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THE SEC'S PROPOSED CHANGES TO ITS NAMES RULE

In this article, the authors discuss the SEC's proposed changes to its names rule (Rule 35d-1) in detail. They begin with the statutory and regulatory background. They then turn to the proposed rule changes, observing at the outset that the proposal would dramatically expand the universe of terms that would be covered by the rule. They then discuss other topics related to a fund's announced 80% investment policy. They conclude with a critique of the proposal's interpretive uncertainty and compliance burden.

By Corey F. Rose, Matthew E. Barsamian, Austin G. McComb, and Nadeea R. Zakaria *

On May 25, 2022, the SEC proposed changes to Rule 35d-1 ("the Proposal") under the Investment Company Act of 1940.[1] Rule 35d-1 currently provides a framework for applying Section 35(d) of the 1940 Act's prohibition on the use of materially deceptive or misleading names. Rule 35d-1 requires funds whose names contain certain terms to invest, under normal circumstances, at least 80% of their assets in the type of investments suggested by such terms. The Proposal would significantly expand the scope of fund names that are subject to the rule, impose a new ongoing compliance requirement, narrow the circumstances under which a fund may depart from an 80% investment policy, and impose new disclosure and testing requirements.

This article examines the statutory and regulatory backdrop against which these changes are proposed, provides an overview of the Proposal, and identifies significant challenges the Proposal would pose if adopted in its current form.

[1] Inv. Co. Act Rel. No. IC-34593 (2022) ("Proposing Release").

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I. STATUTORY BACKGROUND

As initially enacted, Section 35(d) of the 1940 Act provides that "[i]t shall be unlawful for any registered investment company hereafter to adopt as a part of the name or title of such company, or of any security of which it is the issuer, any word or words which the Commission finds and by order declares to be deceptive or misleading."[2] Section 35(d) is, in essence, anti-fraud provision premised on truth-in-advertising principles. In its original form, Section 35(d) required that the SEC declare a particular fund name to be deceptive or misleading and then to pursue a claim against the fund in federal court to prohibit its further use.[3] However, given the statute's "extremely cumbersome" procedural hurdles, it was rarely invoked.[4] To address this, as part of the National Securities Markets Improvement Act of

[2] § 80a-34(d) (1940).

[3] *Id.*; Inv. Co. Act Rel. No IC-24828 (2001) (hereinafter, the "2001 Adopting Release").

[4] H.R. Rep No. 104-622, at 50 (1996).

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1996, Congress amended Section 35(d) to authorize the SEC "by rule, regulation, or order, to define such names or titles as are materially deceptive or misleading."[5] The SEC was thus provided with a more straightforward method of establishing the circumstances under which a fund name would be deemed to be materially deceptive or misleading, with the expressed aim to "improve the efficiency and usefulness of investment company advertising."[6]

II. REGULATORY BACKGROUND

Having been granted new rulemaking authority with the 1996 amendment to Section 35(d), the SEC soon thereafter sought public comment on a proposed new rule in February 1997.[7] The proposal would establish new Rule 35d-1 under the 1940 Act, which 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."[8] The proposed rule's 80% threshold would supplant a 65% threshold that had been established by the staff of the SEC's Division of Investment Management through no-action and other guidance.[9] In a speech expressing support for the proposal, then-Director of the Division of Investment Management Paul Roye observed that it was meant to address the Division's sense that the staff's historical 65% threshold was "too low" and that "investors need greater assurance that a company's investments will be consistent with its name."[10] At the same time, then-Chairman of the SEC Arthur Levitt cautioned that investors should be discouraged from relying heavily on a fund's name as a definitive source of information about the fund.[11] In another speech delivered in the period between the proposal and adoption of Rule 35d-1, Chairman Levitt remarked, "I think it would be destructive to force each fund to carry a label, and thereby reduce its investment options. The fund industry has gotten along just fine for half a century without such pigeonholing."[12] Such statements appear to reflect the Commission's and the staff's understanding of the need to strike a balance between protecting investors from deceptive naming conventions and preserving an appropriate degree of flexibility for funds.

The 2001 adopting release for Rule 35d-1 reflects this balance. For example, although the proposal had called for the 80% investment policies of all funds subject to the rule to be fundamental policies within the meaning of Section 8(b)(3) of the 1940 Act (and thus only able to be changed with the approval of a majority of the fund's shareholders), the adopting release softened this requirement in favor of permitting most funds to make changes to an 80% investment policy, provided that they first provide 60-day notice to investors.[13] The SEC

[5] § 80a-34(d) (1996); Pub. L. No. 104-290, § 208, 110 Stat. 3416, 3432 (1996). The full text of Section 34(d) now reads: "It shall be unlawful for any registered investment company to adopt as a part of the name or title of such company, or of any securities of which it is the issuer, any word or words that the Commission finds are materially deceptive or misleading. The Commission is authorized, by rule, regulation, or order, to define such names or titles as are materially deceptive or misleading." *Id.*

[6] H.R. Rep No. 104-864, at 40 (1996).

[7] Inv. Co. Act Rel. No. IC-22530 (1997) ("1997 Proposing Release").

[8] *Id.*

[9] *Id.*

[10] "The Challenge of Making Best Practice, Common Practice," Remarks by Paul Roye, Director, Division of Investment Management, SEC (Dec. 4, 2000) (*available at* https://www.sec.gov/news/speech/spch438.htm).

[11] "The Future for America's Investors – Their Rights and Obligations," Remarks by Arthur Levitt, Chairman, SEC (Jan. 16, 2001) ("[D]on't rely on a fund's name as the only source of information about its investments and risks.") (*available at* https://www.sec.gov/news/speech/spch457.htm).

[12] "Taking the Mystery Out of Mutual Funds," Remarks by Chairman Arthur Levitt, SEC (Feb. 25, 1997) (*available at* https://www.sec.gov/news/speech/speecharchive/1997/spch146.txt).

[13] Any fund may choose to make its 80% investment policy fundamental under the rule; however, other than funds whose names suggest that their distributions are exempt from federal income tax or from both federal and state income tax, which are

indicated that it agreed with commenters who opposed the proposed fundamental policy requirement that it would unduly restrict investment strategies and deter the use of descriptive fund names.[14] The adopting release also expanded the circumstances under which non-compliance with a fund's 80% investment policy would be acceptable. Whereas the proposed rule would have limited deviations from a fund's 80% investment policy to situations in which the fund was assuming a "temporary defensive position," the final rule liberalized this restriction by instead requiring funds to comply with their 80% investment policy "under normal circumstances."

With respect to its scope, current Rule 35d-1 reaches fund names that suggest: (1) government approval or guarantee; (2) investment in certain investments or industries; (3) investment in certain countries or geographic regions; or (4) that a fund's distributions are exempt from federal income tax or from both federal and state income tax ("tax-exempt funds"). Notably, in adopting current Rule 35d-1, the SEC declined to codify certain existing staff positions regarding a number of specific terms, including "balanced," "index," "small, mid, or large capitalization," "international" and "global."[15] Instead, the Commission stated that the staff of the Division of Investment Management "would continue to give interpretive advice with respect to investment company names not covered."[16] The SEC, in the 2001 Adopting Release, indicated that in evaluating such terms, the staff "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."[17] The Commission also underscored that Rule 35d-1 would not apply to fund names that suggest a type of investment *strategy* as opposed to a type of investment, citing "growth" and "value" as examples of terms denoting an investment strategy.[18] In addition, the Commission observed that names indicating the maturity of debt instruments held by a fund — such as "short-term," "intermediate-term," and "long-term" — would not be captured by Rule 35d-1 but would continue to be addressed by existing staff positions that the portfolios of funds bearing such names should have an appropriate dollar-weighted average maturity.[19] Soon after the adoption of Rule 35d-1, the staff of the Division of Investment Management reiterated and clarified these positions and others in a set of Frequently Asked Questions (the "FAQ").[20] In the FAQ, the staff also acknowledged that certain terms (such as "income") could, depending on their context, connote *either* an investment objective or strategy (and thus be excluded from the scope of Rule 35d-1), on the one hand, or a type of investment (which would be within the scope of the rule), on the other hand. The staff cited "fixed income" as an example of a use of the term "income" that would be within the scope of the rule because it relates to a type of investment.[21]

III. PROPOSAL

On May 25, 2022, the SEC proposed new changes that would, among other things, significantly expand the scope of Rule 35d-1, impose a new ongoing compliance framework, and establish new recordkeeping and disclosure requirements.[22] In the Proposing Release, the SEC also proposed guidance on a number of matters relating to Rule 35d-1, including the treatment of derivatives for purposes of compliance with a fund's 80% investment policy.

A. Expansion of Scope of Covered Terms

The Proposal would dramatically expand the universe of terms that are covered by Rule 35d-1. Under the Proposal's expanded new standard, in addition to the categories of terms already covered, names suggesting a focus "in investments that have, or whose issuers have, particular characteristics" would also require the adoption of an 80% investment policy.[23] In this regard, the Proposing Release clarifies, in a departure from existing guidance, that "even where a fund name could

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required to have an 80% investment policy that is a fundamental policy.

[14] Rule 35d-1(a)(2)(ii) and (a)(3)(iii); 2001 Adopting Release.

[15] The 2001 Adopting Release observed that, in the Commission's view, a reasonable investor could conclude that such terms suggest more than one investment focus.

[16] 1997 Proposing Release.

[17] 2001 Adopting Release.

[18] *Id.*

[19] *Id.*

[20] *Frequently Asked Questions about Rule 35d-1 (Investment Company Names)*, SEC (Dec. 4, 2001) (*available at* https://www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm).

[21] *FAQ* at Questions 9-10.

[22] Proposing Release.

[23] *Id.* at 19.

be construed as referring to an investment strategy, it nevertheless can also connote an investment focus" and come within the scope of Rule 35d-1.[24] The Proposal specifically identifies three examples of terms suggesting investments that have, or whose issuers have, particular characteristics: "growth," "value," and terms indicating that the fund's investment decisions incorporate one or more environmental, social, and/or governance ("ESG") factors. The Adopting Release identifies several additional terms that would implicate the expanded rule: "global," "international," and "income," among others.[25]

Under the Proposal, Rule 35d-1 would continue to exclude terms suggesting characteristics of a fund's overall portfolio (*e.g.*, "balanced"), particular investment techniques (*e.g.*, "long/short"), possible results to be achieved (*e.g.*, "real return"), retirement target dates, and other terms indicating a fund's objectives without specifying the fund's investments or intended investment.[26] Critically, however, while the Commission acknowledges that certain terms—such as "growth" or "income"—could refer either to a particular portfolio investment or to the overall objective that a fund seeks to achieve, the Proposing Release indicates that terms such as these *must* be read to refer to particular portfolio investments, regardless of whether the fund has prominent disclosure indicating the intended meaning of the term. Similarly, the Proposing Release states that terms like "intermediate-term bond" would be within the scope of the rule, despite the staff's position in the FAQ identifying these as terms suggesting characteristics that should be measured at the portfolio level, and thus excluded (as further discussed below).[27] That is, the Proposing Release would appear to categorically resolve all ambiguity by treating such terms as within the scope of the rule.[28]

The Proposal would also expand Rule 35d-1 by addressing the use of ESG terms in fund names and, consequently, positions the Proposal as a component of the SEC and SEC staff's broader set of initiatives in that area.[29] Examples of ESG terms identified in the Proposing Release include "socially responsible investing," "sustainable," "green," "ethical," "impact," and "good governance" to the extent that they are used to describe ESG factors to be considered in making investment decisions.[30] In addition to incorporating ESG-related terms into the scope of the rule, the Proposal would also deem to be *per se* materially deceptive and misleading the use of ESG terms in the name of an "integration" fund (*i.e.*, a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but for which such ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio).[31] The SEC observed in the Proposing Release that the use of ESG terms by integration funds could "overstate" the importance of such factors in the fund's investment strategy.[32]

B. Acceptable Deviations and Ongoing Compliance

In another significant departure from the current Rule 35d-1 framework, under the Proposal, a fund would no longer be required to satisfy its 80% investment policy "under normal circumstances." Instead, the Proposal sets forth a limited set of circumstances in which a fund may depart from its policy.[33] These exceptions are: (1) because of market fluctuations not caused by the fund; (2) to meet unusually large redemptions or respond to unusually large cash inflows; (3) to open a position in cash, cash equivalents, or government securities as a response to adverse market, economic, political, or other conditions; or (4) repositioning fund assets during major structural change (*e.g.*, reorganization, formation, or

[24] *Id.* at 20.

[25] *Id.* at 19-24.

[26] *Id.* at 24-25.

[27] *Id.* at 23-24; *FAQ* at Question 11.

[28] *Id.* at n. 49.

[29] Simultaneously with the Proposal, the SEC issued a proposal that would require registered funds and certain investment advisers to disclose ESG-related investment practices. Inv. Co. Act Rel. No. IC-34594 (2022). Separately, on March 21, 2022, the SEC issued a proposed rule that would require operating companies to disclose certain climate-related information, including information about their climate-related risks and greenhouse gas emissions metrics that could help investors assess those risks. Rel. No. 33-11042 (2022).

[30] Proposing Release at n. 32. To the extent these terms are used to describe the investment strategy of the fund (*e.g.*, "sustainable growth"), it is unclear whether these terms would be viewed as within the scope of the rule. *Id.* at n. 49.

[31] *Id.* at 81-84.

[32] *Id.* at 82.

[33] *Id.* at 33-35.

after change of investment policy).[34] Except with respect to the last item in this list, a fund would be required to return to compliance "as soon as reasonably practicable," but no longer than 30 days.[35] The SEC clarified that "as soon as reasonably practicable" does not mean "as soon as possible," and that this standard is intended to permit a fund's investment adviser to return to compliance in a manner that seeks to avoid harming the fund and its shareholders (*e.g.*, "by causing the fund to purchase illiquid assets at a premium").[36] On the other hand, the Proposing Release also indicates that the SEC expects that "most temporary departures would last substantially less than 30 days."[37]

Perhaps most impactful, the Proposal would also replace Rule 35d-1's existing time-of-acquisition test with an ongoing compliance requirement. Currently, under Rule 35d-1, a fund that is out of compliance with its 80% investment policy due to a passive breach (such as due to market fluctuations, large inflows or redemptions, or other factors outside the fund's control) simply would be prohibited from acquiring additional securities that do not satisfy its 80% investment policy.[38] As such, a fund generally is not required to rebalance its portfolio in the event of a passive breach.[39] In place of this framework, the Proposal would establish an ongoing compliance requirement that would permit departures only in the limited circumstances (and subject to the timing limitations) described above. The SEC stated in the Proposing Release that an ongoing compliance requirement was intended to address the phenomenon of portfolio "drift" over time resulting in a fund's portfolio no longer aligning with its name, notwithstanding the fund's technical compliance with Rule 35d-1.[40]

C. Treatment of Derivatives

The Proposal provides guidance on the treatment of derivatives instruments for purposes of a fund's 80% investment policy. First, the Proposal clarifies that derivatives instruments generally would be valued using their notional amount (rather than their market value), with certain adjustments, when determining a fund's compliance with its 80% investment policy. The Proposing Release observed that such an approach serves as a more effective measure of a fund's investment exposure to the reference asset or metric underlying a derivatives instrument.[41] The Proposal would require a fund to convert interest rate derivatives to their 10-year bond equivalents and to delta adjust the notional amounts of options contracts.[42] A fund would be permitted to reduce the total value of its assets by excluding cash and cash equivalents up to the notional amounts of the derivatives instruments to avoid "double-counting" of the fund's exposure to such instruments.[43] Second, the Proposal would permit a fund to include in its 80% bucket any derivatives instrument that provides investment exposure to one or more of the market risk factors associated with the investments suggested by the fund's name.[44]

D. Other Guidance

If adopted, the Proposal would codify that compliance with a fund's 80% investment policy is not a safe harbor with respect to the prohibitions against adopting a name that is materially deceptive or misleading under Section 35(d). The SEC in the Proposing Release made a number of noteworthy observations on this point. Specifically, the Commission indicated that even if a fund adopts and complies with an 80% investment policy, its name can nevertheless be materially misleading or deceptive if the fund invests a "substantial" amount of the remaining 20% of its portfolio in investments that are "antithetical" to the fund's investment focus.[45] The SEC also stated in

[34] *Id.* at 34.

[35] *Id.* With respect to new funds launching, the 30-day limit is extended to 180 days. There is no time limit specified for reorganizations. *Id.* If a fund has a non-fundamental 80% investment policy and is proposing to change its policy, the fund may begin to deviate from the policy as soon as the required notice to shareholders is issued.

[36] *Id.* at 34, n. 57.

[37] *Id.* at 37.

[38] Specifically, Rule 35d-1(b) provides that the 80% investment policy requirements "apply at the time a [f]und invests its [a]ssets."

[39] Rule 35d-1(b); 2001 Adopting Release.

[40] Proposing Release at 35-36.

[41] *Id.* at 51-52.

[42] *Id.*

[43] *Id.* at 53-54.

[44] *Id.* at 55-56.

[45] *Id.* at 69. The Commission offers as an example "a 'fossil fuel-free' fund making a substantial investment in an issuer with fossil with fossil free reserves." *Id.* The SEC indicated that this "antithetical" investment concept could also arise where "a fund invests in a way such that the source of a substantial portion of the fund's risk or returns is different from that which an investor reasonably would expect based on the fund's name,

the Proposing Release that an index fund's name could be deemed to be materially misleading or deceptive despite the adoption of and compliance with an 80% investment policy to invest in assets connoted by a specific index in circumstances where the reference index's composition is contradictory to that index's name.[46]

E. Changes in 80% Investment Policies

The Proposal would continue to permit open-end funds and listed closed-end funds to treat their 80% investment policies as non-fundamental, other than tax-exempt funds. However, the Proposal would require 80% investment policies of unlisted closed-end funds (including unlisted business development companies ("BDCs")) to be fundamental policies.[47] The SEC observed that, unlike shareholders of open-end funds and funds that are listed on an exchange, investors in unlisted closed-end funds and BDCs do not have an effective way to exit their investments in the event that they object to an upcoming change in the fund's 80% investment policy.[48]

In addition, while the Proposal would preserve the current requirement that shareholders must be provided with at least 60 days' notice of any change in a fund's 80% investment policy, it would codify certain technical requirements relating to the notice requirement, which reflect practices that the SEC observed are already taken by some funds.[49]

F. Recordkeeping and Disclosure

The Proposal would impose additional requirements on funds with respect to recordkeeping and disclosure. A fund would be required to define terms included in its name related to its investment focus and describe the investment criteria for selecting the investments described by those terms in its prospectus.[50] Any definition employed by a fund would be required to have a "meaningful nexus" between the term and the fund's investment focus, and to reflect the term's plain English meaning or established industry use.[51]

Funds would also be required to report on compliance with their 80% investment policies on Form N-PORT. This would include disclosing which investments are included in the fund's 80% basket, the total value of the 80% basket, and the number of days, if any, that the fund was non-compliant with its 80% investment policy during the period covered by the report.[52]

The Proposal would also establish new recordkeeping requirements, which would include, among other things, the information required to be disclosed in Form N-PORT (as described above) and any notices sent to shareholders regarding any change to the 80% investment policy. Moreover, any fund that does not adopt an 80% investment policy would be required to maintain a written record of the fund's analysis that such a policy is not required.[53] Such records would be required to be kept for at least six years.[54]

IV. INTERPRETIVE UNCERTAINTY AND COMPLIANCE BURDENS

The Proposal, if adopted, would raise numerous interpretive issues, including, among others:[55]

- The Proposal would introduce significant uncertainty as to what terms would be deemed to suggest a focus in investments that have, or whose issuers have, particular characteristics. As noted above, the Proposal provides only a short list of examples of terms that would be implicated by the expanded scope of the rule. As a result, funds, their advisers, and their counsel (as well as the Commission's staff) would be faced with sorting out the details, which could cause inconsistent application and heightened regulatory risk.

- Once a term has been determined to come within the rule's scope, funds would face additional interpretive issues in identifying whether particular

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regardless of the fund's compliance with the requirements of the names rule." *Id.*

[46] *Id.* at 70.

[47] *Id.* at 65.

[48] *Id.* at 65-66.

[49] *Id.* at 92.

[50] *Id.* at 72. Those included are Forms N-1A, N-2, N-8B-2 and S-6.

[51] *Id.* at 74-75.

[52] *Id.* at 95-98.

[53] *Id.* at 102.

[54] *Id.* at 105.

[55] For further reference on these interpretive issues and more, see generally: *Comments on Investment Company Names,* SEC (Nov. 3, 2022) (*available at* https://www.sec.gov/comments/s7-16-22/s71622.htm).

investments fall within the resulting 80% investment policy. Generally, in contrast to the terms currently covered by Rule 35d-1, the Proposal would include terms that are inherently subjective and do not lend themselves to quantitative, asset-based tests. For example, determining whether a given security represents a "value" stock involves a judgement-driven exercise. Such terms thus pose significant challenges to those tasked with monitoring and ensuring compliance with a fund's 80% investment policy, and could require the input of portfolio management personnel, diverting their attention from core portfolio management activities. This subjectivity also creates a risk that investors, the Commission, or the Commission staff could disagree with a fund's interpretation of an investment's status vis-à-vis the fund's 80% investment policy.[56]

- In certain instances, the guidance provided in the Proposing Release results in inconsistent approaches to similar concepts. For example, as discussed above, the Proposing Release states that the Proposal's 80% investment policy requirements would not apply to terms — such as "duration" — that describe "characteristics of a fund's portfolio as a whole." However, the Proposing Release also indicates that terms such as "intermediate-term bond" *would* implicate Rule 35d-1 under the proposed amendments, notwithstanding the staff's long-established view, discussed above, that such terms are properly addressed through the imposition of an appropriate dollar-weighted average maturity, measured at the portfolio level, rather than by applying an 80% investment policy to each of the fund's investments.[57] In light of this ambiguity, funds and advisers may struggle to determine whether certain terms implicate Rule 35d-1, and a fund's portfolio managers may be subject to new constraints in selecting investments to achieve the fund's target maturity profile.

- Although the Release clarifies that terms that indicate a particular result or outcome that a fund seeks to achieve do not suggest a focus on investments that have particular characteristics, the distinction is inherently unclear with respect to many terms.[58] For example, certain terms — such as "growth" or "income" — could refer either to a particular portfolio investment or to the overall objective that a fund seeks to achieve. Critically, the Proposing Release would appear to categorically require that terms such as these be read to refer only to the particular portfolio investment, regardless of whether the fund provides prominent disclosure indicating the intended meaning of the term.[59]

- Many terms that would be implicated by the Proposal (such as "growth" and "value") are fluid concepts that involve qualitative judgments based on criteria that can vary among data sources, individual portfolio management teams, and over time. For example, a single issuer may, under reasonable alternative definitions, be regarded as both a growth and a value company simultaneously or may transition from one category to another.[60] Moreover, different managers may apply different criteria and definitions to evaluate issuers — a phenomenon that is even more pronounced in the case of funds with multiple advisers.

- The Proposal's ongoing compliance requirement imposes both operational challenges (in the form of continuous monitoring even where no portfolio activity is occurring) and significant constraints on portfolio management flexibility. A fund that passively breaches its 80% investment policy due to a severe market dislocation could be forced to sell certain investments into that same adverse market rather than weathering the storm. Simply put, market dislocations could last longer than the 30 days the Proposal would allow a deviation from the 80% investment policy to continue.

[56] As former Chairman Arthur Levitt remarked in connection with the adoption of Rule 35d-1 in 2001, "if you consider yourself a 'value investor,' don't just buy a fund with the word 'value' in it. Your definition of value may be stocks that pay regular dividends; the fund manager may interpret it as beaten-down Internet stocks. As the winds shift direction, you shouldn't be surprised to see what was called yesterday's tech fund is now today's value fund." "The Future for America's Investors – Their Rights and Obligations," Remarks by Arthur Levitt, Chairman, SEC (Jan. 16, 2001) (*available at* ttps://www.sec.gov/news/speech/spch457.htm).

[57] *FAQ* at Questions 11 and 12.

[58] *Id.* at 25.

[59] Proposing Release at n. 49.

[60] According to analysis published by S&P Global, "over the past 10 years, on average, 166 securities in the S&P 500, 131 securities in the S&P Midcap 400, and 188 securities in the S&P SmallCap 600, fell into both the growth and value indices." *Distinguishing Style from Pure Style*, S&P Dow Jones Indices, Research, 1-2 (Jan. 2019) (*available at* https://www.spglobal.com/spdji/en/documents/research/research-distinguishing-style-from-pure-style.pdf).

- Under more ordinary market conditions, under the Proposal, a fund could be forced to sell holdings due, for example, to a small-cap issuer "graduating" to mid-cap status. Forced sales in such circumstances, even when the portfolio management team believes the holdings could further increase in value, could generate unwanted capital gains, increase transaction costs, reduce diversification, and impose longer-term negative consequences on a portfolio. For example, this requirement would prohibit any fund with the term "small-cap" in its name from giving its portfolio managers discretion to retain a stock where the portfolio managers' thesis is proving to be correct, such that the issuer of the stock now qualifies as a "mid-cap" issuer, which could not be addressed by prospectus disclosure.

- Statements by the SEC in the Proposing Release, if included in an adopting release, could impose on index funds and their advisers new oversight responsibilities with respect to index providers.[61] In particular these statements could be read to require funds to closely and continuously scrutinize the operations of unaffiliated index providers and to expose funds to the risk that their names could be considered materially deceptive during periods leading up to an index's rebalancing, at which time certain securities slated to be removed from the index because they no longer satisfy its criteria could be viewed as no longer satisfying an index fund's 80% investment policy.

- The SEC also expressed in the Proposing Release that a fund's name could be misleading or deceptive even if it adopts and complies with an 80% investment policy if certain of the fund's investments are "antithetical" to its investment focus. Interpreting and complying with this highly subjective concept could prove challenging for certain funds and investment advisers.

V. CONCLUSION

If adopted in its current form, the Proposal would present significant challenges for registered funds, BDCs, and their sponsors. As described herein, the Proposal introduces considerable interpretive uncertainty and limits the flexibility of impacted funds to adapt quickly to changing market circumstances, among other significant issues. Further, the Proposal arrives against the backdrop of a highly active regulatory environment, in which fund sponsors are hard at work implementing a number of recently adopted rules — a state that, given the pace of recent SEC rule proposals impacting registered funds, has no clear end in sight. ■

[61] Proposing Release at 70 (stating that even though an index fund may be appropriately invested in its disclosed index, the "underlying index may have components that are contradictory to the index's name" and that under such circumstances, the fund's name may be materially deceptive or misleading).

BUZZFEED CASE HIGHLIGHTS NEW TRENDS IN SPAC LITIGATION

In this article, the authors discuss the Buzzfeed case as an exemplar of emerging trends affecting SPAC transactions.

By Benjamin Daniels, Arila Zhou, and Sabrina Galli *

INTRODUCTION

Special purpose acquisition companies ("SPACs") have been under the microscope this year.[1] As markets cooled, shareholders have sought to recoup investments in these "blank check" companies by lobbing accusations of securities fraud, breach of fiduciary duty, breach of contract, and violations of state-specific blue-sky laws.

One highly publicized example is the litigation over a business combination transaction between Buzzfeed, Inc., a digital media company ("Old Buzzfeed") and 890 5th Avenue Partners, Inc. a SPAC ("890").[2] When the intended transaction was publicly announced in mid-2021, the market was at first excited because 890 had about $287.5 million in its trust account from the proceeds of its public offering and private placement. But most public shareholders of 890 redeemed their shares in connection with the transaction and about $271.3 million from the trust account was returned to those investors, leaving around $16.2 million in the trust account available to the combined company at the closing.[3] The lawsuit that followed highlights emerging trends affecting SPAC transactions, including the difficulty of handling employee-shareholder disputes and the importance of clear arbitration agreements.

BUZZFEED DECIDES TO GO PUBLIC THROUGH A SPAC

Founded in 2006, Old Buzzfeed grew from a website of digital lists into a digital-media conglomerate. Its ability to engage younger audiences gained the attention of more traditional media outlets. For example, in 2016, NBCUniversal invested $200 million in Old Buzzfeed at a valuation of $1.7 billion. This allowed Old Buzzfeed to expand beyond its original website to entities such as BuzzFeed News, Huffpost, Complex Networks, and Torando Labs.

This success led to an increasing interest in bringing the company public. In mid-2021, at the peak of the SPAC trend, Old Buzzfeed announced it would merge with 890. The SPAC had two subsidiaries created for the transaction, called Merger Sub I and Merger Sub II. The merger involved two transactions. First, Old Buzzfeed would merge with Merger Sub I and become the surviving entity and a wholly owned subsidiary of 890. Second, Old Buzzfeed then merged into Merger Sub II, with Merger Sub II becoming the surviving company. The transaction also included an acquisition of Complex Networks, a global youth entertainment network spanning major pop culture categories. At the closing, Merger Sub II was renamed BuzzFeed Media Enterprises, Inc. and remained as a wholly owned subsidiary of 890, which was renamed BuzzFeed, Inc. ("New Buzzfeed").

[1] *See, e.g., In re MultiPlan Corp. S'holders Litig*., 268 A.3d 784 (Del. Ch. 2022) (establishing a heightened standard for evaluating the fairness of acts by SPAC officers and directors because of inherent conflicts that exist between them and public stockholders); *In re Romeo Power Inc. Sec. Litig*., No. 21 Civ. 3362 (LGS), 2022 BL 190788 (S.D.N.Y. June 02, 2022) (addressing the application of the "forward-looking statements" defense to a securities lawsuit if asserted by a SPAC); *Jedrzejczyk v. Skillz Inc*., No. 21-cv-03450-RS, 2022 BL 231688 (N.D. Cal. July 5, 2022) (requiring proof of falsity and scienter in a securities fraud lawsuit against a SPAC).

[2] The company is named after the fictional address for the mansion of the "Avengers" in the Marvel cinematic universe.

[3] https://www.sec.gov/ix?doc=/Archives/edgar/data/1828972/000110465921148188/tm2134844d1_8k.htm.

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The transaction was announced by Old Buzzfeed in June 2021. Highlights of the deal were that 890 had around $288 million in its trust account, $150 million financing was secured, implied valuation at the closing for Old Buzzfeed would be around $1.5 billion, and Old Buzzfeed would acquire Complex Networks before the closing.[4]

Despite initial excitement, the ensuing months saw investors sour on the deal, and union issues plagued the digital-media company. In connection with the closing, $271.3 million was redeemed by public shareholders of 890, and only $16.2 million in the trust account was made available to New Buzzfeed at the closing.

The business combination was approved by shareholders of 890 in late 2021. Common stock and warrants of New Buzzfeed remain listed and traded on Nasdaq Capital Market. After an initial price bump, the company's shares plummeted. Old Buzzfeed employees who owned shares in the company claim they lost millions in the transaction.

EMPLOYEE-SHAREHOLDERS CHALLENGE THE TRANSACTION

In early 2022, Buzzfeed employees launched two arbitrations against New Buzzfeed.[5] They claim that New Buzzfeed and its directors (1) should not have approved the merger and (2) should have better informed employees about how to sell their shares.

New Buzzfeed opposed arbitration and wanted to litigate in state court. In *Buzzfeed, Inc. v. Hannah Anderson*, Docket No. 2022-0357 (Del. Ch. Apr 22, 2022), the company asked the court to stay the arbitration and allow the parties to proceed through the court system. The employees moved to dismiss, arguing that their employment contracts required arbitration.[6]

THE COURT SIDES WITH NEW BUZZFEED

The Court decided that the case will go forward in state court.[7] In deciding to allow the case to proceed, the court had to determine whether the arbitration clause in the employment agreement conflicted with New Buzzfeed Charter's forum selection clause.[8] Ultimately, the court determined that no such clash existed because New Buzzfeed is not bound by the employment agreements.[9]

The court's decision was rooted in the structure of the transaction that formed New Buzzfeed. As noted above, Old Buzzfeed had merged with Merger Sub I and survived the merger and then merged with and into Merger Sub II, with Merger Sub II surviving the second merger. That entity took on all the liabilities of Old Buzzfeed. This "triangular merger" structure protected the buyer, (890/New Buzzfeed) from the target's (Old Buzzfeed) liabilities by placing them in a subsidiary rather than absorbing them into the parent.

To this end, Section 2.3(b) of the merger agreement provides:

> Without limiting the generality of the foregoing, and subject thereto, at the Effective Time, all the property, rights, privileges, immunities, powers, franchises, licenses and authority of Merger Sub II and the Surviving Entity shall vest in the Surviving Company, and all debts, liabilities, obligations, restrictions, disabilities and duties of each of Merger Sub II and the Surviving Entity shall become the debts, liabilities, obligations, restrictions, disabilities and duties of the Surviving Company. [10]

The employees' agreements were with Old Buzzfeed, whose liability flowed into Merger Sub II.

Based on this structure, the court determined that New Buzzfeed was not bound by the employment

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[4] https://www.sec.gov/Archives/edgar/data/1828972/000110465921085218/tm2120621d1_ex99-3.htm.

[5] Plaintiffs' Opposition to Defendants' Motion to Dismiss the Verified Complaint on Jurisdictional Grounds at *1, *Buzzfeed, Inc. v. Hannah Anderson*, Docket No. 2022-0357 (Del. Ch. Apr 22, 2022).

[6] Affidavit of Rhonda Powell in Support of Plaintiffs' Motion for Summary Judgment dated June 16, 2022, ¶ 5, *Buzzfeed, Inc. v. Hannah Anderson*, Docket No. 2022-0357 (Del. Ch. Apr 22, 2022); Katie Robertson, *BuzzFeed argues that employee dispute should be moved to a court*, N.Y. TIMES (April 25, 2022), https://www.nytimes.com/2022/04/25/business/media/buzzfeed-employees-stock.html.

[7] October 28, 2022 Memorandum Opinion, *Buzzfeed, Inc. v. Hannah Anderson*, Docket No. 2022-0357 (Del. Ch. Apr 22, 2022) (hereinafter the "Decision").

[8] Decision at 16.

[9] Decision at 17.

[10] *See* Section 2.3 of the Merger Agreement*;* https://www.sec.gov/Archives/edgar/data/1828972/000110465921085218/tm2120621d1_ex2-1.htm.

agreements as it was not a signatory to the agreements or bound as a non-signatory.[11]

The court found no reason to treat New and Old Buzzfeed as the same operating entity, noting that Delaware law treats parents and subsidiaries as "separate corporate entities."[12]

Specifically, the court stated:

> Delaware law rejects the theory that "a parent and its wholly owned subsidiaries constitute a single economic unit." Delaware law presumptively treats parents and wholly owned subsidiaries as separate corporate entities. Defendants have not given this Court any reason to treat New Buzzfeed and Operating Co. as a single corporate entity.[13]

The court also found that New Buzzfeed was not bound under estoppel principles because it "did not accept a direct benefit from the Employment Agreements" and New Buzzfeed's involvement was not foreseeable.[14] As a result, the Chancery Court did not hold New Buzzfeed liable to the employment agreements or find that New Buzzfeed was bound by the arbitration provision.

Ultimately, the Chancery Court denied the employees' motion to dismiss and granted New Buzzfeed's motion for summary judgment in part, finding that New Buzzfeed (1) "did not enter into arbitration agreements with Defendants" and (2) "Plaintiffs did not agree to arbitrate Defendants' Arbitration Claims." However, the court did not grant Plaintiffs' third request for declaratory relief, which sought "a declaration that if Defendants wish to pursue their claims, they must do so in this Court, under the New Buzzfeed FSC." The Chancery Court denied the third request, finding that it was advisory and speculative how or whether the employees would refile their claims.

CONCLUSION

The *Buzzfeed* decision signals that Delaware courts are inclined to honor the corporate form in SPAC transactions, including the traditional separation of liabilities between sister and parent corporations. Among other things, the court accepted the corporate structure that Buzzfeed used to go public, tracing the liability through the various transactions. In some ways this is welcome news for SPACs and their sponsors, as the structure of the transaction has been honored in this case. That said, SPACs and their sponsors should conduct robust due diligence of any potential targets, including a detailed review of all employment agreements, union contracts, and agreements that grant employees shares or options as part of their compensation. Depending on the entity's goals, corporate bylaws and charters could include forum selection clauses, arbitration clauses, limitations of liability, and exculpatory language for officers and directors.

Further, it remains to be seen if the Buzzfeed SPAC litigation signals a move away from digital media, a rise in employee-shareholder litigation, or is simply an example of shareholder litigation stemming from SPAC transactions. For example, Forbes Global Media Holdings Inc. had an agreement in place with SPAC Magnum Opus Acquisition Limited but terminated said agreement.[15] Through the SPAC merger, Forbes would have gone public at a $630 million valuation.[16] While there may not be an explicit connection between the Buzzfeed de-SPAC transaction and Forbes's decision to terminate its SPAC plans, many media companies are moving away from SPAC plans. Market participants should keep a close eye on *Buzzfeed* to gauge the effect of the decision. ■

[11] Decision at 33.

[12] Decision at 32 (citing *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 667 (Del. Ch. 2012); *Wenske v.Blue Bell Creameries, Inc.*, 2018 WL 5994971, at *5 (Del. Ch. Nov. 13, 2018).

[13] Decision at 32.

[14] Decision at 33.

[15] *Forbes Announces Termination Of SPAC Transaction*, FORBES (June 1, 2022), https://www.forbes.com/sites/forbespr/2022/06/01/forbes-announces-termination-of-spac-transaction/?sh=6d75fb737f4e.

[16] Lauren Hirsch and Benjamin Mullin, *Forbes, Chronicler of Wealthy and Powerful, Will Scrap Plan to Go Public via SPAC*; N.Y. TIMES (May 31, 2022), https://www.nytimes.com/2022/05/31/business/media/forbes-public-spac-deal.html.

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