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# SEC's Final Amendments to Fund "Names Rule"

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On September 20, 2023, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 35d-1 (the "Names Rule") under the Investment Company Act of 1940, as amended, which is intended to prohibit the use of fund names that the SEC thinks have the potential to mislead investors about a fund's investments and risks. The SEC claims that the changes modernize and strengthen the Names Rule to enhance investor protection and address developments in the fund industry over the past 20 years since it was originally adopted.

**Why it matters:**

Fund names are not only the first piece of information that investors receive about a fund, but they are considered by the SEC to play a crucial role in conveying information to investors regarding their investment options. Before these changes, the Names Rule required funds with names suggesting a focus in specific type of investments, industries, or geographical regions to invest at least 80 percent of their fund assets in the type of investment, industry, or geographic region suggested by the fund name (an "80% investment policy"). The final amendments expand this requirement to more funds by including more terms that trigger the implementation of an 80% investment policy, including those with names suggesting characteristics like "growth" or "value," or thematic investment focuses such as Environmental, Social, or Governance ("ESG") factors. Funds will also need to review their compliance with the 80% investment policy quarterly and take corrective action within specific time frames – typically 90 days – if they deviate from it, unlike the prior Names Rule that did not expressly require correction for "passive breaches" caused by changes in the market value of investments held by a fund.

The final amendments also introduce enhanced prospectus disclosure requirements for terminology used in fund names, ensuring consistency with plain English meanings or established industry usage. Additional reporting and recordkeeping requirements for compliance with names-related regulations also apply.

The amendments will go into effect 60 days after publication in the Federal Register. Fund groups with net assets of $1 billion or more will have 24 months to comply, while those with net assets of less than $1 billion will have 30 months.

**Key Takeaways:**

The final amendments introduced by the SEC include several key elements.

- *Expansion of scope*: The final amendments expand the scope of the "Names Rule" by requiring an 80% investment policy for any fund with a name suggesting a focus on investments with specific characteristics. This includes terms like "growth" or "value" and those indicating the incorporation of ESG factors. Formerly, various terms were considered to be descriptions of a fund's investment strategy and outside of the coverage of the Names Rule.

- *Temporary Departures from the 80% Investment Requirement*: Unlike the rule proposal, under which funds would have been permitted to depart from the fund's 80% investment policy only under certain specified circumstances, the final amendments retain the requirement for funds to invest in accordance with their 80% policy under "normal circumstances" and apply the requirement at the time a fund acquires an asset. Also, in a departure from the rule proposal, the final amendments add a new provision that requires a fund to conduct at least quarterly reviews of its portfolio holdings. The final amendments also include specific time frames—generally 90 days, as opposed to 30 days in the rule proposal—for getting back into compliance if a fund departs from the 80% requirement as a result of drift or in other than normal circumstances.

- *Derivatives*: The final amendments generally require funds to use a derivatives instrument's notional amount, rather than its market value, when determining the value of a fund's assets to determine compliance with the 80% investment policy. An important change from the rule proposal is the exclusion of specific currency hedges from the compliance calculation. As proposed, the final amendments also address the derivatives instruments that funds may include in their 80% basket.

- *Unlisted Registered Closed-End Funds and Business Development Companies*: These funds, which now must adopt an 80% investment policy if they have names that would be covered by the Names Rule, generally cannot change their policy without shareholder approval. However, the final amendments allow an exception permitting changes without a vote if certain conditions are met: (1) the fund conducts a tender or repurchase offer with at least 60 days' prior notice of the policy change, (2) that offer is not oversubscribed, and (3) the fund purchases shares at their net asset value. Given the strict requirements of this exception, the amendments essentially make the 80% test of the Names Rule a "fundamental" investment policy in many cases.

- *Enhanced Prospectus Disclosure*: The final amendments require funds to enhance their prospectus disclosures to define the terms used in their names, including the criteria for investment selection.

- *Plain English Requirements*: Terms in fund names suggesting investment focus or tax-exempt status must be consistent with plain English meaning or established industry usage.

- *Form N-PORT Reporting*: Funds must report the value of the 80% basket and whether an investment is included in it. Additionally, they must report the definitions of terms used in their names quarterly, instead of monthly as initially proposed.

- *Recordkeeping*: Recordkeeping provisions related to a fund's compliance are included, which require that funds adhering to an 80% investment policy must maintain records demonstrating their compliance with the updated regulations. Notably, there is a shift from the initial proposal as the final amendments no longer require funds without an 80% investment policy to maintain a record as to why the fund determined an 80% investment policy is not required.

- *Other aspects of the proposal*: The final amendments did not take action on the proposed approach concerning the use of ESG terms in the names of ESG "integration funds." Under the proposed rule, the names of ESG "integration funds" would be considered deceptive if they implied that one or more ESG factors influenced investment decisions. However, these ESG factors were typically not given greater importance than other factors during the investment selection process. In other words, ESG factors might not be the decisive factors when determining whether to include or exclude a particular investment in the fund's portfolio. These funds could select investments based on other criteria, such as macroeconomic trends or specific factors related to individual companies, like price-to-earnings ratios. The final amendments include ESG-focused names within the expanded scope of the 80% investment policy requirement.

**Go Deeper:**

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