1401 H Street, NW, Washington, DC 20005-2148, USA
202-326-5800 www.ici.org

May 22, 2023

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: *Investment Company Names (File No. S7-16-22)*

Dear Ms. Countryman:

The Investment Company Institute[1] is writing to supplement our prior comments on the Securities and Exchange Commission's proposal ("Proposal") to amend Rule 35d-1 under the Investment Company Act of 1940 ("Names Rule").[2] This supplemental letter focuses specifically on certain aspects of the Proposal's approach to tax-exempt funds.

Our 2022 Letter recommended that the Commission eliminate the proposed temporary departures standard from any final rule and maintain the current rule's approach. [3] Since then, it has come to our attention that the proposed temporary departures standard is especially

---

[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $29.9 trillion in the United States, serving more than 100 million investors, and an additional $8.1 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

[2] *See* Investment Company Names, SEC Release No. IC-34593 (May 25, 2022), available at https://www.sec.gov/rules/proposed/2022/ic-34593.pdf ("Proposing Release"). We provided initial comments on several aspects of the Proposing Release in a letter submitted on August 16, 2022. *See* Letter from Eric J. Pan, President & CEO, ICI, and Susan M. Olson, General Counsel, ICI, to Vanessa A. Countryman, Secretary, SEC, dated August 16, 2022 ("2022 Letter"), available at https://www.ici.org/system/files/2022-08/22-ici-cl-names-rule.pdf.

[3] Our 2022 Letter also made a variety of other comments and recommendations, including our strong recommendation that the Commission not expand the universe of types of investments and strategies implicated by the Names Rule to include names suggesting investments with particular "characteristics." As discussed extensively in the 2022 Letter, the proposed expansion would introduce unnecessary complexity and new interpretive questions. For example, the proposed application of the Names Rule to the term "income" presents problems, including that the term "income" may refer to characteristics of a particular security or it can describe an overall outcome that a fund seeks to achieve. *See* discussion on pages 9-10 of the 2022 Letter.

unworkable and detrimental for tax-exempt funds using an 80% investment policy based on the tax character of income distributed ("income test").[4] We therefore urge the Commission to permit any tax-exempt fund using an income test to:

- monitor compliance with its 80% investment policy by looking only at income distributed, rather than income that has been accrued and/or declared but not yet distributed;
- satisfy its 80% investment policy as of the fund's fiscal year end;
- count taxable market discount and derivatives that provide exposure to market risk factors toward its 80% basket; and
- not report on Form N-PORT the number of days that it did not comply with its 80% investment policy.

I. The Commission Should Confirm that a Tax-Exempt Fund Should Monitor Compliance with the Income Test by Looking Only at Income Distributed.

The Names Rule currently requires any fund that has "tax-exempt" in its name to adopt one of two 80% investment policies, and the Commission proposed to continue permitting tax-exempt funds to choose one of those two tests.[5] Specifically, the Names Rule allows, and the Proposal would allow, a fund with "tax-exempt" in its name to adopt either an asset test or income test to satisfy its 80% investment policy requirement. The asset test—which most tax-exempt funds currently rely on—is applied by looking to whether at least 80% of the fund's assets produce income that is exempt from tax. The income test, in contrast, states that a fund will invest "so that at least 80% of the income that it distributes will be exempt" from tax.

---

[4] *See* Proposed Rule 35d-1(a)(3)(i)(B).

[5] Proposed Rule 35d-1(a)(3) provides in part:

> (a) *Materially deceptive and misleading fund names*. 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:
>
> (3) *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:
>
>> (i) The fund has adopted a fundamental policy:
>>
>>> (A) To invest, except under the circumstances provided in paragraph (b)(1) of this section, at least 80% of the value of its assets in investments the income from which is exempt, as applicable, from federal income tax or from both federal and state income tax; or
>>>
>>> (B) To invest, except under the circumstances provided in paragraph (b)(1) of this section, 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; and

For simplicity, we hereinafter refer to the test set forth in subclause (A) above as the "asset test" and the test in subclause (B) above as the "income test."

As an initial matter, the Commission should confirm that compliance with a fund's income test would be based solely on income that has been *distributed* by the fund. The Commission's requirement for daily compliance testing and N-PORT reporting, when most funds distribute income monthly or quarterly, raises questions about whether the Commission instead intends that funds measure compliance by considering the fund's income *accrued* and/or *declared* daily. Looking at income accrued or declared, rather than simply looking at income distributed, would be meaningless to shareholders who, for tax purposes, care only about the tax character of income actually distributed.

If the Commission intends that a fund monitor compliance with its income test by looking at the tax nature of income accrued or declared daily, the proposed compliance monitoring and N-PORT reporting requirements (discussed further below) would be extremely and unreasonably burdensome to implement. Funds would need to obtain tax-adjusted daily distribution information that is not currently required nor maintained in compliance or N-PORT reporting systems, which means funds would need to obtain new information from their Accounting Book of Record (ABOR) systems and/or tax service providers. To obtain this information, funds may need to perform Generally Accepted Accounting Practices (GAAP) or book to tax reconciliations or adjustments that are not typically made on a daily or monthly basis for tax reporting purposes. Funds would have to undertake substantial and expensive modifications to existing systems and establish new processes and data feeds, potentially with multiple service providers, to comply with the proposed requirements. The day-to-day tax character of income that a fund has accrued and/or declared, but has not yet distributed, is not relevant or meaningful to investors. This enormous, costly undertaking, requiring extensive design and building of systems, along with the acquisition and creation of new data, is not justified for information that appears irrelevant to both the Commission and investors.

II. The Proposed Temporary Departures Standard is Unworkable for Tax-Exempt Funds Using the Income Test.

The Proposal would permit a fund to deviate from its 80% investment policy only in certain enumerated circumstances and would require a fund to return to compliance with its 80% investment policy as soon as reasonably practicable and, in any event, within 30 days, with certain specified exceptions.[6] As explained comprehensively in our 2022 Letter, we do not support the proposed standard and indeed see many problems and harms posed for funds and investors by the new approach.

The current Names Rule framework requires a fund to comply with its 80% investment policy "under normal circumstances" and measures compliance using a time-of-acquisition test. We continue to urge the Commission not to alter the "under normal circumstances" standard, nor replace the "at the time of investment" compliance standard. We submit that, in addition to the problems articulated in our 2022 Letter, which would apply equally to tax-exempt funds, the

[6] Proposing Release at 33-34.

proposed temporary departures standard makes even less sense, and presents additional harms, in the context of tax-exempt funds that choose to apply the income test.

Assuming that compliance with a fund's income test would be based solely on income distributed to investors, the Proposal could be read to require that a fund measure compliance with its income test by calculating the percentage of the fund's income distributed that is exempt from tax on a daily basis. Once a fund has made a distribution that consists of less than 80% tax-exempt income, however, there is no way for the fund to "correct" the departure from its 80% investment policy until the fund's *next* distribution, which may not occur until the next month or the next quarter. Moreover, any taxable income causing a fund's income distributed to be lower than 80% likely will be due to capital gains or taxable market discount resulting from the sale of an investment, which is not a permissible reason for a temporary departure under the Proposal.

As various Internal Revenue Code[7] ("Code") provisions effectively force funds to distribute their income (including taxable capital gains) annually,[8] it is likely that one or more of a fund's periodic distributions would not, on its own, comply with the fund's 80% investment policy. We note that investors are informed in fund disclosure of the tax character of fund distributions and of the fact that some portion of a fund's distribution may be taxable, even when a fund invests primarily in assets that generate tax-exempt income. Investors receive tax reporting describing the character of the distributions annually.

The Commission requested comment on whether it should make changes to the proposed temporary departures standard to specifically address tax-exempt funds.[9] If the Commission moves forward with the proposed temporary departures standard, instead of attempting to impose an unworkable standard on tax-exempt funds applying the income test, the Commission must confirm that such funds can measure compliance with their 80% investment policies over the period of the fund's fiscal year, as of the fund's fiscal year end. The Code bases a fund's

---

[7] See Code section 852(b)(5).

[8] See, e.g., Code sections 852(a) (90% distribution requirement for qualification as regulated investment company) and 4982 (annual excise tax on undistributed income and gains).

[9] The Proposing Release's Request for Comment #31 requests as follows:

> Should we make any changes to the proposed temporary departure provisions to more specifically address tax-exempt funds? For example, should the provisions' 30-day limit specifically address tax-exempt funds that adopt a policy to invest their assets so that at least 80% of the income they distribute is tax-exempt, given that income distributions can be less frequent than monthly? How often do such funds engage in temporary departures under the current rule?

The Commission also asked, in the context of proposed N-PORT reporting requirements, about the "lookback period" for the reporting requirement in the context of tax-exempt funds. See Request for Comment #75 in the Proposing Release, which states:

> Is the proposed requirement that funds report the number of days that the value of the fund's 80% basket have dropped below the 80% threshold during the reporting period reasonable? Should the lookback period for this reporting requirement be three months instead of the proposed one-month reporting period? Would this proposed requirement be reasonable for a tax-exempt fund, for example those that distribute income only quarterly or annually, and if not, how should we modify the proposal?

eligibility to pay tax-exempt income on the fund's fiscal year, and we submit that the Names Rule's income test likewise should be based on a fund's fiscal year.

For these reasons, we urge that any final rule not apply the proposed temporary departures standard to tax-exempt funds applying an income test.

III. The Commission Should Permit Tax-Exempt Funds Using an Income Test to Count Taxable Market Discount Toward their 80% Baskets.

We also recommend that tax-exempt funds using an income test be permitted to count taxable market discount toward their 80% baskets, as this income arises from prudent portfolio management. Taxable market discount arises when funds buy tax-exempt bonds at a price that is below both par and the initial offering price. Such discount purchases are often a part of proper and desired investment management of tax-exempt funds and are viewed as being in the best interests of investors. The later recovery of such purchase discounts by instruments maturing, subsequent asset sales, or discount amortization over time may result in fund dividends being properly reported as taxable. For this reason, a tax-exempt fund's income dividends being reported as partially taxable usually reflects proper and desired investment results, is disclosed to investors in year-end tax statements, and is well understood by the investing public.

IV. The Proposed N-PORT Reporting Requirements Should Not Apply to Tax-Exempt Funds Using an Income Test.

As set forth in our 2022 Letter, we strongly oppose the proposed requirement that a fund publicly report the number of days for which it was not in compliance with its 80% investment policy. We believe that presenting this information to investors publicly on Form N-PORT, devoid of context and explanation as to the cause or effect of the deviation, would not communicate meaningful information to investors and risks unnecessary confusion and concern. As indicated above, our recommended approach will not deprive investors of meaningful information because investors in tax-exempt funds will be informed, through fund disclosure, of the tax character of fund distributions and the fact that some portion of a fund's distribution may be taxable, even when a fund invests primarily in assets that generate tax-exempt income. Tax reporting regarding the distributions is also made annually.

This proposed public reporting is particularly concerning and, we submit, meaningless, for tax-exempt funds that apply the income test.[10] As discussed above, such funds typically distribute income no more frequently than monthly or quarterly. Assuming that compliance with a fund's income test would be measured by looking only at income distributed (rather than accrued or declared), it is not clear under the Proposal if, following a distribution that does not, by itself, satisfy the fund's 80% investment policy, the fund would report:

---

[10] In the context of tax-exempt funds using the income test, Proposed Item B.9 of Form N-PORT would require such funds to report the number of days during the reporting period that less than 80% of the income that the Fund distributed was exempt, as applicable, from federal income tax or from both federal and state income tax. *See* footnote 142 of the Proposing Release.

- one day out of compliance (representing the single day of the distribution),
- 30 days out of compliance if it distributes monthly, or
- 90 days, out of compliance if it distributes quarterly.

None of these approaches is helpful to investors, and these disclosures are more likely to cause unnecessary confusion and concern. As stated above, taxable income from market discount, derivatives, and capital gains is a common and expected result of effective investment management of tax-exempt portfolios. Moreover, investors are already fully informed of the tax character of these funds' distributions, as the Code requires funds to report the taxable and tax-exempt amounts as part of their year-end tax reporting documents. Also as discussed above, if the Commission instead intends that compliance with a fund's income test be measured daily by looking at the income accrued and/or declared on a given day, the proposed N-PORT reporting requirements would be an enormous undertaking. Yet, this information would be meaningless to investors, who, for tax purposes, only care about the tax character of income distributed. The implementation and ongoing compliance costs of satisfying the proposed requirements are not justified.

Further, there are serious and legitimate concerns that the proposed reporting would cause unnecessary confusion and concern among investors and lead to absurd results. Consider, for example, a fund that distributes income on a monthly basis. Such a fund could accrue income on 20 days out of the month for which the income accrued is more than 80% tax exempt. Such a fund would therefore accrue income on 10 or 11 days out of the month for which the income accrued is less than 80% tax exempt. The income distributed at the end of that month could be more than 80% tax exempt, satisfying the fund's income test, but the fund could still be required to report 10 days out of compliance in that month. This does not make sense.

V. Tax-Exempt Funds Using Both the Asset Test and Income Test Should Be Permitted to Count Income from Derivatives Providing Exposure to Market Risk Factors Toward Their 80% Baskets.

We are concerned that the Proposal would not permit tax-exempt funds applying the income test to count derivatives that provide investment exposure to one or more market risk factors toward their 80% baskets. Proposed Rule 35d-1(b)(2) states that any tax-exempt fund with an 80% investment policy under the asset test[11] may do so, but it is silent as to any fund with an 80% investment policy under the income test. There is no reason for this disparate treatment. Using derivatives to hedge risk in tax-exempt funds is consistent with investor expectations and principles of prudent investment management. The Commission therefore should permit any tax-exempt fund that uses an income test to also count income from derivatives that provide

[11] In addition to tax-exempt funds that have adopted an asset test as their 80% investment policy, funds that have adopted an 80% investment policy pursuant to Proposed Rule 35d-1(a)(2)(i) would also be permitted to count derivatives that provide investment exposure to one or more market risk factors toward their 80% baskets.

investment exposure to one or more relevant market risk factors toward its 80% basket, even though the income from such derivatives is itself taxable.

We also reiterate our concerns and recommendations as set forth in our 2022 Letter regarding the proposed treatment of derivatives. We understand from the Proposing Release that tax-exempt funds using an asset test would be permitted to count certain derivatives toward their 80% basket, despite the fact that the income from such derivatives would not itself be tax-exempt. We further understand that such derivatives would include derivatives used to hedge related market risks, including interest rate risk. While we generally support this approach, as stated in our 2022 Letter, we urge the Commission to confirm in any final rule that funds may count in their 80% baskets all derivatives that provide exposure to risk factors associated with investments suggested by a fund name (*i.e.*, not just the specific risk factors enumerated in the Proposing Release).

Derivatives play an essential, efficient and expected role in the management of tax-exempt funds. Managing interest rate risk and duration are key reasons for using derivatives (particularly interest rate futures and options/swap strategies). While these derivatives generate taxable income (generally capital gains/losses, but occasionally ordinary income/loss), this use is consistent with the funds' investment objectives. It therefore would be consistent with investor expectations and principles of prudent investment management to count such derivatives toward a tax-exempt fund's 80% investment policy.

* * *

We appreciate the opportunity to provide comments on the proposed amendments to the Names Rule. The concerns addressed in this letter further illustrate that the Commission's proposed Names Rule amendments would introduce investor confusion, increase complexity and interpretive issues, and impose unnecessary and unjustified costs and burdens. If you have any questions, please contact me, Jason Nagler, Senior Director, Fund Accounting & Compliance, or Erica Evans, Assistant General Counsel.

Sincerely,
/s/ Dorothy M. Donohue
Dorothy M. Donohue
Deputy General Counsel, Securities Regulation

cc: Chair Gary Gensler
Commissioner Hester Peirce
Commissioner Caroline Crenshaw
Commissioner Mark Uyeda
Commissioner Jaime Lizárraga

William Birdthistle, Director
Sarah ten Siethoff, Deputy Director
Division of Investment Management