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SEC Adopts Amendments to Fund Names Rule

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On September 20, 2023, the Securities and Exchange Commission (the "SEC") voted to adopt final amendments to modernize Rule 35d-1 of the Investment Company Act of 1940, as amended (the "1940 Act").[1] This rule, commonly referred to as the "Names Rule", regulates the use of names for registered investment companies and business development companies ("BDCs")[2] that may be materially misleading or deceptive.

The amendments largely implement changes first proposed by the SEC last year and are intended to address interpretive issues and industry developments that have arisen since the Names Rule was first adopted in 2001.[3] In the adopting release for the final amendments, the SEC highlighted growing interest in regulated funds with a "thematic" investment focus, particularly those that consider environmental, social, or governance ("ESG") factors in their investment decisions, as an area of particular concern. The SEC noted that the breadth of ESG-related terms used in the industry increases the risk of investor confusion and potential "greenwashing" in fund names. As described in the adopting release, the final amendments are also designed to promote greater specificity in how regulated funds comply with the portfolio requirements under the Names Rule and to increase transparency for investors. Notably, the scope of regulated funds subject to the Names Rule will likely increase as a result of the amendments, while the compliance burden — both from a monitoring and reporting perspective — will increase meaningfully for regulated funds that fall within the scope of the Names Rule.

I. <u>Expanded Scope of the Names Rule</u>

Currently, the Names Rule requires a regulated fund with a name suggesting that the fund focuses on a particular type of investment, a particular industry or a particular geographic area, or whose name suggests a certain tax treatment, to adopt a policy to invest, under normal circumstances, at least 80% of its assets in the type of investments suggested by its name (the "80% rule", and with respect to such a policy, an "80% policy").

The final amendments expand the scope of the 80% rule to additionally apply to any fund name with terms suggesting that the regulated fund focuses in investments that have, or investments whose issuers have, “particular characteristics”. Notably, the SEC declined to specifically define this term in the adopting release for the final amendments given its belief that the term would be sufficiently understood to mean “any feature, quality, or attribute,” and also to ensure that the Names Rule remains evergreen. The adopting release instead provides a non-comprehensive list of terms that the SEC believes have particular characteristics: namely, terms such as “growth” or “value,” and terms referencing a thematic investment focus, including terms indicating that a regulated fund’s investment strategy considers ESG factors.

The SEC noted that the final amendments generally will not apply to certain other terms that have previously fallen outside the scope of the Names Rule because they do not communicate to investors the particular characteristics of a regulated fund’s investments. This includes terms such as “global”, “international”, “intermediate term” (or similar) with respect to bond funds, and other terms that speak to portfolio-wide characteristics rather than investment-specific characteristics. Similarly, the SEC specifically identified certain terms that do not communicate “particular characteristics” of investments comprising a portfolio and therefore do not require an 80% policy, including “real return,” “balanced,” “managed risk,” “long/short,” “hedged” and “sector rotation.”

Notably, the final amendments codify the SEC’s historical position that the Names Rule is not meant to be a safe harbor, and that a fund’s name may still be materially deceptive or misleading under Section 35(d) of the 1940 Act even if a regulated fund adopts and implements an 80% policy. Examples of practices that may violate Section 35(d) despite compliance with the 80% rule include: a regulated fund investing in such a manner that the source of a substantial portion of the fund’s risks or returns is materially different from what an investor would reasonably expect based on the fund’s name; or a regulated fund using an index in its name where a meaningful nexus does not exist between the underlying index’s components and the investment focus suggested by the index’s name.

II. <u>Quarterly Review Requirement and Temporary Departures from an 80% Policy</u>

The Names Rule amendments retain the current requirements for a regulated fund to invest in accordance with its 80% policy “under normal circumstances.” The SEC declined to comprehensively define the scope of “other-than-normal” circumstances in which funds may intentionally depart from their 80% policies, but the adopting release lists examples including temporary departures that occur as a result of market fluctuations, index rebalancing, cash flows/inflows, or temporary defensive positions, among others.

The final amendments retain the current requirement that a regulated fund must measure compliance with its 80% policy at the time it invests its assets. However, under the amendments, a regulated fund must now review its portfolio assets’ compliance with its 80% policy at least quarterly.

Where a regulated fund identifies that its investments are not consistent with its 80% policy as a result of drift, the amendments require funds to come back into compliance as soon as reasonably practicable and, in any event, within 90 consecutive days. Where a regulated fund identifies that the 80% investment requirement is no longer met, it must make all future investments in a manner that will bring the fund into compliance with its 80% policy. In all circumstances, a regulated fund must come back into compliance within 90 consecutive days measured from the time that the fund identifies a departure from its 80% policy (as part of its quarterly review or otherwise), or the time the fund initially departs from the policy in other-than-normal circumstances.

The amendments permit regulated funds to temporarily depart from their 80% policy in connection with a reorganization or fund launch. For fund launches, regulated funds may depart from the 80% policy for a temporary period not to exceed 180 consecutive days starting from the day the fund commences operations. There is no limit prescribed on the time of departure for fund reorganizations.

III. <u>Enhanced Prospectus Disclosure, Form N-PORT Reporting, Notice and Recordkeeping Requirements</u>

<u>Prospectus Disclosure</u>

The amendments require regulated funds subject to the 80% rule to include in their registration statements (specifically on Forms N-1A, N-2, N-8B-2, and S-6) reasonable definitions of the terms used in the funds' names, as well as the criteria used to select the investments that a term describes. Any terms used in a regulated fund's name that suggest an investment focus, or that the fund's distributions are tax-exempt, must also be consistent with those terms' plain English meaning or established industry use of such terms.

Form N-PORT

Pursuant to Form N-PORT amendments, regulated funds subject to the 80% rule (excluding money market funds and small business investment companies) must report (1) whether each investment in the fund's portfolio is in the fund's "80% basket" for purposes of measuring compliance with its 80% policy, (2) the value of the fund's 80% basket, as a percentage of the value of the fund's assets, and (3) the definitions of terms used in the fund's name. As a result, any deviation by a regulated fund from compliance with its 80% policy will be both public and readily apparent.

Notice Requirement

The amendments retain the current Names Rule's requirement that, unless the 80% policy is a fundamental policy of a regulated fund, 60 days' notice must be provided to shareholders of any change in the fund's 80% policy. Such notice must now, however, also describe any accompanying change in the regulated fund's name. The amendments also address regulated funds that use electronic delivery methods for shareholder communication and provide additional guidance on the content and delivery of notices.

Recordkeeping Requirement

The final amendments require regulated funds subject to the 80% rule to maintain certain records documenting their compliance with the Names Rule for at least six years following the creation of each record (or, in the case of notices, following the date the notice was sent) in an easily accessible place for the first two years.

IV. Derivatives-Related Considerations in Assessing Names Rule Compliance

The Names Rule amendments address both (1) the derivatives that a regulated fund may include in its 80% basket and (2) the method of valuation of derivatives instruments.

The amendments permit a regulated fund to include in its 80% basket a derivatives instrument that either provides investment exposure suggested by the fund's name or provides investment exposure to one or more of the market risk factors associated with the investment focus suggested by the fund's name. In determining whether a derivatives instrument provides this type of exposure, the SEC suggests that regulated funds "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 the security."

Pursuant to the amendments, regulated funds that invest in derivatives must generally use the derivatives' notional amount (rather than their market value) for calculating compliance with their 80% policy. Funds are required to make certain other adjustments when performing such calculations, such as excluding certain currency derivatives used as a hedge, converting interest rate derivatives to their 10-year bond equivalents, and delta-adjusting the notional amounts of options contracts[4], among certain other adjustments. Notably, the inclusion of specific guidance regarding the treatment of derivative instruments in the context of the Names Rule clarifies an area that previously lacked definitive guidance.

V. Considerations Regarding Unlisted Registered Closed-End Funds and BDCs

The amended Names Rule prohibits an unlisted registered closed-end fund or BDC that is required to adopt an 80% policy from changing that policy without a shareholder vote. However, such funds are permitted to change their 80% investment policies without such a vote if (1) the fund conducts a tender or repurchase offer with at least 60 days' prior notice of the policy change, (2) that offer is not oversubscribed and (3) the fund purchases shares at their net asset value. This change acknowledges the significant growth of these types of unlisted regulated fund structures in recent years, including both tender offer and interval funds, and addresses concerns around shareholder liquidity in the event of a shift in such a fund's 80% policy without prior shareholder approval.

VI. Compliance Dates

The Names Rule amendments will become effective 60 days after publication in the Federal Register. Larger entities (i.e., fund groups with net assets of $1 billion or more) will have 24 months to comply with the amendments, and smaller entities (i.e., fund groups with net assets of less than $1 billion) will have 30 months to comply.

VII. <u>Takeaways</u>

- The final amendments are less stringent with respect to compliance and monitoring than initially proposed. For example, the proposed amendments would have required subject regulated funds to implement continual or daily compliance monitoring and come back into compliance with their respective 80% policies within 30 days in cases of portfolio drift. Regulated funds that are subject to the Names Rule should have a comparatively easier time complying with the final amendments' quarterly review requirement and the more permissive 90 day period to get back into compliance, as compared to the SEC's initial proposal. However, the ongoing compliance burden under the amended rule, coupled with the N-PORT reporting requirements, reflect a significant shift from prior practice and will likely discourage even temporary "shifts" in portfolio composition that might deviate from a regulated fund's 80% policy, even if such a shift might otherwise arguably be prudent from a market or investment perspective.
- Existing regulated funds that are not presently subject to the Names Rule — particularly those with names including terms such as "growth" or "value" and funds with ESG-related names — should review their names and consider renaming if the terms used could be problematic because they speak to "particular characteristics" of a fund's portfolio investments.
- In line with the preceding bullet, we expect that a number of existing regulated funds that will now become subject to the amended Names Rule may take steps to modify their names in advance of the effective date of the amendments in order to maintain the investment flexibility they previously enjoyed. We believe that this will likely be most prevalent among any non-listed registered closed-end funds and BDCs that currently include terms such as "growth" or "value" in their names, in view of the new shareholder approval and liquidity requirements applicable to future changes in a fund's 80% policy under the amended Names Rule.
- Similarly, we expect that new regulated funds — and particularly new non-listed registered closed-end funds and BDCs — may refrain from including terms in their respective names that could be viewed as speaking to "particular characteristics" of a fund's portfolio, absent a clear marketing reason to do so. As a result, we may see the use of more generic naming conventions for regulated funds moving forward — particularly among funds with investment programs that would not have previously raised Names Rule concerns, such as with growth or value investing

strategies.

[1] Investment Company Names, Release No. IC-3500 (September 20, 2023).

[2] Registered investment companies and BDCs are referred to herein collectively as "regulated funds".

[3] Investment Company Names, Release No. IC-34593 (May 25, 2022).

[4] Delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. Delta-adjusting an option means multiplying the option's unadjusted notional amount by the option's delta. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-34084 (November 2, 2020).

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