

(vi) *How do I buy the Fund's shares?* Provide information about how to purchase the Fund's shares, including any minimum investment requirements. If applicable, disclose any breakpoints in or waivers of sales loads (referring to sales loads as "sales fees (loads)").

(vii) *How do I sell the Fund's shares?* Provide information about how to redeem the Fund's shares.

(viii) *How are the Fund's distributions made and taxed?* Describe how frequently the Fund intends to make distributions and what reinvestment options (if any) are available to investors. State, as applicable, that the Fund intends to make distributions that may be taxed as ordinary income and capital gains or that the Fund intends to distribute tax-exempt income. If a Fund, as a result of its investment objectives or strategies, expects its distributions primarily to consist of ordinary income (or short-term capital gains that are taxed as ordinary income) or capital gains, provide disclosure to that effect. For a Fund that holds itself out as investing in securities generating tax-exempt income, provide, as applicable, the information required by Item 7(d)(2)(ii) of Form N-1A or a general statement to the effect that a portion of the Fund's distributions may be subject to tax.

(ix) *What other services are available from the Fund?* Summarize or list the services available to the Fund's shareholders (e.g., any exchange privileges or automated information services), unless otherwise disclosed in response to paragraphs (c)(2) (i) through (viii) of this section.

(3) The Profile may include an application that a prospective investor can use to purchase the Fund's shares if the application presents with equal prominence the option to invest in the Fund or request the Fund's prospectus.

(4) A Profile of a Fund available as an investment option for participants in a defined contribution plan that meets the requirements for qualification under the Internal Revenue Code of 1986 may omit the information required by paragraphs (c)(2) (vi) through (ix) of this section. In lieu of the application permitted by paragraph (c)(3) of this section, the Fund may include the plan's enrollment form, which does not have to be filed with the Commission.

By the Commission.

Dated: February 27, 1997.

Margaret H. McFarland,
Deputy Secretary.

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17 CFR Part 270

[Release No. IC-22530; File No. S7-11-97]

RIN 3235-AH11

Investment Company Names

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing a new rule under the Investment Company Act of 1940 that would require a registered investment company with a name suggesting that the company focuses on a particular type of investment (e.g., an investment company that calls itself the ABC Stock Fund, the XYZ Bond Fund, or the QRS U.S. Government Fund) to invest at least 80% of its assets in the type of investment suggested by its name. Under current positions of the Commission's Division of Investment Management, these investment companies generally must invest only 65% of their assets in the types of investments suggested by their names. The proposed rule also would address names that suggest an investment company focuses its investments in a particular country or geographic region, names that indicate a company's distributions are exempt from income tax, and names that suggest a company or its shares are guaranteed or approved by the U.S. government. The new rule is intended to address certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks.

DATES: Comments must be received on or before June 9, 1997.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC. 20549-6009. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-11-97; this file number should be included on the subject line if E-mail is used. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW., Washington, DC. 20549-6009. Electronically-submitted comment letters will be posted on the Commission's Internet site (<http://www.sec.gov>).

FOR FURTHER INFORMATION CONTACT:

David U. Thomas, Senior Counsel, or Elizabeth R. Krentzman, Assistant

Director, (202) 942-0721, Office of Disclosure and Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 5th Street, NW., Mail Stop 10-2, Washington, DC. 20549-6009.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today is proposing for comment new rule 35d-1 (17 CFR 270.35d-1) under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) (the "Investment Company Act"). The new rule would apply to all registered investment companies and would require an investment company with a name that suggests that the company focuses on a particular type of investment to invest at least 80% of its assets in the type of investment suggested by its name. In addition, the rule would apply an 80% investment requirement to investment companies with names that suggest the company focuses its investments in a particular country (e.g., the ABC Japan Fund) or geographic region (e.g., the ABC Latin America Fund) and investment companies with names that indicate the company's distributions are exempt from federal income tax (e.g., the XYZ Tax-Exempt Fund) or exempt from both federal and state income tax (e.g., the XYZ New York Tax-Exempt Fund). The rule also would prohibit an investment company from using a name that suggests that the company or its shares are guaranteed or approved by the U.S. government.

In separate companion releases, the Commission is proposing two initiatives designed to improve the disclosure provided to investors by open-end management investment companies ("funds"). First, the Commission is proposing significant amendments to the prospectus disclosure requirements of Form N-1A (17 CFR 274.11A), the registration statement used by funds.¹ These amendments seek to minimize prospectus disclosure about technical, legal, and operational matters that generally are common to all funds and to focus prospectus disclosure on essential information about a particular fund that would assist an investor in deciding whether to invest in that fund. Second, the Commission is proposing new rule 498 under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) and the Investment Company Act, which would permit an investor to buy a fund's shares based on a summary document, or "profile," that contains key

¹ Investment Company Act Release No. 22528 (Feb. 27, 1997) ("Form N-1A Release").

information about the fund.² Under this proposal, investors would receive the fund's prospectus upon request or with the purchase confirmation.

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I. Introduction

Section 35(d) of the Investment Company Act, as amended by the recently enacted National Securities Markets Improvement Act of 1996, prohibits a registered investment company from using a name that the Commission finds by rule to be materially deceptive or misleading.³ Before section 35(d) was amended, the Commission was required to declare by order that a particular name was misleading and, if necessary, obtain a federal court injunction prohibiting further use of the name. In adopting amended section 35(d), Congress reaffirmed its concern that investors may focus on an investment company's name to determine the company's investments and risks, and recognized that investor protection would be improved by giving the Commission rulemaking authority to address potentially misleading investment company names.⁴

The Commission is proposing new rule 35d-1 to address certain investment company names that are likely to mislead an investor about a company's investment emphasis. The Commission believes that investors should not rely on an investment company's name as the sole source of information about a

company's investments and risks.⁵ An investment company's name, like any other single piece of information about an investment, cannot tell the whole story about the investment company.⁶ As Congress has recognized, however, the name of an investment company may communicate a great deal to an investor.

The proposed rule would apply to all registered investment companies, including funds, closed-end investment companies, and unit investment trusts, and would require an investment company with a name that suggests a particular investment emphasis to invest in a manner consistent with its name. The rule, for example, would require an investment company with a name that suggests that the company focuses on a particular type of security (e.g., an investment company that calls itself the ABC Stock Fund, the XYZ Bond Fund, or the QRS U.S. Government Fund) to invest at least 80% of its assets in the type of security indicated by its name. An investment company seeking maximum flexibility with respect to its investments would be free to select a name that does not connote a particular investment emphasis.

Under current positions of the Division of Investment Management ("Division") an investment company with a name suggesting that the company focuses on a particular type of investment generally is required to invest only 65% of its assets in the type of investment suggested by its name.⁷ Division positions with respect to investment company names have evolved over time. Division guidelines accompanying Form N-8B-1, a predecessor of Form N-1A, required a fund to invest at least 80% of its assets in the type of investment indicated by its name.⁸ When the Commission

adopted Form N-1A in 1983, the Division instituted the 65% investment requirement to give funds greater flexibility with respect to their names and investments.⁹

The Commission is proposing the 80% investment requirement to guard against the use of misleading investment company names and to implement Congress's intent in amending section 35(d).¹⁰ Requiring an investment company to invest at least 80% of its assets in the type of investment suggested by its name would provide an investor greater assurance that the company's investments will be consistent with its name. The need for investment companies to invest in a manner consistent with their names would appear to have become more important in recent years as more and more investors have invested in investment companies to meet their retirement goals. These investors typically place greater emphasis on allocating their investment company holdings in well-defined types of investments, such as stocks, bonds, and money market instruments.¹¹ Given the substantial growth of the investment company industry over the last decade, investors face an increasingly diverse universe of investment companies to evaluate when choosing a company suitable for their investment needs.¹²

exclusive of cash, government securities, and short-term commercial paper).

⁹ Investment Company Act Release No. 13436 (Aug. 12, 1983) (48 FR 37928) (applying the 65% requirement with respect to a fund's total assets, but allowing funds to depart from the 65% requirement based on adverse market conditions).

¹⁰ Rule 35d-1 would address misleading investment company names. In contrast, fund professionals and others may categorize investment companies based on a company's investment objectives or strategies and actual portfolio holdings. A fund investing principally in equity securities, for example, may be categorized as an aggressive stock fund or a small-capitalization fund. These categories develop over time and are used by industry and rating services such as Lipper Analytical Services, Inc. and Morningstar, Inc. Morningstar, Inc., for example, currently is revising its investment company classification system to classify a company by its portfolio holdings over a 3-year period (or life of the fund, if shorter). Morningstar, *Morningstar Introduces New Fund Categories* (Oct. 29, 1996) (press rel.).

¹¹ See, e.g., Vickers, *A Price of Success: An Unbalanced Portfolio*, N.Y. Times, Jan. 12, 1997, at F6; Glassman, *With New Year, Stock Up a 401(k) for the Long Term*, Wash. Post, Jan. 1, 1997, at C13. The amount of retirement assets invested in funds increased 145% between 1992 and 1995, with these assets totalling \$1.01 trillion at the end of 1995. ICI, *Mutual Fund Retirement Assets* (Dec. 6, 1996) (ICI News No. ICI-96-98). The ICI estimates that, in 1995, 84% of fund shareholders invested for retirement purposes. *Id.*

¹² According to Division estimates based on data from the ICI and Lipper Analytical Services, between September 1985 and November 1996, investment company assets increased from \$591 billion to \$4.0 trillion and the number of

⁵ See generally "Investor Protection: Tips from an SEC Insider," Remarks by Arthur Levitt, Chairman, SEC, before the Investors' Town Meeting at the Houstonian Hotel, Washington, D.C. (Apr. 12, 1995) ("An informed investor looks beyond the packaging of a fund, and also sees what's inside."); "The SEC and the Mutual Fund Industry: An Enlightened Partnership," Remarks by Arthur Levitt, Chairman, SEC, before the General Membership Meeting of the Investment Company Institute ("ICI") at the Washington Hilton Hotel, Washington, D.C. (May 19, 1995) ("some fund names can leave investors with the wrong impression about [the fund's] safety.").

⁶ See Millman, *First pop the hood: A fund's name may tell you nothing about how it acts*, U.S. News & World Rep., Feb. 3, 1997, at 70.

⁷ See, e.g., Guide 1 to Form N-1A (regarding certain names used by funds). The Division also has addressed certain investment company names in various "Letters to Registrants" ("GCLs").

⁸ Investment Company Act Release No. 7221 (June 9, 1972) (37 FR 12790) (applying the 80% requirement with respect to a fund's assets

² Investment Company Act Release No. 22529 (Feb. 27, 1997).

³ 15 U.S.C. 80a-34(d); Pub. L. No. 104-290, sec. 208, 110 Stat. 3416, 3432 (1996).

⁴ See S. Rep. No. 293, 104th Cong., 2d Sess. 8-9 (1996).

The proposed 80% investment requirement could help reduce confusion when an investor selects an investment company for specific investment needs and asset allocation goals.

The proposed rule would address certain broad categories of investment company names that, in the Commission's view, are likely to mislead investors about a company's investments and risks. The Division would continue to evaluate investment company names not covered by proposed rule 35d-1 (e.g., a name that includes words, such as "international" or "global," that a reasonable investor may conclude suggest more than one investment focus). In determining whether a particular name is misleading, the Division would consider whether the name would lead a reasonable investor to conclude that the company invests in a manner that is inconsistent with the company's intended investments or the risks of those investments.

II. Discussion

A. General

1. Names Indicating an Investment Emphasis in Certain Securities or Industries

Proposed rule 35d-1 would require an investment company with a name that suggests that the company focuses its investments in a particular type of security (e.g., the ABC Stock Fund or XYZ Bond Fund) or in securities of issuers in a particular industry (e.g., the ABC Utilities Fund or the XYZ Health Care Fund) to invest at least 80% of its assets in the indicated investment.¹³ The 80% requirement would allow an investment company to maintain up to 20% of its assets in other investments. In the case of funds, these assets, for example, could include cash and cash equivalents that could be used to meet redemption requests.

The proposed rule would require the 80% investment requirement to be a fundamental policy of the investment company (i.e., a policy that may not be changed without shareholder approval).¹⁴ Consistent with other

requirements under the Investment Company Act, the requirement to adopt the 80% investment requirement as a fundamental policy would prevent a company from changing its name and its investment emphasis without the consent of shareholders.¹⁵ The Commission requests comment on the proposed 80% investment requirement and whether the 80% requirement should be a fundamental policy.

Under the proposed rule, an investment company that includes the words "Treasury" or "government" in its name (e.g., the ABC U.S. Treasury Fund or the XYZ U.S. Government Fund) would be required to invest, as applicable, at least 80% of its assets in U.S. Treasury securities or U.S. government securities.¹⁶ The Commission requests comment whether an investor may infer from a name that includes the words "Treasury" that the investment company invests exclusively in obligations backed by the full faith and credit of the U.S. government. If so, should the proposed rule require these investment companies to invest exclusively in U.S. Treasury obligations?

Under the proposed rule, an investment company with the word "government" in its name could satisfy the 80% investment requirement by investing in government securities, which include many types of instruments ranging, for example, from U.S. Treasury bonds to derivative securities, such as Government National Mortgage Association collateralized mortgage obligations. Investors may not anticipate the extent to which the net asset value of an investment company that invests in government securities may increase or decrease in response to

approval to change a policy deemed fundamental under section 8(b)(3)). Under current Division positions, only investment companies with names suggesting that their distributions are exempt from tax are required to adopt fundamental policies with respect to their investments or distributions. See Guide 1 to Form N-1A (regarding tax-exempt funds).

¹⁵ See section 13(a) of the Investment Company Act (requiring, among other things, an investment company to obtain shareholder approval to change its status from a diversified company to a nondiversified company). See also *infra* note 49.

¹⁶ See section 2(a)(16) of the Investment Company Act (15 U.S.C. 80a-2(a)(16)) (defining government securities as those issued or guaranteed by the U.S. government or any U.S. government agency or instrumentality). The requirement to invest, as applicable, in U.S. Treasury securities or U.S. government securities would apply only to investment companies with names that connote investments in U.S. obligations. An investment company with a name that suggests the company invests in government obligations other than those of the United States (e.g., the ABC French Government Fund) would be required to invest at least 80% of its assets in the type of government securities by its name.

changes in interest rates. In 1994, certain funds with the word "government" in their names declined sharply in value in response to interest rate changes.¹⁷ The Commission requests comment whether, to address the degree of interest-rate sensitivity of the shares of these companies, the rule should restrict the types of government securities that may be used to satisfy the 80% requirement and, if so, what restrictions would be appropriate. For example, the rule could require an investment company with a name that includes the word "government" to invest at least 80% of its assets in U.S. Treasury securities and other comparable government instruments. This approach, however, could have the practical effect of subjecting investment companies with the words "government" and "Treasury" in their names to substantially the same 80% investment requirement and eliminate any differences among these funds. In addition, these types of restrictions would create a separate, narrower definition of "government securities" for the purposes of the rule than that used in the marketplace. Commenters favoring a limitation on the types of instruments that could be used to meet the 80% requirement should suggest specific limitations and discuss why those limitations would be appropriate.¹⁸

2. Names Indicating an Investment Emphasis in Certain Countries or Geographic Regions

The proposed rule would address investment companies with names that suggest that they focus their investments in a particular country (e.g., the ABC Japan Fund) or in a particular geographic region (e.g., the XYZ Latin America Fund) by requiring these companies to meet a two-part 80% investment requirement.¹⁹ First, these companies would be required to have a fundamental policy to invest, as applicable, at least 80% of their assets in securities of issuers that are tied economically to the particular country or geographic region indicated by their names. Consistent with this requirement, a company also would be required to invest in securities that meet any one of the following criteria: (i) Securities of issuers that are organized under the laws of the country or of a

¹⁷ See *Mutual Funds*, Consumer Reports, June 1995, at 415 (a fund with the words "government income" in its name that lost 28% in 1994 "seemed to imply that shareholders would be investing in safe government bonds that produce income").

¹⁸ See also *infra* "Names Suggesting Guarantee or Approval by the U.S. Government."

¹⁹ Proposed rule 35d-1(a)(3).

investment companies (including the individual series of funds) increased from 9,200 to 24,661.

¹³ Proposed rule 35d-1(a)(2). A fund that uses a name suggesting that it is a money market fund would continue to be subject to the maturity, quality, and diversification requirements of rule 2a-7(b) under the Investment Company Act (17 CFR 270.2a-7(b)).

¹⁴ See section 8(b)(3) of the Investment Company Act, 15 U.S.C. 80a-8(b)(3) (regarding policies deemed fundamental by an investment company), and section 13(a)(3) of the Investment Company Act, 15 U.S.C. 80a-13(a)(3) (requiring shareholder

country within the geographic region suggested by the company's name or that maintain their principal place of business in that country or region; (ii) securities that are traded principally in the country or region suggested by the company's name; or (iii) securities of issuers that, during the issuer's most recent fiscal year, derived at least 50% of their revenues or profits from goods produced or sold, investments made, or services performed in the country or region suggested by the company's name or that have at least 50% of their assets in that country or region. Substantially the same 3 criteria have been used to date by the Division to determine whether names of investment companies that focus their investments in particular countries or geographic regions are consistent with section 35(d).²⁰ Since these criteria are relatively broad, the proposed rule would impose the general requirement that a company's investments be tied economically to the country or region indicated by its name.

The Commission requests comment on the proposed approach. In particular, the Commission requests comment on using specific criteria alone to determine whether a company's investments are consistent with its name and, if so, whether the proposed 3 criteria appropriately describe investments in securities of a particular country or region.²¹ Alternatively, the Commission requests comment whether the rule should impose only the general requirement that a company invest at least 80% of its assets in securities of issuers that are tied economically to the country or geographic region indicated by the company's name.²² This approach may give a company the flexibility to invest in additional types of securities that are not addressed by the 3 proposed (or other specific) criteria, but expose the company's assets to the economic fortunes and risks of the country or geographic region

indicated by its name.²³ The Commission requests comment whether this result would be appropriate.

Tax-Exempt Investment Companies

The proposed rule would codify current Division positions applicable to an investment company with a name that suggests that the company's distributions are not subject to income tax. In particular, rule 35d-1 would require a company that uses a name suggesting that its distributions are exempt from federal income tax or from both federal and state income taxes to adopt a fundamental policy: (i) To invest at least 80% of its assets in securities the income from which is exempt, as applicable, from federal income tax or from both federal and state income tax; or (ii) to invest its assets so that at least 80% of the income that it distributes will be exempt, as applicable, from federal income tax or from both federal and state income tax.²⁴ Consistent with current Division positions, the proposed requirements would apply to a company's investments or distributions that are exempt from federal income tax under both the regular tax rules and the alternative minimum tax rules.²⁵

Applying the 80% Investment Requirement

The proposed 80% investment requirement would apply at the time a company invests its assets.²⁶ This approach would be consistent with other investment requirements under the Investment Company Act.²⁷ Under the proposed approach, for example, an investment company subject to the 80% investment requirement would not have to sell portfolio holdings that have increased in value.²⁸ The proposed rule

would require an investment company that no longer meets the 80% investment requirement (e.g., as a result of changes in the value of its portfolio holdings or other circumstances beyond its control) to make future investments in a manner that would bring the company into compliance with the 80% requirement. The Commission requests comment on the proposed approach.

The proposed 80% investment requirement would be based on a company's net assets plus any borrowings that are senior securities under section 18 of the Investment Company Act.²⁹ Division positions that require an investment company to invest at least 65% of its assets in the type of investment suggested by its name apply the 65% requirement based on a company's total assets.³⁰ Total assets may include non-investment assets (such as receivables for shares sold or expense reimbursements) and exclude liabilities that reduce the amount of a company's investments. Certain types of routine transactions, such as unsettled securities transactions and securities loans, may increase a company's total assets because total assets do not reflect certain liabilities.³¹ These transactions have no net effect on a company's portfolio investments and may result in a company failing to satisfy an 80% investment requirement based on total assets, even though, in effect, 80% of the company's portfolio holdings would be invested in a manner consistent with the company's name. Basing the 80% investment requirement on net assets rather than total assets is intended to reflect more closely a company's portfolio investments.

Net assets do not include liabilities such as a company's borrowings, if any. The proposed rule would use net assets plus the amount of any borrowings that are senior securities. This approach seeks to prevent a company from circumventing the 80% investment requirement by investing borrowed funds in securities that are not

²⁰ Letter to Registrants at IIA (Feb. 22, 1993) (using substantially the same 3 criteria, but indicating that the Division would consider other criteria).

²¹ See "The Scope of the US Mutual Fund Industry: Its Regulation and Industry Trends," Remarks by Isaac C. Hunt, Jr., Commissioner, SEC, before the Business Roundtable on "The Development of the Russian Mutual (Unit) Fund Industry and Related Investment Opportunities" at the General Consulate of the Russian Federation, New York, New York (Sept. 20, 1996) (discussing St. Petersburg Long Distance Telephone company, which is organized in Canada and whose securities are traded outside of Russia). See also, e.g., rule 3b-4 under the Securities Exchange Act of 1934 (17 CFR 240.3b-4) (defining a "foreign issuer").

²² Under this approach, an investment company would describe in its prospectus the specific criteria that it uses to select investments that meet the general standard.

²³ For example, an investment company may seek to replicate the currency exposure associated with investing in a particular country by investing in securities denominated in the currencies of other countries.

²⁴ Proposed rule 35d-1(a)(4).

²⁵ Letter from Mary Joan Hoene, Deputy Director, Division of Investment Management, SEC, to Matthew P. Fink, Senior Vice President and General Counsel, ICI (Nov. 3, 1987).

²⁶ Proposed rule 35d-1(b)(1).

²⁷ See section 5(c) of the Investment Company Act (15 U.S.C. 80a-5(c)) (providing that a diversified investment company under section 5(b)(1) of the Act will not lose its status as a diversified company because of changes in the value of its investment since the time of purchase).

²⁸ Similarly, the proposed approach would enable a fund, pending investment of its assets, to meet the 80% investment requirement despite an influx of cash from new investors. Guide 1 to Form N-1A, in contrast, requires a fund "to have invested" at least 80% of its assets in a manner consistent with its name, which could suggest that a fund would be required to sell portfolio securities in order to maintain 80% of its assets in the type of investment suggested by its name.

²⁹ 15 U.S.C. 80a-18. See proposed rule 35d-1(b)(2)(ii) (defining assets for the purposes of the 80% investment requirement).

³⁰ See Guide 1 to Form N-1A (also applying an 80% investment requirement for tax-exempt funds based on a fund's net assets).

³¹ For example, when a company sells a security for settlement in 3 days and simultaneously commits the sale proceeds to purchase another security, the company's total assets would include as receivables amounts for the security sold and the security purchased, although, during the 3-day settlement period, the company's total assets would not reflect the liability for the price of the securities that the company is obligated to purchase. Similarly, when a company lends its securities, total assets would include a receivable for the security loaned and the collateral for the loan, but not the corresponding payable for the loan.

consistent with the company's name.³² The Commission requests comment on the proposed approach and whether there are other transactions that, like borrowings, could increase the amount of assets that a company could invest and should be added to net assets. Alternatively, the Commission requests comment whether using total assets excluding certain transactions, such as unsettled securities transactions and securities loans, would be a more effective basis for the 80% requirement and, if so, what transactions should be excluded from total assets.

Consistent with current Division positions, the proposed rule would contemplate that an investment company may take a "temporary defensive position" to avoid losses in response to adverse market, economic, political, or other conditions.³³ When an investment company assumes a temporary defensive position, the company would be permitted to depart from the 80% requirement and invest in other securities. The Commission requests comment on the proposed approach. In particular, the Commission requests comment whether the Commission should provide specific guidance on when an investment company could appropriately assume a temporary defensive position.³⁴ Commenters favoring this approach should consider whether the rule should establish specific time periods during which a company would be permitted to take a temporary defensive

position. Alternatively, the Commission requests comment whether the rule should give investment companies greater flexibility to assume temporary defensive positions. For example, should an investment company simply disclose the circumstances under which, and the potential length of time during which, the company may assume a temporary defensive position and depart from the 80% investment requirement?

The Commission also requests comment whether certain investment companies may require more flexibility than others in meeting the 80% investment requirement. For example, an investment company with a name that suggests the company invests in securities associated with a developing country may need the flexibility to invest significant portions of its assets in other securities pending the availability of suitable investments in the developing country indicated by its name. The Commission requests comment whether and how these or other circumstances should be addressed.

B. Names Suggesting Guarantee or Approval by the U.S. Government

Consistent with the requirements of section 35(a) of the Investment Company Act, the proposed rule would prohibit an investment company from using a name that suggests that the company or its shares are guaranteed or approved by the U.S. government or any U.S. government agency or instrumentality.³⁵ The proposed rule also would codify a Division position that prohibits an investment company from using a name that includes the words "guaranteed" or "insured" or similar terms in conjunction with "United States" or "U.S. government." The Division adopted this position to address concerns that names with these terms may lead investors to conclude erroneously that the value of an investment company's shares is guaranteed or insured by the U.S. government.³⁶

³⁵ Proposed rule 35d-1(a)(1). See section 35(a) of the Investment Company Act (15 U.S.C. 80a-34(a)) (prohibiting an investment company from representing or implying in any manner that the company or its shares are guaranteed or approved by the U.S. government).

³⁶ See Letter from William R. McLucas, Director, Division of Enforcement, and Gene A. Gohlke, Acting Director, Division of Investment Management, SEC, to Registrants (Oct. 25, 1990). A similar concern may be raised when an investment company has a name that is the same as or similar to the name of a bank that advises the company or through which the company's shares are sold. The Division has taken the position that, absent disclosure informing investors that the investment company is not federally insured, these names are

U.S. government securities differ among themselves with respect to the amount of credit support provided by the U.S. government. Including the word "guarantee" or similar terms in an investment company's name could be used to address the degree of credit risk associated with the types of government securities in which a particular company invests. For example, while U.S. Treasury bonds are supported by the full faith and credit of the United States, government securities issued by the Federal National Mortgage Association ("Fannie Mae") are supported by Fannie Mae's ability to borrow from the U.S. Treasury. The proposed rule, however, would prohibit a company from using a name such as the "ABC Fund for Investing in U.S. Guaranteed Assets," even though the company invests at least 80% of its assets in government obligations that are, in fact, guaranteed as to payment of principal and interest by the full faith and credit of the U.S. government. The Commission requests comment whether the proposed prohibition is appropriate. In addition, since the fund industry distinguishes between Treasury and other government funds and investors may understand the differences between these funds, the Commission requests comment whether a reasonable investor would understand that using terms such as "guaranteed" or "insured" in conjunction with the words "U.S. government" reflect the credit risk of a company's investments. Alternatively, would a reasonable investor be misled into believing that names using these terms mean that an investment in the company is guaranteed or insured by the U.S. government from any risk of loss, including the risk that the value of the company's shares may decrease in response to interest rate changes?

C. Other Investment Company Names In General

The proposed rule would not codify Division positions with respect to certain investment company names. The Division, for example, has provided guidance in the past about the use of a name that includes words such as "balanced," "index," "small, mid, or large capitalization," "international,"

misleading because an investor is likely to believe that an investment in the company is insured by the Federal Deposit Insurance Corporation or otherwise protected against loss. See Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management, SEC (May 13, 1993). The proposed amendments to Form N-1A would continue to require a fund with a name that is the same as or similar to a bank's name to disclose that it is not federally insured. See Form N-1A Release, *supra* note 1.

³² Section 18 of the Investment Company Act restricts the issuance of senior securities, which include borrowings (except bank borrowings that satisfy certain asset coverage conditions). Investment companies may borrow without being deemed to have created a senior security by establishing a segregated account with liquid assets that collateralize 100% of the market value of the borrowing. See Investment Company Act Release No. 10666 (Apr. 18, 1979) (44 FR 25128); Merrill Lynch Asset Management, L.P. (pub. avail. July 2, 1996). For purposes of the rule, net assets would include only those borrowings that are senior securities (i.e., any borrowings that are not fully collateralized by amounts maintained in a segregated account). By virtue of segregating assets to collateralize the borrowing, an investment company should not be able to circumvent the 80% requirement because the amount of company's assets available for investment would not be increased.

³³ Proposed rule 35d-1(b)(3). See Letter to Registrants at ILE (Feb. 25, 1994) ("1994 GCL"). See also Form N-1A Release, *supra* note (proposing to require a fund to disclose, if applicable, certain information in its prospectus about the possibility of taking temporary defensive positions).

³⁴ Many investment companies have the flexibility to assume temporary defensive positions and depart from investment policies unrelated to their names. See 1994 GCL, *supra* note (noting that investment companies may depart from a policy to concentrate in a particular industry or group of industries to avoid losses in response to adverse market, economic, political, or other conditions).

and "global."³⁷ The Commission believes that a reasonable investor could conclude that these names suggest more than one investment focus. For example, while an investment company with a name that includes the words "international" or "global" generally suggests that the company invests in more than one country, these terms may describe a number of investment companies that have significantly different investment portfolios. Among other things, the number of countries in which an "international" or "global" investment company may invest at any one time may appropriately differ from company to company.³⁸

The Division would continue to give interpretive advice with respect to investment company names not covered by the proposed rule.³⁹ In determining whether a particular name is misleading, the Division would consider whether the name would lead a reasonable investor to conclude that the company invests in a manner that is inconsistent with the company's intended investments or the risks of those investments.⁴⁰

³⁷ See Guide 4 to Form N-1A (funds that use the word "balanced" in their names); Letter to Registrants at I.L.A. (Jan. 17, 1992) (investment companies that include the word "index" in their names); 1994 GCL, *supra* note 33, at I.L.D. (investment companies with names that include the terms "small, mid, or large capitalization"). The Commission does not license the use of a particular investment company name, although the Division has considered and would continue to address whether the use of a particular name would be misleading because it is the same as or similar to the name of an existing registered investment company. See Guide 1 to Form N-1A.

³⁸ In the past, the Division distinguished "global" and "international" investment companies by suggesting that an investment company with "global" in its name invest in securities of at least 3 different countries (which may include the United States) and that an investment company with "international" in its name invest in securities of at least 3 countries outside the United States. Letter to Registrants at I.L.A.2 (Jan. 3, 1991). The Division no longer distinguishes the terms "global" and "international."

³⁹ As a general matter, an investment company should define the terms used in its name in discussing its investment objectives and strategies in the prospectus. See 1994 GCL, *supra* note 33, at I.L.D. (using this approach for investment companies that include the words "small, mid, and large capitalization" in their names).

⁴⁰ See *In re Alliance North Am. Gov't Income Trust, Inc. Securities Litigation*, No. 95 Civ. 0330 (LLM), 1996 U.S. Dist. LEXIS 14209, at *8 (S.D.N.Y. Sept. 27, 1996); *The Private Investment Fund for Governmental Personnel, Inc.*, 37 S.E.C. 484, 487-88 (1957). The 80% investment requirement generally would apply to a company's investment focus as disclosed in the company's prospectus. The Commission, however, recognizes that the 80% investment requirement would not be appropriate in all cases (e.g., with respect to an investment company that uses the word "balanced" in its name).

In connection with the proposed amendments to Form N-1A, information about the organization and operations of investment companies and Division

2. Names and Average Weighted Portfolio Maturity and Duration

Investment companies investing in debt obligations often seek to distinguish themselves by limiting the maturity of the instruments they hold. These investment companies may call themselves, for example, "short-term," "intermediate-term," or "long-term" bond or debt funds.⁴¹ The Division has required investment companies with these types of names to have average weighted portfolio maturities of specified lengths. The Division, for example, has required an investment company that includes the words "short-term," "intermediate-term," or "long-term" in its name to have a dollar-weighted average maturity of, respectively, no more than 3 years, more than 3 years but less than 10 years, or more than 10 years.⁴² The Division no longer intends to use these criteria because it believes a reasonable investor would not necessarily expect that investment companies with these names would be limited in this manner.⁴³ In addition, the Division and Commission believe that the average weighted maturity of an investment company's portfolio securities may not accurately reflect the sensitivity of the company's share prices to changes in interest rates.⁴⁴

In view of the shortcomings associated with analyzing interest rate volatility based on average weighted maturity, investment companies and investment professionals increasingly evaluate bond portfolios based on "duration," which reflects the sensitivity of an investment company's

interpretive positions is proposed to be incorporated in a new "Investment Company Registration Package," which would be prepared by the Division. See Form N-1A Release, *supra* note 1. The Investment Company Registration Package would include general guidance about avoiding the use of a name that is the same as or similar to the name of another investment company and about names that a reasonable investor may conclude suggest more than one investment focus including, for example, use of names that include the terms "small, mid, or large capitalization."

⁴¹ The term "bond," by itself, does not imply that the security has a particular maturity. See also 1994 GCL, *supra* note 33, at III.A. (indicating that a fund should describe in its prospectus what it considers to be a "bond").

⁴² See Investment Company Act Release No. 15612 (Mar. 9, 1987) [52 FR 8268, 8301] (proposing to codify these positions in a guideline).

⁴³ As in the case of other investment company names, the Division would address these terms on a case-by-case basis in light of the disclosure provided by the investment company.

⁴⁴ In 1994, some investors did not anticipate how certain investment companies would perform when interest rates declined over a relatively short period of time. See, e.g., Antilla, *A New Concept in Fund Ads: Truth*, N.Y. Times, July 10, 1994, at C13 (regarding the performance of certain short-term bond funds).

returns to changes in interest rates.⁴⁵ In a concept release on improving risk disclosure, the Commission requested comment whether, if an investment company's name or investment objective refers to maturity, the maturity of the company's investments should be required to be consistent with the duration of the company's portfolio.⁴⁶ A number of commenters supported this approach, and the Division is in the process of developing recommendations relating to duration and the maturity of an investment company's investments. As part of its consideration of this issue, the Division requested the Investment Company Institute ("ICI") to consider various methods of calculating duration and asked the ICI to report its findings.⁴⁷ In response, the ICI formed a committee to consider this issue and the committee has agreed to inform the Division of its findings. As the Division continues to consider this issue, the Commission requests further comment whether the maturity of a company's portfolio suggested by the company's name should be consistent with the portfolio's duration.⁴⁸ The Commission requests specific comment on an appropriate method or methods to calculate portfolio duration.

D. Effective Date

The Commission proposes to allow an investment company up to one year from the effective date of the proposed rule to comply with the rule's requirements. A one-year period is intended to give an investment company sufficient time to make any necessary adjustments to its portfolio holdings to comply with proposed rule 35d-1 or, if the company does not wish to be bound by the requirements of the new rule, to change its name.⁴⁹ The

⁴⁵ See, e.g., Rekenthaler, *Duration Arrives*, Morningstar Mutual Funds 1-2 (Jan. 21, 1994).

⁴⁶ Investment Company Act Release No. 20974 (Mar. 29, 1995) (60 FR 17172, 17175-76).

⁴⁷ Letter to Paul Schott Stevens, General Counsel, ICI, from Barry P. Barbash, Director, Division of Investment Management, SEC (Feb. 15, 1996) (File No. S7-10-95); Letter to Barry P. Barbash, Director, Division of Investment Management, SEC, from Paul Schott Stevens, Senior Vice President and General Counsel, ICI (Mar. 11, 1996) (File No. S7-10-95). See also Letter to Barry P. Barbash, Director, Division of Investment Management, SEC, from Craig Tyle, Vice President and Senior Counsel, ICI (Dec. 17, 1996) (enclosing preliminary recommendations relating to a standardized methodology for calculating portfolio duration) (File No. S7-10-95).

⁴⁸ Pending further action on this issue, the Division would consider, on a case-by-case basis, an investment company's use of duration in connection with the maturity suggested by the company's name.

⁴⁹ Certain investment companies have fundamental policies to invest at least 65% of their assets in the type of investments suggested by their

Commission requests comment on the proposed transition period.

III. General Request for Comments

The Commission requests that any interested persons submit comments on proposed rule 35d-1, suggest additional changes (including changes to related rules that the Commission is not proposing to amend), or submit comments on other matters that might affect the proposed rule. Commenters suggesting alternative approaches are encouraged to submit proposed rule or form text. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (5 U.S.C. 801 *et seq.*), the Commission also is requesting information regarding the potential impact of the proposed rule on the economy on an annual basis. Commenters should provide empirical data to support their views.

IV. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("Analysis") in accordance with 5 U.S.C. 603 regarding proposed rule 35d-1. The Analysis explains that the proposed rule would require a registered investment company with a name suggesting that the company focuses on a particular type of investment to invest at least 80% of its assets in the type of investment suggested by its name. The Analysis also explains that the proposed rule is intended to address investment company names that are likely to mislead investors about an investment company's investments and risks.

The Analysis discusses the impact of the proposed rule on small entities, which are defined, for the purposes of the Investment Company Act, as investment companies with net assets of \$50 million or less as of the end of the most recent fiscal year (17 CFR 270.0-10). The Commission estimates that approximately 3,846 investment companies would be subject to the proposed rule. Of these, approximately, 771 (20%) are investment companies that would be small entities. The Commission believes that there are no

other duplicative, overlapping, or conflicting federal rules.

Only those investment companies that have names suggesting a particular investment emphasis would be required to comply with the proposal. To comply with the proposed rule, an investment company with a name that suggests the company focuses on a particular type of investment would have to adopt a fundamental policy to invest at least 80% of its assets in the type of investment suggested by its name. The 80% requirement would allow an investment company to maintain up to 20% of its assets in other investments. An investment company seeking maximum flexibility with respect to its investments would be free to use a name that does not connote a particular investment emphasis.

As stated in the Analysis, the Commission considered several alternatives to proposed rule 35d-1 including, among others, establishing different compliance or reporting requirements for small entities or exempting them from all or part of the proposed rule. Because an investment company could choose to use a name that does not suggest a particular investment, the Commission believes that the proposed rule would not impose additional burdens on small entities and that separate treatment for small entities would be inconsistent with the protection of investors.

The Commission encourages the submission of comment on the Analysis, including specific comment on (i) the number of small entities that would be affected by the proposed rule and (ii) the discussion of the impact of the rule on small entities. Comments will be considered in the preparation of the Final Regulatory Flexibility Analysis if the proposed rule is adopted. A copy of the Analysis may be obtained from John M. Ganley, Senior Counsel, Securities and Exchange Commission, 450 5th Street, NW., Mail Stop 10-2, Washington, DC 20549-6009.

V. Statutory Authority

The Commission is proposing rule 35d-1 under sections 5, 7, 8, 10, and 19(a) of the Securities Act (15 U.S.C. 77e, 77g, 77h, 77j, and 77s(a)) and sections 8, 30, 35, and 38 of the Investment Company Act (15 U.S.C. 80a-8, 80a-29, 80a-34, and 80a-37). The authority citations for the rule precede the text of the amendments.

VI. Text of Proposed Rule

List of Subjects in 17 CFR Part 270

Investment companies, Securities.

For the reasons set out in the preamble, the Commission is proposing to amend Chapter II, Title 17 of the Code of Federal Regulations as follows:

PART 270—GENERAL RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

The authority citation for part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a-1 *et seq.*, 80a-37, and 80a-39 unless otherwise noted;

* * * * *

2. Add § 270.35d-1 to read as follows:

§ 270.35d-1 Investment company names.

(a) For purposes of section 35(d) of the Act (15 U.S.C. 80a-34(d)), a materially deceptive and misleading name of a Fund includes:

(1) *Names suggesting guarantee or approval by the U.S. government.* A name suggesting that the Fund or the securities issued by it are guaranteed, sponsored, recommended, or approved by the U.S. government or any U.S. government agency or instrumentality, including any name that uses the words "guaranteed" or "insured" or similar terms in conjunction with the words "United States" or "U.S. government."

(2) *Names suggesting investment in certain securities or industries.* A name suggesting that the Fund focuses its investments in a particular type of security or securities or in securities of issuers in a particular industry or group of industries, unless the Fund has adopted a fundamental policy under section 8(b)(3) of the Act (15 U.S.C. 80-8(b)(3)) to invest, as applicable, at least 80% of the value of its Assets in the particular securities or in securities of issuers in the particular industry or industries suggested by its name.

(3) *Names suggesting investment in certain countries or geographic regions.* A name suggesting that the Fund focuses its investments in a particular country or geographic region, unless the Fund has adopted a fundamental policy under section 8(b)(3) of the Act to invest, as applicable, at least 80% of the value of its Assets in securities of issuers that are tied economically to the particular country or geographic region suggested by its name. In meeting this requirement, a Fund must invest, as applicable, in:

(i) Securities of issuers that are organized under the laws of the country or of a country within the geographic region suggested by the Fund's name or that maintain their principal place of business in that country or region;

(ii) Securities that are traded principally in the country or region suggested by the Fund's name; or

names. The Investment Company Act does not require shareholder approval to adopt a new fundamental policy. See section 13(a)(3) of the Investment Company Act (requiring shareholder approval to deviate from a fundamental policy). An investment company that has a fundamental policy to invest at least 65% of their assets in the type of investment suggested by its name generally would be expected to meet the higher 80% investment requirement. A company would decide, based on its individual circumstances, whether it is necessary to seek shareholder approval to change its investment policy.

(iii) Securities of issuers that, during the issuer's most recent fiscal year, derived at least 50% of their revenues or profits from goods produced or sold, investments made, or services performed in the country or region suggested by the Fund's name or that have at least 50% of their assets in that country or region.

(4) *Tax-exempt Funds.* A name suggesting that the Fund's distributions are exempt from federal income tax or from both federal and state income tax, unless the Fund has adopted a fundamental policy under section 8(b)(3) of the Act:

(i) To invest at least 80% of the value of its Assets in securities the income from which is exempt, as applicable,

from federal income tax or from both federal and state income tax; or

(ii) To invest its Assets so that at least 80% of the income that it distributes will be exempt, as applicable, from federal income tax or from both federal and state income tax.

(b)(1) The requirements of paragraphs (a)(2) through (4) of this section apply at the time a Fund invests its Assets. If, subsequent to an investment, these requirements are no longer met, the Fund's future investments must be made in a manner that will bring the Fund into compliance with those paragraphs.

(2) For purposes of this section:

(i) *Fund* means a registered investment company and any series of the investment company.

(ii) *Assets* means net assets plus the amount of any borrowings of the Fund that are senior securities under section 18 of the Act (15 U.S.C. 80a-18).

(3) Notwithstanding the requirements of paragraphs (a)(2) through (4) of this section, a Fund may, to the extent permitted by its fundamental policies, make other investments to avoid losses while assuming a temporary defensive position in response to adverse market, economic, political, or other conditions.

Dated: February 27, 1997.

By the Commission.

Margaret H. McFarland,
Deputy Secretary.

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