2024 IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE

THE LATEST TRENDS AND COMPLIANCE BEST PRACTICES FOR REGISTERED INVESTMENT COMPANIES

STRADLEY RONON STEVENS & YOUNG, LLP

SARA CROVITZ

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Please note that this outline reproduces discussion and analysis that were published by Stradley Ronon Stevens & Young, LLP in client alerts and various publications put out closest to the dates of the rulemaking developments described throughout. Accordingly, while some of the timing descriptions have been updated, the specific commentary continues to speak as of the date of each original alert.

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COMPLIANCE-RELATED ENFORCEMENT ACTIONS:

SEC ENFORCEMENT ACTION FOR INADEQUATE AML PROGRAM IN VIOLATION OF RULE 38a-1

Based on a regulatory update originally published on November 30, 2023

The SEC has instituted and settled an administrative proceeding against the investment adviser to a mutual fund family in connection with the funds' failure to develop and implement a reasonably designed anti-money laundering ("AML") program.[1] The rules of the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") require mutual funds to develop and implement AML programs tailored to their own business structures, including certain minimum requirements. However, for a period of several years the funds did not have an AML compliance program specifically for mutual funds. Instead, the funds adopted an AML program designed for the U.S. operations of the adviser's parent, a large multinational bank, which did not address the specific AML compliance requirements for the mutual fund business. The funds also relied on a vendor-provided software system for transaction monitoring, but the funds failed to periodically calibrate the system to evaluate its effectiveness, allowed most alerts to be closed without review, and failed to review dozens of transaction types. In addition, the funds failed to provide ongoing training to employees for several years, even though that training is specifically required by rule.

The SEC found that the adviser, which was responsible for establishing AML policies and procedures for the funds, caused the funds' violation of Rule 38a-1 under the 1940 Act. That rule requires registered funds to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, including AML rules adopted by FinCEN. The adviser was ordered to cease and desist from further violations of Rule 38a-1 and to pay a civil money penalty in the amount of $6 million. The SEC stated that it took into account remedial acts undertaken by the adviser and cooperation afforded the SEC staff. The adviser neither admitted nor denied the SEC's findings.

SEC CONTINUES TO FOCUS ON ESG; THIRD ADVISER SETTLES ESG-RELATED ENFORCEMENT PROCEEDING

Based on client alert originally published September 28, 2023

On Sept. 25, 2023, the Securities and Exchange Commission (SEC or the Commission) entered into a settlement order (the Order) with DWS Investment Management Americas, Inc. (DIMA) for alleged violations of Sections 206(2) and 206(4) of the Investment Advisers Act of 1940, as amended (Advisers Act), and Rules 206(4)-7 and 206(4)-8 thereunder.[2] DIMA agreed to cease

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[1] *DWS Investment Management Americas*, Release No. IA-6431 (Sept. 25, 2023), https://www.sec.gov/files/litigation/admin/2023/ia-6431.pdf.

[2] In re: DWS Investment Management Americas, Inc., IAA Release No. 6432 (Sept. 25, 2023), available at https://www.sec.gov/files/litigation/admin/2023/ia-6432.pdf.

and desist from violating the Advisers Act and a censure; it also agreed to pay a $19 million penalty.

In the Order, the Commission alleges that DIMA made materially misleading statements about its controls for incorporating environmental, social and governance (ESG) factors in research and investment recommendations for ESG-integrated products, including certain actively managed mutual funds and separately managed accounts. Additionally, the Commission alleges that DIMA marketed itself as a leader in ESG that adhered to specific policies for integrating ESG considerations into its investments, but that DIMA failed to implement certain provisions of its global ESG integration policy as it had led clients and investors to believe it had. Finally, the Commission noted DIMA's failure to adopt and implement policies and procedures reasonably designed to ensure that its public statements about its ESG-integrated products were accurate.

According to the Order, even though DIMA marketed itself as an ESG leader to clients and to investors in the funds that it managed, beginning in August 2018, DIMA failed to adequately implement certain provisions of the DWS Group GmbH & Co. KGaA (DWS, DIMA's parent company) global ESG integration policy (the Policy) in advising DIMA's ESG integrated products or to otherwise adopt and implement reasonably designed policies and procedures to ensure that its public statements about ESG integrated products were accurate. Among other things, in 2019, a version of the Policy was uploaded on DWS's U.S. public website, through which DIMA marketed its advisory services. In marketing itself and its managed funds and strategies, DIMA represented that, through this Policy, its research analysts were required to include financially material and reputation-relevant ESG aspects in valuation models, investment recommendations, and research reports and consider material ESG aspects as part of their investment decisions. However, the SEC concluded that this representation was misleading because DIMA failed to adequately implement the Policy's research and monitoring compliance requirements. The SEC found internal analyses showed DIMA research analysts having inconsistent levels of documented compliance with the Policy's requirements to consider ESG factors in research and valuation models. The Policy remained published on the website, creating the impression that DIMA's employees were following the Policy.

The Order follows similar settlements by Goldman Sachs Asset Management, L.P. (GSAM)[3] and by BNY Mellon Investment Adviser, Inc. (BNY)[4], for ESG policies and procedures failures. In the GSAM settlement, the SEC order stated that GSAM, despite having a common framework for ESG investment processes that included a proprietary ESG questionnaire, did not complete the ESG questionnaire for all issuers prior to those issuers' inclusion in ESG investment products. In the BNY settlement, the SEC order stated that BNY misstated ESG policies for certain mutual funds that it managed, and that BNY represented or implied in various statements that all investments in the funds had undergone an ESG quality review, even though that was not always the case.

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[3] In re: Goldman Sachs Asset Management, L.P., IAA Release No. 6189 (Nov. 22, 2022), available at https://www.sec.gov/files/litigation/admin/2022/ia-6189.pdf (GSAM Settlement).

[4] In re: BNY Mellon Investment Adviser, Inc., IAA Release No. 6032 (May 23, 2022), available at https://www.sec.gov/files/litigation/admin/2022/ia-6032.pdf (BNY Settlement).

KEY TAKEAWAYS:

- The SEC is maintaining its position that investment advisers should adopt compliance policies and procedures under Rule 206(4)-7 related to the ESG investment process. Although Rule 206(4)-7 does not explicitly require policies related to investment processes, this enforcement action and the two before it demonstrate that the SEC interprets the compliance rule to require such policies to prevent ESG-related funds from deviating from their stated investment goals. Investment advisers should consider their existing policies and procedures in light of this Order.
- The Order does not allege any facts indicating that DIMA's employees' failure to comply with the Policy and consider ESG factors in research and valuation models materially impacted the employees' investment decisions, nor does it allege any material impact on clients or investors. These omissions indicate that the SEC continues to seek to enforce technical violations of the Advisers Act and rules, regardless of materiality to investment decisions. Investment advisers should consider reevaluating their training for applicable personnel (compliance, investments, legal, etc.) to confirm that all personnel understand their obligations regarding the firm's ESG policies and practices. Investment advisers also should confirm that appropriate monitoring and controls are in place with regard to those policies and procedures.
- The SEC's investigation began more than two years ago, after a whistleblower alleged that DWS's annual report grossly exaggerated the amount of assets that were under ESG integration. As DWS noted in its press release relating to the settlement, the Order does not allege material misstatements in relation to DIMA's financial disclosures or the prospectuses of its funds.
- **The penalties against investment advisers for failing to adopt and/or implement ESG policies and procedures are increasing.** While the BNY settlement was for $1.5 million, and the GSAM settlement was for $4 million, this Order eclipses the other two with a $19 million penalty (in spite of the Order's statement that the SEC gave DIMA remediation and cooperation credit).

PRACTICAL GUIDANCE FOR FUND DIRECTORS ON VALUATION OVERSIGHT

Based on practical guidance originally published in October 2023

Executive Summary

Proper valuation of a fund's portfolio securities is critical to the calculation of a fund's net asset value per share. While fund independent directors do not play a day-to-day role in the pricing of a fund's individual investments, directors bear the ultimate responsibility for valuing those securities without a readily available market quotation. Under section 2(a)(41) of the Investment Company Act of 1940 (the "1940 Act"), such securities must be assigned a "fair value" as determined in good faith by a fund's board of directors.

Rule 2a-5 under the 1940 Act ("Rule 2a-5" or the "Rule") provides requirements for determining fair value in good faith, addresses valuation practices, and outlines the role of a fund's board of directors with respect to the fair value process. Rule 2a-5 allows the board to designate a valuation

designee to perform fair value determinations. In almost all cases, the valuation designee must be the fund's investment adviser. When boards designate a valuation designee, the board's role becomes one of oversight.

This outline examines the valuation of a fund's portfolio securities, requirements surrounding fund valuation procedures, the board's responsibility in overseeing valuation, and the responsibilities of the valuation designee under Rule 2a-5. Beyond the specific requirements of Rule 2a-5, boards must determine how to perform their ongoing oversight, including considering how to organize themselves to oversee the valuation process; determining the frequency, type and format of board reporting; and developing a communication process with management.

The board, however, may avail itself of additional assistance for valuation oversight. The fund's chief compliance officer ("CCO"), auditor, and the fund's and/or independent directors' legal counsel each have a unique perspective on the valuation process that can be helpful to fund directors.

Director oversight of valuation is a board responsibility and acts as a safeguard to protect a fund and its shareholders. This outline provides an overview of the legal responsibilities of directors in carrying out these important duties and offers suggestions directors may find useful in doing so.

Valuation Introduction

Proper valuation of a fund's assets is essential for the calculation of net asset value per share ("NAV"). The 1940 Act permits transactions in open-end fund shares only at a price based on NAV.[5]

Inaccurate valuation of a fund's underlying investments can have significant consequences if not identified and corrected. If portfolio securities are not valued appropriately, one category of shareholders (either sellers of fund shares or buyers of the shares) will gain a benefit at the expense of the other group. A consistent and accurate valuation process is essential for pricing of fund shares and performance calculations.

Fund directors have a statutory obligation to determine the fair value of securities for which market quotations are not readily available.[6] However, Rule 2a-5 permits boards to designate the day-to-day responsibility for determining the fair value of all or some securities to a "valuation designee," who generally must be the fund's adviser.[7] Rule 2a-5 generally requires that the board, or the valuation designee:

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[5] *See* Rule 22c-1 under the 1940 Act, which applies to open-end funds and unit investment trusts. Calculation of NAV is also important for closed-end funds, including those closed-end funds that issue new shares. It also enables investors in exchange-traded closed-end funds to determine whether their shares are trading at a premium or discount. *See* Section 23(b) of the 1940 Act. Under Rule 2a-7 under the 1940 Act, money market funds are permitted to use amortized cost or penny rounding method to value fund shares. This report does not address these issues.

[6] Rule 2a-5(b).

[7] *Id.*

- Assess and manage valuation risks;
- Establish and apply fair value methodologies;
- Test the appropriateness and accuracy of the methodologies selected; and
- Oversee pricing services, if used.[8]

When a board designates the fair value determinations to its adviser under Rule 2a-5, the board's role becomes one of oversight, largely through various reporting requirements outlined in Rule 2a-5.[9] Given that boards typically designate valuation responsibilities to a valuation designee, this outline assumes such designation throughout and discusses valuation-related responsibilities accordingly.[10]

Rule 2a-5 replaces a patchwork of prior SEC guidance that surrounded the valuation process. The Rule establishes a consistent framework for determining fair value.[11] In addition to the permitted designation, the Rule provides more formalized processes for management of valuation risks, oversight of pricing services, and testing of valuation methodologies.

The following graphic generally illustrates the responsibilities of the board and valuation designee.

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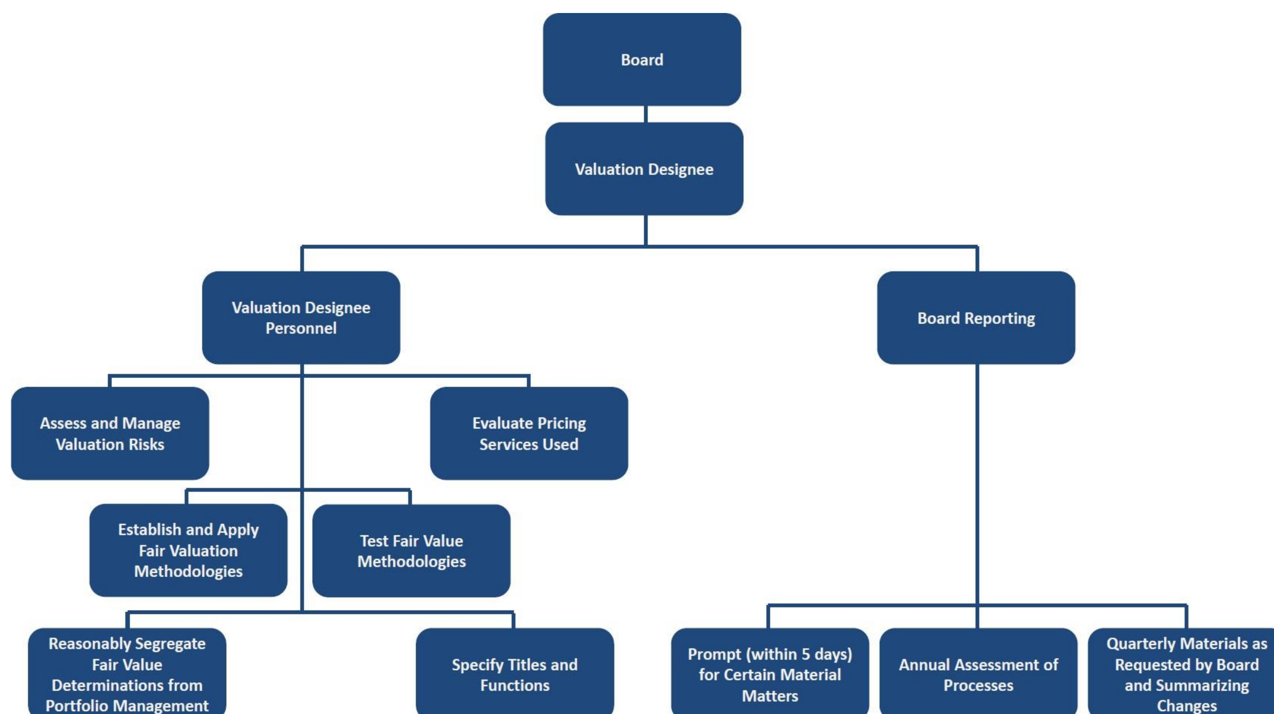
[8] Rule 2a-5(a).

[9] *See* Good Faith Determinations of Fair Value, Investment Company Act Release No. 34128 (Dec. 3, 2020) (hereinafter, the "Adopting Release"), at 9.

[10] Some boards may be unable to designate fair value determinations, for example, due to constraints at the adviser regarding segregation of valuation from portfolio management personnel.

[11] Adopting Release at 7-8.



The Adopting Release states that board oversight of valuation should be an "iterative process."[12] Such a standard requires that boards and service providers remain vigilant to new issues and changing market dynamics that may create price uncertainty in the valuation process. The fund's valuation procedures should adapt to meet changes in a fund's investment strategies and underlying investments. Due to the constantly evolving nature of valuation issues, advisers and boards should work together to build a process that continues to be actively monitored and effective.

This outline[13] is designed to provide information to boards about their responsibilities for fund valuation. Because Rule 2a-5 applies to all registered investment companies, including open-end mutual funds, exchange-traded funds, business development companies, and closed-end funds,[14] the information provided herein is intended to be broadly useful for fund boards of all types. This outline will detail the legal requirements related to fund valuation practices and discuss how boards may carry out their responsibilities in overseeing the valuation process.

How is NAV Determined?

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[12] *Id.* at 57.

[13] This publication has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. One representative from each member group serves on the Forum's Steering Committee. The Forum's current membership includes over 1000 independent directors, representing 145 mutual fund groups. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues relating to its individual circumstances.

[14] Adopting Release at 9.

The 1940 Act requires that registered investment companies offer and redeem their shares at a price based on the fund's current NAV.[15] A fund's NAV per share is calculated based on the value of the fund's portfolio securities and other assets less any liabilities, divided by the total number of outstanding shares of the fund. Mutual funds calculate their NAVs on each business day at a time set by the fund.[16] Most funds calculate their NAVs at the time of the close of the New York Stock Exchange ("NYSE"), which is usually 4:00 pm Eastern time. Under the 1940 Act, securities and assets without "readily available" market quotations are valued at fair value as determined in good faith by a fund's board of directors.[17] Rule 2a-5 defines "readily available" and establishes requirements for determining fair value in good faith for purposes of the 1940 Act.

"Readily Available" Market Quotes

If a security has a market quotation that is "readily available," its value is that market quotation.[18] A market quotation is considered readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.[19]

The definition of "readily available market quotations" is consistent with the definition of a level 1 input in the fair value hierarchy outlined in U.S. Generally Accepted Accounting Principles ("GAAP"). A security will be considered to have a readily available market quotation if its value is determined solely by reference to these level 1 inputs.[20] Level 1 inputs are defined as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date, and generally correspond with exchange-traded securities and certain derivatives.[21]

Market Quotations Not "Readily Available"

In some cases, market quotations are not "readily available," even for securities trading on exchanges. For instance, a particular security may have had a market quotation, but the price may no longer be reliable if there has been a gap in time or if a significant event has taken place after the last market price, but before the fund's NAV is calculated so that the quotation does not reflect

[15] *See* Rule 22c-1 under the 1940 Act.

[16] *See* Rule 22c-1(b) under the 1940 Act (requiring the NAV to be calculated at least once daily at the time or times set by the fund's board).

[17] Section 2(a)(41) of the 1940 Act. *See also* Rule 2a-4 under the 1940 Act.

[18] *See* Section 2(a)(41) under the 1940 Act.

[19] Rule 2a-5(c).

[20] Adopting Release at 89.

[21] Financial Accounting Standard Board Accounting Standards Codification 820: Fair Value Measurements and Disclosures (hereinafter "ASC 820").

the current market value at the time a fund calculates its NAV.[22] For example, the fund may be unable to rely on the last market price in the following circumstances:

- The primary market on which a security trades (other than the NYSE) closes before the time at which the fund's NAV is calculated;
- A security experiences a halt in trading;
- Events close markets early;
- Scheduled market holidays (other than NYSE holidays); and
- An absence of trading in a particular security.

Equity securities of foreign issuers traded on foreign exchanges are likely to fall into this category. Foreign markets close before the close of the NYSE; therefore, the closing price of the foreign exchange may be several hours old at the time a fund calculates its NAV. With respect to foreign securities, the SEC has stated that funds generally should identify and monitor for the kinds of significant events that, if they occurred after the market closes in the relevant jurisdiction but before the fund prices its shares, would materially affect the value of the security and therefore may suggest that market quotations are not reliable.[23] To address this, many fund groups systematically determine the fair value of equity.

securities traded in foreign countries as of the time a fund calculates its NAV. Many fund groups also employ third-party pricing services that offer methodologies involving statistical analyses and quantitative models for calculating fair value adjustments that can be applied to such foreign equities.

In addition to foreign securities, many fixed-income securities, securities traded over the counter ("OTC"), and securities priced using evaluated prices from third-party pricing services also are not considered to have readily available market quotations.[24]

"Fair Value"

If a security's price is deemed not to be "readily available," that security must be fair valued. Fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[25] The SEC has recognized that for any particular investment, there may be a range of appropriate values that could reasonably be considered fair value, and

The SEC has recognized that there may be more than one value that is reasonably considered fair value.

[22] Adopting Release at 26.

[23] *Id.*

[24] *Id.* at 94-95.

[25] *Id.* at 23, n. 67; ASC 820.

fair value will depend on the facts and circumstances of the particular investment, the relevant market, and market participants.[26]

What are the Valuation Designee's Responsibilities under Rule 2a-5?

Boards Typically Designate Day-to-Day Responsibilities for Valuation

Rule 2a-5 specifically allows a board to designate a valuation designee, who in almost all cases must be the fund's adviser.[27] The SEC limited designation to the adviser given the adviser's fiduciary duties to, and comprehensive and direct knowledge of, the fund(s) it advises.[28]

Fund Valuation Procedures

Policies and procedures reasonably designed to comply with the requirements of Rule 2a-5 must be adopted under Rule 38a-1 under the 1940 Act ("Rule 38a-1").[29] **Where the board has designated a valuation designee, the valuation designee must adopt, and the board must approve, policies and procedures to comply with the requirements of Rule 2a-5.**[30] While funds had valuation policies and procedures prior to the adoption of Rule 2a-5, implementation of the Rule required most funds and advisers to update their policies and procedures to align with the new requirements. The policies and procedures should be reasonably designed to:

- Periodically assess material risks associated with the determination of the fair value of fund investments, including material conflicts of interest, and manage those identified valuation risks;
- Establish and apply appropriate fair value methodologies to be used in the valuation process (including periodic review of the appropriateness and accuracy of the methodologies, and monitoring for circumstances that may necessitate the use of fair value);
- Periodically test appropriateness and accuracy of the fair value methodologies used in the valuation process; and
- Oversee pricing services (third-party vendors that provide pricing estimates and other information to funds) when used in the valuation process.

Each of these requirements is discussed in more detail below.

Assess and Manage Valuation Risks

[26] Adopting Release at 22.

[27] *See id.* at 8.

[28] *See id.* at 44-45.

[29] *Id.* at 38-39.

[30] *Id.* at 40.

Rule 2a-5 requires periodic assessment of any material risks associated with the determination of fair value of a fund's investments, including any material conflicts of interest.[31] Once risks are identified, they must be managed.[32] The Rule gives the valuation designee flexibility to determine a fund's particular risks and how often those risks should be assessed and reevaluated.[33] The SEC has provided the following non-exhaustive list of examples of valuation risks that may be considered:

- The types of investments held or intended to be held by the fund and the characteristics of those investments;
- Potential market or sector shocks or dislocations and other types of disruptions that may affect a valuation designee's or a third-party's ability to operate;
- The extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the valuation designee;
- The proportion of the fund's investments that are fair valued as determined in good faith (especially with respect to securities valued using level 3 inputs), and their contribution to the fund's returns;
- Reliance on service providers that have more limited expertise in relevant asset classes, the use of fair value methodologies that rely on inputs from third-party service providers, and the extent to which third-party service providers rely on their own service providers (so-called "fourth- party" risks); and
- The risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.[34]

As the SEC's list of risks is not meant to be exhaustive, additional risks may apply to a given fund. Please see Appendix 1 for some additional potential valuation risks and questions that boards may want to consider.

Establish and Apply Fair Value Methodologies

Rule 2a-5 requires establishing and applying fair value methodologies, which must entail:

- Selecting and applying in a consistent manner appropriate fair value methodologies, including specifying the key inputs and assumptions specific to each asset class or portfolio holding;
- Periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary changes or adjustments; and

[31] Rule 2a-5(a)(1).

[32] *See id.*

[33] Adopting Release at 14.

[34] *Id.* at 16-17.

- Monitoring for circumstances that may necessitate the use of fair value.[35]

A fund's valuation process must include a description of the methodologies that the adviser will use when making fair valuation determinations.[36] The SEC expects such descriptions to be fairly detailed; simply stating the name of a model to be used would not be sufficient without providing additional detail on the specific qualitative and quantitative factors to be considered, the sources of the methodology's inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take the form of a formula).[37] Methodologies often establish a hierarchy that determines the sources that an adviser will use when valuing securities. Different hierarchies can be established for different types of securities. Fair valuation methodologies may be changed if different methodologies are equally or more representative of fair value of the investments, and such changes must be reported to the board as required by Rule 2a-5.[38] Methodologies must be consistent with the principles of the valuation approaches laid out in ASC 820.[39]

Testing of Fair Value Methodologies

Rule 2a-5 requires testing the appropriateness and accuracy of the fair value methodologies used, which must include identifying such testing methods, and the minimum frequency with which testing will occur.[40] Rule 2a-5 does not prescribe particular testing methods or a minimum frequency for testing, leaving this to funds to determine based on their unique circumstances.[41] Calibration and back-testing are common examples of testing used by funds. Calibration, according to the SEC, "is the process for monitoring and evaluating whether there are material differences between the actual price the fund paid to acquire portfolio holdings that received a fair value under the [1940] Act and the prices calculated for those holdings by the fund's fair value methodology at the time of acquisition."[42] Back-testing, according to the SEC, "involves a comparison of the fair value ascribed to the fund's investment against observed transactions or other market information, such as quotes from dealers or data from pricing services."[43]

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[35] Rule 2a-5(a)(2).

[36] *See* Adopting Release at 18, n. 51.

[37] *Id.*

[38] Rule 2a-5(a)(2)(i); Rule 2a-5(b)(1)(i)(A)(2)(ii).

[39] Adopting Release at 21.

[40] 2a-5(a)(3).

[41] 2a-5(a)(3).

[42] *Id.*, n. 89.

[43] *Id.* at 30, n. 91

Funds have flexibility to determine

testing methods and frequency.

In addition to calibration and back-testing, other commonly used testing methods include:

- Data analysis using vendor pricing (for instance, comparing prices provided by various pricing services);
- Conducting "deep dives" of methodologies and assumptions applied to a sample of securities;
- Price challenges; and
- Utilizing third parties to test certain methodologies.

Oversight of Pricing Services

Many funds use third-party pricing services. Rule 2a-5 requires that the valuation designee oversee pricing services, if used, including establishing the process for approving, monitoring, and evaluating each pricing service provider.[44] Pricing services should be subject to oversight so that the valuation designee has a reasonable basis to use the pricing information it receives as an input in determining fair value in good faith.[45] **Boards should understand that pricing services typically do not accept legal responsibility for prices they generate even if done negligently.**

The SEC provided a list of factors that should generally be considered by valuation designees before deciding to use a pricing service, as follows:

- The qualifications, experience, and history of the pricing service;
- The valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected (if at all) as market conditions change;
- The quality of the pricing information provided by the service and the extent to which the service determines its pricing information as close as possible to the time as of which the

[44] Rule 2a-5(a)(4). While the SEC declined to adopt a specific list of criteria for who may qualify as a pricing service under the Rule (citing that such a definition may become outdated over time, and the scope of a pricing service is generally understood by boards and advisers), in the Adopting Release the SEC provided that "we refer to pricing services as third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or information to assist in determining the fair value of fund investments." Adopting Release at 34. The SEC further explained that it "believe[s] that the types of entities that would be pricing services under the final rule would include pricing services as defined in the PCAOB standards." *Id.* at 35. Therefore, directors should be mindful that the definition of pricing service extends to third-party pricing specialists and experts that provide input into a fund's process.

[45] Adopting Release at 32.

fund calculates its net asset value;

- The pricing service's process for considering price "challenges," including how the pricing service incorporates information received from pricing challenges into its pricing information;
- The pricing service's actual and potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and
- The testing processes used by the pricing service.[46]

Boards now often rely on updates on pricing service due diligence from the valuation designee, rather than meeting regularly with the pricing service.

While the SEC provided that this list of factors should generally be considered "before" deciding to use a pricing service, the factors also are often utilized in ongoing oversight. Advisers, depending on their particular circumstances, also may utilize "scorecards" before determining to use a pricing service, which act to survey and score vendors through polling on various metrics and criteria. Historically, some boards have met with pricing services periodically to conduct due diligence visits. However, since the implementation of Rule 2a-5, many boards may now rely on the valuation designee to report to the board on such due diligence meetings.

The valuation designee must report to the board quarterly on any material changes or events related to its oversight of pricing services.[47] In developing the content of these reports, the valuation designee can consider the factors that the SEC has provided related to oversight of pricing services with respect to each pricing service used. The adviser's report may also include items such as an examination of the financial stability of the pricing service, its ownership, and any affiliations that the pricing service has with the adviser. Lastly, the report will often discuss diligence conducted related to ongoing monitoring, which may include due diligence visits to determine whether the pricing service continues to have competence in valuing particular securities and maintains an adequate control environment.

Additionally, valuation designees must have a process in place outlining the circumstances under which they may challenge prices provided by pricing services.[48] While pricing challenges should be governed by robust process with appropriate controls, boards should recognize that price challenges can be a part of a healthy valuation process. For example, an adviser may have a process for challenging quotations by a pricing service when the quotation is at odds with information known to the adviser, such as information on recent trades.

How Does the Adviser Carry Out its Valuation Responsibilities?

Adviser-Organized Valuation Committees

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[46] *Id.* at 37.

[47] Rule 2a-5(b)(1)(i)(A)(2)(iii).

[48] Adopting Release at 31.

In many cases, the adviser relies on a valuation committee composed of individuals with the experience and expertise necessary to value a fund's portfolio securities. Such committees are often comprised of all or a majority of advisory personnel, though personnel of other fund service providers may also be members. Independent directors generally do not serve on the adviser's valuation committee.

Consistent with the reasonable segregation requirements of Rule 2a-5 (*discussed in the next section*), with respect to any valuation committee the adviser should specify:

- The titles of the persons responsible for determining the fair value of the designated investments and the particular functions for which persons with the identified titles are responsible; and
- The specific personnel with duties associated with price challenges, including those with the authority to override a price, along with the roles and responsibilities of such persons.[49]

Reasonable Segregation

Rule 2a-5 requires that the valuation designee "specifies the titles of the persons responsible for determining the fair value of the designated investments, including by specifying the particular functions for which they are responsible, and reasonably segregates fair value determinations from the portfolio management of the fund such that the portfolio manager(s) may not determine, or effectively determine by exerting substantial influence on, the fair values ascribed to portfolio investments."[50] The SEC provided that an example of this "would be if the fair values ascribed to portfolio investments are based solely on information provided by the portfolio manager."[51] Nonetheless, under Rule 2a-5, portfolio managers are not prohibited from being involved in the fair value process; however, their involvement may present potential conflicts of interest. For instance, advisers and portfolio managers may have an incentive to inflate the value of portfolio investments because the adviser typically receives a management fee that is calculated based on a percentage of the fund's net assets. Further, portfolio managers are generally evaluated based on a fund's performance, and the NAV of the fund can be a key component of their compensation. Therefore, the SEC has provided that if portfolio managers provide a significant amount of input on the fair value of an investment, the segregation process should be appropriately rigorous and robust to mitigate these and any other potential conflicts of interest.[52]

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[49] *See Id.* at 76-77.

[50] Rule 2a-5(b)(2).

[51] Adopting Release at 80, n. 298.

[52] *Id.* at 81.

Portfolio management can be involved in the fair value process, subject to appropriate checks and balances.

Adviser Resources for Valuing Securities

The board should determine what resources the adviser has for determining the fair value of the fund's portfolio securities. Portfolio managers can be some of the most knowledgeable resources in determining fair value of securities due to their deep knowledge of a fund's investments, though such involvement must be consistent with the "reasonable segregation" requirement (*detailed in the prior section*). The portfolio manager also will be able to provide information during times when the price movement of a security is not what is expected.

In addition to portfolio management personnel, the adviser may also develop its own proprietary pricing model methodologies. Quantitative pricing models can be important additions to or alternatives to market prices – particularly with respect to difficult-to-value securities like certain structured products and derivatives.

In addition to internal resources, a fund's valuation designee may also receive assistance from third parties, including pricing services, pricing specialists, fund administrators, sub-advisers, accountants, internal auditors, or counsel.[53] The SEC has provided that this assistance can take a variety of different forms. For example, third parties may conduct back-testing as specified by the valuation designee or perform calculations as part of the application of a valuation method.[54] **Receiving outside assistance, however, does not change the valuation designee's responsibilities under the Rule – the valuation designee remains ultimately responsible for the fair value determinations, and may not designate or assign that responsibility to a third party.[55]**

Broker Quotes Used in Valuing a Fund's Securities

Broker quotes can be valuable inputs into fair valuations of securities. In determining how broker quotes are used in the valuation of a fund's securities, some considerations include:

- The circumstances under which broker quotes may be used in lieu of a valuation provided by a pricing service;
- Whether broker quotes may be the sole source used for determining the value of a particular

[53] *Id.* at 52.

[54] *Id.* at 51.

[55] *Id.* at 52.

security;

- Whether the procedures include a preference for quotes from two or three brokers, as well as the circumstances under which only one quote can be relied on; and
- The process by which brokers are selected and how frequently those brokers are changed.[56]

[56] For an example of a process the SEC considered to be deficient, *see* In the Matter of Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc. Administrative Proceeding File No. 3-13507 (June 8, 2009) (providing that a fund's valuation committee had not reviewed or approved a broker's method for determining prices, but continually used the broker's quotes to override a pricing service's lower prices).

SEC ADOPTED AMENDMENT TO RULE 35d-1 (THE NAMES RULE) UNDER THE 1940 ACT

Based on a client alert originally published October 24, 2023

The U.S. Securities and Exchange Commission (SEC) adopted amendments on Sept. 20 (the Release) to Rule 35d-1 (the Names Rule or Rule) under the Investment Company Act of 1940 (the 1940 Act).[57] The Rule addresses the names of registered investment companies and business development companies (collectively, funds)[58] that the SEC considers to be materially misleading or deceptive unless used in accordance with provisions of the Rule. As described by SEC Commissioner Hester Peirce, when someone walks into a pizza shop, there is a general expectation that they are not going to get sushi. The revised Names Rule is designed to provide the same experience to investors.

With the expansion of the Names Rule's scope, it is estimated that approximately 75% of all funds will be affected by the Release in some manner. The final amendments to the Names Rule include:

- Expanding the scope of the Names Rule to include terms suggesting an investment focus in investments that have, or whose issuers have, "particular characteristics" (e.g., growth, value or terms indicating that a fund's investment decisions incorporate one or more environment, social or governance (ESG) factors, and/or terms that reference a thematic investment focus).
- Requiring ongoing (i.e., at least quarterly) testing of portfolio investments for purposes of determining compliance with a fund's 80% investment policy.
- Specifying time periods (generally 90 days) for funds to come back into compliance in connection with temporary departures.
- Incorporating requirements for purposes of valuing and including derivatives in a fund's 80% investment policy.
- Requiring impacted funds to incorporate prospectus disclosure defining the terms used in a fund's name, including specific criteria used to choose the investments described by the terms.

Expanded Scope of the Names Rule

The Release expands the scope of the Names Rule to require a fund to adopt a policy to invest at least 80% of its assets in accordance with any fund name that suggests an "investment focus." The definition of "investment focus" includes investments in "a particular type of investment or investments, a particular industry or group of industries, or particular countries or geographic regions" – all terms that were previously subject to the Names Rule. The definition, however, was expanded to include terms that suggest that a fund is focused on "investments that have, or

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[57] Investment Company Names, Investment Company Act Release No. 35000 (September 20, 2023).

[58] The Names Rule was also modified to require that the 80% investment policy and recordkeeping requirements will only apply to unit investment trusts at the time of initial deposit.

investments whose issuers have, particular characteristics." The SEC noted the expansion does not distinguish between a type of investment and an investment strategy because a fund name might connote a particular investment focus and result in reasonable investor expectations regardless of whether the fund's name describes a strategy (e.g., growth or value) as opposed to a type of investment (e.g., equity or fixed income).

The SEC declined to provide an enumerated list of terms that would be included in the expanded scope in an attempt to make the Names Rule evergreen. The SEC did, however, note that the primary terms it anticipated that would be brought within the scope of the expanded Names Rule would include terms such as "growth" and "value," terms with ESG- or sustainability-related characteristics, and terms that reference a thematic investment focus.

Expanded Scope
Names that suggest an "investment focus": • Broadened to include terms suggesting that the fund focuses on investments that have, or investments whose issuers have, particular characteristics. • Particular characteristics not defined, but described as any "feature, quality, or attribute." **Non-exclusive examples** • Growth or value. • Terms indicating that the fund's investment decisions incorporate one or more ESG factors. • Terms that reference a thematic investment focus (e.g., drones, metaverse, big data, gig economy and Gen Z). **Additional Examples** • While the SEC declined to specifically highlight additional examples of terms that suggest a fund focuses on investments that have, or investments whose issuers have, particular characteristics, funds should consider the applicability of the amendments to other terms that the SEC's disclosure staff have historically noted should include 80% investment policies (e.g., "income," "dividend" and "credit").
Terms That Continue to Be Excluded

Terms that reference and/or suggest:
• **Characteristics of the portfolio as a whole.**
  ○ Duration
  ○ Maturity-related terms (i.e., intermediate-term)
  ○ Global or international
• **Negative or exclusionary screening process**
  ○ Fossil-fuel-free-funds may not require an 80% investment policy.
  ○ Section 35(d) concerns (i.e., should not invest in issuers with fossil fuel reserves).
• **Results of portfolio investments in the aggregate**
  ○ ESG "uplift" or "aware" funds that systematically overweight or underweight investments within the given universe based on ESG criteria

- **Portfolio-wide result:**
  - Real return, balanced or managed risk
- **An investment technique:**
  - Long/short or hedged
- **Asset allocation determinations**
  - Retirement or sector rotation funds
- **Well-known organizations, affinity groups, or specific population of investors**

<u>Note:</u> All funds, however, continue to be subject to Section 35(d)'s prohibition on materially misleading or deceptive names.

Consistent with the Proposal,[59] when a fund's name suggests an investment focus that has multiple elements (e.g., the XYZ Technology and Growth Fund), the fund's investment policy must address each of those elements. The SEC noted that a fund could but is not required to have 80% of its assets invested in each term of the name. Alternatively, the SEC noted that the adviser retains discretion in determining how best to allocate investments under such an 80% policy, going as far as noting that a fund could have "no minimum or maximum investment requirements specified for either category." Moreover, even if a fund has a term in its name that does not require an 80% investment policy alongside one that does (e.g., the "Technology and Real Return Fund"), the fund still must adopt an 80% investment policy for the term that does require a policy.

For funds of funds, the SEC confirmed that an acquiring fund is permitted to include the entire value of the underlying fund in calculating compliance with its 80% investment policy without looking through to the underlying fund's investments. The SEC provided an example indicating that an acquiring fund can count an underlying fund with an 80% policy in a subsection of the industrial sector as part of the acquiring fund's 80% policy in the industrial sector. However, the SEC noted it would not be reasonable to ignore situations where the fund of funds knows that an underlying fund is not investing consistent with its investment focus, which may be the case in investments made in affiliated funds.

<u>Key Takeaways</u>:

- The primary impact of the expansion is that a larger percentage of funds will now become subject to the Names Rule (i.e., absent modifying their names), which will create new ongoing compliance costs and additional requirements, as described below, that may impact how such funds manage their portfolios.
- Fund managers should start to evaluate their fund names and strategies to confirm the impact of the amendments and to ensure they have a sufficient amount of time to come into compliance, which may require Board action and related notifications to shareholders. Fund managers that determine to change fund names in light of the amendments should consider intermediary relationship and marketing implications.
- In an attempt to provide flexibility, the SEC included guidance for funds whose names suggest an investment focus that has multiple elements, noting that a fund could have "no

[59] Investment Company Names, Investment Company Act Release No. 34593 (May 25, 2022) (the "Proposal").

minimum or maximum investment requirements specified for either category." This flexibility may lead to unintended consequences and ultimately be reined back in through subsequent guidance or the disclosure review process. For example, it is unlikely the SEC intended to provide "US equity" funds with the flexibility to adopt an investment policy with no minimum percentage in US issuers or equity securities. Nevertheless, fund managers should always be cognizant of Section 35(d)'s requirement that a fund's name may not be materially deceptive or misleading.

- The Release focuses on thematic funds, which may have names for which the investments may be hard to track for purposes of the Names Rule. Therefore, fund managers may need to carefully craft the names of these funds so that they are both descriptive to investors, but also do not present a compliance risk with respect to complying with Section 35(d) and the Names Rule.
- A number of terms remain subject to interpretation under the Names Rule, and we expect that the SEC disclosure staff's review process will continue to be a driver of determining what names are subject to the Rule despite the stated objective in the Release to eliminate the disclosure staff's ad hoc interpretations (i.e., investment strategy v. type of investment).

Compliance Testing and Policies and Procedures

In a change from the Proposal, under which funds would have been permitted to depart from an 80% investment policy only under specified circumstances, the Release retained the requirements that a fund's 80% investment policy applies under normal circumstances and at the time the fund invests its assets. To limit the potential for long-term drift, the amended Rule, however, will require:

1. **Quarterly Testing**: The Names Rule will require that a fund review, at least quarterly, each portfolio investment for purposes of determining compliance with the fund's 80% policy, as opposed to requiring a fund to continuously reassess its portfolio investments. To the extent that a fund identifies as part of the quarterly review that the characteristics of the fund's existing investments are inconsistent with the fund's 80% investment policy, the fund must address this in accordance with the Rule's requirements for temporary departures.
2. **Temporary Departures:** Once a fund determines it is not in compliance with its 80% investment policy it must come back into compliance as soon as reasonably practicable, but no later than 90 consecutive days. This can be done by selling investments that fall outside of a fund's 80% basket and/or by purchasing securities that fall within it. The 90 days are measured from the time the fund identifies a departure (i.e., as a part of its quarterly review or otherwise) or the time the fund initially departs from its policy, in other-than-normal circumstances.
3. **Repeated Deviations:** The Release noted that if a fund were to deviate serially or frequently from its 80% investment policy, it may suggest that those circumstances are in fact normal and may raise questions regarding the appropriateness of the fund's name.
4. **Special Fund Events:** In the following circumstances, funds would be permitted to deviate from their 80% investment policies for longer than 90 days:

a. **Fund Launches:** A fund will be permitted 180 days to ramp up and come into compliance with its 80% investment policy.

b. **Reorganizations:** A fund will be permitted to deviate from its 80% investment policy to reposition or liquidate the fund's assets in connection with a reorganization (no time period is given).

c. **Notice to Shareholders:** A fund will be permitted to deviate from its 80% investment policy where notice was provided to shareholders regarding a change in the fund's 80% investment policy.

Additionally, as proposed, the Release stated that a fund's name may be materially deceptive or misleading under Section 35(d) even if the fund complies with the Names Rule. The SEC noted this could occur if a fund were to invest in such a way that the source of a substantial portion of the fund's risk or returns is materially different from that which an investor would reasonably expect based on the fund's name, or if the fund used its 20% basket to invest in assets that are materially inconsistent with the investment focus or risk profile reflected by the fund's name.[60] The SEC did not adopt the Proposal's amendment to define the names of ESG "integration funds"[61] as materially deceptive and misleading if the name includes terms indicating that the fund's investment decisions incorporate one or more ESG factors.

The Release noted that a tax-exempt fund that applies the income test to determine compliance with its 80% policy would be required to review the portfolio at least quarterly to determine whether the fund's assets are invested so that at least 80% of the income that it distributes will be exempt from federal income tax or from both federal and state income tax.

With respect to funds' compliance policies and procedures, the Release reiterated the SEC's expectation that funds' written compliance policies and procedures, which generally are required to be designed to prevent violations of the federal securities laws, should cover the Names Rule and Section 35(d). Further, with respect to index funds, the SEC also noted that funds should adopt and implement written policies and procedures reasonably designed to ensure that the indexes selected by a fund do not have materially misleading or deceptive names themselves.[62]

Key Takeaways:

- While the Release provided more flexibility than the Proposal, the quarterly testing requirement will incorporate a new compliance test that will require funds to evaluate prior

[60] The SEC provided two specific examples of a "green energy and fossil fuel-free" fund making a substantial investment in an issuer with fossil fuel reserves, or a "conservative income bond" fund using the 20% basket to invest in highly volatile equity securities that introduce significant volatility into a fund that investors would expect to have lower levels of volatility associated with lower-yielding bond.

[61] The Proposal had described integration funds as funds that consider one or more ESG factors alongside other, non-ESG factors in the fund's investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process.

[62] Index providers typically provide no guarantee as to the accuracy of the indexes they publish and are not subject to the same rules as investment advisers and funds, which raises concerns that an investment adviser and/or fund could be held responsible for the accuracy of the index providers.

investments on an ongoing basis, which could potentially force a fund to sell investments it would not otherwise have.

- The compliance testing required by the Release puts additional responsibilities on compliance departments and may necessitate hiring additional compliance staff or third-party vendors.

- To the extent not already adopted, funds should review their compliance policies and procedures to ensure they cover compliance with Section 35(d) and the Names Rule. The SEC noted that these policies should address all funds, not just those subject to the Names Rule.

- While funds have always been subject to Section 35(d)'s requirements, to the extent a fund is subject to the Names Rule, the Release signals that the SEC may put an increased focus on funds' 20% baskets. Accordingly, funds should confirm that they have processes in place to monitor and evaluate what investments/risks/exposures are included in the 20% baskets of funds subject to the Names Rule.

Derivatives Calculations in a Fund's 80% Investment Policy

One aspect of the Proposal that drew less pushback from the industry, and that was adopted largely as proposed, was the valuation of derivatives instruments for purposes of determining compliance with a fund's 80% investment policy, as well as the derivatives that a fund may include in its 80% basket.

1. **Use of derivatives' notional amounts, with currency hedging exclusion.** The Release will require a fund to use the notional value of a derivative instrument, rather than its market value, to determine compliance with its 80% investment policy. The Release noted the amendments were intended to increase comparability regarding how funds value derivatives for purposes of determining compliance with the Names Rule (e.g., some funds were valuing their derivatives at notional value, while others would use market values). The SEC chose notional value because it believes notional value better reflects a derivative instrument's investment exposure.[63]

   In a change from the Proposal, the Release requires a fund to exclude from its 80% investment policy calculation certain currency derivatives that hedge the risks associated with one or more specific foreign-currency denominated investments held by a fund if:

   a) It is entered into and maintained by the fund for hedging purposes, and

   b) The notional amounts of the derivatives do not exceed the value of the hedged investments (or the par value, therefore, for fixed-income investments) by more than

[63] The Release also provided guidance noting that, when calculating the notional amount of a fund's derivatives, interest rate derivatives must be converted to their 10-year bond equivalents and funds must delta adjust the notional amount of options contracts.

10%.[64]

The SEC adopted this modification in response to concerns that utilizing the notional value of derivatives could limit funds' use of derivatives for hedging purposes. For example, consistent with the Names Rule, a U.S. equity fund may utilize its 20% basket to invest in foreign stocks and utilize derivatives to hedge the currency risk. If the notional value of those currency derivatives were included in the denominator of a fund's 80% compliance calculation, they could have a high notional amount and put the fund out of compliance, even though the derivatives were being used to reduce the fund's exposure to foreign securities risks. Accordingly, the modification was adopted to address these concerns and avoid limiting the use of derivatives for hedging purposes.

2. **Deduction of cash and cash equivalents and certain U.S. Treasuries.** As adopted, the Names Rule will *permit, but not require,* a fund to deduct cash and cash equivalents and U.S. Treasuries with remaining maturities of one year or less from assets up to the notional amounts of the fund's derivatives investments. This was a welcome change from the Proposal, which would have allowed the deduction, but limited it to cash and cash equivalents. Commenters expressed concerns that the Proposal would exclude a number of investments that funds may use as collateral for derivatives (e.g., U.S. Treasuries maturing in under five years, investment-grade corporate bonds and repurchase agreements), but the SEC ultimately only broadened the scope for U.S. Treasuries maturing in one year or less.
3. **Deduction of closed-out derivatives positions.** In a change from the Proposal, the Release specifically permits a fund to exclude any closed-out derivatives positions when calculating assets for purposes of determining compliance with its 80% investment policy if these positions result in no credit or market exposure to the fund. Closed-out positions are not required to be closed out with the same counterparty[65] in order for a fund to exclude them from the calculation of its assets.
4. **Inclusion of derivatives in the 80% basket.** As adopted, the Names Rule will permit a fund to include in its 80% basket derivatives instruments that provide investment exposure to one or more of the market risk factors associated with the investment focus suggested by the fund's name. This approach will allow derivatives instruments to be included in a fund's 80% basket if:
    a) They function as a substitute for direct investments in the securities suggested by the fund's name; or
    b) They are used to facilitate the fund's investment in those securities by increasing or decreasing the fund's exposure to risk factors associated with those securities (e.g., interest rate derivatives).

[64] The SEC declined to extend the exclusion to interest rate derivatives, noting they are difficult to distinguish from transactions that create exposures to (or detract from) the investment focus that a fund's name suggests.

[65] Some commenters had noted that Rule 18f-4 does not allow netting offsetting positions across different counterparties for purposes of determining whether a fund qualifies as a limited derivatives user; however, the SEC noted the same concerns underlying the approach of Rule 18f-4 do not apply for the Names Rule.

For purposes of determining whether a derivative provides exposure to one or more of the market risk factors associated with a fund's name assets, the fund generally should consider whether the derivative provides investment exposure to any explicit input that the fund uses to value its name assets (e.g., where a change in that input would change the value of the security).

5. **Valuation of short positions.** Funds must value each physical short position using the value of the asset sold short.

Key Takeaways:

- The SEC specifically notes in the Release that including derivatives in a fund's 80% basket to the extent that they negate the primary market risk factor associated with the fund's name could result in a fund's name being materially deceptive and misleading, notwithstanding the fund's adoption of an 80% investment policy and compliance with the requirements of the Names Rule.

- The SEC's disclosure staff have historically provided comments requesting that funds use the market value of derivatives for purposes of testing compliance with their 80% investment policies. As a result, many funds test compliance with their 80% investment policies based on the market value of derivatives. Accordingly, such fund groups should evaluate whether impacted funds remain in compliance with their 80% investment policies when using a derivative's notional value.

Disclosure Requirements

Prospectus disclosure. The Release included new amendments to funds' registration forms (i.e., Form N-1A, Form N-2, Form N-8B-2 and Form S-G) that will require prospectus disclosure defining the terms used in the fund names that are subject to the Names Rule (excluding any trade name of a fund or its adviser), including the specific criteria used by a fund to select the investments that the term describes, if any.[66] The SEC noted the requirements are designed to help investors better understand how the fund's investment strategies correspond with the investment focus that the name suggests, as well as to provide additional information about how the fund's management seeks to achieve the fund's objective.

The Release noted a fund would have the flexibility to use "reasonable" definitions of the terms included in its names; however, these definitions need to be consistent with the terms' plain English meaning(s) or established industry use.[67] The SEC noted that the definition must have a "meaningful nexus" between the term used in the fund's name and the fund's investment focus and could be derived from a variety of sources (e.g., the dictionary, prior public disclosures,

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[66] "Terms" are any word or phrase used in a fund's name related to the fund's investment focus or strategies.

[67] Funds will also be required to tag information that will be included under the Release in their prospectus, using structured data language. This requirement will also apply to UITs, which are not currently subject to structured data tagging requirements.

industry codes or classifications, and/or a colloquial understanding of the term).[68] In addition, the SEC noted that in situations where a term that is not subject to the Names Rule is in a fund's name (i.e., therefore does not need to be defined), such term can still provide context for a term in the fund's name that is subject to the Names Rule. This context may modify an investor's expectations with respect to the fund's investment focus (e.g., the Emergent Technology Fund), which can be relevant for purposes of defining the fund's name and for determining which securities are properly allocated to the fund's 80% basket.

To address concerns regarding the difficulty with defining terms that may involve more subjectivity than terms that have traditionally been subject to the Names Rule, and how to allocate investments to such 80% baskets, the SEC provided certain examples in the Release. For example, the SEC provided an example of two "Latin American" funds (i.e., geographically focused funds that are subject to the Names Rule) and noted that, while the funds could have different definitions of what "Latin America" means for their fund, the SEC believed both definitions were consistent with the term's plain English meaning or industry use.

Key Takeaways:

- While this aspect of the Proposal did not generate as much pushback as others, it does create a new disclosure requirement for funds subject to the Names Rule.
- The new requirements replace the prior disclosure requirements applicable to funds that focus their investments in particular countries or geographic regions.
- The Release did not address commenters' concerns that the inclusion of a new disclosure requirement could subject funds to unequal levels of scrutiny by SEC disclosure staff with respect to their definitions of terms and their disclosed criteria.

Notice requirement. Consistent with the current requirements, the Names Rule will continue to require that, unless a fund's 80% policy is a fundamental policy, 60 days' notice must be provided to shareholders of any change in the fund's 80% policy. The Release, however, modernizes and clarifies the requirement in several ways:

- Must be provided separately. The notice cannot be built into the fund's prospectus or other required shareholder communications. If the notice is delivered in paper form, it may be provided in the same envelope as other written communications.
- Legend requirement. The fund must prominently indicate to investors in the notice legend any changes made to its name that accompany a change in investment policy, in addition to changes made to the policy itself.

[68] However, the Release states that the use of text analytics to assign issuers to industries based on the frequency of particular terms in an issuer's disclosures was not, in and of itself sufficient to create a reasonable nexus. The Release also addressed funds that offer strategies that seek exposure to issuers that are likely to generate significant revenue from certain industries in the future, stating that the funds could signal to investors this strategy by using the terms "emergent", "future" or another similar term in the fund's name. However, the SEC endorsed the 50% revenue or income test in the Release as reasonable.

- Content requirements. The notice must describe, as applicable, the fund's 80% investment policy, 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 changes.
- Allow for electronic delivery. Notices may be provided electronically to those investors who opt-in to electronic delivery. For these notices, the Release requires that the statement appear on the subject line of the email communication that includes the notice. Funds will not be permitted to post notices to their websites as an alternative to sending the notice directly to shareholders.

Form N-Port reporting. The Release also adds the following new reporting requirements to Form N-PORT applicable to registered management investment companies and exchange-traded funds organized as unit investment trusts (UITs) (i.e., other than money market funds or small business development companies (BDCs) that adopt an 80% investment policy:

- Identify each investment in a fund's portfolio that is in the fund's 80% basket.
- Report the value of a fund's 80% basket, as a percentage of the value of the fund's assets.
- Report the definition of the terms used in a fund's name, including the specific criteria the fund uses to select the investments the term describes, if any.

In a change from the Proposal, this information will need to be reported for the third month of each quarter, instead of every month. The frequency of this reporting is designed to correspond with the new quarterly review requirement. In a change from the Proposal, the Release does not require that funds report the number of days that the value of a fund's 80% basket fell below 80% of the value of the fund's assets during the reporting period.

Key Takeaways:

- Funds may face significant costs to comply with these disclosure requirements and may need to hire additional staff or third-party vendors to assist.
- If a fund determines in its quarterly assessment that it has fallen out of compliance with its 80% investment policy, it may be unable to come back into compliance prior to its Form N-PORT filing obligations, and therefore, will be alerting the SEC and investors of a compliance issue.

Unlisted Registered Closed-End Funds and Business Development Companies ("BDCs")

Under the amended Names Rule, an unlisted registered closed-end fund or BDC subject to the Names Rule is prohibited from changing its 80% investment policy unless authorized by a vote of the majority of the outstanding voting securities of the fund. However, in a modification from the Proposal, such a fund would be permitted to change its policy without a vote if:

a) The fund conducts a tender or repurchase offer in advance of the change;

b) The fund provides at least 60 days' prior note of any change in the policy in advance of the offer;

c) The offer is not oversubscribed; and

d) The fund purchases shares at their net asset value.

The requirement that any tender or repurchase offer must not be oversubscribed to avoid a shareholder vote to change an 80% policy of an unlisted closed-end fund or BDC puts those funds in a tough position, as whether the offer is oversubscribed would not be known in advance when the 60 days' notice of the 80% policy change is required. In addition, some unlisted registered closed-end funds frequently have oversubscribed repurchase offers and may therefore not be able to take advantage of this flexibility.

Recordkeeping

The Release will require funds that are subject to the 80% investment policy requirement to maintain certain records documenting their compliance with the Names Rule, including with respect to temporary departures. In a change from the Proposal, the Names Rule will not require funds that do not adopt an 80% investment policy to maintain a written record of their analysis that the policy is not required under the Rule.

Compliance Dates

The effective date of the Release was Dec. 11, 2023. The compliance dates will be Dec. 11, 2025, for smaller fund families and June 11, 2026 for larger fund families.