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SEC Modernizes the "Names Rule" for Funds

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What's in a name? According to the Securities and Exchange Commission, quite a bit. On September 20, 2023, the SEC **adopted amendments** to the Investment Company Act of 1940, most notably to the "Names Rule" governing the names of funds to ensure that they do not mislead investors regarding the fund's risks and investment characteristics. **The SEC commented** that the updates are designed to "address[] materially deceptive and misleading use of environmental, social, or governance (ESG) terminology in fund names."

As the SEC noted, the fund's name "is the first piece of information that investors receive" and **signals to investors** the types of investments the fund will pursue. The Names Rule was first implemented in 2001 and required any fund whose name suggested an investment in a particular type of industry or geographic location to invest 80% of its assets accordingly. This 80% rule could be implemented in two ways: (1) a fund could implement a "fundamental policy" for its investment strategy that could not be changed without shareholder approval; or (2) a notice policy that allowed a fund to amend its investment strategy subject to a 60-day notice period to shareholders.

The amended rule will implement five major new changes:

First, the 80% investment policy requirement will now apply to any fund name that contains terminology suggesting the fund invests according to certain themes and characteristics. The "primary types of names" that the revised rule is intended to cover are ones like "growth" or "value" or terms that reflect the fund's intention to align itself with ESG factors. The rule will also require a fund to value its derivative investments according to the derivatives' notional amount instead of its market value when calculating compliance with the 80% rule.

Second, funds will be required to inform investors through prospectus disclosures the definitions of the terms used in the fund's name as well as the criteria for determining which investments the fund will pursue in connection with its thematic investment strategy. Additionally, any fund names that imply a particular investment focus or tax-exempt status must be consistent with the plain-English use of those terms or relevant industry terminology.

Third, funds will still be required to comply with the 80% rule at the time the fund invests assets and "under normal circumstances." The amendments now additionally require the fund to review its investment portfolio on a quarterly basis and provides for a 90-day period to restore compliance if a fund is out of compliance with its 80% investment policy.

Fourth, a registered closed-end fund whose shares are not listed on a national securities exchange by and large will be prohibited from altering its 80% investment policy absent shareholder approval. The SEC commented that this requirement is intended to prevent funds from altering their investment strategy where holders of the fund are limited in their options to sell their investments. Under the amendments, a fund can avoid a shareholder vote if it offers a repurchase or tender opportunity.

Fifth, the amendments update the notice requirement for certain funds to address the use of electronic delivery methods and communications to provide additional specificity regarding the substantive content of the notice and delivery mechanisms.

The amended rule became effective as of December 10, 2023. Fund with net assets in excess of $1 billion will be required to comply within 24 months, while those with less than $1 billion will have 30 months.

Taking the Temperature: The Names Rule is consistent with the SEC's overall focus on ESG issues. For example, as we have noted previously, the SEC formed the ESG Task Force within the Division of Enforcement "to develop initiatives to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment." Likewise, the SEC's Division of Examinations' examination priorities for 2023 included a focus on ESG-related advisory services and fund offerings. The SEC stated that "the Division will continue its focus on ESG-related advisory services and fund offerings, including whether funds are operating in the manner set forth in their disclosures. In addition, the Division will assess whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in the investors' best interests." The Names Rules furthers this examination priority. Even earlier, in April 2021, the Division of Examinations issued a Risk Alert focused on ESG investment by asset managers, stating that "in response to investor demand, investment advisers and funds have expanded their various approaches to ESG investing and increased the number of product offerings across multiple asset classes. This rapid growth in demand, increasing number of ESG products and services, and lack of standardized and precise ESG definitions present certain risks. For instance, the variability and imprecision of industry ESG definitions and terms can create confusion among investors if investment advisers and funds have not clearly and consistently articulated how they define ESG and how they use ESG-related terms, especially when offering products or services to retail investors. Actual portfolio management practices of investment advisers and funds should be consistent

with their disclosed ESG investing processes or investment goals." In July 2021, the SEC's Asset Management Advisory Committee's ESG subcommittee issued a series of recommendations "to improve the data and disclosure used for ESG investing, in order to create better transparency for investors, and better verifiability of investment products' ESG strategies and practices."

More generally, financial regulators in many jurisdictions have attempted to address ESG-related issues in the asset management industry, in part due to greenwashing concerns. We reported late last year, for instance, on the decision by a number of large asset managers to downgrade European ESG funds totaling tens of billions of dollars from Article 9 – the highest sustainability classification under the EU's Sustainable Finance Disclosure Regulation (SFDR) – to the broader, and less restrictive, Article 8. These announcements followed draft guidelines published by the European Securities and Markets Authority as part of a consultation on funds' names using ESG or sustainability-related terms. As defined in the SFDR, Article 8 funds are those that promote Environmental or Social characteristics but do not have them as the overarching objective. Article 9 funds are those that have specific sustainable goals as their objective.