

**MEMO# 34168**

June 1, 2022

# SEC Proposes Amendments to the Fund Names Rule

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TO: ICI Members SUBJECTS: Disclosure

ESG RE: SEC Proposes Amendments to the Fund Names Rule

On May 25, the Commission issued a proposal for amendments to Investment Company Act of 1940 Rule 35d-1, [\[1\]](#) which regulates fund names (the "Names Rule"), as well as associated rules and forms. The proposal passed by a vote of three-to-one.

Currently, the Names Rule requires any fund with a name suggesting an investment focus to adopt a policy to invest 80% of the value of its assets consistent with the fund name. At a high level, the proposed amendments would make the following changes to the current rule:

- **Scope:** Expand the scope of the rule to apply to any fund name with terms suggesting that the fund focuses on investments that have particular characteristics, including ESG factors.
- **Temporary Departures from Compliance:** Allow funds to depart temporarily from the Name Rule's requirement to invest in compliance with an 80% investment policy only under specifically enumerated circumstances.
- **Derivatives:** Require funds to use a derivatives instrument's notional amount, rather than its market value, for the purpose of determining the funds' compliance with their 80% investment policies.
- **Unlisted closed-end funds (CEFs) and business development companies (BDCs):** Require CEFs and BDCs to make their 80% investment policies "fundamental" fund policies, which require shareholder votes for any changes.
- **Enhanced prospectus disclosure:** Require funds to define terms used in their names and the criteria used to select investments in their prospectuses.
- **Plain English:** Require that any terms used in a fund's name that suggest an investment focus or tax-exempt status be consistent with plain English meaning or established industry use.
- **Use of ESG Terminology:** Determine that integration funds [\[2\]](#) with names that indicate that fund investment decisions incorporate one or more ESG factors would be materially deceptive or misleading.
- **Modernized notice requirement:** Update the notice requirement to address funds' use

of electronic delivery.

- Form N-PORT: Require funds to report compliance with the updated Names Rule, including whether each portfolio investment meets its investment policy for compliance with the rule.

The public comment period will remain open for 60 days after publication in the Federal Register. We summarize the proposal and statements from the SEC Chair Gensler and Commissioners Peirce, Lee, and Crenshaw below.

## **Background on the Names Rule**

The SEC adopted the current version of the Names Rule in 2001 to help "ensure that a fund's name does not misrepresent the fund's investments and risks."[\[3\]](#)

The current Names Rule generally requires that if a fund name suggests that a fund has an investment focus (particularly a focus on type of investment, geography, or industry) or that a fund is tax-exempt, the fund must adopt a policy to invest 80% of the value of its assets consistent with the fund name. The fund can either designate the 80% investment policy as a "fundamental policy" that cannot be changed without shareholder approval or provide investors 60 days' notice to any change in the investment policy.[\[4\]](#)

The SEC finds in the Proposing Release that the current Names Rule has created several interpretive and practical issues that should be addressed in a rule update. Specifically:

- While the current rule addresses fund names that include terms suggesting an investment focus, fund names that include terms connoting fund strategies, objectives, and policies, such as "growth" or "value," are not clearly covered by the rule. The SEC particularly notes the need for clarity about how fund names suggesting ESG investment strategies fit within the scope of the rule.
- The current rule requires funds to determine compliance with the 80% investment policy at the time of making an investment, as opposed to a fund always maintaining the required level of investment.
- Funds increasingly use derivatives, but the current Names Rule does not address how to include a derivatives instrument in the fund's 80% basket.
- The current rule suggests that funds must deliver notices under the Names Rule on paper.

## **Expanding the Scope of the Names Rule**

The SEC proposes broadening the scope of the Names Rule to apply to fund names that include terms suggesting that the fund focuses on investments with particular characteristics, such as "growth," "value," "global," "income," or "intermediate term" or similar terms, or ESG terms, like "green" or "sustainable." Even when these terms can be understood to be referring to a fund's investment strategy, if they also can be understood to be an investment focus, the SEC proposes to find those terms to be within the scope of the rule. Fund names within the scope of the rule would be materially deceptive and misleading unless supported by an 80% investment policy.

The SEC distinguishes terms that it would consider outside the scope of the rule because they would not connote an investment focus, including terms that suggest characteristics of the fund's overall portfolio, such as a certain duration or that the fund is "balanced." Similarly, the SEC states that names that suggest a possible result ("real return") or retirement target date would be out of scope. The SEC acknowledges that "[i]n some cases, what would be appropriate to include in the fund's 80% basket would be context-specific."

The SEC also notes that some funds with names implying an investment focus on in specific types of issuers currently use text analysis of an issuer's disclosures to determine if the issuer aligns with the fund's investment focus. The SEC warns funds that "we do not believe it is reasonable to conclude that an issuer is in a given industry solely because the issuer's disclosure documents frequently include works associated with the industry."

### **Temporary Departures from the 80% Investment Policy**

The SEC proposes permitting funds to depart temporarily from the Name Rule's requirement to invest in compliance with their 80% investment policies only under the following circumstances:

- Market fluctuations, or other circumstances where the temporary departure is not caused by the fund's purchase or sale of a security or the fund's entering into or exiting an investment.
- Unusually large cash inflows or unusually large redemptions.
- Taking positions in cash and cash equivalents or government securities to avoid a loss in response to adverse market, economic, political, or other conditions.
- Repositioning or liquidating a fund's assets in connection with a reorganization, fund launch, or when notice of a change in the fund's 80% investment policy has been provided to shareholders under the rule.

Except for fund launches, reorganizations, or when notice of policy change has been sent to shareholders,[\[5\]](#) the proposed rule amendments would require a fund to bring its investments back into compliance with the 80% investment requirement within 30 consecutive days.

### **Considerations Regarding Derivatives in Assessing Names Rule Compliance**

The SEC proposes requiring funds, in calculating their assets for the purpose of Names Rule compliance, to value each derivative using its notional amount, rather than its market value. The SEC notes that the notional amount is generally a measure of a fund's investment exposure to the underlying reference asset or metric. In calculating notional amounts, a fund would be required to convert interest rate derivatives to their 10-year bond equivalents and delta adjust the notional amounts of options contracts. The SEC believes that these "tailoring adjustments" best reflect the fund's investment exposures for purposes of compliance with the Names Rule

In addition, the SEC would require funds to reduce the value of their assets by excluding cash and cash equivalents up to the notional amounts of the derivatives.

Further, in addition to any derivatives instruments that a fund includes in its 80% basket because the derivatives provide investment exposure to the investments suggested in the fund's name, the fund may include in its 80% basket a derivatives instrument that provides investment exposure to one or more of the market risk factors associated with the investments suggested by the fund's name. Such derivatives may be used to facilitate the fund's investment in its securities by increasing or decreasing the fund's exposure to risk factors associated with those securities.

### **Unlisted Closed-End Funds and BDCs**

The SEC proposes to require that a fund's 80% investment policy be a fundamental policy for CEFs and BDCs that do not have shares that are listed on a national securities exchange. The SEC defines a "fundamental" policy as one that is adopted under section

8(b)(3) of the Investment Company Act or, in the case of BDCs, is a policy that is changeable only if authorized by a vote of the majority of the outstanding voting securities of a fund. The SEC makes this proposal because shareholders in unlisted CEFs and BDCs generally will have no recourse to redeem their shares on an exchange if a fund were to change its investment policy and investment focus. Thus, the proposal would ensure that those shareholders have a vote on a change in investment policy.

## **No Safe Harbor**

The SEC proposes a new provision in the Names Rule to reiterate that a fund's name can be materially deceptive or misleading even if the fund complies with its policy to invest 80% of the value of its assets consistent with its fund name. The SEC provides an example of a fund that complies with its 80% investment policy but the remaining 20% of investments includes assets that are antithetical to the fund's stated investment purpose. Further, a fund that is "perpetually" out of compliance with the 80% investment requirement through temporary departures may also be materially deceptive or misleading under the rule.

## **Prospectus Disclosure**

The SEC proposes to amend fund registration forms<sup>[6]</sup> to require a fund under the Names Rule to disclose the definitions of terms used in its name and the criteria the fund uses to select investments in its prospectus. The SEC would define "terms" to mean a word or phrase used in a fund's name related to the fund's investment focus or strategies, other than any trade name of the fund or its advisers.

The SEC states that funds have flexibility to use reasonable definitions of the terms that their names use. A fund's use of reasonable definitions of the terms used in the fund's name may not, however, otherwise change the meaning of these terms to be inconsistent with their plain English meaning or established industry use.

## **Plain English and Established Industry Use**

The SEC proposes to require a fund under the Names Rule to use terms in the fund's name consistently with those terms' plain English meanings or established industry use. However, the SEC believes that the meaning of a term used in a fund name should not be permitted to be materially altered by fund disclosure. Thus, if a fund were to use a term in its name inconsistently with the term's plain English meaning, the proposed rule would find the name to be materially deceptive or misleading even if the fund's prospectus defines a given term in the name so as to match the fund's investments.

## **ESG Terms and Integration Funds**

The SEC proposes to determine that the fund names of integration funds would be materially deceptive or misleading if those names include terms suggesting that the fund's investment decisions incorporate one or more ESG factors.

The Proposing Release defines "integration funds" 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. As a result, ESG factors may not be ultimately determinative in deciding to include or exclude any particular investment in the portfolio. The SEC believes it would be misleading for a fund for which ESG factors are generally no more significant than other factors in the investment selection process to include ESG terminology in its name because doing so could overstate the importance of ESG in the fund's selection of investments. Including ESG terms in the fund's name would suggest that the ESG factors play a more

prominent role in that selection process.

## **Modernizing the Notice Requirement**

As discussed above, the current Names Rule provides that funds either must adopt their 80% investment policy as a fundamental policy of the fund or else provide notice to fund shareholders if any changes are made to the 80% policy, 60 days prior to the changes. The SEC proposes to retain this notice alternative, which it believes is appropriate in situations where there are not significant barriers for shareholders to choose to exit a fund.

The proposed amendments would require the content of the notices to describe the fund's 80% investment policy, the nature of the change to the policy, the fund's old and new names, and the effective date of any changes. Funds using the notice alternative would be required to provide a prominent statement on the notice that it is regarding a change in the investment policy and/or fund name change. If notice is provided electronically, the proposed rule's required prominent statements would be placed in the subject line of an email or the equivalent in other means of electronic communication.

## **Form N-PORT Reporting**

The SEC proposes several new reporting items on Form N-PORT related to the Names Rule.

Funds, other than money market funds, that are required by the Names Rule to have an 80% investment policy, would be required to report:

- The value of the fund's 80% basket, as a percentage of the fund's assets.
- If applicable, the number of days that the value of the fund's 80% basket fell below the value of the fund's assets during the reporting period.

This information would be publicly available for the third month of each fund's quarter.

The SEC also proposes to require funds, other than money market funds, to report on Form N-PORT whether each portfolio investment is included in the fund's 80% basket. This information would also be publicly available for the third month of each fund's quarter. The SEC acknowledges that some funds may have an investment focus where the selection of the 80% basket investments involves some degree of subjectivity and believes that this reporting would clarify such funds' decision-making for investors and Commission staff.

## **Recordkeeping**

The SEC proposes to require funds subject to an 80% investment policy to maintain written records documenting compliance with the Names Rule. Specifically, the recordkeeping requirements would include:

- The fund's records of which investments that are included in the fund's 80% basket.
- The value of the fund's 80% basket.
- The reasons for any departures from the 80% investment policy.
- The dates of any departures from the 80% investment policy.
- Any notices sent to the fund's shareholders pursuant to the Names Rule.

The SEC also proposes that funds that are not required to adopt an 80% investment policy to maintain a written record of the fund's analysis that such a policy is not required under the Names Rule. In doing so, the SEC acknowledges that certain names do not suggest an investment focus and are thus not required to adopt a policy.

## Transition Period, Compliance Date, and Withdrawn Staff Guidance

If the proposed rule amendments are adopted, the SEC proposes a one-year transition period for funds to prepare to comply with the proposed rule amendments and a one-year compliance period for funds to bring their fund names and disclosures into conformity.

The SEC is also reviewing current staff guidance on the Names Rule, including staff Frequently Asked Questions and no-action letters, to determine which guidance should be withdrawn in connection with adopting the proposed changes to the rule.

## Chair and Commissioner Statements

SEC Chair Gary Gensler and Commissioners Hester Peirce, Allison Herren Lee, and Caroline A. Crenshaw delivered statements on the proposal.

- Chair Gensler<sup>[7]</sup> stated that "A lot has happened in our capital markets in the past two decades. As the fund industry has developed, gaps in the current Names Rule may undermine investor protection. In particular, some funds have claimed that the rule does not apply to them—even though their name suggests that investments are selected based on specific criteria or characteristics."
- Commissioner Peirce<sup>[8]</sup> stated that "even a perfectly fitting name carries only a bit of information about a fund, and we must encourage investors to look beyond fund disclosures." She expressed several concerns about the proposal, including that:
  - The application of the 80% investment policy requirement to names suggesting that a fund focuses on investments with "particular characteristics," most prominently, those associated with ESG, will rely on subjective judgments.
  - The outright prohibition on integration funds' use of ESG in their names could result in substantive changes in the way some funds are managed.
- Commissioner Lee<sup>[9]</sup> discussed the current Names Rule's distinction between fund name terms denoting an investment focus, which are in scope for the rule, versus those denoting an investment strategy, which are not. "If you find yourself a bit confused about the difference between 'focus' and 'strategy,' you are not alone. In fact, experience has shown that when it comes to fund names, this distinction often elevates form over substance." She also supported the proposal in light of recent investor demand for ESG investments.
- Commissioner Crenshaw's statement<sup>[10]</sup> focused on how a fund's name provides investors with a general idea about what the fund is—and isn't—investing in. "[I]n the world of investing—the world of retirement accounts, college savings accounts, and accounts for buying your first home—there is simply quite a lot riding on a name." Given the changes in the fund industry over the past two decades, the Names Rule was ripe for updating.

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### endnotes

<sup>[1]</sup> See Investment Company Names, Release No. IC-34593 (May 25, 2022) ("Proposing

Release"), available at <https://www.sec.gov/rules/proposed/2022/33-11067.pdf>. The SEC issued a request for comment on Fund Names in March 2020 (see Request for Comments on Fund Names, Release No. IC-33809 (Mar. 2, 2020), available at <https://www.sec.gov/rules/other/2020/ic-33809.pdf>). ICI responded to the request for comment in two letters. See <https://www.sec.gov/comments/s7-04-20/s70420-7717204-222968.pdf> and <https://www.sec.gov/comments/s7-04-20/s70420-7152133-216418.pdf>.

[2] The Proposing Release defines integration fund as a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but such ESG factors are generally no more significant than other factors in the investment selection process.

[3] Investment Company Names, Release No. IC-24828 (Jan. 17, 2001), available at <https://www.sec.gov/rules/final/ic-24828.htm>.

[4] Funds including "tax-exempt" in their fund names must make the 80% investment policy a fundamental policy.

[5] The proposed rule would not limit the time of departures associated with fund reorganizations or where the fund has provided notice that it intends to change its 80% investment policy. Additionally, the time for departures associated with fund launches could last for 180 consecutive days.

[6] Specifically, Forms N1-A, N-2, N-8B-2, and S-6.

[7] Chair Gary Gensler, Statement on Proposed Updates to Name Rule (May 25, 2022), available at <https://www.sec.gov/news/statement/gensler-statement-proposed-updates-names-rule-052522>.

[8] Commissioner Hester Peirce, Statement on Investment Company Names (May 25, 2022), available at <https://www.sec.gov/news/statement/peirce-fund-names-statement-052522>.

[9] Commissioner Allison Herren Lee, What's in a Name? Aligning Fund Names with Investor Expectations (May 25, 2022), available at <https://www.sec.gov/news/statement/lee-names-rule-statement-052522>.

[10] Commissioner Caroline A. Crenshaw, A Rose By Any Other Name: Statement on Proposed Amendments to the Names Rule (May 25, 2022), available at <https://www.sec.gov/news/statement/crenshaw-statement-names-rule-052522>.