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Client Alert

Current Issues Relevant to Our Clients

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SEC Issues Guidance on Fund Names That Suggest Protection from Loss

The staff of the Securities and Exchange Commission's (the "SEC") Division of Investment Management recently published guidance to clarify the obligations of registered investment companies when using fund names that suggest safety or protection from loss. A copy of the staff's guidance is available here.

Background

Section 35(d) of the Investment Company Act of 1940 (the *"1940 Act"*) prohibits the use of any word or words in a fund's name that the SEC finds materially deceptive or misleading. Whether a fund name is deceptive or misleading is dictated by (1) Rule 35d-1 under the 1940 Act, (2) general publicly-issued SEC guidance and (3) SEC staff comments issued to specific funds in the course of the normal registration statement review process. In recent fund registration statement reviews, the SEC staff has increasingly scrutinized the use of certain words implying safety or protection from loss in the names of funds. While these terms are generally not specifically addressed in Rule 35d-1, the SEC staff believes that words such as "protected" and "guaranteed," when left unqualified, may be misleading or may contribute to investors' misunderstanding of the true risks of a given fund. The SEC has recently requested that some existing and new funds using the word "protected" in their names either qualify the use of "protected" within their names or remove the word altogether.

Division of Investment Management Guidance

As a result of this heightened scrutiny, the SEC staff recently issued public guidance to assist industry participants in evaluating fund names. The guidance affirms that the SEC staff will object to names that may create an impression of protection or safety or absence of risk of loss where the name does not include qualifying language defining the scope and limits of the protection. The staff then offers guidance regarding the appropriate naming of funds that advertise protection from loss.

General Use of "Protected," "Guaranteed" and Similar Terms

The guidance suggests that a fund should reevaluate its name if the name suggests safety or protection from loss and the fund exposes investors to market, credit or other risks. For example, some funds that use "protected" in their names seek to manage volatility through use of cash positions, short-term fixed income instruments, short positions on futures, or similar investments. The staff expressed concern with these funds because the degree to which these strategies succeed or fail is uncertain. In particular, the staff is likely to question the use of "protected," "guaranteed" or similar terms in a fund name unless additional qualification is included within the name to adequately describe the nature and limits of any protection offered. In particular, the staff notes that funds have chosen to replace "protected" with "managed risk" in some cases.

Third Party Protection

The guidance also suggests that a fund should reevaluate names that include "protected" or similar terms if the fund has entered into a contract with a third party to make up shortfalls in net asset value to ensure that the name adequately communicates the limitations of the third party protection. For example, the staff notes that third party protection often includes contractual limits on the amount of protection provided or the time during which the protection is provided. The staff also notes that funds typically remain subject to the credit risk of any third party protection provider. Significantly, the guidance notes that the SEC staff has thus far not identified *any* fund names in this category that use "protected" in a way that adequately addresses the staff's concern.

Does Prospectus Disclosure Help?

Funds that use "protected" and similar terms in their names often provide prospectus disclosures that explain the limitations of any protection offered by the fund.

Unfortunately, the SEC staff does not necessarily believe that prospectus disclosure adequately addresses naming concerns due to the staff's belief that investors sometimes focus on a fund's name to determine the fund's investment objectives and risks (including in advertisements where full prospectus disclosure is not present). As a result, the staff has requested fund name changes even where a prospectus provides disclosure that supplements or explains the fund's name.

Other Considerations
Although not mentioned in the recent guidance, Rule 35d-1 provides that a fund name is materially deceptive and misleading if it suggests that the fund or the securities issued by it are guaranteed, sponsored, recommended, or approved by the United States government or any United States 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." Accordingly, funds that use U.S. Treasury securities to achieve principal protection should also assess fund names with this provision in mind.

Past Similar Guidance—Principal-Protected Structured Notes

The concerns articulated in the recent SEC staff guidance are the latest in an ongoing focus by regulators on principal-protected products. Both the SEC and the Financial Industry Regulatory Authority, Inc. (*"FINRA"*) have focused attention on principal-protected structured products in the past that funds might find helpful in assessing fund names, disclosure and sales practices. In April 2012, the Division of Corporation Finance's Office of Capital Markets Trends sent letters to certain financial institutions in connection with their structured note offerings that, among other things, advised firms that titles using the term "principal protected" should include balanced information about limitations to the principal protection feature. The SEC staff advised issuers that they should evaluate the titles used for their different types of structured notes and should revise titles to clearly describe the product in a balanced manner and avoid titles that stress positive features without also identifying limiting or negative features. A sample of the SEC letter is available here. In December 2009, FINRA issued a regulatory notice to its member firms reminding firms of their sale practice obligations in connections with principal-protect notes. For additional information, see our January 2010 client alert titled "FINRA Reminds Firms of Their Principal-Protected Notes Sales Obligations" available here.

What Should I Do Now?

Generally, the SEC staff seems to be of the view that fund names suggesting safety or protection from loss deserve particular scrutiny for the potential to mislead investors. In light of this, the SEC staff encourages investment advisers and fund boards of directors to evaluate any fund name that suggests safety or protection from loss and to consider whether a name change is appropriate to address any potential for investor misunderstanding. Fund sponsors in the development stage of any new fund that will seek to offer principal protection should assess the staff guidance when considering possible fund names.

For More Information

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