

**MEMO# 13057**

January 18, 2001

## **SEC ADOPTS NEW RULE UNDER INVESTMENT COMPANY ACT RELATING TO FUND NAMES**

[13057] January 18, 2001 TO: SEC RULES MEMBERS No. 6-01 CLOSED-END INVESTMENT COMPANY MEMBERS No. 2-01 COMPLIANCE ADVISORY COMMITTEE No. 4-01 UNIT INVESTMENT TRUST MEMBERS No. 2-01 ACCOUNTING/TREASURERS COMMITTEE No. 3-01 RE: SEC ADOPTS NEW RULE UNDER INVESTMENT COMPANY ACT RELATING TO FUND NAMES

The Securities and Exchange Commission has adopted a new rule under the Investment Company Act, Rule 35d-1, relating to investment company names.<sup>1</sup> Specifically, Rule 35d-1 requires a registered investment company (including mutual funds, closed-end funds, and UITs) with a name suggesting that the fund focuses on a particular type of investment or industry to invest at least 80% of its assets in the type of investment suggested by its name. Rule 35d-1 also addresses names suggesting that a fund focuses its investments in a particular country or geographic region, names indicating that a fund's distributions are exempt from income tax, and names suggesting that a fund or its shares are guaranteed or approved by the U.S. government. The final rule reflects many comments made by the Institute on the proposal. The effective date of the new rule is March 31, 2001, however funds will have until July 31, 2002 to comply with the rule's requirements. The most significant aspects of Rule 35d-1 are summarized below and a copy of the rule is attached.

**80 Percent Investment Requirement** Rule 35d-1 requires that a fund with a name that suggests that the fund focuses its investments in a particular type of investment or in investments in a particular industry invest at least 80% of its assets in the type of investment suggested by the fund's name.<sup>2</sup> The rule also requires funds with names that suggest that they focus their investments in a particular country

<sup>1</sup> SEC Release No. IC-24828 (January 17, 2001) ("Release").

<sup>2</sup> The Release notes that the proposal would have required a fund with a name that suggests that the fund focuses its investments in a particular type of security to invest at least 80% of its assets in the indicated securities. According to the Release, the final rule uses the word "investments" instead of "securities" to permit, in appropriate circumstances, a fund to include a synthetic instrument in the 80% basket if it has economic characteristics similar to the securities included in that basket.

<sup>3</sup> For a fund in a particular geographic region to meet a two-part 80% investment requirement. Specifically, Rule 35d-1 requires any such fund 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 fund also must disclose in its prospectus the specific criteria that are used to select investments that meet this standard.

Finally, Rule 35d-1 requires that a fund that uses a name suggesting that its distributions are exempt from federal income tax or from both federal and state income taxes to adopt a fundamental policy: (i) to invest at least 80% 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 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. This requirement would apply to a company's investments or distributions that are exempt from federal income tax under both the regular tax rules and the alternative minimum tax rules.<sup>4</sup>

**Change in Investment Policy** In response to comments on the proposal, including those of the Institute, the SEC has modified the proposed requirement that the 80% investment requirement be a fundamental policy of the fund. The rule, as adopted, generally will provide funds with an alternative to the fundamental policy requirement. Specifically, in lieu of adopting the 80% requirement as a fundamental policy, a fund will be permitted to adopt a policy that it will provide notice to shareholders at least 60 days prior to any change to its investment policy.<sup>5</sup>

The SEC adopted as proposed, however, the provision that the 80% investment requirement be adopted as a fundamental policy for tax-exempt funds. The Release states that this requirement is consistent with the Division of Investment Management's position that a tax-exempt fund may not change its tax-exempt status without shareholder approval.

**3 The proposal would have required funds to invest in securities that met one of three criteria specified in the rule. The change in the final rule was made in response to comments, including those of the Institute, that opposed the proposed requirement because the specific criteria would have been too restrictive to the investments that a fund could make.**

**4 The Release notes that the 80% investment requirement is not intended to create a safe harbor for fund names and that a name may be materially deceptive and misleading even if the fund meets the 80% requirement. For example, the Release states that index funds generally would be expected to invest more than 80% of their assets in investments connoted by the applicable index. In addition, a UIT with a name indicating that its distributions are tax-exempt may have a misleading name even if it invests 80% of its assets in tax-exempt investments. The Division of Investment Management currently applies a 95% investment requirement to tax-exempt UITs.**

**5 The rule requires this notice to be in plain English in a separate written document. In addition, the notice, as well as the envelope containing the notice, must contain a prominent statement such as "Important Notice Regarding Change in Investment Policy." As an alternative to this requirement, if the notice is sent in a separate mailing, the prominent statement may appear either on the envelope or on the notice itself. The Release also states that a fund should update its prospectus to reflect an upcoming change in its 80% investment policy by means of an amendment to its registration statement or a prospectus supplement or "sticker" no later than the time that it provides notice to its current shareholders of the change in policy.**

**3 Names Suggesting Guarantee or Approval by the U.S. Government** Rule 35d-1 prohibits a fund from using a name that suggests that the fund or its shares are guaranteed or approved by the U.S. Government or any U.S. government agency or instrumentality.

**Application of the Rule's Requirements** The 80% investment requirement generally applies at the time when a fund invests its assets. A fund that no longer meets the 80% investment requirement will be required to make future investments in a manner that would bring the fund into compliance with the 80% requirement. A fund, however, will not be required to sell any portfolio holdings that have increased in value to come into compliance with the rule.<sup>6</sup>

The 80% investment requirement will be based on a fund's net assets plus any borrowings for investment purposes. The proposal would have required that the 80% investment requirement be based on a fund's net assets plus any borrowings that are senior securities under Section 18 of the Investment Company Act. The Release states that this change was made to reflect comments, including those of the Institute, that basing the 80% requirement on a fund's net assets plus any borrowings for investment purposes would more closely track the SEC's objective of preventing a fund from circumventing the 80% requirement by investing borrowed funds in investments that

are not consistent with its name. In addition, in response to comments, including those of the Institute, that allowing funds to depart from complying with the 80% requirement only in order to take a “temporary defensive position” was too narrow an exception and did not give funds sufficient flexibility to manage their portfolios, Rule 35d-1 requires funds to comply with the 80% requirement “under normal circumstances.”

**Other Investment Company Names** The Release states that Rule 35d-1, as adopted, does not codify Division positions with respect to fund names including the terms “balanced,” “index,” “small, mid, or large capitalization,” “international,” and “global.” Nevertheless, the Release states that fund names including the terms “small, mid, or large capitalization” and “index” suggest a focus on a particular type of investment and that funds that use these terms will be subject to the 80% investment requirement of the rule. The Release also states that the term “balanced” does not suggest a particular investment focus but rather a particular type of diversification among investments, and therefore “balanced” funds will not be subject to the rule. In addition, the Release states that the term “foreign” indicates investments that are tied economically to countries outside the U.S. and that a fund that uses this term would be subject to the 80% requirement. The terms “international” and “global,” however, connote diversification among investments in a number of different countries throughout the world and funds using these terms will not be subject to the rule. Finally, the rule does not apply to fund names that

**6 The final rule also contains a grandfather provision that provides that a UIT that has made an initial deposit of securities before the rule’s compliance date will not be required to comply with the 80% investment requirement.**

**4incorporate terms such as “growth” and “value” that connote types of investment strategies as opposed to types of investments.**

**Names and Average Weighted Portfolio Maturity and Duration** The Release notes that although the proposal stated that the Division did not intend to continue to use criteria that required funds investing in debt obligations and that use descriptive names identifying the maturity of the instruments they hold (i.e., “short-term,” “intermediate-term,” or “long-term”) to have average weighted portfolio maturities of specified lengths,<sup>7</sup> the Division has re-evaluated this position and has concluded that it will continue to apply these maturity criteria because they provide reasonable constraints on the use of those terms. The Release also notes that the SEC and the Division do not intend compliance with the Division’s maturity guidelines to act as a safe harbor in determining whether a name is misleading and that in a case, for example, where a fund’s name was consistent with the Division’s maturity guidelines, but the “duration” of the fund’s portfolio was inconsistent with the sensitivity to interest rates suggested by the fund’s name, the name may be misleading.

**Ari Burstein Associate Counsel** Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 13057. ICI Members may retrieve this memo and its attachment from ICINet (<http://members.ici.org>). Attachment (in .pdf format)

**7 Specifically, the Division has required a fund that included the words “short-term,” “intermediate-term,” or “long-term” in its name have a dollar-weighted average maturity of, respectively, no more than 3 years, more than 3 years but less than 10 years, or more than 10 years.**