to using ESG terms in naming ESG integration funds. Importantly, the SEC noted that the new Names Rule is not a safe harbor. Thus, in the SEC's view, a fund's name "may be materially deceptive or misleading even where the fund complies with its 80% policy."

Scope and Requirements for a Fund's 80% Policy

Under the adopted amendments, any fund whose name suggests that the fund focuses its investments in a particular area or has certain characteristics (such as thematic funds or "growth" or "value") will need to include an 80% policy. The amendments were adopted with the belief that a fund name communicates an investment's focus to investors and an expectation that the fund will invest in securities that further that focus. Importantly, while the SEC did not adopt the ESG integration funds aspect of the proposed rule, this new 80% requirement does apply to funds with ESG factors in their name. The SEC provided examples of characteristics that would fall under this 80% policy requirement, which include names that suggest, "a particular type of investment, or investments in a particular industry or geographic focus, and fund names suggesting that a fund's distributions are tax-exempt." In its release, the SEC explained that the phrase, "particular characteristics," should be "adequately understood to mean any feature, quality, or attribute." The SEC specifically mentioned funds that include "growth or value" in the names, as these funds typically did not need a policy under the old Names Rule. Conversely, funds that include "balanced," "global" or "international" will not need an 80% policy under the amended rules as these terms simply refer to a fund's method in creating a portfolio rather than the contents of what is in the portfolio. When a fund contains two or more terms that suggest an investment focus, the fund needs to create an 80% policy that addresses both terms, either separately or in the aggregate.

Along with the expanded scope of terms that will now require an 80% policy under the amended Names Rule, a fund needs to define the terms used in its name and disclose the criteria for determining investments that fall within this definition. The fund's prospectus is required to include this disclosure. The definition is designed to allow the fund to distinguish its investment strategy from other funds with similar names. The SEC explained this could specifically apply in differentiating terms such as "growth" or "sustainable." However, the definition must be "consistent with the term's plain English meaning or established industry use." Thus, while two funds may define a term differently, neither can be so unique as to stray from the plain English meaning and cause investor confusion. Terms that do not have standard definitions or meanings such as "Latin America," a fund can define the term in different ways regarding how the strategy utilizes the term. However, there must be a reasonable connection between the investment in securities and the fund's investment focus.

In another key change from the proposed amendments, the final rule will require funds to determine compliance with its 80% policy on an at-least quarterly basis rather than continually as proposed. Under the amended rule, a fund must comply with its 80% policy at the time that it invests and "under normal conditions." The SEC intentionally did not specifically define "under normal conditions" and thus left it up to the fund to determine what are or are not normal conditions. When a fund departs from its 80% policy under "other-than-normal circumstances," the fund will have 90 days from the initial departure to get back into compliance. Under the amended rule, a newly launched fund will have 180 days to become compliant with its 80% policy. In the case of a reorganization, the period for getting back into compliance as the SEC recognized it, could take more time to complete the reorganization. The SEC chose to include the 90-day requirement rather than adopting the list of approved circumstances included in the proposed rule. The SEC noted in the release, however, that if a fund is routinely departing from its 80% policy due to "other-than-normal circumstances," that would bring into question whether those circumstances are truly "other-than-normal." Such departures would potentially cast doubt on whether it is appropriate for the fund to continue deviating from its policy or whether the fund's name is consistent with its underlying investments. The fund would also need to keep a record of the date and reason for departure.

When a fund breaks its 80% policy due to drift, it must get back into compliance "as soon as reasonably practicable," but it must be accomplished within 90 days from the time the fund discovered the violation. The SEC noted, however, that once the fund has identified this departure, it "must make all future investments in a manner that will bring the fund into compliance." If a fund is unable to get back into compliance with its 80% policy, the fund needs to inform its shareholders that it will change its name to one that better reflects its investments and strategy. Under the adopted amendments, a fund's 80% policy must be fundamental, or it must adopt either a policy to provide shareholders with at least 60-days' notice of a change in its 80% policy. Such a notice must include a description of the 80% policy, the nature of the policy change, the fund's new and old names, and the effective date of any investment policy and/or name changes.

Policies Regarding Derivative Instruments

Under the final amendments, when a fund employs a derivatives strategy, the fund will generally be required to use the notional value to determine if 80% of its funds are invested in accordance with the focus its name suggests. The SEC explained that using the notional value for derivatives would help to "ensure that a fund's investment activity is consistent with the investment focus." However, unlike in the proposed amendments, a fund needs to exclude certain derivatives that hedge currency risk for a fund's "foreign-currency denominated investments." Thus, these derivatives will not be included in the fund's total assets or the total number in the 80% "basket." This change from the proposed rule was done because of the desire to not limit the use of derivatives for hedging purposes and the belief that these derivatives generally would not cause a fund's name to be deceptive. A fund *must* exclude a currency derivative when it is "(1) entered into and maintained by the fund for hedging purposes, and (2) the notional amounts of the derivatives do not exceed the value of the hedged investments." In determining the notional amounts, a fund will need to convert "interest rate derivatives to their 10-year bond equivalents and to delta adjust the notional amounts of option contracts." This adjusted amount is designed to better represent a fund's exposure to interest rates.

Conversely, under the amendments, a fund is *allowed* to choose whether to deduct cash and cash equivalents (including U.S. Treasuries) with maturities of one year or less from its assets up to the notional amount of its derivatives. This is a change from the proposed rule, which would have *required* deductions for cash and cash equivalents only. In another change from the proposed rules, a fund is also permitted to exclude closed-out positions when determining assets for compliance with its 80% policy, as long as those positions do not result in credit or market exposure to the fund. The SEC explained this change was made because closed-out positions would not affect the fund's risks and thus not create a problem for shareholders based on the fund's name.

Regarding what derivative positions must be included in a fund's 80% calculation, the SEC adopted the amendments substantially as proposed. Therefore, a fund must include derivative positions that "provide investment exposure to one or more of the market risk factors associated with the investment focus." The SEC added that a fund should consider "whether the derivative provides investment exposure to any explicit input that the fund uses to value its name assets" when determining whether the derivative provides exposure to a risk factor associated with the investment focus. Additionally, a fund must include the notional value of "each physical short position" in the numerator and denominator of its 80% calculation. As part of the amended rule, the SEC also changed the definition of "asset" to mean "net assets plus the amount of any borrowings for investment purposes."

Unlisted Registered Closed-End Funds and BDCs, and Index Funds

Under the amended Names Rule, unlisted, registered closed-end funds and Business Development Companies (BDCs) that are required to adopt an 80% policy will generally be required to obtain authorization from a shareholder vote to change its 80% policy. In a change from the proposed rule however, funds will not need a shareholder vote if: 1) the fund conducts a tender offer with at least 60 days prior notice about the change; 2) that offer is not oversubscribed; and 3) the purchase is done at the share's net asset value. The SEC believed that providing shareholders the opportunity to sell their shares would allow those who do not want to invest under the new policy to exit the fund. However, the SEC noted that if the offer is oversubscribed, the fund must obtain authorization from a shareholder vote as this means shareholders are not in favor of the change.

The SEC confirmed that under the amended rule, an index fund that includes an index's name in its name does not need to adopt an additional 80% policy related to the market index. In this case, the 80% policy to invest its assets in the market index's components is enough. The SEC added that under rule 38-1, index funds should adopt written policies and procedures to ensure the underlying index is not materially misleading or deceptive.

Changes to Forms and Record Keeping

As originally proposed, a fund is required to keep records related to its compliance with and deviations from its 80% policies. However, in a significant change from the proposed rules, a fund that does not adopt an 80% policy will not need to keep a record of why a policy is not required.

As part of the amended rule, the SEC has made changes to form N-PORT to enhance transparency, which includes a new section to report the definition of the terms used in the fund's name, whether an investment is in a fund's basket for the purposes of its 80% policy, and the value of the fund's 80% policy basket as a percentage of the value of fund assets. Along with this change are amendments to

Form N-1A, Form N-2, Form N-8B-2 and Form S-6. The amendments will also require that most of the new reporting information be tagged in structured data language (Inline XBRL).

Compliance Dates

The new Names Rule will become effective 60 days after publication in the Federal Register. Compliance dates are set at 24 months following the effective date for fund groups with net assets over $1 billion and 30 months for fund groups with net assets below $1 billion.

Observations

Funds and their advisers should identify which funds will be captured by the new Names Rule. Funds that use terms such as “growth” or “value” in their name or are thematic in nature should consider how such terms will be defined and whether they can satisfy the 80% policy required by such terms. Funds, their advisers and boards should begin planning for the necessary compliance testing, recordkeeping, and reporting requirements, and consider whether current funds and their names and/or strategies may need modification.

FOR MORE INFORMATION

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