

SEC Updates Fund Names Rules

On September 20, 2023, the SEC voted four to one to issue a [final rule](#) updating the 20-year-old “Names Rule” to ensure that a fund’s name accurately reflects the fund’s investments and risks.

Highlights of the rule include:

- Broadens the scope of the 80% investment policy requirement to cover an additional 2,200 funds. The new rule more clearly covers using “thematic” strategies—artificial intelligence, health and wellness, travel/tourism, or environmental, social, and governance (ESG) funds.
- A fund must use a derivatives instrument’s notional amount for compliance with its 80% investment policy (excluding certain currency hedges).
- An unlisted registered closed-end fund or a business development company (BDC) that is required to adopt an 80% investment policy cannot change its policy without a shareholder vote.
- A fund’s prospectus must include the definitions of terms used in its name, including the criteria used to select investments that each term describes.
- New quarterly reviews of investments are required for consistency with the 80% investment policy requirement and additional record-keeping.



Background

Section 35(d) in the original *Investment Company Act of 1940* allowed the SEC to declare—by order—that a particular name was misleading. The *National Securities Markets Improvement Act of 1996* granted the SEC broader authority to promulgate rules prohibiting deceptive names and, in 1997, the SEC released a proposal creating Rule 35d-1, which was adopted—with significant changes—in 2001. These amendments granted the SEC the power to act by rule, regulation, or order and to define names or titles that are materially deceptive or misleading. The 2001 regulation required covered funds to invest at least 80% of their assets in the type of investment featured in their names. SEC research indicated that currently 8,100 or 60% of funds are required under the current name rule to maintain an 80% investment policy.

Scope

The current Names Rule generally requires that if a fund’s name suggests a **focus in a particular type of investment**, e.g., equity or debt, or in investments in a particular **industry or geographic focus**, the fund must adopt a policy to invest at least 80% of the value of its assets in the type of investment, or in investments in the industry, country, or geographic region suggested by its name.

The final rule is more expansive and will cover any fund with a name suggesting that a fund focuses on investments that have—or whose issuers have—**particular characteristics**, whether or not those terms connote an investment strategy. The new rule more clearly covers the use of “thematic” strategies—growth, value, artificial intelligence, health and wellness, travel and tourism, ESG, sustainable, and socially responsible. The SEC acknowledges that some terms like “equity” have a standard definition versus terms like “growth” or “value.”

Funds have flexibility to ascribe reasonable definitions for the terms used in their names and flexibility to determine the specific criteria the fund uses to select the investments that the term describes.

No Safe Harbor

A fund's name could be materially deceptive or misleading under §35(d), even if that fund has complied with the 80% investment policy requirement. If a fund uses its 20% basket to invest in assets that are materially inconsistent with the investment focus or risk profile reflected by the fund's name, the fund's name would be materially deceptive or misleading under §35(d).

Additional ESG Fund Proposal

In a significant change from the proposal, the final rule drops provisions related to "integrated" ESG funds, which would have made it materially 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.

However, this is not the end of potential ESG regulation for funds. A separate proposal was issued in May 2022 that would require new disclosures to give investors consistent, comparable, and reliable information on funds' and advisers' use of ESG factors, including:

- New disclosures on ESG strategies in fund prospectuses, annual reports, and adviser brochures
- Implementing a layered, tabular disclosure approach for ESG funds to allow investors to easily compare ESG funds
- Greenhouse gas (GHG) emissions disclosures for portfolio investments of certain environmentally focused funds

Resource: [Investment Advisers & Companies Face New ESG Disclosures](#)

80% Investment Policy Requirement

The Names Rule currently requires funds with certain names to adopt a policy to invest 80% of their assets in the investments suggested by that name. The new final rule adds a requirement that a fund must reassess its portfolio investments at least quarterly to determine compliance with the 80% threshold. (The proposal would have required continuous compliance.)

Derivatives

The Names Rule previously had no provisions for how derivatives should be treated in a fund's 80% calculation, and most funds currently use a derivative market value. SEC research indicates 26% of funds have derivatives exposure. Funds will be required to use a derivatives instrument's notional amount (rather than market value) to determine the fund's compliance with its 80% investment policy, with adjustments for certain currency hedges. A fund must exclude a currency derivative if it:

- Is entered into and maintained by the fund for hedging purposes, and
- The notional amounts of the derivatives do not exceed the value of the hedged investments (or par value for fixed-income investments) by more than 10%.

In determining compliance with its 80% investment policy, a fund can deduct from assets: 1) cash and cash equivalents, 2) U.S. Treasury securities with remaining maturities of one year or less, up to the notional amounts of the fund's derivatives instruments, and 3) any closed-out derivatives positions if those positions result in no credit or market exposure to the fund.

Other Special Guidance

- **Multiple Elements.** If a fund's name includes terms suggesting an investment focus on multiple elements, the fund's 80% investment policy must address all of the elements in the names. A fund can take a reasonable approach in specifying how the fund's investments will incorporate each element.
- **Fund of Funds.** It would generally be reasonable for a fund of funds or other acquiring fund to include the entire value of its investment in an appropriate acquired fund when calculating compliance with the 80% investment requirement without looking through to the acquired fund's underlying investments.
- **Unit Investment Trusts.** UITs are subject to the 80% investment policy requirement at the time of initial deposit, but not on an ongoing basis.

Temporary Departures from 80% Investment Policy

The amendments retain the Names Rule's current requirements for a fund to invest in accordance with its 80% investment policy "under normal circumstances," and for the 80% investment requirement to apply at the time a fund invests its assets.

Other-Than-Normal Circumstances

Departure from the fund's 80% policy in other-than-normal circumstances is time-limited to 90 consecutive days from the initial departure. When a fund deviates from the 80% investment requirement due to other-than-normal circumstances, the fund is required to maintain a record documenting the date of the departure and the reason for the departure, including why the fund determined the circumstances are other than normal. (The proposal specified when temporary departures would have been permitted, including as a result of market fluctuations, index rebalancing, unusually large cash inflows or redemptions, or defensive positions in response to adverse market, economic, political, or other conditions. Unlike the proposal, the final rule amendments give funds the flexibility to determine what constitutes other-than-normal circumstances.)

Fund Launches & Reorganizations

Funds are permitted to invest less than 80% of their assets in the 80% basket temporarily in order to reposition or liquidate assets in connection with a reorganization or to launch a fund. There is no time limit on departures associated with fund reorganizations. For fund launches, funds have a temporary period to depart from the 80% investment requirement that is not to exceed 180 consecutive days starting from the day the fund commences operations.

Unlisted Registered Closed-End Funds & BDCs

The final rule generally prohibits a registered closed-end fund or BDC whose shares are not listed on a national securities exchange from changing its 80% investment policy without a shareholder vote. This prohibition would ensure these investors could vote on a change in investment policy given their limited options to exit their investments if the change were made. Subject to certain conditions, a fund can make changes to its 80% investment policy without a shareholder vote if the fund conducts a tender or repurchase offer in advance of the change.

Prospectus Disclosure, Reporting, & Record-Keeping

A fund prospectus must include a disclosure that defines the terms used in a fund's name, including the criteria the fund uses to select the investment that the term describes.

Updates to Form N-PORT for registered investment companies (other than money market funds and BDCs) include the following new disclosures:

- For each portfolio investment, whether the investment is included in the fund's 80% basket
- The value of the fund's 80% basket, as a percentage of the value of the fund's assets
- The definitions of terms used in the name and any selection criteria associated with these terms

Consistent with the current rule, the final rule amendments continue to require that, unless a fund's 80% investment policy is a fundamental policy, notice must be provided to shareholders of any change in the fund's 80% investment policy. Updates to modernize the current notice requirements include:

- Clarifying the current requirement that the notice must be provided separately from any other documents
- Updating the legend requirements alerting the investor to a change in investment policy and/or name
- Specifying the content that the notices include
- Allowing electronic delivery

Funds will be required to maintain:

- Written records, for each investment, documenting whether the investment is included in the fund's 80% basket and, if so, the basis for including that investment in the 80% basket and the value of the fund's 80% basket, as a percentage of the value of the fund's assets
- Written records documenting the fund's review of its portfolio investments' inclusion in the fund's 80% basket, to be conducted at least quarterly, including whether each investment is included in the fund's 80% basket and the basis for including each investment in the 80% basket
- If during this review or otherwise, the fund identifies that the 80% requirement is no longer met, written records documenting the date this was identified and the reason for any departures from the 80% investment policy.
- If there was a departure from the 80% requirement in other-than-normal circumstances, written records documenting the date of any such departure and the reason the fund departed, including why the fund determined that circumstances are other-than-normal
- Any notice sent to the fund's shareholders pursuant to the rule

All records must be maintained 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 of records must be maintained in an easily accessible place.

Compliance Dates

The final rule amendments will be effective 60 days after publication in the **Federal Register**. The compliance date is 24 months from the effective date for funds with net assets of \$1 billion or more and 30 months for funds with net assets of less than \$1 billion.

Conclusion

The asset management team at Forvis Mazars has more than 50 years of experience providing accounting, tax, and consulting services to various types of investment holdings, including conventional debt and equity

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investments, loans, businesses, alternative investments, and other unique assets. The ESG & Climate Risk team at Forvis Mazars provides consulting services for ESG investment policy and process development, financed emissions, climate physical and transition risk management, ESG software selection and implementation, and sustainability. As of August 2022, Convergence Optimal Performance ranked Forvis Mazars as a top 25 accounting and audit firm to registered investment advisors. Forvis Mazars also was ranked in the top 20 by AUM. We have experience providing services to fund complexes with net assets ranging from a couple million to several billion dollars. Our experience allows us to provide tailored services to help meet your unique needs. For more information, visit forvismazars.us.

Contributors

Brian Matlock

Partner – National Asset Management Industry Leader

brian.matlock@us.forvismazars.com

Dirk Cockrum

Managing Director – ESG & Climate Risk

dirk.cockrum@us.forvismazars.com

Anne Coughlan

Director – Professional Services Group

anne.coughlan@us.forvismazars.com