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Securities Regulation Daily Wrap Up, INVESTMENT COMPANIES—SEC tightens rule that guards against misleading investment fund names, (Sept. 20, 2023)

Securities Regulation Daily Wrap Up

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By Suzanne Cosgrove

A fund's name is the first data point an investor encounters when weighing an investment option, one commissioner noted.

The SEC on Wednesday approved, by a 4-to-1 Commission vote, the adoption of amendments to Rule 35d-1, known as the fund names rule, under the Investment Company Act of 1940. The changes address concerns that certain fund names could delude investors about an investment company's holdings and risks and update the original funds name rule that took effect more than 20 years ago.

"As the fund industry has developed over the last two decades, gaps in the current names rule may undermine investor protection," said SEC Chair Gary Gensler in introductory remarks ahead of the vote. "Today's final rules will help ensure that a fund's portfolio aligns with a fund's name," he said.

The updated rule will apply not only to funds whose names suggest a focus in particular investments, industries, or geographies -- but also to funds whose names indicate they hold investments with particular characteristics, including names that reference environment, social and governance (ESG)-related factors through names such as "sustainable," "green," or "socially responsible," Gensler said.

It also includes names that imply a focus on characteristics like "growth" and "value," or thematic names, like those that reference artificial intelligence, big data, or health innovation.

Specifically, the SEC stated that the amendments aim to improve and broaden the scope of funds that must comply with the current requirement to adopt a policy to invest at least 80 percent of their assets in accordance with the investment focus that is suggested by the fund's name. The amendments also provide enhanced disclosure and reporting requirements related to terms used in fund names, and they establish additional recordkeeping requirements.

The Commission is also adopting enhanced prospectus disclosure requirements for terminology used in the fund names, and additional requirements for funds to report information on Form N-PORT regarding compliance with the names-related regulatory requirements.

80 percent target. "I hope investors continue to review other disclosures like fund prospectuses and shareholder reports, but the premise of the names rule is that investors should be able to get a general idea (about their investments) from the fund's name itself," said Commissioner Caroline Crenshaw.

Under the original rule, 60 percent of funds were required to invest at least 80 percent of the fund's assets in the investment focus suggested by its name, said Commissioner Jaime Lizárraga. "With today's reforms, more than three-quarters of funds in the marketplace will now be covered by an improved standard that more accurately represents the fund's investment mix."

To address the rule's application to derivatives instruments, the amendments will require funds with derivatives in their holdings to use the derivatives' notional amount, rather than their market value, to determine the funds' compliance with their 80 percent investment policy.

ESG funds and greenwashing. Since the names rule was first adopted in 2001, certain trends have emerged that warrant targeted action, including the broadening of fund investment options and the growth of ESG investment strategies, Lizárraga said.

One study found that by the end of 2021, approximately $8 trillion of the total U.S. assets under management was invested in sustainable strategies, he said. Between 2001 and 2021, ETFs and equity mutual funds that invest in specific sector funds increased by 70 percent.

The rise in investor-driven demand for ESG products has been accompanied by a worrying trend in disclosures that fail to accurately support the underlying investment mix – often referred to as “greenwashing,” Lizárraga noted. The rule reforms provide clarity to investors by preventing a fund from calling itself a name that is misleading, deceptive, or inconsistent with its investments, he said.

Solitary objection. Commissioner Hester Peirce raised several questions about the fund name rule amendments, including whether the commissioners were overselling them. “What investors don’t realize is that funds with the same name can be very varied,” she said. Nonetheless, she voted to support the release, which she said was more practical than what was originally proposed: it requires only quarterly review of investments for consistency with the 80 percent test and allows up to 90-day departures from the 80 percent test under other-than-normal circumstances.

Further, the N-Port requirements, while onerous and costly, “could be a step towards modernizing the disclosure program by allowing more automation,” Peirce said.

However, Commissioner Mark Uyeda cast his vote against the final rule amendments. “While the adopting release makes a number of changes from the proposal, they ultimately do not go far enough,” Uyeda said.

“I am particularly concerned with the potential lack of transparency as to how the Commission’s staff will administer the rule,” he said. “Smaller funds may not have the resources to sift through a mountain of EDGAR correspondence to decipher the staff’s views, and all funds – including larger funds – will incur significant costs in complying with the expanded rule.”

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