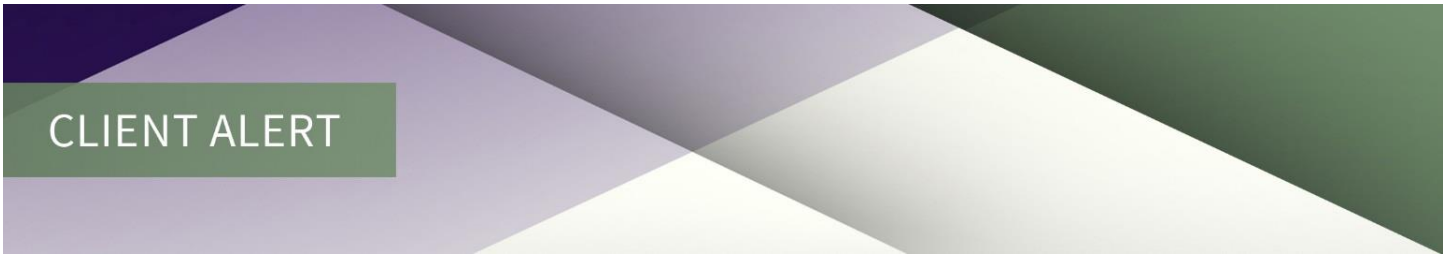

SEC Proposes Amendments to Investment Company Act "Names Rule"

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AUTHORS

Anne C. Choe | Elliot J. Gluck | Benjamin J. Haskin | Jay Spinola
Benjamin B. Allensworth

On May 25, 2022, the U.S. Securities and Exchange Commission (the "SEC") voted to propose amendments to Rule 35d-1 (often referred to as the "Names Rule") under the Investment Company Act of 1940 (the "Investment Company Act") and amendments to certain registration and reporting forms in connection with the Names Rule amendments.[1] The proposed Names Rule (the "Proposed Rule") follows the SEC's request for comment on the Names Rule in 2020, in which the SEC sought feedback on whether the requirements of the Names Rule are effective and whether there are viable alternatives that the SEC should consider. The Names Rule generally requires a registered investment company or business development company (a "Fund") with a name that suggests it has a focus in particular types of investments, industries or geographic regions, or that its distributions are tax-exempt, to adopt a policy to invest at least 80% of the value of its assets in investments consistent with its name (an "80% investment policy").

If adopted as proposed, the potential implications of the proposed amendments are significant. The Proposed Rule represents a substantial expansion of the scope of the application of the Names Rule. Among other things, the expanded reach of the Proposed Rule would cover Fund names with environmental, social and governance ("ESG") or similar terms, highlighting the SEC's increased focus on ESG Funds. Further, if the Proposed Rule is adopted as proposed, many

[1] *See* Investment Company Names, Investment Company Act Release No. 34593 (May 25, 2022) (the "Proposing Release"), available here.

Funds would have to change their names and/or adopt 80% investment policies. The proposed amendments also would result in increased disclosure, compliance testing and SEC reporting requirements for Funds.

Overview of the Proposed Rule

The following is a summary of the proposed changes:

- *Expanded Scope.* The Proposed Rule would expand the scope of Fund names required to have an 80% investment policy to include names with terms suggesting that the Fund focuses in investments that have (or whose issuers have) particular characteristics. This would include Fund names with terms such as "growth" or "value" or terms that suggest a Fund's investment decisions incorporate one or more ESG factors.

- *Temporary Departures from 80% Investment Policy.* The Proposed Rule would require Funds to maintain compliance with their 80% investment policy at all times except for temporary departures.

- *Treatment of Derivatives.* The Proposed Rule would require Funds to use the notional amount of a derivatives instrument, rather than its market value, for the purpose of determining a Fund's compliance with its 80% investment policy, and clarify that a Fund may include certain derivatives used for hedging and other similar purposes in its 80% basket (defined below).

- *Unlisted Closed-End Funds and BDCs.* The Proposed Rule would require unlisted closed-end Funds and business development companies ("BDCs") to make their 80% investment policy a fundamental policy (*i.e.*, a policy that may not be changed without shareholder approval).

- *Enhanced Prospectus Disclosure.* Proposed amendments to registration forms[2] would require a Fund to define in its prospectus the terms used in its name, including the criteria the Fund uses to select the investments that the term describes.

- *Plain English for Name Terms.* The Proposed Rule would require that any terms used in the Fund's name that suggest either an investment focus, or that the Fund is a tax-exempt Fund, be consistent with those terms' plain English meaning or established industry use.

- *Integration Funds.* The Proposed Rule would deem the names of "integration Funds" to be materially deceptive or misleading if the name indicates that the Fund's investment decisions incorporate one or more ESG factors, but such factors are no more significant than other non-ESG factors in the investment selection process.

[2] Specifically, Form N-1A, Form N-2, Form N-8B-2, and Form S-6.

- *Notice, Reporting and Recordkeeping Requirements.* The Proposed Rule would update the Names Rule's shareholder notice requirement and subject Funds to specific recordkeeping requirements documenting compliance with the Names Rule. The SEC's proposed changes also would amend Form N-PORT to require disclosure regarding a Fund's compliance with the Names Rule and disclosure with respect to each portfolio investment, indicating whether the investment is included in the Fund's 80% basket.[3]

- *No Safe Harbor.* The Proposed Rule would codify that compliance with the Names Rule does not provide a safe harbor under Section 35(d) of the Investment Company Act.

Expanded Scope of the 80% Investment Policy Requirement

The Proposed Rule would expand the Names Rule's 80% investment policy requirement to apply to any Fund name with terms suggesting that the Fund focuses in investments that have, or investments whose issuers have, particular characteristics. This would include, for example, Fund names with terms such as "growth" or "value" or terms indicating that the Fund's investment decisions incorporate one or more ESG factors. The SEC has previously taken the position that Fund names that incorporate terms such as "growth" and "value" connote an investment objective, strategy, or policy ("investment strategies"), and are therefore not within the scope of the 80% investment policy requirement. The proposed expansion also would apply to other Fund names that historically may not have required an 80% investment policy (depending on the context), such as names that include terms like "global," "international," "income," or "intermediate term (or similar) bond."

In the Proposing Release, the SEC states that the proposed expansion of the 80% investment policy requirement "recognizes that even where a fund's name could be construed as referring to an investment strategy, it nevertheless can also connote an investment focus." "Investment focus" means a focus in a particular type of investment or investments, a particular industry or group of industries, particular countries or geographic regions, or investments that have, or whose issuers have, particular characteristics. The Proposing Release notes that there would continue to be Fund names that would not require a Fund to adopt an 80% investment policy because the names would not suggest an investment focus (*e.g.*, names that reference characteristics of a Fund's portfolio as a whole like "duration" or "balanced," that reference a particular investment technique such as "long/short," or that reference elements of an investment thesis without specificity as to the particular characteristics of the component portfolio investments).

The SEC requests input on whether Funds will be able to reasonably determine what investments qualify for purposes of their 80% investment policy and whether, in this regard, it is likely that Funds with similar names will come to different reasonable determinations. While the Proposed Rule would reduce uncertainty regarding whether a term in a Fund name is an investment strategy or an investment focus, the SEC's request for input is an indication that the Proposed Rule's

[3] *See* proposed Items B.9 and C.2 of Form N-PORT.

exclusion of investment techniques and elements of an investment thesis suggests that the Proposed Rule may be subject to further refinement.

The Proposing Release makes clear that when a Fund's name suggests an investment focus that has multiple elements, the Fund's 80% investment policy must address all of the elements in the name. The Proposing Release notes, for example, that the investment policy for a Fund with the name "ABC Wind and Solar Power Fund" could provide that each security included in the 80% basket[4] must be in both the wind and solar industries, or instead that 80% of the value of the Fund's assets will be invested in a mix of investments, with some solar investments, some wind investments, and some investments in both industries.[5] The Proposing Release notes that Funds may take a reasonable approach in specifying how a Fund's investments will incorporate each such element in the name. The SEC notes that, in some cases, what would be appropriate to include in a Fund's 80% basket would be context-specific. For example, Funds currently do not include the value of short positions in their 80% baskets, absent some terminology in the Fund's name such as "inverse," "hedged," or "long/short" that suggests to investors that short activity is or may be part of the Fund's investment approach.[6]

While the Names Rule allows Funds to define terms used in their names in a reasonable way, the Proposed Rule would subject Funds to the requirement that any terms used in their names that suggest an investment focus, or that they are tax-exempt Funds, must be consistent with those terms' plain English meaning or established industry use. The Proposing Release notes that Funds may take different approaches when determining whether a particular investment should be treated as being an investment in a particular industry. For example, the SEC states that it would be reasonable for a Fund to define securities in a given industry as securities issued by companies that derive more than 50% of their revenue or income from, or own significant assets in, the industry, but that there may be instances where the percentage could be smaller (*e.g.*, the issuer is an acknowledged leader in the industry).[7] As a consequence of the different possible approaches to appropriately assign individual companies that have multiple business lines, there may continue to be ambiguity in practical application of the Names Rule.

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4 Proposed Rule 35d-1(g)(1) would define "80% basket" as investments that are invested in accordance with the investment focus that the Fund's name suggests.

5 The Proposing Release seeks input on whether the Proposed Rule should require a Fund whose name includes multiple elements to invest some specific minimum percentage in each element. Proposing Release at 30.

6 The SEC requests comment on Funds' current practices regarding the treatment of short positions for purposes of an 80% investment policy and whether any changes would be appropriate. Proposing Release at 31-32.

7 In the Proposing Release, the SEC states that text analytics of an issuer's disclosures may be a helpful component of a Fund's analysis of the reasonableness of determining whether an issuer is in a particular industry, but a Fund cannot reach a determination of reasonableness solely because an issuer's disclosures frequently use words associated with an industry. Proposing Release 27-28.

Temporary Departures from 80% Investment Policy

Unlike the Names Rule, which applies the 80% investment policy "under normal circumstances" and at the time a Fund invests its assets, the Proposed Rule would permit a Fund to depart temporarily from its 80% investment policy only under the following specified circumstances: (i) as a result of 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 (such as where certain of a small cap Fund's investments are no longer small cap); (ii) to address unusually large cash inflows or unusually large redemptions (notably, neither the Proposed Rule nor the Proposing Release defines the term "unusually large"); (iii) to take a position in cash and cash equivalents or government securities to avoid a loss in response to adverse market, economic, political, or other conditions; or (iv) to reposition or liquidate the Fund's assets in connection with a reorganization,[8] to launch the Fund, or when notice of a change in the Fund's 80% investment policy has been provided to Fund shareholders at least 60 days before the change pursuant to the Proposed Rule.

The Proposed Rule provides that for each of the above circumstances, a Fund would have to bring its investments back into compliance with the 80% investment policy within 30 consecutive days, except with respect to: (i) Fund launches, where the temporary departure may not exceed a period of 180 consecutive days from the date the Fund commences operations; (ii) reorganizations, for which the Proposed Rule does not specify a time period regarding temporary noncompliance with a Fund's 80% investment policy; and (iii) when the 60-day notice has been provided to shareholders. Notwithstanding the maximum periods set out in the Proposed Rule, in all cases, a Fund would need to be in compliance with its 80% investment policy as soon as reasonably practicable.[9]

Considerations Regarding Derivatives in Assessing Names Rule Compliance

The Proposed Rule addresses both the valuation of derivatives instruments[10] for purposes of determining compliance with a Fund's 80% investment policy, as well as the derivatives instruments that a Fund may include in its 80% basket. With respect to valuation, the Proposed Rule would require a Fund to value each derivative instrument using its notional amount for purposes of the Fund's 80% investment policy, with certain adjustments for interest rate derivatives and

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8 "Reorganization" is defined in Section 2(a)(33) of the Investment Company Act and includes a voluntary liquidation.

9 Proposed Rule 35d-1(b)(1). The Proposing Release notes that "as soon as reasonably practicable" would not strictly mean "as soon as possible" in all cases and is intended to allow for consideration by the adviser of how to return to compliance in a manner that best serves the interest of the Fund and its shareholders, but in no case longer than any applicable time period in Proposed Rule 35d-1. Proposing Release at 34, n. 57.

10 Proposed Rule 35d-1(g)(3) would define "derivatives instrument" as any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or a similar instrument.

options.[11] A Fund also must reduce the value of its assets by excluding cash and cash equivalents up to the notional amounts of the derivatives instruments, as described below.

A Fund also must determine whether a derivative instrument should be included in its 80% basket. The Proposed Rule would provide that a Fund should include a derivative instrument in its 80% basket if: (i) the derivatives instrument provides investment exposure to the investments suggested by the Fund's name, or (ii) the derivatives instrument hedges exposure or provides investment exposure to one or more of the market risk factors (*e.g.*, interest rate, credit, or foreign currency risk) associated with the investments suggested by the Fund's name.

Options and Interest Rate Derivatives. In calculating notional amounts, the Proposed Rule would require a Fund to convert interest rate derivatives to their 10-year bond equivalents and to delta adjust the notional amounts of options contracts. The proposed requirement to convert interest rate derivatives to 10-year bond equivalents is designed to result in adjusted notional amounts that better represent a Fund's exposure to interest rate changes, and the proposed requirement to delta adjust options is designed to provide for a more tailored notional amount that better reflects the exposure that an option creates to the underlying reference asset.

Deduction of Cash. The Proposed Rule would require the deduction of cash and cash equivalents from assets (*i.e.*, the denominator in the 80% calculation) up to the notional amounts of the Fund's derivatives exposure. Because cash and cash equivalents that effectively function as low-risk collateral for the Fund's derivatives do not provide additional market exposure, the SEC believes that including cash and cash equivalents would effectively "double count" the Fund's exposure.

However, if a Fund holds derivatives and securities, like investments in equities or bonds, for collateral, both the notional amounts of the derivative instruments and the value of the securities would be required to be included because the Fund would be obtaining market exposure through the derivative instrument and the securities held for collateral.

Use of ESG Terminology in Fund Names

The Proposing Release notes that there has been a recent uptick in filings by Funds with investment focuses in ESG, and that competitive market pressures create incentives for asset managers to include ESG terminology in their Funds' names that is designed to attract investor assets. As discussed above, the Proposed Rule would require Funds that use ESG or similar terms in their names to adopt an 80% investment policy with respect to such terms.

The Proposing Release addresses Funds that consider one or more ESG factors alongside other, non-ESG factors in their investment decisions, but such ESG factors are generally no more significant than other factors in the investment

[11] A Fund's use of notional amounts when determining the value of the Fund's assets in the 80% basket would not affect the Fund's valuation practices under Rule 2a-5 under the Investment Company Act [17 CFR 270.2a-5]. Proposing Release at 51, n. 79.

selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio (termed as "integration funds"). The Proposed Rule would treat the names of integration funds as materially deceptive and misleading if the name includes terms suggesting that the Fund's investment decisions incorporate one or more ESG factors.[12]

Defined Terms Disclosure

In addition to the Proposed Rule, the SEC proposes to update Funds' registration forms, requiring each Fund that is required to adopt and implement an 80% investment policy to include disclosure in its prospectus that defines the terms used in its name, including the specific criteria the Fund uses to select the investments that the term describes, if any.[13] For purposes of the proposed disclosure requirements, "terms" would mean any word or phrase used in a Fund's name, other than any trade name of the Fund or its adviser, related to the Fund's investment focus or strategies.[14]

The Proposing Release states that this disclosure requirement would codify certain best practices in the industry. The proposed disclosure requirement would not, however, otherwise alter or address disclosure that Funds currently provide, for example, in response to prospectus disclosure requirements regarding investment policies.

Unlisted Closed-End Funds and BDCs

The Proposed Rule would require unlisted closed-end Funds and BDCs' 80% investment policies to be "fundamental," meaning they may not be changed without shareholder approval. The rationale for the proposed change is because a shareholder in an unlisted closed-end Fund or BDC would have no ready recourse, such as the ability to redeem or quickly sell shares, if the Fund were to change its investment policy and investment focus indicated by the Fund's name.

Modernizing the Notice Requirement

The Proposed Rule would modernize the Names Rule's requirement to provide shareholders with notice of a change in a Fund's 80% investment policy (if not fundamental). The prominent statement regarding a change in a Fund's 80% investment policy required under the Names Rule also would need to reference the Fund's name change, if applicable. The Proposed Rule would clarify that the prominent statement be included: (i) on the notice and envelope, if applicable, for notices delivered in paper form; and (ii) in the subject line of the email communication, or equivalent indication, if

[12] The SEC requests comment on whether a Fund should be able to use an ESG term in its name as long as the Fund also identifies itself in its name as an integration fund and whether the term "integration" is sufficiently understood by investors. The SEC's questions indicate that there may be circumstances in which ESG factors have greater significance than other factors, but are not determinative, creating some uncertainty as to whether in those circumstances it would be misleading to include ESG terms in a Fund's name. Proposing Release at 85-86.

[13] This requirement would replace the current Names Rule requirement for Funds with names suggesting investment in particular countries or geographic regions to disclose the specific criteria used to select investments that meet its 80% investment policies.

[14] Funds would tag new information to be included using Inline eXtensible Business Reporting Language, or Inline XBRL.

delivered in electronic form. Further, if delivered in paper form, the Proposed Rule requires that the shareholder notice must be provided as a separate document from other shareholder communications, though it may be mailed together with other communications. Under the Proposed Rule, the notice must describe, as applicable, the Fund's 80% investment policy, the nature of the change to the 80% investment policy, the Fund's old and new names, and the effective date of any investment policy and/or name changes.

Compliance with Proposed Rule Not a Safe Harbor from Section 35(d)

Section 35(d) of the Investment Company Act prohibits a Fund from adopting as part of its name or title any word or words that the SEC finds are materially deceptive or misleading.[15] The Proposed Rule would codify existing SEC guidance by providing that a Fund's name may be materially deceptive or misleading under Section 35(d) of the Investment Company Act even if the Fund complies with the Proposed Rule's requirement to adopt and implement an 80% investment policy. The Proposing Release states that a Fund's name could be materially deceptive or misleading for purposes of Section 35(d) if the Fund were to invest in a way such that the source of a substantial portion of the Fund's risk or returns is different from that which an investor reasonably would expect based on the Fund's name, regardless of the Fund's compliance with the requirements of the Proposed Rule. In addition to confirming that the Proposed Rule does not provide a safe harbor from Section 35(d), the Proposing Release seeks input on whether certain Funds, such as index Funds and ESG-focused Funds, should be subject to a higher investment policy threshold than 80% (for example, 95% of a Fund's assets).[16]

N-PORT Reporting Requirements

The SEC also proposed amendments to Form N-PORT to include a new reporting item for Funds, other than money market Funds, regarding Funds' 80% investment policies. A Fund subject to the new N-PORT reporting requirements would be required to report: (i) the value of the Fund's 80% basket, as a percentage of the value of the Fund's assets; and (ii) if applicable, the number of days that the value of the Fund's 80% basket fell below 80% of the value of the Fund's assets during the reporting period, in each case, as of the end of the reporting period.

In addition, the SEC proposed to add a new Form N-PORT reporting item requiring a Fund, other than a money market fund, subject to the 80% investment policy requirement to indicate, with respect to each portfolio investment, whether the

[15] 15 U.S.C. 80a-34(d). BDCs, which are not registered investment companies, are subject to the requirements of Section 35(d) pursuant to Section 59 of the Investment Company Act [15 U.S.C. 80a-58].

[16] The SEC also requests comments on the treatment of Funds including index names in the Fund name when the Fund invests in component securities of the index, but those component securities are not closely tied to the type of investments suggested by the applicable index name that is included in the Fund's name. Proposing Release at 71.

investment is included in the Fund's 80% basket. A Fund would be required to provide this information, along with the information it reports for each of its portfolio investments on Form N-PORT, as of the end of the reporting period.

Recordkeeping Requirements

The Proposed Rule would require a Fund that is required to adopt an 80% investment policy to maintain the following written records[17] documenting its compliance under the 80% investment policy provisions of the Proposed Rule:

(i) which investments are included in the Fund's 80% basket and the basis for including each such investment in the 80% basket;

(ii) the value of the Fund's 80% basket, as a percentage of the value of the Fund's assets;

(iii) the reasons for any Fund departures from the 80% investment policy;

(iv) the dates of any Fund departures from the 80% investment policy; and

(v) any notice sent to the Fund's shareholders regarding a change in its 80% investment policy.

The Proposed Rule also would require a Fund that does not adopt an 80% investment policy to maintain a written record of the Fund's analysis that such a policy is not required under the Proposed Rule.[18]

Unit Investment Trusts

The Proposed Rule would include certain exceptions for unit investment trusts ("UITs") that have made their initial deposit of securities prior to the effective date of any final rules the SEC adopts. Specifically, these UITs would be excepted from the requirements to adopt an 80% investment policy and the recordkeeping requirements, including recordkeeping for Funds which do not adopt an 80% investment policy, unless the UIT has already adopted—or was required to adopt at the time of the initial deposit—an 80% investment policy under the Names Rule.

Transition Period and Compliance Date

Comments are due on the proposed amendments 60 days after publication in the Federal Register, and any final rule adopted by the SEC would provide a one-year compliance period. The Proposing Release also notes that the SEC staff

[17] The Proposed Rule would require Funds to maintain these records for at least six years following the creation of each required record (or, in the case of notices, following the date the notice was sent), the first two years in an easily accessible place.

[18] Such Funds must maintain this record, in an easily accessible place, for a period of not less than six years following the Fund's last use of its name.

is reviewing its no-action letters and other statements addressing compliance with the Names Rule to determine which letters and statements should be withdrawn in connection with any adoption of the Proposed Rule.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Anne C. Choe
202 303 1285
achoe@willkie.com

Elliot J. Gluck
212 728 8138
egluck@willkie.com

Benjamin J. Haskin
202 303 1124
bhaskin@willkie.com

Jay Spinola
212 728 8970
jspinola@willkie.com

Benjamin B. Allensworth
202 303 1273
ballensworth@willkie.com