

October 9, 2023

SEC Significantly Expands Fund ‘Names Rule’

Final Amendments Expand Existing Requirements to Broader Range of Funds and Increase Disclosure and Other Obligations of Funds Subject to the Rule

SUMMARY

On September 20, 2023, the SEC voted 4 to 1 (Commissioner Uyeda dissenting) to adopt amendments¹ (the “Final Amendments”) to Rule 35d-1² (the “Names Rule”) under the Investment Company Act of 1940. The Names Rule, which was originally adopted in 2001, is designed to prevent the name of a registered investment company or business development company (“BDC” and, together, a “fund”) from misrepresenting the fund’s investments and risks.³ The Final Amendments, the first SEC rulemaking addressing fund names that refer to environmental, social or governance (“ESG”) criteria to be finalized,⁴ significantly expand the scope of the Names Rule, raise many interpretive issues as to whether a certain name conveys an investment strategy, focus or theme, and will impose substantial compliance costs, including from additional reporting obligations, on funds.⁵

The Final Amendments are generally in line with the proposal, which we summarized and discussed in [our publication](#) dated June 3, 2022.⁶ However, as described in more detail below, the SEC made certain changes that addressed commenters’ concerns with some of the more onerous aspects of the proposed amendments.

Highlights of the Final Amendments include:

- **Expanded Scope:** Consistent with the proposal, the Final Amendments expand the scope of the 80% investment policy (defined below) to apply to any fund name with terms suggesting that the fund focuses in investments that have, or investments whose issuers have, particular characteristics, including terms such as “growth” and “value” and names that indicate the fund incorporates ESG factors in its investment decisions.

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- **Enhanced Disclosure:** Consistent with the proposal, the Final Amendments impose enhanced fund prospectus disclosure requirements that require a fund subject to the 80% investment policy to define the terms used in its name, including the criteria the fund uses to select the investments that the term describes. Also consistent with the proposal, any terms used in the fund's name that suggest an investment focus, or that the fund's distributions are tax-exempt, must be consistent with those terms' plain English meaning or established industry use.
- **Quarterly Review:** In a change from the proposal and consistent with the previous Names Rule's requirements,⁷ the Final Amendments require that a fund must invest in accordance with its 80% investment policy "under normal circumstances." The Final Amendments require that a fund review its portfolio assets' treatment under its 80% investment policy ("80% basket") at least quarterly, which is another change from the proposal. However, the fund must determine whether an asset fits into its 80% basket at the time of acquisition.
- **Temporary Departures:** The Final Amendments permit temporary departures (generally 90 days whereas the proposal would have only permitted 30 days) from the 80% investment policy during "other-than-normal" circumstances.
- **Updated Valuation for Derivatives and Short Sales:** As proposed, the Final Amendments require a fund to value all of its derivatives positions using notional amounts, rather than market value for the purpose of determining the fund's compliance with its 80% investment policy. But in a change from the proposal, the Final Amendments require that a fund value its short positions by the price of the asset sold short. When calculating its 80% basket, a fund may reduce the value of its derivative and short positions by the value of its cash, cash equivalents and U.S. Treasury securities. A fund may also exclude the value of any derivatives used to hedge currency risk associated with its foreign-currency-denominated investments.
- **Unlisted Closed-End Fund and BDC Investment Policy Changes:** The Final Amendments restrict 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. However, in a change from the proposal, the Final Amendments permit such a fund to 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, subject to certain conditions.
- **Shareholder Notice:** The Final Amendments retain the previous Names Rule's shareholder notice requirement for any change in a fund's 80% investment policy (unless the 80% investment policy is a fundamental policy) and update the rule with respect to the use of electronic delivery.
- **Expanded Form N-PORT Reporting:** The Final Amendments expand reporting items on Form N-PORT (filed by registered management investment companies and exchange-traded funds organized as unit investment trusts or "UITs," other than money market funds or small business investment companies) to include information about compliance with a fund's 80% policy, as proposed.

The SEC did not adopt the proposed prohibition of the use of ESG terminology in a fund name if such a fund met the proposed definition of an ESG "integration fund" (*i.e.*, a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but such ESG factors are generally no more significant than other factors in the investment selection process).⁸ Instead, the SEC notes that it was not taking action on this aspect because it is continuing to consider comments on its separate proposal that would impose additional disclosure obligations on ESG funds and investment advisers that consider ESG factors in the significant investment strategies or methods of analysis they pursue.⁹

The compliance dates for the Final Amendments are longer than the proposed one-year compliance period. Instead, the SEC adopted a tiered compliance date with fund groups with net assets of \$1 billion or more having 24 months after the effective date and fund groups with net assets of less than \$1 billion having 30 months after the effective date.

OVERVIEW OF THE FINAL AMENDMENTS

80% Investment Policy

The previous Names Rule generally required a fund with a name suggesting a focus in a particular type of investment, or in investments in a particular industry or geographic region, to 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 (“80% investment policy”).¹⁰ The Final Amendments significantly expand the 80% investment policy to fund names that include terms suggesting that the fund focuses in investments that have, or where issuers have, particular characteristics.¹¹ However, the SEC declined to expressly define the term “particular characteristics” in the rule because it believes the term will be understood to mean any feature, quality or attribute.¹² The Final Amendments, in a change from the previous Names Rule, also do not distinguish between a type of investment and an investment strategy. The SEC states that a fund’s name (regardless of whether it describes an investment strategy or a type of investment) might suggest a particular investment focus and create reasonable investor expectations that the fund invests in a manner that is consistent with its name.¹³ The SEC provides additional guidance on what terms might suggest an investment focus:

- With respect to terms “growth” and “value,” the SEC states that “[i]f terms in a fund’s name can reasonably be understood to reference either the characteristics of a fund’s individual investments or the intended result of a fund’s portfolio investments in the aggregate, the fund will be required to adopt an 80% investment policy.”¹⁴
- The 80% investment policy applies to “thematic” terms in a fund’s name if using a “thematic” term indicates fund strategy.¹⁵ The SEC cites Commission staff observations in the increase in filings by funds using such terms and states that thematic terms suggesting an industry focus, like “travel” or “health and wellness,” may qualify, whereas terms suggesting demographic or historical themes, like “millennial” or “post-Corona,” may not, as they do not suggest a focus in a type of investment or industry.¹⁶

While the SEC did not adopt the proposed prohibition on the use of ESG terminology in the names of ESG “integration funds,” it addressed the use of ESG-related terms in a fund’s name. The SEC asserts that the breadth of ESG-related terms, as well as evolving investor expectations around terms like “sustainable” or “socially responsible,” heighten the potential for investor confusion and “greenwashing” in fund names.¹⁷ The SEC explains that, unlike many other non-ESG investment strategies, some ESG-related strategies are not well-established or commonly understood by the investing public.¹⁸ Because ESG terms in a fund’s name communicate to investors that the fund will invest in issuers that have particular characteristics, like other terms that are covered by the expanded scope of the Names Rule,

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the SEC reasons that there is not a principled basis to treat ESG terms differently than other terms that have the potential to be materially deceptive or misleading.

The SEC also identifies several types of fund names that do not suggest an investment focus and will not require the fund to adopt an 80% investment policy.¹⁹ These include the following:

- names that reference characteristics of a fund's portfolio as a whole, such as names indicating the fund seeks to achieve a certain portfolio "duration" or that the fund is "balanced";
- names that reference a particular investment technique, such as "long/short";
- names that suggest a possible result to be achieved, such as "real return"; and
- names that reference a retirement target date.²⁰

Similarly, overly broad terms such as "global" and "international" that describe a fund's approach to constructing a portfolio but do not communicate the composition of the portfolio with any particularity will not require an 80% investment policy because, according to the SEC, the terms on their own suggest no particular investment focus.²¹ Yet, the SEC determined to include the term "sustainable," which would seem to fit within the same rationale, while noting the fund has discretion to reasonably define the terms in the fund's name.²² The SEC also states that "ESG uplift" strategies²³ do not require an 80% investment policy.²⁴ The SEC explains that these strategies are executed solely on a relative basis at the portfolio level and include terms in the fund's name associated with this investment strategy to signal this different approach to investors.²⁵

Inclusion in a Fund's 80% Basket

Under the Final Amendments and consistent with the proposal, in determining whether a particular asset is invested in accordance with the investment focus that the fund's name suggests (*i.e.*, qualifies for inclusion in the 80% basket²⁶), there must be a meaningful nexus between the investment and the investment focus suggested by the name.²⁷ Further, the SEC states, consistent with the proposal, that a fund may define the terms used in its name in a reasonable way and that it would generally be reasonable for a fund to determine that a sufficient nexus exists between certain securities and a given industry if the securities are issued by companies that derive more than 50% of their revenue or income from, or own significant assets in, the industry.²⁸ Commenters stated that the 50% revenue test may not always be appropriate to determine whether a company is part of a given industry, particularly for new companies and nascent industries and business sectors, and urged the SEC to clarify the reasonableness standard as it applies to designating investments in a fund's 80% basket. Commenters noted that advisers need the flexibility to evaluate investments based on a totality of criteria beyond revenue tests.²⁹

The SEC provides guidance for when a fund's name suggests an investment focus that has multiple elements. Specifically, the fund's 80% investment policy must address all the elements in the name, although it would permit the fund to take a reasonable approach in specifying how the fund's investments

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will incorporate each such element in the name.³⁰ For example, the “XYZ Technology and Growth Fund” could have an investment policy to fill the 80% basket with securities that fall in both categories or, alternatively, some mix of non-growth technology investments and non-technology growth investments.³¹ The SEC also provides guidance for a fund of funds and an acquiring fund, stating that such a fund may include the entire value of qualifying fund investments in its 80% investment bucket. For example, that same “XYZ Technology and Growth Fund” may count the entire value of its investment in the “ABC Microchips Fund” when calculating compliance with the 80% investment requirement, provided that the ABC Microchips Fund has its own policy that 80% of its portfolio consists of investments in the microchip sector.³²

Plain English and Established Industry Use

The Final Amendments require that terms used in a fund’s name suggesting an investment focus must also be consistent with those terms’ plain English meaning or established industry use.³³ If in its prospectus a fund defines a term used in its name in a way that is inconsistent with both its plain English meaning or established industry use, such name would be considered to be materially deceptive or misleading under the Final Amendments, even if the fund’s prospectus disclosure defines a given term in the name to match the fund’s investments.³⁴ The SEC has previously stated that disclosure would not be permitted to “fix” or “remedy” a misleading name that uses terms in a way that is inconsistent with their plain English meaning or established industry use, and therefore is “contrary to reasonable expectations.”³⁵ The Names Rule is not a safe harbor.³⁶ A fund’s name may still be materially deceptive or misleading under section 35(d) of the Investment Company Act of 1940 even if the fund adopts an 80% investment policy and otherwise complies with the rule’s requirement to adopt and implement the policy.³⁷

Generally, the SEC acknowledges that overall context is important in how an investor interprets a fund’s name and states that the Final Amendments are designed to give fund managers reasonable discretion to define terms in a fund’s name and to allocate investments reasonably into the 80% basket in accordance with the investment focus the name conveys, which can be dependent on the context of the terms in a name.³⁸

Temporary Departures from the 80% Investment Policy

The Final Amendments permit a fund to temporarily depart from the 80% investment requirement by allowing it to temporarily invest less than the required 80% of the value of the fund’s assets in accordance with the fund’s investment focus.³⁹ Like the previous rule, the Final Amendments require a fund to determine at the time it invests whether the investment is in the fund’s 80% basket and to follow the 80% investment policy during “normal circumstances.”⁴⁰ But, in a change from the proposal, the Final Amendments require a fund subject to the 80% investment policy to review the fund’s investment portfolio at least quarterly to determine whether the fund’s investments continue to be consistent with the fund’s 80% investment policy. A fund, however, will need to consider the value of its current investments in its 80% basket when making additional acquisitions, but will not need to assess the characteristics of those

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investments until the next quarterly review.⁴¹ The SEC notes that, relative to the proposal, the rule requiring a fund to review its portfolio quarterly will reduce compliance costs and is congruent with the quarterly N-PORT reporting requirement (discussed below).⁴²

The Final Amendments also retain the previous rule's approach of allowing a fund to determine what constitutes other-than-normal circumstances.⁴³ The Final Amendments include specific timeframes — generally 90 consecutive days, as opposed to 30 days as proposed — for getting back into compliance.⁴⁴ While a fund can define other-than-normal circumstances for purposes of departure from the 80% investment requirement, the SEC states that a fund's intentional departure (as opposed to drift) must be in "other-than-normal" circumstances, which could include but is not limited to the proposal's list of circumstances.⁴⁵ The SEC notes that determining whether circumstances are "normal" depends on the facts and circumstances.⁴⁶ However, if a fund deviated in other-than-normal circumstances frequently, this may suggest that those circumstances are "normal" and may raise questions about the appropriateness of the fund's name under Section 35(d) if the fund's portfolio is not invested consistent with its name for prolonged periods of time.⁴⁷

If a fund unintentionally drifts from the 80% investment requirement, it has to come back into compliance as soon as reasonably practicable. In all circumstances, a fund must come back into compliance within 90 consecutive days as measured from the time the fund identifies a departure from the 80% investment policy.⁴⁸ The fund must make all future investments in a manner that will bring the fund into compliance with the fund's 80% investment policy.⁴⁹ Generally, the SEC states that a fund that has departed from its 80% investment policy for more than 90 days must either change its name or seek exemptive relief from the SEC.⁵⁰

The Final Amendments permit a temporary departure from the 90-day requirement in the case of newly launched funds (the rule permits 180 days instead) and funds conducting a reorganization (the rule does not contain a timeframe).⁵¹ Though the Final Amendments do not specify a timeframe for conducting a reorganization, these funds, like all funds, must comply with the 80% investment requirement as soon as reasonably practicable.⁵²

Use of Derivatives and Short Sales in Assessing Names Rule Compliance

The Final Amendments, consistent with the proposal, require that, in calculating its assets for purposes of Names Rule compliance, a fund value each derivative instrument using its notional amount with certain adjustments (rather than its market value). However, in a change from the proposal, a fund must value each physical short position using the value of the asset sold short.⁵³ In calculating the value of its portfolio and 80% basket, a fund may reduce the value of its derivative and short positions by the value of any held cash, cash equivalents and U.S. Treasury securities with remaining maturities of one year or less.⁵⁴ In a change from the proposal, and in response to commenters' concerns that the proposal would limit the use of derivatives for hedging purposes, a fund must exclude from its 80% calculation any

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derivatives that hedge currency risk associated with a fund's foreign-currency-denominated investments.⁵⁵ Specifically, a fund must exclude a currency derivative if it: (1) is entered into and maintained by the fund for hedging purposes; and (2) the notional amount of the derivatives does not exceed the value of the hedge investments (or the par value thereof, in the case of fixed-income investments) by more than 10%.⁵⁶

In addition to any derivative instruments that provide investment exposure to the investments suggested by the fund's name, a fund may also include in its 80% basket a derivative instrument that provides investment exposure to one or more of the market risk factors associated with the investment focus suggested by a fund's name.⁵⁷ The SEC states that, in determining whether a derivative instrument provides investment exposure to one or more of the market risk factors associated with a fund's name assets, a fund should generally consider whether the derivative provides investment exposure to any explicit input that the fund uses to value its name assets, where a change in that input would change the value of the security.⁵⁸

The Final Amendments, consistent with the proposal, require a fund to convert interest rate derivatives to their 10-year bond equivalents (by multiplying the derivative's unadjusted notional amount by the ratio of the derivative's duration to the duration of the reference security) and to delta adjust the notional amounts of options contracts.⁵⁹ According to the SEC, absent these adjustments, a fund could manufacture compliance by investing in interest rate derivatives with large unadjusted notional amounts but little exposure to the underlying reference asset.⁶⁰

Names Rule Notice

Consistent with the previous rule and proposal, the Final Amendments require that a fund notify its shareholders at least 60 days prior to any change in the fund's 80% investment policy, unless the 80% investment policy is a fundamental policy of the fund.⁶¹ The Final Amendments, however, provide for electronic delivery and further specify the content and delivery of the notice.⁶² They require the notice to contain a prominent statement that references the fact of the name change (which is in addition to the previous requirement that the notice contain a prominent statement that it contains a change in investment policy), putting investors on alert to the name change⁶³ as well as specifying that the contents of the notice include 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 change.⁶⁴

Unlisted Closed-End Funds and BDCs

The Final Amendments require that a registered closed-end fund or BDC that does not have shares that are listed on a national securities exchange that is required to adopt an 80% investment policy must make its 80% investment policy a fundamental investment policy and would only be able to change such policy by a vote of the majority of the outstanding voting securities of the fund.⁶⁵ However, in a change from the proposal, such a fund will be permitted to make changes to its 80% investment policies without this vote if

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the fund conducts a tender or repurchase offer in advance of a policy change; provided that (i) the fund give at least 60 days' notice to its investors, (ii) any tender offer is not oversubscribed and (iii) the shares are purchased at their net asset value.⁶⁶ According to the SEC, if the offer is oversubscribed, it suggests that shareholders do not support the policy change.⁶⁷ In that case, a fund would be required to conduct a shareholder vote or instead abandon the policy change. The SEC notes that the exception is designed to provide funds with increased optionality and mitigate concerns that the proposal would have put unlisted registered closed-end funds and BDCs at a disadvantage against other types of funds.⁶⁸

Form N-PORT Reporting

The Final Amendments require N-PORT filers (*i.e.*, registered investment companies and exchange-traded funds organized as unit investment trusts (“UIT”)) that have an 80% investment policy to report on their Form N-PORT (1) whether each fund investment is part of the 80% basket, (2) the value of the 80% basket, as a percentage of the value of the fund’s assets, and (3) the definitions of the terms used in the fund’s name.⁶⁹ In a change from the proposal, the Final Amendments do not require a N-PORT filer to report the number of days that the value of the fund’s 80% basket fell below 80% of the fund’s assets during the reporting period.⁷⁰

Unit Investment Trust

In a modification from the proposal, a fund organized as a unit investment trust (“UIT”) will only be subject to the 80% investment policy and recordkeeping requirements of the Final Amendments at the time of initial deposit of securities.⁷¹ The proposal, which was designed to be generally consistent with treatment of UITs under the previous rule, would have excepted UITs that made their initial deposit of securities prior to the proposal’s effective date from the requirements to adopt an 80% investment policy and to maintain written records unless the UIT already adopted – or was required to adopt at the time of initial deposit – an 80% investment policy under the previous rule.⁷² The proposal would have required a newly formed UIT to comply on an ongoing basis, which would have effectively required a UIT to rebalance its portfolio post-deposit.⁷³ Under the Final Amendments, a UIT that has a name that requires an 80% investment policy and whose initial deposit occurs after the compliance date of the Final Amendments will not be required to review its portfolios quarterly for compliance or comply with the final amendments’ temporary departure requirements.⁷⁴ Other provisions of the rule will continue to apply to all UITs.⁷⁵

Other Amendments

- **Registration Forms:** The Final Amendments modify fund registration forms—specifically, Form N-1A, Form N-2, Form N-8B-2 and Form S-6—so that each fund required to adopt and implement an 80% investment policy would also be required to include disclosure in its prospectus that defines any word or phrase used in a fund’s name related to the fund’s investment focus or strategies.⁷⁶ Such disclosures would also include the specific criteria the fund uses to select the investments that the term describes, if any.⁷⁷ While a fund has “flexibility to use reasonable definitions of the terms” used in its name, as described above, the definitions should have “a meaningful nexus between the term used in the fund’s name and the fund’s investment focus.”⁷⁸

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- **Recordkeeping:** The Final Amendments require a fund subject to the 80% investment policy to maintain records documenting its compliance. Specifically, such fund is required to maintain: (1) written records, at the time the investment is made, detailing whether and why the investment is included in the 80% basket and the value of the fund's 80% basket as a percentage of the value of the fund's assets; (2) written records documenting the fund's review of its portfolio investments, to be conducted at least quarterly; (3) written records documenting any departure from the 80% investment policy; (4) written records documenting the rationale for the fund's departure and an explanation of why the fund determined the circumstances were other-than-normal; and (5) records of any notice sent to the fund's shareholders pursuant to the rule.⁷⁹ These records must be maintained for at least six years. As described above, UITs need to comply with these requirements only at the time of initial deposit.⁸⁰ Finally, in a departure from the proposal, a fund that does not adopt an 80% investment policy is not required to maintain a written analysis of why it is exempt.⁸¹

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ENDNOTES

- 1 Investment Company Names, SEC Release No. 33-11238 (Sept. 20, 2023) (“SEC Release”), available at <https://www.sec.gov/files/rules/final/2023/33-11238.pdf>; see also SEC Fact Sheet: Final Rules: Amendments to the Fund “Names Rule” (Sept. 20, 2023), available at <https://www.sec.gov/files/33-11238-fact-sheet.pdf>.
- 2 17 C.F.R. § 270.35d-1.
- 3 *Id.* at 23.
- 4 See Investment Company Names, SEC Release No. 33-11238 (Sept. 20, 2023) (the “Proposed Amendments Release”), 82, available at <https://www.sec.gov/files/rules/final/2023/33-11238.pdf> (noting that fund names are “the first piece of fund information investors see and can have a significant impact on their investment decision”).
- 5 Despite the changes made from the proposal, Commissioner Uyeda voted against the Final Amendments, stating that the rule will create “significant compliance costs . . . [that] ultimately will be borne by investors.” Commissioner Mark T. Uyeda, Statement on Investment Company Names (Sept. 20, 2023) (“Uyeda Statement”), available at <https://www.sec.gov/news/statement/uyeda-statement-names-rule-092023>. Reversing her stance from the proposal and voting for the Final Amendments, Commissioner Peirce explained that the “final rule . . . is better and more practical than what we proposed.” Commissioner Hester M. Peirce, Pizza or Pizza? Statement on Investment Company Names (Sept. 20, 2023) (“Peirce Statement”), available at <https://www.sec.gov/news/statement/peirce-statement-names-rule-092023>. Though, both Commissioners raised concerns about the breadth of the rule and how it will be enforced. See Peirce Statement (“I do worry about . . . the potential ambiguities around what is covered and what is not”); see Uyeda Statement (“The fund names rule has been marked by difficult interpretative issues that have caused registrants and Commission staff to spend an inordinate amount of effort and resources to resolve fund name questions.”).
- 6 See Proposed Amendments Release.
- 7 The effective date for the Final Amendments is 60 days after publication in the Federal Register. Until such date, what we refer to as the “previous Names Rule” or “previous rule” in this publication is still the current rule. See SEC Release at 1.
- 8 *Id.* at 18.
- 9 See Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, SEC Release No. 33-11068 (May 25, 2022), available at <https://www.sec.gov/rules/proposed/2022/33-11068.pdf>. This separate proposal was issued on the same day as the Names Rule Proposal. For more detail on that proposal, see our [publication](#) on the ESG Proposal.
- 10 See SEC Release at 8.
- 11 *Id.* at 18; see also Final Rule 35d-1(a)(2).
- 12 *Id.* at 30. Though, in response to commenters’ concerns that “particular characteristics” was too vague, the SEC includes an illustrative parenthetical in the rule text that provides as examples fund names with terms such as “growth” or “value” and those indicating that the fund’s investment decisions incorporate one or more ESG factors. The SEC states that the parenthetical is designed to give non-exclusive examples of terms that suggest that a fund focuses on investments that have, or whose issuers have, particular characteristics. The SEC notes that it adopted this approach rather than an enumerated list of terms included in the expanded scope of the Names Rule due to the broad diversity of fund investment strategies and fund names and to ensure that the rule remains evergreen. *Id.*
- 13 *Id.* at 31.

ENDNOTES (CONTINUED)

- 14 *Id.* at 45.
- 15 *Id.* at 32-33. Themes may be industry specific, like cybersecurity, health and wellness or travel and tourism, or specific in other ways, like drones, smart cities, metaverse and big data. When using a “thematic” term that suggests an investment focus, a fund will be required to adopt an 80% policy under the Final Amendments. *Id.* at 32.
- 16 *Id.*
- 17 *Id.* at 53.
- 18 *Id.*
- 19 *Id.* at 43-44.
- 20 *Id.*
- 21 *Id.*
- 22 *Id.* at 54.
- 23 The SEC describes “ESG Uplift” strategies as a fund beginning with a given universe of investments and systemically over- or under-weights investments, but not adding new investments, within the given universe based on ESG criteria with the objective of achieving a more favorable ESG profile at an aggregate fund level as compared to the benchmark or investment universe within a specific tracking error target. *Id.* at 42-43.
- 24 *Id.* at 45.
- 25 *Id.*
- 26 See Final Rule 35d-1(g) (defining “eighty percent (80%) basket” as “investments that are invested in accordance with the investment focus that the fund’s name suggests”).
- 27 See SEC Release at 45-46.
- 28 The SEC notes that there also may be instances where the percentage could be smaller, such as where a large company is a dominant firm in a given industry. *Id.* at 47-48. The SEC also states that the use of text analytics to assign issuers to industries based on the frequency of particular terms in an issuer’s disclosures is not, in and of itself, sufficient to create a reasonable nexus because it is not 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. *Id.* at 48.
- 29 *Id.* at 46.
- 30 *Id.* at 50.
- 31 *Id.*
- 32 *Id.*
- 33 *Id.* at 121.
- 34 *Id.*
- 35 See Proposed Amendments Release at 80. In adopting the Final Amendments, the Commission notes that the reference to industry use is not designed to prevent a fund from defining a name term in reference to an emerging or developing definition or from defining a name term in a way that is subject to industry debate. See SEC Release at 123.
- 36 *Id.* at 107.
- 37 A fund’s name may also be materially deceptive or misleading if, for example, a fund complies with its 80% investment policy but makes a substantial investment with the remaining 20% basket that is antithetical to the fund’s investment focus or invests in a way such that a substantial

ENDNOTES (CONTINUED)

- portion of the fund's risk or return is different from what would reasonably be expected based on the fund's name, regardless of the fund's compliance with the requirements of the Names Rule. The SEC gives the example of a "conservative income bond" fund investing its 20% basket in highly volatile equities that introduce significant volatility into a fund that investors would expect to have lower levels of volatility associated with short-term bonds. *Id.* at 107-110.
- 38 *Id.* at 49.
- 39 Rule 35d-1(b). The amendments to the temporary departure provision are applicable not only to funds whose name suggest a particular investment focus but also to tax-exempt funds that are required to invest their assets in accordance with the provisions of Rule 35d-1(a)(3). See SEC Release at 54.
- 40 See Rule 35d-1(a)(2)(i) and Rule 35d-1(b)(1).
- 41 See SEC Release at 58 ("When a fund acquires a new investment, Investment B, the fund must assess the characteristics of Investment B when it invests to determine whether it should be included in the 80% basket. When determining whether 80% of the fund's assets are invested in the 80% basket when Investment B is made, the fund must consider the value of Investment A, but would not have to re-assess the characteristics of Investment A. Each quarter, the fund must re-assess the characteristics of Investments A and B for consistency with the fund's 80% investment policy.").
- 42 *Id.* at 58.
- 43 *Id.* at 68. The SEC did not adopt the proposal's requirement that funds would only have been permitted to depart from the fund's 80% investment policy under specified circumstances. The SEC notes that this proposed requirement, coupled with the proposed requirement that a fund come back into compliance within 30 consecutive days, would have effectively required funds to continuously assess their portfolios to determine compliance with the 80% Investment Policy. *Id.* at 34-35.
- 44 *Id.* at 58-61. The SEC received substantial commenter feedback on the burden of implementing a continual monitoring program. Commenters noted that some of the information that a fund would need to monitor may include metrics measured over a period of time longer than a single day. *Id.* This change in the Final Amendments means that fund's investments that are included in the 80% basket at the time of investment will continue to be considered part of the 80% basket unless a fund identifies them otherwise as part of its quarterly assessments. An investment that a fund identifies as inconsistent with the fund's 80% Investment Policy outside of its quarterly reassessments also would not be able to be considered as part of the fund's 80% basket. *Id.* at 58.
- 45 Under the Proposal, temporary departures would have been permitted only: (1) 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; (2) to address unusually large cash inflows or unusually large redemptions; (3) to take a position in cash and cash equivalents or government securities to avoid losses in response to adverse market, economic, political or other conditions; or (4) to reposition or liquidate a fund's assets in connection with a reorganization, 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 rule. See Proposed Amendments Rule 35d-1(b).
- 46 SEC Release at 69.
- 47 *Id.*
- 48 Rule 35d-1(b).
- 49 *Id.*

ENDNOTES (CONTINUED)

- 50 SEC Release at 75-77.
- 51 *Id.* at 79. The SEC does not believe that not imposing a time limit for departures associated with fund reorganizations is inconsistent with investors' reasonable expectations because planned reorganizations, which can take longer than 180 days, will be disclosed and likely will be a permanent change to the nature of the investor's investment. *Id.*
- 52 *Id.*
- 53 For example, if a fund sold short one share of a security for \$100, the market value of the position would be \$0 at that time because the fund has \$100 in short sale proceeds but also a liability in the form of the obligation to return a share worth \$100. If the fund had obtained the same short exposure via a swap, the notional amount would be \$100. Valuing the physical short position at \$100 for purposes of the names rule—the value of the asset sold short—provides comparable values for names rule purposes for the swap and physical short sale in this example. *Id.* at 100.
- 54 *Id.* at 194.
- 55 Funds must remove these hedging derivatives from the entire calculation, not just the 80% basket. *Id.* at 173.
- 56 Rule 35d-1(g). The SEC limited this exclusion to currency derivatives so as to ensure that it would not result in the Names Rule calculation excluding instruments that create economic exposures that should be considered in assessing whether a fund's name is materially deceptive in light of its portfolio. See SEC Release at 86-88. The Commission has previously distinguished currency derivatives, when directly matched to particular investments held by the fund, as instruments that predictably and mechanically provide the anticipated hedging exposure. On the other hand, other types of hedging transactions executed through derivatives are difficult to distinguish from transactions that create exposures that contribute to (or detract from) the investment focus that a fund's name suggests. While no commenter suggested the specific approach to currency derivatives that the final amendments include, according to the SEC, this approach addresses commenters' concerns about ways in which the proposal could limit hedging activities. *Id.*
- 57 *Id.* at 173.
- 58 *Id.* at 99. The SEC gives the example of a fund whose name indicates a focus in mortgage securities to include derivatives in its 80% basket that manage the prepayment risk of these securities. *Id.* at 99-100. When a fund calculates the value of its 80% basket, all derivative instruments, other than those used to hedge against currency risk, would be included in the denominator in the calculation, and all derivatives in the fund's 80% basket would be included in the numerator in the calculation. *Id.* at 196.
- 59 35d-1(g).
- 60 *Id.* at 89. The SEC gives the example of deep out-of-the-money options that are notionally substantial but provide little exposure to the reference security. *Id.* at 90.
- 61 Final Rule 35d-1(a)(2)(ii) and Final Rule 35d-1(d); see also Final Rule 35d-1(g).
- 62 See SEC Release at 125.
- 63 *Id.*
- 64 *Id.* at 128.
- 65 *Id.* at 19-20.
- 66 *Id.*
- 67 *Id.* at 107.
- 68 *Id.* at 106.

ENDNOTES (CONTINUED)

69 *Id.* at 129-133.

70 The final Form N-PORT amendments modify the proposed reporting approach by requiring reported information for the third month of each quarter, instead of for every month. Given that the final amendments will not require continual names rule compliance monitoring as proposed, and instead will require that a fund review its portfolio for compliance no less than quarterly, the reporting timeframe in the final Form N-PORT requirements therefore reflects the period for review that will otherwise be mandated by the Final Amendments. *Id.*

71 *Id.* at 149-150.

72 *Id.* at 148.

73 *Id.*

74 *Id.* at 149-150.

75 *Id.*; see also Rule 35d-1(e).

76 *Id.* at 113.

77 *Id.*

78 *Id.* at 116. See also *id.* at 117 (noting the requirement that funds tag new information using Inline eXtensible Business Reporting Language, a structured, machine-readable data language).

79 *Id.* at 141-142.

80 *Id.* at 148.

81 *Id.* at 140-141.

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