

## IN THE NAME OF TRANSPARENCY: SEC VOTES TO SIGNIFICANTLY EXPAND RULE 35D-1 ("NAMES RULE")

On September 20, 2023, in a 4-to-1 vote, the US Securities and Exchange Commission (the “SEC” or the “Commission”) adopted amendments to Rule 35d-1 (the “Amended Rule 35d-1”) under the Investment Company Act of 1940 (the “Investment Company Act”). According to the SEC, the amendments are designed to increase investor protection by, among other things, improving and clarifying the requirement for certain funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus that the fund’s name suggests. We believe these amendments are likely to result in increased compliance costs and oversight, and as a result, fund companies should begin to review their existing fund line-up to determine the impact that the Amended Rule 35d-1 will have on their funds.<sup>1</sup>

### AMENDED RULE 35D-1

The Amended Rule 35d-1 does not depart significantly from the Proposed Rule 35d-1, with the exception of a few notable differences listed below:

- **Temporary Departures from a Fund’s 80% Investment Policy**

The Proposed Rule 35d-1 included a requirement that a fund review its portfolio assets’ treatment under its 80% investment policy daily, and generally required that a fund would have to bring its investments back into compliance with the 80% investment policy within 30 consecutive days. The Amended Rule 35d-1 instead will require a fund to review its

<sup>1</sup> On May 25, 2022, the Commission first proposed to amend both Rule 35d-1 under the Investment Company Act (the “Proposed Rule 35d-1”) and rules and forms under both the Investment Advisers Act of 1940 (the “Advisers Act”) and the Investment Company Act to require registered investment advisers, certain advisers that are exempt from registration, registered investment companies, and business development companies (“BDCs”), to provide additional information regarding their environmental, social, and governance (“ESG”) investment practices (the “ESG Proposal”). We provided a Client Alert on the Proposed Rule 35d-1 and ESG Proposal and note the SEC did not address the ESG Proposal on September 20, 2023.

80% investment policy at least quarterly and provides a fund 90 days to return to compliance, if it deviates<sup>2</sup> from its 80% investment policy.<sup>3</sup> While voting to approve the Proposed Rule 35d-1, Commissioner Peirce queried in her remarks "[w]hy not allow fund boards the ability to override the 90-day limitation on departures from the 80% rule? One can imagine situations in which an illiquid security will take a couple extra weeks to sell." She further noted that "[a] board is well-positioned to think about the trade-offs between renaming the fund and remaining out of compliance with the 80% test for longer than 90 days."<sup>4</sup>

- **Unlisted Closed-End Funds and BDCs**

The Amended Rule 35d-1 will require a registered closed-end fund or BDC, whose shares are not listed on a national securities exchange, to adopt the 80% policy as a fundamental policy and a change in such policy would require shareholder vote and approval. However, after receiving a number of comments from market participants, the Amended Rule 35d-1, as an alternative to soliciting shareholder votes to change the fundamental policy, will now also permit such registered closed-end fund or BDC to make changes to its 80% investment policies by conducting a tender or repurchase offer in advance of the change, subject to certain conditions.

- **Derivatives**

The Amended Rule 35d-1 stipulates that funds should use the notional amount of a derivatives instrument to check compliance with the 80% investment policy, with some modifications. Notably, certain currency hedges are excluded from this compliance calculation. Additionally, the Amended Rule 35d-1 clarifies which derivative instruments can be included in a fund's 80% basket.

- **N-PORT Reporting Requirement**

The Proposed Rule 35d-1 stipulated that the Form N-PORT reporting requirement, which requires funds (except in the case of money-market funds and BDCs) to report on Form N-PORT the value of the fund's 80% basket as well as each investment that is included in the fund's 80% basket, would take place on a monthly basis. The Amended Rule 35d-1 softened this schedule to require reporting only for the third month of each quarter.

- **Expansion of the Names Rule**

The Amended Rule 35d-1 did not differ from the Proposed Rule 35d-1 in applying the 80% investment policy requirement to any fund name with

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<sup>2</sup> The SEC adopted a requirement to invest in accordance with the 80% requirement "under normal circumstances," combined with a set time frame to come back to 80%. Thus, the Amended Rule 35d-1 places a limit on the length of time that a fund may depart in other-than normal circumstances to 90 consecutive days after the initial departure.

<sup>3</sup> The Names Rule previously required the 80% investment policy to be calculated at the time of purchase. While the Amended Rule 35d-1 retains the "at the time of purchase" test, it also adds the requirement that fund companies review quarterly their compliance with the Amended Rule 35d-1.

<sup>4</sup> See Hester Peirce, Commissioner, U.S. Sec. & Exch. Comm'n, Statement on Investment Company Names (September 20, 2023), <https://www.sec.gov/news/statement/peirce-statement-names-rule-092023>

terms suggesting that the fund focuses in investments that have, or investments whose issuers have, particular characteristics. The primary types of names that the Amended Rule 35d-1 is anticipated to cover include fund names with terms such as “growth” or “value” or certain terms that reference a thematic investment focus (e.g., “artificial intelligence” or “big data”), including terms indicating that the fund’s investment decisions incorporate one or more ESG factors.

- **Integration Funds**

Under the Proposed Rule 35d-1, the names of ESG “integration funds” would have been defined as materially deceptive and misleading if the name included terms indicating that the fund’s investment decisions incorporate one or more ESG factors.<sup>5</sup> The Commission declined to take action regarding “integration funds” in the Amended Rule 35d-1, but the subject is likely to be revisited if the Commission moves forward with the ESG Proposal.

The Commission estimates that, under the current Names Rule, 62% of open-end and closed-end funds registered with the Commission are subject to an 80% investment policy.<sup>6</sup> The Commission estimates that 75% of funds would now be subject to the Amended Rule 35d-1.<sup>7</sup> The Amended Rule 35d-1 will become effective 60 days after publication in the Federal Register. Fund groups with net assets of \$1 billion or more will have 24 months to comply with the amendments, and fund groups with net assets of less than \$1 billion will have 30 months to comply.

We will provide a more detailed analysis of the Amended Rule 35d-1 at a future date.

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<sup>5</sup> U.S. Sec. & Exch. Comm’n, Investment Company Names (May 25, 2022), available at <https://www.sec.gov/rules/proposed/2022/33-11067.pdf> at 21.

<sup>6</sup> *Id.* at 226.

<sup>7</sup> *Id.*

## CONTACTS

**Vadim Avdeychik**  
Partner

**T** +1 212 878 3055  
**E** vadim.avdeychik  
@cliffordchance.com

**Jeff Berman**  
Partner

**T** +1 212 878 3460  
**E** jeffrey.berman  
@cliffordchance.com

**Cliff Cone**  
Partner

**T** +1 212 878 3180  
**E** clifford.cone  
@cliffordchance.com

**Jefferey LeMaster**  
Partner

**T** +1 212 878 3206  
**E** jefferey.lemaster  
@cliffordchance.com

**Eric Bernstein**  
Associate

**T** +1 212 878 3411  
**E** eric.berstein  
@cliffordchance.com

**Dennis Morrisroe**  
Associate

**T** +1 212 880 5708  
**E** dennis.morrisroe  
@cliffordchance.com

**Andrew Nelson**  
Associate

**T** +1 212 878 8284  
**E** andrew.nelson  
@cliffordchance.com

**Emily Picard**  
Associate

**T** +1 212 878 3495  
**E** emily.picard  
@cliffordchance.com

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Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

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