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Funds Not Caged by SEC Names Rule Amendments: Roaming Room Remains

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The SEC recently adopted amendments to its investment company "names" rule that apply to most SEC-registered funds, including underlying funds in which registered insurance company separate accounts invest. While the amendments, and the SEC's interpretive guidance in its adopting release, are quite extensive, some of the key effects are to:

- Revise the analysis of what words, if included in a fund's name, will require the fund generally to follow a policy of investing at least 80% of the fund's net assets in industries, investment types, or geographical areas suggested by the fund's name. For example, unlike the rule previously in force, the amendments add names referring to "value" or "growth" or mentioning "ESG" factors to the many other names that generally require an 80% policy.
- Add new requirements that, if a fund is required to adopt an 80% policy, (a) the fund's prospectus (as well as periodic reports the fund files with the SEC on Form N-PORT) must include disclosures defining the terms used in its name, including the specific criteria, if any, that the fund uses to select investments described by those terms, and (b) those definitions must be reasonable and consistent with the terms' "plain English" meanings or established industry use. Most of this new prospectus information must be tagged using Inline XBRL.
- Require such a fund to (a) monitor compliance with its 80% policy at least quarterly (as well as, under normal circumstances, at the time of any investment); (b) restore compliance within 90 days after any noncompliance is identified (including noncompliance resulting from changes in the value or characteristics of the fund's existing portfolio investments or any decision by a fund to deviate from the 80% policy due to non-normal circumstances); and (c) on a quarterly basis report to the SEC on Form N-PORT the then percentage of the fund's net assets that it classifies as qualifying for the 80% basket and, as to each portfolio investment, whether that investment is so classified.

- Call for a "meaningful nexus" to exist between the fund's name and each portfolio investment that the fund assigns to its 80% basket, as the SEC adopting release prescribes and explains in some detail.
- Add new requirements for how derivative positions held by a fund must be treated for purposes of the 80% test.
- Prescribe extensive additional record-keeping requirements for funds that must follow an 80% policy, although other funds are relieved of a previous requirement to maintain certain records documenting their decision that they do not require an 80% policy.

These and other consequences of the amendments raise a number of potentially important questions and decisions for funds, at least some of which may require or merit considerable analysis. For example:

- For a fund that does not currently follow an 80% policy, (a) do the amendments require the fund to adopt such a policy, and (b) if so, should the fund modify its investment program or name to escape any such requirement?
- For a fund that currently follows an 80% policy, (a) do the amendments permit the fund to terminate that policy without making any change in its investment program or name, and (b) should the fund terminate its 80% policy, even if it must change its investment program or name to do so?
- For a fund that decides to follow an 80% policy in compliance with the amended rule, can and should the fund make any changes in its investment program or the administration thereof to reduce the burdens or costs of such compliance? In most cases, some cost-savings can be achieved.

Fortunately, the amendments leave the door open for funds to take actions that in many cases will enable them to escape or mitigate the costs and burdens of being subject to an 80% policy requirement. This is especially important, because the changes outlined above will substantially increase those costs and burdens.

Authored By

Thomas C. Lauerman

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