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Legal Update

SEC Requests Comments on Investment Company Act Fund Names Rule

Shakespeare wrote: "What's in a name? That which we call a rose by any other name would smell as sweet."[1] Apparently, the US Securities and Exchange Commission ("SEC") isn't so sure. On March 2, 2020, the SEC published a request for comment on Rule 35d-1 under the Investment Company Act of 1940 (the "Rule"). The SEC adopted the Rule in January 2001 in an effort to further protect investors against misleading or deceptive names of registered investment companies and business development companies ("funds"). As a general matter, the Rule requires a fund to invest at least 80% of its assets in the manner suggested by its name.

Since the Rule's adoption, the SEC staff has provided guidance regarding fund names on an "ad hoc" basis during the review of fund registration statements and in other statements, such as "frequently asked questions" and IM Guidance Updates. However, the SEC and the industry have identified certain challenges in applying the Rule. The factors that have contributed to these challenges, as described by the SEC, and its requests for comment, are summarized below.

The Five Contributing Factors to Current Fund Names Challenges

Derivatives and Leverage – The SEC stated that funds are increasingly using derivatives and other financial instruments that provide leverage. Because the 80% test in the Rule is an asset-based test, the SEC believes that the test may not be well-suited to derivatives investments that provide exposure to a "type of investment" (as specified in the Rule). As an example, the SEC offered that the 80% test may not provide an appropriate framework when the market values of derivative investments held by funds are relatively small but the potential exposure is significant.[2]

> In 2019, the SEC re-proposed a derivatives rule for registered investment companies, but that rule related solely to Section 18 of the Investment Company Act of 1940 ("ICA"). In 2011, the SEC published a concept release and request for comment regarding fund derivatives usage under the ICA, but that release did not address compliance with the Rule, which was adopted in 2001. To date, there is no formal, definitive guidance from the SEC regarding derivatives usage under the ICA or the rules thereunder.

Hybrid Investments – The SEC said that funds are increasingly using hybrid financial instruments that have a subset of the characteristics of more common asset types used in a fund's name. As an example, the SEC offered that convertible securities may have characteristics of both debt and equity securities, behaving more like debt or more like equity, depending on then-current market conditions. The SEC staff has observed both debt and equity funds that include convertible securities as part of their 80% policies under the Rule.

Index Funds – The SEC stated that the number of index-based funds is growing. The SEC staff has observed that index constituents may not always be closely tied to the type of investment suggested by the index's name, which raises questions under the Rule when the fund's name includes the name of the index.

Qualitative Assessment/ESG Funds – The SEC stated that the number of funds with investment mandates that include criteria that require some degree of qualitative assessment or judgment of certain characteristics (such as funds that include one or more environmental, social, and governance-oriented assessments or judgments in their investment mandates (e.g., "ESG" investment mandates)) is growing. These funds often include these parameters in the fund name. The SEC staff has observed that some funds appear to treat terms such as "ESG" as an investment strategy and thus not subject to the Rule, while others appear to treat "ESG" as a type of investment that is subject to the Rule.

ESG/sustainable investing is a hot topic for the SEC and its staff. In its examination priorities for 2020, the SEC's Office of Compliance Inspections and Examinations ("OCIE") stated that it "has a particular interest in the accuracy and adequacy of disclosures provided by [registered investment advisers] offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria."[3] In January 2020, the SEC proposed amendments to modernize Regulation S-K financial disclosures (the proposed rule; the corresponding press release). Although these amendments and the release accompanying them did not specifically address ESG matters, Chairman Jay Clayton, Commissioner Hester Pierce, and Commissioner Allison Lee each issued separate public statements voicing their respective views on ESG disclosure matters.

Marketing Pressure – The SEC stated that asset managers may have an incentive to use fund names as a way of differentiating new funds, which drives managers to select fund names that are more likely to attract assets (such as names suggesting various emerging technologies) but may not be consistent with the purpose of the Rule.

Request for Comments

The SEC requested input from the industry on the above challenges as well as alternatives to the current fund names framework. The SEC would like to hear from the industry regarding numerous topics, including the following, summarized below:

Selection and Use of Names – The SEC would like to know how funds select their

names and use they use them (e.g., communicating investment and risk information, marketing).

The 80% Threshold – The SEC wants to know whether an 80% threshold is still appropriate and, if not, what a more appropriate threshold might be (e.g., 65%, 95%). It also wants to know if the percentage should be applied at the time of investment (as is the case under the Rule) or whether it should apply on a continuous basis.

Asset-Based Test – The SEC has asked whether the current asset-based test is appropriate and what challenges such a test raises. In addition, it wants to know whether there are other tests that would be more appropriate (e.g., a test that requires that the type of investment suggested by a fund's name contribute at least a minimum amount to a fund's returns).

Derivatives – The SEC observed that, although many funds have asserted that a derivative's notional value would be more appropriate than its market value for purposes of complying with the 80% test, funds generally use market value. The SEC has questioned whether it should address this and, if so, how. For example, if the approach is based on notional value, the SEC asked whether the Rule should permit or require a fund to make adjustments to notional value (e.g., delta adjust options contracts or present interest rate derivatives as 10-year bond equivalents). The SEC also asked about the possibility of other methodologies, e.g., measures of risk.

Shareholder Notice – The SEC would like to know whether the shareholder notices regarding changes to a fund's 80% policy are useful and whether the Rule should impose different requirements in certain cases (e.g., when a change in name is accompanied by an important change in investment strategy or exposure).

Industry Classification – The SEC has asked about how funds determine whether a particular investment is part of a particular industry (e.g., third-party industry classifications or indices; minimum level of assets, revenues, or profits tied to an industry; a company's market share of an industry; or text analytics). The SEC asked whether there are circumstances under which a company should be considered part of an industry even if its revenues or assets attributable to that industry are less than a certain percentage (e.g., less than 50%), are not quantifiable, or could be classified in more than one industry. Lastly, the SEC inquired about the possibility of a test based on a minimum amount of revenue or assets attributable to the industry.

Investment Strategies – The Rule does not apply to the use of investment strategy terms (e.g., growth, value, tax-sensitive, income) as opposed to a type of investment. The SEC would like to know whether a strategy should be distinguished from a type of investment under the Rule and, if so, how. It further asked whether the Rule should be amended to apply specifically to investment strategies.

ESG/Sustainable Investing – Echoing the concerns of certain SEC commissioners and an explicit OCIE examination priority, the SEC specifically asked whether the Rule should apply to terms like "ESG" or "sustainable." The questions raised by the SEC on this topic are numerous and include:

- Are investors relying on these terms as indications:
  - ✓ Of the types of assets in which a fund invests or does not invest (e.g., investing in carbon-neutral companies, avoiding oil and gas companies);
  - ✓ Of the fund's investment strategy (e.g., investing with the objective of bringing value-enhancing governance, asset allocation, or other changes to the

operations of the underlying companies);

  - ✓ That the funds' objectives include non-economic objectives; or
  - ✓ Of a combination of the above?

- Should the Rule impose specific requirements on when a particular investment may be characterized as ESG or sustainable, and, if so, what should those requirements be?
- Should there be other limits on a fund's ability to characterize its investments as ESG or sustainable? For example, ESG (environment, social, and governance) relates to three broad factors. Given that, must a fund select investments that satisfy all three factors to use the "ESG" term?
- For funds that currently treat "ESG" as a type of investment subject to the Rule, how do those funds determine whether a particular investment satisfies one or more "ESG" factors, and are these determinations reasonably consistent across funds that use similar names?
- Instead of tying terms such as "ESG" in a fund's name to any particular investments or investment strategies, should the Rule instead require funds using these terms to explain to investors what they mean?

Global/International – The Rule does not apply to the use of the terms "global" or "international," but the SEC has asked whether it should and, if so, what factors should be used to determine whether the term "global" or "international" is misleading. The SEC also asked whether a fund that uses these or similar terms in its name be required to invest a certain percentage of assets in a minimum number of countries or invest a minimum percentage of assets outside of the United States. Importantly, assuming the Rule were to apply to these terms, the SEC asked how funds should treat multinational companies with a significant presence (e.g., revenues, assets) in more than one country or region. For example, should a fund invested in a diversified set of 30 or more US-incorporated and US -headquartered companies, where each company derives a certain level of its revenues (e.g., 25%) from outside the United States, be able to call itself a "global" or "international" fund without running afoul of the Rule?

Actively Managed, Tax Managed, Long-Term, and Short-Term – The Rule does not apply to the use of the terms "actively managed," "tax managed," "long-term," and "short-term," but the SEC is now asking whether it should.

Organizations/Affinity Groups – The SEC wants to know whether fund names identifying well-known organizations, specific affinity groups, or a particular population of investors (e.g., "veterans," "municipal employees") raise concerns and, if so, how should they be addressed.

Fund Ticker Symbols – The SEC observed that funds may select ticker symbols that are intended to convey information about how a fund invests. Now, the SEC has questioned whether the Rule should apply to fund tickers.

Closed-End Funds and Business Development Companies – Should registered closed-end funds or business development companies be treated differently than open-end funds under the Rule? If so, how should each fund type be treated and why? For example, because the securities of closed-end funds and business development companies are not redeemable and may not be publicly traded, does the 60-day notice requirement for changes to a fund's 80% policy provide meaningful protections to investors in such funds? If not, what changes are appropriate? Are there any other types of funds or other vehicles that should be treated

differently under the Rule or under the general antifraud provisions of the Federal securities laws?

Other Issues – The SEC has questioned whether funds should be required to connect (via hyperlink or other immediately accessible means) their names to a more detailed discussion of the fund's investment strategy. It has also asked whether there are approaches other jurisdictions or other regulated industries use that may work well in the United States.

Conclusion

Many funds and their investment advisers have been grappling with these questions for quite some time (e.g., global/international, industry classification in certain circumstances, derivatives treatment), while other questions posed by the SEC are of a more recent ilk (e.g., ESG and sustainable investing). Ultimately, even if the SEC does not move forward on any Rule amendments at this time, funds and their advisers would be well advised to review the request for comment, consider the policy reasons underlying the SEC's questions, and evaluate current and prospective fund names, related investment policies and strategies, and corresponding disclosures, particularly as they relate to ESG and sustainable investing. Should funds and advisers wish to submit comments, the deadline for submission is May 5, 2020.

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Endnotes

[1] William Shakespeare, Romeo and Juliet act 2, sc. 2.

[2] The SEC noted that the release adopting the Rule stated that in appropriate circumstances, a fund can count a synthetic instrument (such as a derivative) toward its 80% policy if the instrument has economic characteristics similar to the securities included in the policy. However, the release did not tell funds how to account for the value of these instruments for purposes of complying with the fund's 80% policy. See also Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Release No. IC-29776 (August 31, 2011).

[3] See Mayer Brown's January 23, 2020, Legal Update at https://www.mayerbrown.com/en/perspectives-events/publications/2020/01/ocies-2020-examination-priorities-variations-on-recurring-themes