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PROPOSED AMENDMENTS TO THE NAMES RULE

ISSUES AND OBSERVATIONS

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Background: Rule 35d-1 or the "Names Rule"

- Promulgated under Section 35(d) of the Investment Company Act, which prohibits fund names that are "materially deceptive or misleading"
- Adopted in 2001
- Currently requires a fund with a name suggesting that the fund focuses on the following categories to adopt an "80% policy":
  - A particular type of investment
  - A particular industry
  - A particular geographic area
  - Tax-exempt funds
- Guidance in Frequently Asked Questions issued by the SEC Staff of the Division of IM

Proposed Amendments – Fast Facts

- "Investment Company Names"
- Theme: Contents Match the Label . . . and Prove It!
- Adds almost 1,000 words to the Names Rule (743 words vs. 1,732 words)
- Overview:
  - Broader scope (includes strategies)
  - More prescriptive on disclosure requirements
  - Specific compliance/correction obligations
  - New treatment of derivatives compliance
  - More disclosures and SEC reporting

Increased Scope

- **In addition to:**
  - investments in a particular type of investment or investments;
  - investments in a particular industry or group of industries; and
  - investments in a particular country or geographic region
- **To be included:** names that suggest a focus on "investments that have, or whose issuers have, particular characteristics"
- **Not included:** "names that reference characteristics of a portfolio as a whole" or "elements of an investment thesis without specificity as to particular characteristics"
  - **NOTE:** Funds are required to maintain a written record of the analysis that the Names Rule does not apply
- Closed-End Funds/BDCs: 80% policy must be fundamental

What's in a Name (Covered by the Proposal)?

- ✓ Value
- ✓ Growth
- ✓ ESG (with restrictions)
- ✓ Global
- ✓ International
- ✓ Income
- ✓ Intermediate term (or similar) bond
- ✓ Whatever the SEC Staff says? (see recent SEC correspondence to fund filings)

- × Long/Short
- × Real Return
- × Retirement Target

Enhanced Prospectus Disclosure

- Definitions of "the terms used in its name"
  - In: words or phrases used in a fund's name "related to the fund's investment focus"
  - There is flexibility, but "bond" can't be defined as "stock"
- Disclosure of "the specific criteria the fund uses to select the investments that the term describes, if any"
  - Current requirement, but applicable only to countries/geographic regions
- Plain-English requirement – disclosure can't modify a name
  - Example: A Solar Energy Fund 80% policy could not apply broadly to "alternative" energy
- ESG Funds must be ESG-Focused Funds or Impact Funds (not Integration)

What Is a "Reasonable" Fund Name?

- For a defined term to be reasonable, there must be a "meaningful nexus between the given investment and the focus suggested by the name"
- *Example*: the SEC stated that it's reasonable for a fund to define securities in a given industry as companies that derive 50% of their revenue or income from, or own significant assets in, the industry
- **What is:** The SEC left open the possibility that the 50% revenue test could be a smaller percentage, "such as where a large company is a dominant firm in a given industry (e.g., the firm is an acknowledged leader in the industry)"
- **What is not:** The SEC also acknowledged that some registrants use text analytics to assign issuers to industries based on the frequency of particular terms in an issuer's disclosure (e.g., "blockchain")
  - Text analytics is a helpful component of a fund's analysis, but the SEC does not think it's reasonable to conclude that an issuer is in a given industry solely because the issuer's disclosure documents frequently include words associated with the industry

Noncompliance with 80% Policy

- Not just a time-of-purchase test; the proposal would eliminate "under normal circumstances" qualifications
- Deviation would be permitted only for:
  - Market action
  - Order flows
  - Unfavorable conditions
  - Orderly transitions
- Time-bound correction requirement; "as soon as reasonably practicable," subject to:
  - No more than 30 consecutive days (180 for fund launches)
  - Fund reorganizations and instances where the 60-day notice requirement has been fulfilled default to reasonably practical standard
- Repeated noncompliance may nevertheless violate Section 35(d) even if each temporary departure is permissible under the proposed rule

Derivatives

- A Fund is permitted to include synthetic instruments in the 80% policy if it has economic characteristics similar to the securities included in the 80% policy
  - Includes not only exposures to investments suggested by the fund's name, but also exposure to one or more of the market risk factors associated with such investments (e.g., interest rate risk, credit spread risk and foreign currency risk)
- Notional amount generally serves as a measure of a fund's investment exposure to an underlying reference security and is therefore more indicative of a fund's investment focus

Calculation of Derivatives Under the 80% Policy

- Calculations must be based on (adjusted) notional value
  - (interest rate derivatives adjusted to 10-year bond equivalents)
  - Delta adjusted options
- **Numerator**: Qualifying investments + Absolute value of notional value of qualifying derivatives (i.e., providing exposure to factors suggested by the fund's name)
- **Denominator**: All investments + Absolute value of notional value of ALL derivatives – cash up to the notional value
- Note: does not affect valuation practices under Section 2a-5 and is consistent with the calculation requirements of Section 18f-4

Derivatives Examples

Example 1 (Excluding Cash Up to Notional)	Example 2 (Including Hedging Transactions)
Holdings: • $80 equity swap; • $80 UST; • $20 other (non-qualifying securities).	Holdings: • $100 foreign equity swap • $100 currency forwards (not "equity" investments) • Nothing else
Rule Math: • Num: $80 swap • Den: $80 swap + $80 UST + $20 other – $80 UST • $80 / ($80 + $80 + $20 - $80) = $80 / $100 = 80% Compare: • Num: $80 swap • Den: $80 swap + $80 UST + $20 other ~~– $80 UST~~ • $80 / ($80 + $80 + $20) = $80 / $180 = 44%	Rule Math: • Num: $100 swap + $100 forwards • Den: $100 swap + $100 forwards • ($100 + $100) / ($100 + $100) = $200 / $200 = 100% Compare: • Num: $100 swap ~~+ $100 forwards~~ • Den: $100 swap + $100 forwards • $100 / ($100 + $100) = $100 / $200 = 50%

Other Provisions

- Edelivery of notices re: policy changes (and names changes)
- N-PORT Reporting
  - Percentage of qualifying investments
  - Days of noncompliance
  - Qualification of individual investments
- Recordkeeping
  - Which investments were qualifying investments?
  - Percentage of qualifying investments
  - Reasons for any "departures" and the dates thereof
  - Shareholder notices

Not a Safe Harbor

- Compliance with the 80% policy does not necessarily mean compliance with the Names Rule
- SEC: A Fund could comply with its 80% policy but still be noncompliant with the Names Rule, e.g., when:
  - A 20% basket has an investment antithetical to the fund's investment focus (e.g., investment in RJ Reynolds in a tobacco-free fund)
  - Fund invests in a way that a substantial portion of the fund's risk or returns is different from what an investor would reasonably expect based on the fund's name (e.g., a short-term bond fund using the 20% basket to invest in highly volatile equity securities that introduce significant volatility to a portfolio greater than expected)
  - A passive fund is invested 80% or more in its underlying index, but the underlying index has components that are contradictory to the index's name

The Good

- Edelivery of notices re: policy changes (and names changes)
- Fund of Funds
  - Can include the value of the acquired fund without looking through the acquired fund's investments, provided that the acquired fund itself has an appropriate 80% Policy
- Unit Investment Trusts
  - Excepts funds that made an initial deposit of securities prior to the effective date of any final Names Rule from complying with the 80% policy and recordkeeping requirements if they were not required to do so at the time of the initial deposit

The Bad and the Ugly

- N-PORT Reporting
  - Percentage of qualifying investments counted toward 80% Policy
  - Days of noncompliance, if applicable
  - Qualification of individual investments
- Recordkeeping
  - Which investments were qualifying investments?
  - Percentage of qualifying investments
  - Reasons for any "departures" and the dates thereof
  - Shareholder notices
  - Funds that do not adopt an 80% policy must maintain a written record of their analysis supporting the position that the 80% policy is not required

Observations and Issues

- Comment periods close **August 16**
- Objective tests of subjective criteria will be challenging for active managers
  - What is a "value" investment and when does it stop being one?
  - Must it be measured against a "value" index or other independent source?
- Compliance challenges
  - What is "global"? International? How are they subject to the 80% test?
- How will names such as "XYZ strategy fund" be impacted?
- Passive funds appear to have obligations independent from their indexes
- Potential look through for acquired funds with no names policy
- Managers-of-managers implications
- How does this impact filing obligations (i.e., (a) vs. (b) filing determination)?

Related Resources

→ → →

For more information on recent SEC developments and Rule proposals, read our LawFlashes:

- **The Name Game: SEC Proposes Expanding Scope of Registered Funds' 'Names Rule'**
- **Green and Bear It: SEC Proposes ESG Rules for Advisers and Registered Funds**

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With more than a decade of experience as senior in-house counsel with global investment managers, **Lance** has a deep understanding of mutual fund law and operation and is fluent in the myriad regulations applicable to investment managers. He is well versed in the creation of investment products and environmental, social and governance (ESG) and sustainability matters. Lance works extensively on regulatory policy matters engaging with various financial services regulators, including the US Securities and Exchange Commission, US Department of Labor, Internal Revenue Service, and US Department of Treasury.

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Laura's practice focuses on the regulation of investment companies and investment advisers. Laura regularly represents exchange-traded funds (ETFs), mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, and investment advisers. She counsels both well-established clients and clients that are new to the industry on a variety of regulatory, transactional, compliance and operational issues, including the development of new financial products and services, federal and state registration issues, the preparation and implementation of compliance programs, business combinations involving investment companies and investment advisers, interpretive and "no-action" letter requests, requests for Securities and Exchange Commission exemptive relief, and regulatory examinations. Laura also counsels investment advisory clients on matters, including advertising and communications with the public, investment adviser registration, and separately managed account (or wrap fee) programs. Laura also has significant experience representing "liquid alt" funds, funds that invest through offshore subsidiaries, and funds that utilize QFII/RQFII quotas to invest directly in securities issued and traded in China.

Prior to joining Morgan Lewis, Laura was a partner in the financial services practice of another international law firm, where she also served on the firm's diversity committee. Before that, Laura was assistant general counsel in the asset management division of a global bank and an associate in the Washington D.C. office of Morgan Lewis.

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John counsels clients on investment company and investment adviser regulatory issues and related issues affecting broker-dealers and transfer agents. He also assists clients with forming and acquiring investment companies and investment advisers. John routinely handles matters involving the establishment, representation, and counseling of exchange traded investment companies (ETFs), their advisers, and listing markets.

Additionally, John advises clients on regulatory and transactional matters, including development of new products and services; federal and state registration and compliance issues; Securities and Exchange Commission (SEC), FINRA, and state investigations and enforcement actions; mergers and acquisitions involving investment companies and investment advisers; interpretive and "no-action" letter requests; SEC exemptive orders; and related matters. John previously worked on some of the key ETF legal milestones, including the first fixed-income ETFs, the first 12(d)(1) relief for ETFs, actively managed ETFs, leveraged and inverse ETFs, and the first ETF in a master-feeder structure.

Before entering private practice, John served on the staff of the SEC in its Investment Management Division. He regularly speaks at industry conferences and has authored or co-authored several articles covering a wide variety of securities regulatory issues and the books Mutual Fund Regulation and Compliance Handbook and Regulation of Exchange-Traded Funds.

Ranked a leading US lawyer for investment management by Chambers USA since 2005, John's clients told Chambers editors that they appreciate "he is able to see things from a business as well as legal perspective." John was also selected by Ignites as the 2008 "Fund Titan" in the category of "Outside Counsel."

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Abby counsels registered investment companies and investment advisers in connection with their organization, registration, and operation, including advice on regulatory and compliance matters. Abby also advises US and international clients on compliance with the Investment Company Act and the Investment Advisers Act. She regularly works with exchange-traded funds (ETFs), open-end funds, closed-end funds, and investment advisers of varying sizes and assets under management. Abby also counsels clients on the preparation and filing of registration statements, proxy statements, and exemptive applications with the US Securities and Exchange Commission.

Prior to re-joining Morgan Lewis, where she began her career, Abby was the general counsel of a private-label ETF investment adviser, which manages over $5 billion in assets of a variety of index and actively managed ETFs, including domestic and international equity, emerging and frontier markets, fixed income, fund of funds, thematic, and sector-specific products. As general counsel, Abby oversaw all legal and regulatory aspects of the offering and operation of the ETFs and the adviser's overall investment advisory business, which included provision of sub-advisory services and portfolio management to '33 Act exchange-traded products. She regularly drafted and negotiated commercial agreements and vendor and service provider agreements on behalf of the investment adviser. Additionally, she provided counsel on various corporate and transactional matters related to the company and its business lines.

Prior to that, Abby was an associate at a London-based international law firm, where she counseled US and non-US investment advisers of private funds and hedge funds on complying with numerous provisions of the Investment Advisers Act and non-US investment companies on offerings in the US.

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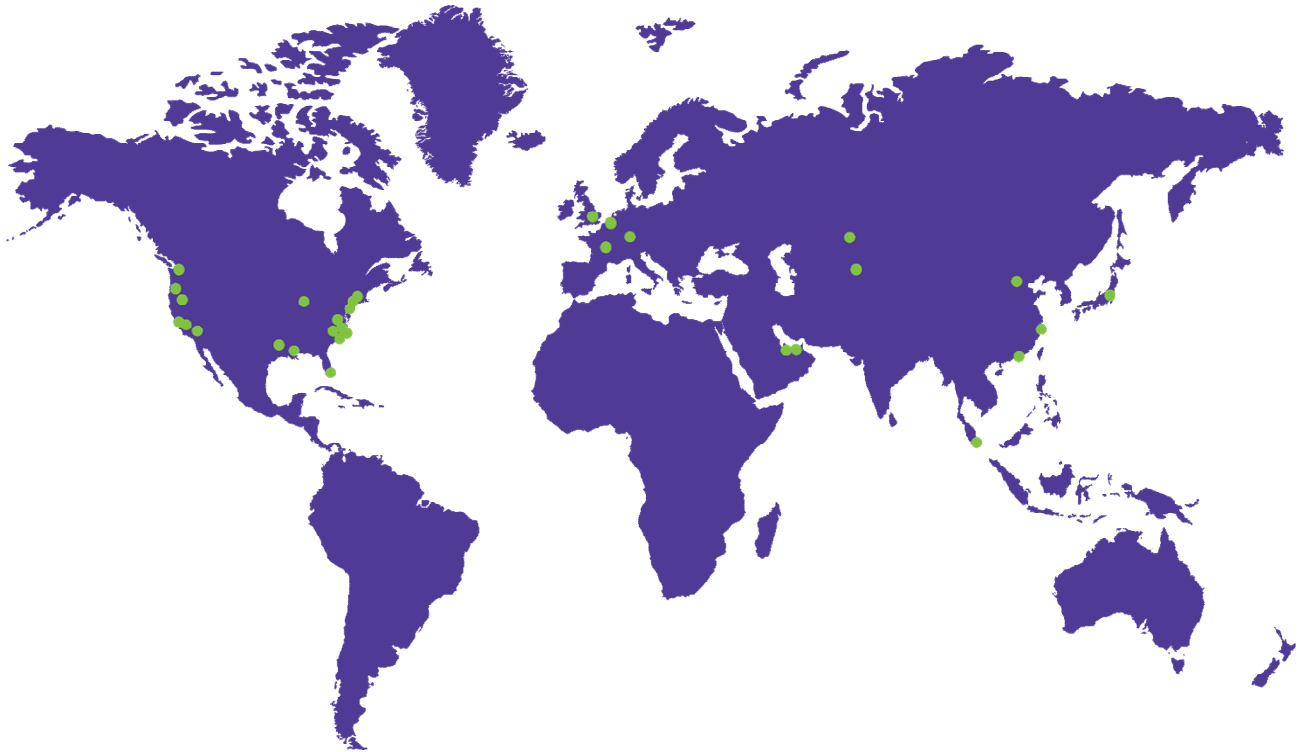

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