

MEMO# 32261

March 4, 2020

SEC Requests Comment on Fund Names Rule

[32261]

March 4, 2020 TO: ICI Members SUBJECTS: Derivatives
Disclosure
Fund Accounting & Financial Reporting
International/Global
Portfolio Oversight RE: SEC Requests Comment on Fund Names Rule

The Securities and Exchange Commission published a release seeking public comment on the framework for addressing potentially misleading names of registered investment companies and business development companies under section 35(d) of the Investment Company Act of 1940, rule 35d-1 thereunder (the “Names Rule”), and the antifraud provisions of the Federal securities laws.[\[1\]](#)

The Release notes that the Commission is seeking public comment particularly in light of market and other developments since the adoption of the Names Rule in 2001. It also notes that the staff and the industry have identified a number of challenges regarding the application of the Names Rule since the rule’s adoption. Comments are due to the SEC 60 days after publication in the *Federal Register*.

The Commission is concerned about fund names that are likely to mislead investors about a fund’s investments and risks. According to the Release, “[b]ecause of the importance of fund names to investors and certain challenges regarding the application of the Names Rule, the Commission is assessing whether the existing rule is effective in prohibiting funds from using names that are materially deceptive or misleading, and whether there are alternatives that the Commission should consider.”

The Release recites the history and intent of the Names Rule and notes that “fund names remain a common area for staff comment as part of the disclosure review process.”[\[2\]](#) It also raises a series of questions for commenters to address, the most important of which are summarized below.

Scope of Rule

The Names Rule requires a fund to invest at least 80 percent of its assets in the manner suggested by its name. The Names Rule does not apply to fund names that describe a fund’s investment objective, strategy, or policies. The Release then asks a series of questions related to the asset-based test, including those below.

- Does the 80 percent threshold of fund assets in the type of investment suggested by the fund name continue to be appropriate?
- If not, what is a more appropriate threshold and why? For example, should it be lower (e.g., 65 percent) or higher (e.g., 95 percent)?
- Should the threshold apply only at the time of investment—as is the case in the current Names Rule—or should a fund be required to maintain that level of investment?
- Is an asset-based test appropriate for determining whether the use of a particular name is misleading?

Funds' Use of Derivatives

The Release notes that complying with the Names Rule (and its asset-based test) may raise particular challenges for funds that gain exposure to a “type of investment” through the use of derivatives. It further notes the Commission’s understanding that, although “many funds have asserted that a derivative’s notional value would be more appropriate than its market value for purposes of complying with the 80 percent investment policy, funds generally use market value on account of the Names Rule’s asset-based test.”[\[3\]](#) The Release then asks a series of related questions, including those set forth below.

- Should the Commission address this type of Names Rule-related challenge for funds that invest in derivatives? If so, how? For example, should the approach take derivatives’ notional value into account, and if so, how? Would there be any operational or interpretive challenges associated with this approach, and if so, what would they be and how should the Commission’s rules and guidance address these challenges?
- Should an approach based on notional values permit or require a fund to make any adjustments to derivatives’ notional values (e.g., should a fund be permitted or required to delta adjust options contracts, or present interest rate derivatives as 10-year bond equivalents)?
- Should funds account for derivatives holdings using a methodology other than market value or notional value? If so, what methodology should be used and why? Should we, for example, focus on measures of risk? If so, which risk measure(s) would be most effective for this purpose?

Names Rule Notice Requirement

The Release also seeks comment regarding the provision in the Names Rule that allows funds to elect to provide investors with 60 days’ notice prior to changing the fund’s 80 percent investment policy. The Commission asks several related questions.

- Is the information provided in these notices useful for investors?
- Does the Names Rule’s notice requirement provide meaningful investor protection? If not, why not?
- Should the rule impose different or more specific requirements in certain cases, such as when a change in name is accompanied by significantly different investment strategies and exposures? If so, when and what type of requirements?
- Should a fund be required to obtain shareholder approval prior to changing its 80 percent policy?

Investment Strategy vs. Type of Investment

The Release notes that the Names Rule does not apply to the use of terms that suggest an investment strategy (such as “growth” or “value”) but does apply to a type of investment and asks whether a strategy should be differentiated from a type of investment. It notes

that the staff has observed a number of challenges that funds face in applying the Names Rule and assessing whether certain terms in fund names comply with the rule. The Commission asks a series of related questions, including those set forth below.

- Should the Names Rule apply to terms such as ESG or “sustainable” that reflect certain qualitative characteristics of an investment?
- Are investors relying on these terms as indications of the types of assets in which a fund does or does not invest (e.g., investing only in companies that are carbon neutral, or not investing in oil and gas companies or companies that provide substantial services to oil and gas companies)?
- Alternatively, are investors relying on these terms as indications of a strategy (e.g., investing with the objective of bringing value-enhancing governance, asset allocation or other changes to the operations of the underlying companies)? Or are investors relying on these terms as indications that the funds’ objectives include non-economic objectives?
- Or are investor perceptions mixed among these alternatives or otherwise indeterminate? If investor perceptions are mixed or indeterminate, should the Names Rule impose specific requirements on when a particular investment may be characterized as ESG or sustainable and, if so, what those requirements should be?
- Should there be other limits on a fund’s ability to characterize its investments as ESG or sustainable? For example, ESG (environment, social, and governance) relates to three broad factors: must a fund select investments that satisfy all three factors to use the ESG term? For funds that currently treat ESG as a type of investment subject to the Names Rule, how do such funds determine whether a particular investment satisfies one or more ESG factors? Are these determinations reasonably consistent across funds that use similar names?
- Instead of tying terms such as ESG in a fund’s name to any particular investments or investment strategies, should we instead require funds using these terms to explain to investors what they mean by the use of these terms?

Fund Names with Global or International

The Release notes that the Names Rule does not apply to the use of the terms “global” or “international” and asks if it should so apply. The Release then asks a series of related questions, including those described below.

- What factors should be used to determine whether the term “global” or “international” is not misleading?
- Should a fund that uses these or similar terms in its name be required to invest a certain percentage of assets in a minimum number of countries or invest a minimum percentage of assets outside of the United States?
- If the Names Rule were to apply to terms such as “global” or “international,” how should funds treat multinational companies with a significant presence (e.g., revenues or assets) in more than one country or region? For example, should a fund invested in a diversified set of 30 or more US-incorporated and US-headquartered companies, where each company derives a certain level of its revenues (e.g., 25 percent) from outside the United States, be able to call itself a “global” or “international” fund without running afoul the Names Rule?

Closed-End Funds and Business Development Companies

The Release notes that the securities of closed-end funds and business development companies are not redeemable and may not be publicly-traded. Given that, the Commission asks whether the 60-day notice requirement for changes to a fund’s 80 percent policy

provide meaningful protections to investors in such funds? If not, what changes are appropriate?

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endnotes

[1] See SEC Release No. IC-33809 (March 2, 2020) (“Release”), *available at* <https://www.sec.gov/rules/other/2020/ic-33809.pdf>. The Release is a request for comment, not a rulemaking proposal. If, and to the extent that, the Commission determines to issue specific proposed amendments to the Names Rules, it would need to do so through a separate rulemaking proposal subject to public comment.

[2] Release at page 7.

[3] Release at page 11.

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