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The Regulation of Mutual Fund Names and the Societal Role of Trust: An Exploration of Section 35(d) of the Investment Company Act

Larry D. Barnett*

ABSTRACT

Section 35(d) of the Investment Company Act (“the Act”) authorizes the Securities and Exchange Commission (“the SEC” or “the Commission”) to regulate the names of investment companies that are registered with the Commission, and bars registered investment companies — the vast majority of which are mutual funds — from using names that contain words “that the Commission finds are materially deceptive or misleading.” This article relates the regulation of investment company names to the importance to society of trust. Pertinent case law under section 35(d) is reviewed and Rule 35d-1 is discussed. This article also considers fund names that are not covered either by section 35(d) or by Rule 35d-1 — specifically, names that are ‘cute’ or ‘catchy’ — and suggests a possible revision of the section. The suggested revision employs a behavioral science, value-neutral approach to fund names rather than the present value-based approach.

I. INTRODUCTION

*“In real life, unlike in Shakespeare, the sweetness of the rose depends upon the name it bears. Things are not only what they are. They are, in very important respects, what they seem to be.”*¹

Structurally, a name is a spoken sound — and, in all but preliterate societies, a set of written characters — that labels a tangible or intangible referent. The importance of a name stems not from its structure, however, but from its effect on social life. Functionally, a name channels perceptions of that which it labels and thereby characterizes its referent;² as a result, a name molds the behavior of the persons who

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1. Hubert H. Humphrey, *quoted in* COLE’S QUOTABLES, The Quotations Page, at [http://www.quotationspage.com/Hubert H. Humphrey](http://www.quotationspage.com/Hubert%20H.%20Humphrey) (last visited Feb. 15, 2005).

2. BENJAMIN LEE WHORF, *The Punctual and Segmentative Aspects of Verbs in Hopi*, 12 LANGUAGE 127 (1936), *reprinted in* LANGUAGE, THOUGHT, AND REALITY: SELECTED WRITINGS OF BENJAMIN LEE WHORF 51 (John B. Carroll ed., 1956) [hereinafter LANGUAGE, THOUGHT, AND

use it.³ At the same time, a name is not inevitably linked to a particular referent; a name and its referent are brought together by the social system employing the name.⁴ Even after the link is established and a name has a meaning, moreover, the referent of a name — especially in a society that is economically complex and culturally heterogeneous — can be imprecise, may differ subtly from one subculture to another within a social system, and can shift over time.⁵ The meaning of a name is thus neither predetermined nor constant across space and time. As the United States Supreme Court long ago observed, “[a] word is not a crystal, transparent and unchanged[;] it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used.”⁶

As creations of society, names and their significations are an essential aspect of person-to-person communication, and like all tools that contribute to the operation of a social system, names have a sociological character. The failure to recognize and appreciate this character can damage not just the credibility of the persons who promote and use a name, but in some circumstances can also injure the very core of society. Names are accordingly important to a social system, and their sociological nature cannot be ignored by law.

The present article is based on two related sociological propositions. They are that (1) the functioning of a society depends in part on the extent to which its language is employed to facilitate or impair trust in interpersonal relationships and (2) in situations where language is used in a manner that reduces trust, the law of the society will, if informal mechanisms prove inadequate, adopt prescriptions and proscriptions to guard against these misuses of language. More generally, this

REALITY]. “We are inclined to think of language simply as a technique of expression, and not to realize that language first of all is a classification and arrangement of the stream of sensory experience which results in a certain world-order” *Id.*, in LANGUAGE, THOUGHT, AND REALITY, at 55. See Benjamin Lee Whorf, *An American Indian Model of the Universe*, reprinted in LANGUAGE, THOUGHT, AND REALITY, *supra*, at 57 (unlike English, the Hopi language contains no word for ‘time,’ and users of the Hopi language therefore have “no general notion or intuition of ‘time’ as a smooth flowing continuum in which everything in the universe proceeds at an equal rate, out of a future, through a present, into a past”).

3. BENJAMIN LEE WHORF, *The Relation of Habitual Thought and Behavior to Language*, in LANGUAGE, CULTURE, AND PERSONALITY 75 (Leslie Spier ed., 1941), reprinted in LANGUAGE, THOUGHT, AND REALITY, *supra* note 2, at 134.

4. Leslie A. White, *The Symbol: The Origin and Basis of Human Behavior*, reprinted in LANGUAGE, MEANING AND MATURITY 252 (S. I. Hayakawa ed., 1954).

5. See LUDWIG WITGENSTEIN, *PHILOSOPHICAL INVESTIGATIONS* (G. E. M. Anscombe trans., Macmillan 3d ed., Blackwell Publishing 2001) (1973). Cf. Augustine Ihator, *Understanding the Cultural Patterns of the World — An Imperative in Implementing Strategic International PR Programs*, 45 PUB. REL. Q. 38 (2000).

6. *Towne v. Eisner*, 245 U.S. 418, 425 (1918).

article advances the thesis that, as an integral component of society, law protects and promotes societal equilibrium. Colloquially stated, law is a servant, not a master, of society. As a consequence, language and its names become subjects of government regulation in some contexts.

Though the two propositions that underlie this article may seem abstract and esoteric, they are of distinct practical importance. This article applies the propositions to the names of mutual funds — specifically, the treatment of fund names by the Investment Company Act⁷ and the regulation of fund names under the Act by the SEC. The topic merits attention because nearly half of all households in the United States have an investment in an open-end mutual fund⁸ and because the names of mutual funds are believed capable of influencing potential investors.⁹

If mutual fund names are able to have a substantial effect on investors, names that are seriously misleading can cause considerable damage to the public welfare. The extent of the potential damage is suggested by a 1996 survey of a national sample of individuals who were investment decision-makers in their households and had personal investments in securities (either directly or through mutual funds or participant-directed retirement plans). The survey, which was sponsored by an organization of state securities regulators, concluded that only one in five of the decision-makers was “very knowledgeable” regarding investment-related subjects,¹⁰ indicating that a

7. 15 U.S.C. §§ 80a-1 - 64 (2000).

8. INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK 80 (44th ed., 2004) [hereinafter MUTUAL FUND FACT BOOK], available at <http://www.ici.org> (last visited Feb. 15, 2005). The term ‘open-end’ fund is defined in the text accompanying note 20 *infra*.

Among households with an investment in an open-end fund in 2004, the median number of funds owned was four. Two-thirds of these households held a fund outside, and almost two-thirds (63%) held a fund inside, an employer-sponsored defined-contribution retirement plan. *Id.* at 82 (preliminary data). The preceding percentages add to more than one-hundred, because some households owned funds in both ways, *i.e.*, apart from a retirement plan and through a retirement plan.

9. Investment Company Names, Investment Company Act Release No. IC-24828, 66 Fed. Reg. 8509, 8510 (Feb. 1, 2001) [hereinafter Release No. IC-24828].

It was not until 2003, however, that the impact of fund names on investors was the subject of a well-designed empirical study. The study is discussed in part III-a below on Empirical Research on the Impact of Fund Names.

10. Princeton Survey Research Associates, The Investor Protection Trust Investor Knowledge Survey: A Report on the Findings 9 (April 1996) (unpublished manuscript, on file with the author). Investors were deemed “very knowledgeable” if they correctly answered at least seven of eight questions that were designed to measure knowledge relevant to investing. *Id.* at 7.

Among investors who had a personal (as opposed to a retirement plan) account in a mutual fund, approximately one out of four was judged “very knowledgeable,” a somewhat higher percentage than among all investors who were interviewed. *Id.* at 10.

large segment of the population is susceptible to manipulation when investing in securities. The implications of the study were portrayed as follows:

This data suggest that millions of investors, particularly women and older investors, are 'sitting ducks' for investment fraud and abuse. These are not encouraging findings for a society that is moving increasingly to a 'self-serve' approach to personal finance. Better-informed decision-making is going to be critically important as Americans find themselves confronted with more and more choices they must make about major money matters, such as the investment of retirement savings.¹¹

The last sentence merits elaboration. Investments in mutual funds represent fully one-fifth of the assets accumulated by Americans for retirement (*e.g.*, through employer-sponsored pension plans, Individual Retirement Accounts, and personally funded annuities).¹² If most individuals who own securities are unsophisticated about such investments, the manipulation of fund investors — through *inter alia* the names of funds — can put at risk a significant portion of the wealth on which Americans will rely for retirement. The regulation of fund names under section 35(d) of the Act is a means to combat this manipulation.

II. THE NATURE AND GROWTH OF MUTUAL FUND

A mutual fund is a relatively simple concept: A group of investors pool assets and delegate to a person (*i.e.*, an investment adviser) the task of managing these assets pursuant to a contract requiring that the assets be devoted to the acquisition — and, when appropriate, the disposition — of securities. The typical mutual fund in the United States is organized by its investment adviser and seeks investors from the general population¹³ — or at least the segment of the population that has the economic resources permitting investments in securities. The public nature of mutual funds, and the abuse of the trust of Americans who bought the shares they issued, led Congress to adopt two statutes in 1940¹⁴: The Investment Company Act, which empow-

11. Press Release, Investor Protection Trust, Survey: Financial Illiteracy, Bad Habits, Dangerous Mix for Investors (May 14, 1996), <http://www.investorprotection.org/upr/mission.html> (last visited Feb. 15, 2005). The quoted comments were made by Mark Griffin, who was a trustee of the organization sponsoring the study and director of the Division of Securities, Department of Commerce, State of Utah.

12. MUTUAL FUND FACT BOOK, *supra* note 8, at 85.

13. See *Lessler v. Little*, 857 F.2d 866, 870 (1st Cir. 1988).

14. COMM. BANKING & CURRENCY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 1775 (76th Cong., 3d Sess.), at 3-4, 11 (1940).

ers the SEC to regulate the funds,¹⁵ and the Investment Advisers Act, which empowers the Commission to regulate the persons responsible for selecting the securities for the portfolios of the funds.¹⁶

The Act classifies mutual funds as one type of investment company,¹⁷ but mutual funds are by far the most popular type.¹⁸ Specifically, a mutual fund is a management investment company,¹⁹ *i.e.*, a vehicle that issues and sells securities (“shares”) to its investors, that acquires securities with the assets derived from the purchase of its shares, and that continuously applies its investment objectives and strategies to its portfolio of securities. Two types of management companies are distinguished by the Act: (1) management companies issuing shares that the companies buy back at the request of their shareholders (“open-end” funds) and (2) management companies issuing shares that, once sold by the companies to the public, can only be traded by their beneficial owners in transactions effected with investors purchasing the shares (“closed-end” funds).²⁰ Thus, the key

15. Ch. 686, title I, 54 Stat. 789 (1940) (codified as amended at 15 U.S.C. § 80a-1 *et seq.* (2000)).

16. Ch. 686, title II, 54 Stat. 847 (1940) (codified as amended at 15 U.S.C. § 80b-1 *et seq.* (2000)). The Investment Advisers Act covers a broad range of activities pertaining to securities investments, one of which is advising investment companies. See the definition of investment adviser at 15 U.S.C. § 80b-2(a)(11) (2000).

17. If an investment vehicle is not an investment company, it is not a mutual fund. An investment vehicle that would be an investment company under § 3(a) of the Act is not deemed to be an investment company if it satisfies the requirements of any one of the paragraphs of section 3(b) or section 3(c) of the Act. 15 U.S.C. § 80a-3 (2000).

18. See *infra* note 20.

19. 15 U.S.C. § 80a-4 (2000).

20. As used in this article, the term ‘mutual funds’ includes both open-end funds and closed-end funds.

In addition to mutual funds (*i.e.*, management investment companies), unit investment trusts and face-amount certificate companies are deemed to be investment companies by the Act. 15 U.S.C. § 80a-4 (2000). A unit investment trust has a specified termination date and issues to each of its investors a security (*i.e.*, a ‘unit’) that represents an interest in a largely unchanging portfolio of equities or bonds. Investment Company Institute, *Frequently Asked Questions About Unit Investment Trusts*, at http://www.ici.org/funds/abt/faqs_uits.html (last visited Feb. 15, 2005). A face-amount certificate company issues to each of its investors a security (*i.e.*, certificate) that constitutes a debt of the company to the investor; the investor makes regular payments to the company until the security matures, at which time the investor receives the amount owed, *i.e.*, the face amount of the security. JOHN DOWNES & JORDAN ELLIOT GOODMAN, *BARRON’S FINANCE & INVESTMENT HANDBOOK* 302-303 (4th ed. 1995).

Few face-amount certificate companies appear to exist today. An indication of the rarity of face-amount certificate companies is that no information on their number and assets is supplied by the Investment Company Institute, which is the national association of investment companies in the United States. Investment Company Institute, at http://www.ici.org/site_index.html (last visited Feb. 15, 2005). On the other hand, the Institute furnishes data on the number and assets of mutual funds and of unit investment trusts: At the end of 2003, the market value of the net assets of open-end mutual funds (including money market funds) was approximately \$7.414 trillion, the market value of the assets of closed-end mutual funds was approximately \$214 billion,

difference between open-end funds and closed-end funds is that shares of the former are “redeemable”²¹ but shares of the latter are not. However, while open-end funds are much more common than closed-end funds,²² there appears to be no empirical evidence that the name of a fund influences decisions to invest differently, or to a different degree, when funds are open-end than when funds are closed-end. As a result, this article examines the names of funds without drawing a distinction between the two types of funds.²³

Since its adoption in 1940, the Investment Company Act has authorized regulation of the names of investment companies registered with the Securities and Exchange Commission,²⁴ but such regulation has become a more important matter over the last two decades because of the rapid rise in the number of funds: The numerical increase in funds has *seriatim* enlarged the number of fund names, the potential variety of names, and the possible manipulation of investors by fund names. The accompanying graph shows the increase in open-end funds that invest in equities, in bonds or comparable fixed-income instruments, or in both.²⁵ Such funds, which do not include money mar-

and the market value of the assets of unit investment trusts was approximately \$36 billion. MUTUAL FUND FACT BOOK, *supra* note 8, at 107, 145, 146. The combined assets of open-end and closed-end mutual funds thus exceeded the assets of unit investment trusts by a ratio of roughly 212 to 1.

‘Exchange-traded funds’ are also investment companies. They are so named because investors sell and purchase fund shares on exchanges. The funds themselves sell and redeem their shares just in large blocks. Exchange-traded funds are registered with the Commission either as open-end funds or as unit investment trusts. Standards Relating to Listed Company Audit Committees, Investment Company Act Release No. IC-25885, 68 Fed. Reg. 2638, 2648 (Jan. 17, 2003). Exchange-traded funds are excluded from the data used in this article. According to the Investment Company Institute, the first exchange-traded fund became available in January 1993; at the end of 2003, there were 119 exchange-traded funds and the combined net assets of these funds totaled approximately \$151 billion. MUTUAL FUND FACT BOOK, *supra* note 8, at 105; Investment Company Institute, *Frequently Asked Questions About Exchange-Traded Funds*, at http://www.ici.org/funds/abt/faqs_etfs.html (last visited Feb. 15, 2005).

21. 15 U.S.C. § 80a-5(2000). A “redeemable security” is defined at 15 U.S.C. § 80a-2(a)(32) (2000).

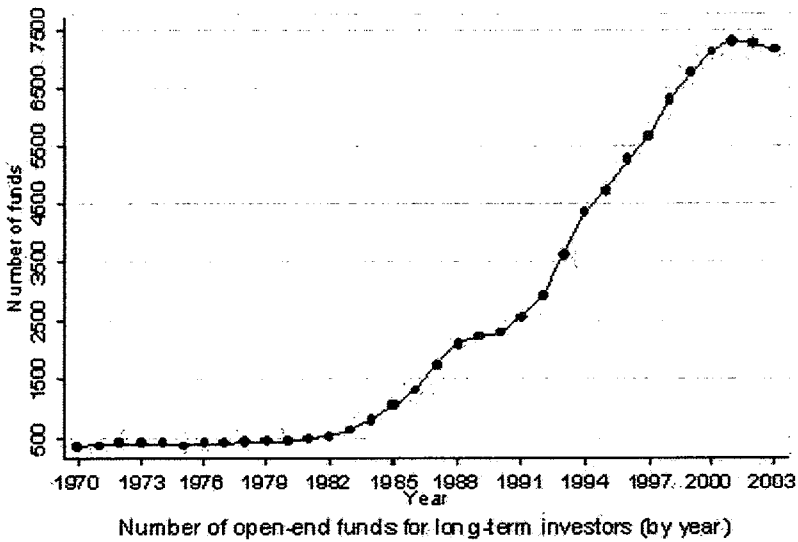
22. The Investment Company Institute reports data for the end of 2003 on 586 closed-end funds, the assets of which totaled approximately \$214 billion. The Institute reports data, for the same time point, on 7,153 ‘long-term’ open-end funds, *i.e.*, open-end funds that invest in stocks, in bonds or similar fixed-income securities, or in both and that are intended for long-term investors; the net assets of these open-end funds amounted to approximately \$5.362 trillion. Calculated from MUTUAL FUND FACT BOOK, *supra* note 8, at 107, 109, 145.

23. If research were to establish that the effect of fund names on investment decisions depends on whether the funds are open-end or closed-end, regulation of fund names will need to vary with fund type.

24. Ch. 686, title I, § 35, 54 Stat. 840 (1940) (codified as amended at 15 U.S.C. § 80a-34 (2000)).

25. The data used in the graph are the number of ‘long-term funds’ in MUTUAL FUND FACT BOOK, *supra* note 8, at 109.

ket funds, are designed for long-term investors and are likely to be the most significant for the public welfare — and hence for law — since their investors can suffer sizable losses. Closed-end funds are omitted from the graph because their numbers are not available for all of the years covered.²⁶ The number of closed-end funds is evidently quite small,²⁷ however, and their omission is unlikely to alter the trend or noticeably affect its magnitude.



The number of open-end funds for long-term investors increased from 361 in 1970 to 7,153 in 2003, but as the graph discloses, growth was slow prior to the decade of the 1980s. Indeed, funds numbered just 458 in 1980. Thereafter, the number began to expand rapidly: A doubling occurred between 1980 and 1985 (from 458 to 1,068), another doubling took place between 1985 and 1988 (from 1,068 to 2,127), and a further doubling occurred between 1988 and 1994 (from 2,127 to 4,362). Between 1994 and 2003, the number rose by another three-fifths (from 4,362 to 7,153). Unquestionably, there has been dramatic numerical growth since 1980 in open-end funds for long-term investors, and fund names that are devised to attract investors to funds have presumably increased as well.

26. See *MUTUAL FUND FACT BOOK*, *supra* note 8 at 145.

As stated in note 20 *supra*, exchange-traded funds are also omitted from the graph.

27. See *supra* note 22.

III. THE IMPORTANCE OF FUND NAMES

But do fund names influence the decisions of investors? While it is commonly thought that fund names matter, the question has been the subject of just a single empirical study — a study that was completed only in 2003.²⁸ More than six decades have elapsed since the Act was proposed and enacted, and during this time, both Congress and the SEC have simply *assumed* that fund names are able to affect investment decisions to a meaningful degree. The assumption garners some support from research in linguistics on the general influence of words on behavior,²⁹ but until the recent study, there was no research that tested the assumption with quantitative data and a rigorous statistical technique.

a. *Empirical Research on the Impact of Fund Names*

Because of the uniqueness and quality of the study, its design as well as its findings will be described. In the study, whether the names of mutual funds affected the decisions of investors was investigated by examining name *changes* that involved particular styles of investing in equity securities. Specifically, name changes were studied when the new fund names expressed either a value orientation or a growth orientation to equities and/or when the new fund names expressed an emphasis either on large capitalization issuers or on small capitalization issuers of equities. The name changes were assessed in terms of whether they followed and/or preceded shifts in monthly equity-fund money flows during a period of approximately seven years (April 1994 through July 2001); to eliminate the role of factors that might be creating or masking a link between name changes and money flows, the influence of a number of other variables was statistically removed. Name changes, the investigators found, tended to follow shifts in the flow of money into or out of the investment styles being studied: After investors started to commit larger amounts of money to a given equity investment style, equity funds became more likely to adopt names that referred to the favored style, and after investors started to commit smaller amounts of money to a given equity investment style, equity funds became more likely to drop names that referred to the disfavored style. In addition — and the relevant finding for purposes of section 35(d) of the Act — investors rewarded these types of name changes, whether or not the portfolio holdings of the funds conformed

28. P. Raghavendra Rau *et al.*, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows* (Aug. 2003), J. FIN. (forthcoming) (on file with author).

29. See notes 2 and 3 *supra*.

to their new names. To be exact, equity mutual funds whose new names identified styles preferred by investors, and equity mutual funds whose new names no longer identified styles disliked by investors, attracted approximately twenty-two percent more money over the twelve months that followed their name changes than did matching funds whose names remained the same.

It is important to note that the study, while groundbreaking, did not answer a number of questions to which answers are necessary if we are to ascertain whether section 35(d) is fulfilling its goal of protecting investors. The study suggests that fund names can appreciably influence the volume of money moving into or out of mutual funds (or at least funds that focus on equity securities), but research has yet to identify the proportion and types of individuals who are influenced. These questions could not be answered by the study, because the variables it measured were characteristics of *funds* and answers to the questions require data on *investors* in funds. However, in order to know whether section 35(d) should be amended by Congress and/or whether rules should be adopted under the section by the SEC, empirical research on the questions is required. In particular, research is needed to determine (1) the percentage of individual investors who alter the amounts they invest in mutual funds because of changes in fund names; (2) the proportion of the securities investments owned by individuals that are moved into or out of mutual funds because of changes in fund names; (3) the demographic, social, and economic attributes that differentiate individuals whose investment decisions are affected by changes in fund names from individuals whose investment decisions are unaffected; and (4) the impact of changes in fund names on the decisions of individuals not only in terms of funds that invest in equity securities but also in terms of funds that invest in debt securities.

To locate evidence bearing on whether it should be assumed that names of funds are important to a broad range of individual investors, I undertook a search for relevant studies on other topics done in marketing and in psychology. None of the studies I found in the field of marketing was useful for determining whether the assumption is justified, mainly because these studies considered names of brands rather than names of particular products.³⁰ In the field of psychology, however, one study is pertinent and furnishes evidence bolstering the as-

30. E.g., Merrie Brucks *et al.*, *Price and Brand Name as Indicators of Quality Dimensions for Consumer Durables*, 28 J. ACAD. MARKETING SCI. 359 (2000); Tulin Erdem & Michael P. Keane, *Decision-making Under Uncertainty: Capturing Dynamic Brand Choice Processes in Turbulent Consumer Goods Markets*, 15 MARKETING SCI. 1 (1996).

sumption.³¹ The hypotheses of the study were tested with data from undergraduate college students who, in two experiments that are relevant to the present article, formulated rules to describe sets of pictures that had been drawn by children. The pictures were grouped into sets, and each set carried a label supplied by the researchers. Labels, however, varied between sets: Some labels specified a variable on which the children-artists differed — e.g., “drawn by creative and noncreative children” — and hence could evoke the prior knowledge, including the expectations, of the college students regarding the source of the pictures. These labels shaped the students’ perceptions of the pictures they were describing. Other labels made no reference to the attributes of the children-artists, but simply utilized a number (e.g., “group 1”). The latter labels thus carried no substantive connotations.

The experiments found that labels appreciably altered the manner in which the pictures in a category were described: “[M]anipulating prior knowledge by simply varying category labels has a profound influence on [the] rules” applied to the picture sets.³² More generally, the interpretation of a stimulus was affected not only by the current experiences of the individual exposed to the stimulus but also by her or his psychological resources, and the psychological resources that operated on the stimulus were influenced markedly by the words depicting the stimulus.

Unfortunately, the study utilized data from a small number of self-selected individuals who were drawn from a limited population,³³ and whether the findings of the study can be generalized to the population as a whole is therefore unclear. Nonetheless, the results of the study are consistent with other evidence (including evidence from linguistics³⁴) that has been reviewed in this article: Empirical research, although limited, supports the proposition that labels mold perceptions and actions. If the proposition is correct, the names of mutual funds can affect the behavior of most investors.

In short, although behavioral and social scientists have produced just one study to date that has focused directly on the impact of fund names, the available evidence consistently suggests that investors can be swayed by fund names. This conclusion, however, raises a ques-

31. Edward J. Wisniewski & Douglas L. Medin, *On the Interaction of Theory and Data in Concept Learning*, 18 *COGNITIVE SCI.* 221 (1994).

32. *Id.* at 229.

33. Both of the experiments summarized in the text were conducted with undergraduate students at a single university. One experiment involved 124 undergraduates; the other experiment involved 40 undergraduates. The students in the experiments were granted course credit for their participation.

34. See the text accompanying notes 2 and 3 *supra*.

tion: If such an effect occurs, why does law need to impose restrictions on fund names? On the surface, the question has an easy answer – simply put, law advances notions of fairness, and fairness demands that investors not be manipulated by fund names. Beneath the question, however, is a matter that goes to the heart of the legal system. Specifically, we must consider the elements that comprise the foundation of law in a society. The failure to recognize and appreciate one particular element – social capital – can jeopardize not only the acceptance by the citizenry of the legal system but imperil the very fabric of society.

b. *Trust and Government Regulation in Society*

Societies possess and utilize *social* resources that are distinct from the resources found in the characteristics of an individual (*e.g.*, reading skill and health). The resources of a society are thus not properties of individuals even though individuals draw upon them. Rather, the resources of a society belong to the society — *i.e.*, the resources of a society are properties of the society — and they inhere in the *relationships* that exist among the members of the society. In sociology, the resources of society have been denominated “social capital,”³⁵ and they differ in type and amount between countries.³⁶

Because societal resources influence the manner in which the subsystems of society operate — *i.e.*, because social capital affects how, and how well, the components of a society function— research on social capital is pertinent to the present article. A society is unlikely to have a prosperous financial system if the social capital of the society is severely impaired. Indeed, one of the resources of a society — trust — may be a causal factor in investment activity: The relative level of investment in a country has been found by one study to respond directly to the level of trust among the residents of the country.³⁷

While trust is a key component of social capital and the recognition of trust as a significant feature of society is not recent in sociology,³⁸ only during the last half of the 1990s did sociologists begin to conduct sophisticated quantitative research on trust. The following paragraphs review some of this research. That only a limited number of well-

35. James S. Coleman, *Social Capital in the Creation of Human Capital*, 94 *AM. J. SOC.* S95 (1988).

36. RONALD INGLEHART, *CULTURE SHIFT IN ADVANCED INDUSTRIAL SOCIETY* 36-42, 64-65 (1990).

37. Paul J. Zak & Stephen Knack, *Trust and Growth*, 111 *ECON. J.* 295, 307-11 (2001).

38. See J. David Lewis & Andrew Weigert, *Trust as a Social Reality*, 63 *SOC. FORCES* 967, 968 (1985).

designed sociological studies of trust have been done is unfortunate, because sociologists bring a unique perspective to trust in particular and to social capital in general. The neglect of trust, however, is not confined to sociology. Economists, too, have devoted relatively little effort to the topic.³⁹

Given the insights that sociological research on trust may furnish, two aspects of trust that have been investigated by sociologists are reviewed here. Both aspects are pertinent to the regulation of investment companies. The first aspect is the interplay of three variables – degree of commitment to small groups, level of social uncertainty (*i.e.*, level of risk in dealing with other persons), and strength of trust. The three variables, and the extent to which they affect each other, are of interest, because all of the variables involve interpersonal relationships and because social capital exists in such relationships. The United States and Japan have been the focus of the research⁴⁰ since these countries are characterized by markedly different patterns of social interaction: Social ties among the members of small groups (*e.g.*, families) are stronger in Japan than in the United States, but trust in other persons generally (*i.e.*, generalized trust) is stronger in the United States than in Japan. The two countries thus offer an opportunity to examine the link, if any, that exists between small-group social ties and generalized trust; to determine whether the link remains after the influence of other variables is removed; and to identify factors that act as antecedents of both. Logic suggests the existence of a pervasive, persistent link between social ties and generalized trust: Strong interpersonal ties within small groups may hinder the development of trust outside such groups. If so, the intensity of small-group ties will be inversely related to the intensity of generalized trust.

Data from the United States and Japan indicate that, *ceteris paribus*, the level of uncertainty faced by individuals is the antecedent of the strength of social ties within small groups, *i.e.*, an increase in the former generates an increase in the latter. In turn, the intensity of interpersonal ties in small groups is inversely related, both as cause and as effect, to the level of generalized trust: As small-group interpersonal ties become stronger, *ceteris paribus*, the development of generalized trust is impeded, but as generalized trust is intensified by (other)

39. Michael Perelman, *The Neglected Economics of Trust*, 57 AM. J. ECON. & SOC. 381 (1998).

The study by Zak and Knack, *supra* note 37, does not appear to negate the general observation by Professor Perelman, whose article was published three years earlier.

40. Toshio Yamagishi *et al.* *Uncertainty, Trust, and Commitment Formation in the United States and Japan*, 104 AM. J. SOC. 165 (1998).

broad social forces and/or by particular historical events, small-group interpersonal ties are needed less and are therefore not as common.

The preceding findings explain why a nation-state must act to curb the exploitation of investors by, for example, regulating the names of mutual funds. A society that does not protect investors from manipulation can be expected to experience *seriatim* an increase in uncertainty, an expansion of social ties within small groups, and a reduction in the degree to which others in general are trusted. As small-group ties in a society become more intense and pervasive, the cohesiveness of society as a collective entity is weakened. A nation-state whose economy requires a robust, society-wide financial system will thus find that the exploitation of securities investors, by altering the organization of social life, carries unacceptable consequences and cannot be allowed to continue. In legal parlance, the public welfare is threatened.

The second aspect of trust that has been investigated by sociologists is whether the level of trust has changed among Americans during recent decades. Two studies have reported a decrease in the extent to which individuals are trusted. One study, relying on time-series data for each of nine years from 1975 to 1994, found "a strong and consistent decline" in a measure of whether individuals were trusted, but no secular decline in whether four prominent societal institutions were trusted.⁴¹ The second study, using data for eighteen years from 1972 to 1998, considered the joint impact of changes in age, in time period, and in birth cohort (year of birth) on whether individuals were trusted and concluded that an overall secular decline in trust had occurred. The decline was attributed to the effect of shifts in the level of trust (1) in successive birth cohorts beginning in the 1940s and/or (2) in different age groups beginning in the 1980s.⁴²

If the secular reduction in generalized trust in other individuals is not arrested, there may be long-lasting damage to the securities markets in the United States and, in turn, to the financial system of the country. Every society undoubtedly needs at least a minimal level of social capital if it is to be economically competitive, and presumably a threshold exists below which a society starts to disintegrate. Therefore, no society can afford to allow the trust of its members to wither indefinitely, and in order to protect and promote social capital, a soci-

41. Pamela Paxton, *Is Social Capital Declining in the United States? A Multiple Indicator Assessment*, 105 AM. J. SOC. 88, 121(1999). The four institutions were Congress, the education system, the executive branch of the federal government, and organized religion.

42. Robert V. Robinson & Elton F. Jackson, *Is Trust in Others Declining in America? An Age-Period-Cohort Analysis*, 30 Soc. Sci. Res. 117, 140 (2001).

ety must curb the short-term, self-seeking behavior of individuals. One means by which a society may be able to do so is through regulation authorized by statute, and potential subjects of regulation include securities and activities bearing on securities transactions.

IV. SECTION 35(D) OF THE INVESTMENT COMPANY ACT

The main statutory source for the regulation of names of mutual funds is paragraph (d) of section 35 of the Act. Paragraph (a) of section 35 of the Act requires that, in issuing or selling a security issued by an investment company registered with the SEC, a person may not assert or imply “in any manner whatsoever” – a phrase encompassing a fund name⁴³ — that (1) the United States, its agencies or instrumentalities guarantee, sponsor, recommend or have approved either the security or the investment company, (2) the Federal Deposit Insurance Corporation insures the security or company, or (3) a bank or insured depository institution guarantees or backs the security or company.⁴⁴ However, paragraph (d) of section 35 is considerably broader than paragraph (a); indeed, a portion of paragraph (a) is covered by a rule adopted by the Commission under paragraph (d).⁴⁵ As a result, it is paragraph (d) on which this article focuses.

Paragraph (d) of section 35 was amended in 1996⁴⁶ and is presently worded as follows:

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 au-

43. Government Securities Management Co., SEC No-Action Letter (Jan. 30, 1976), 1976 SEC No-Act. LEXIS 225. See *In the Matter of Civil and Military Investors Mutual Fund, Inc.*, Investment Company Act Release No. 2723 [1957-1961 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,595, at 50,298 (June 9, 1958), available at 1958 SEC LEXIS 405; Generic Comment Letter, SEC No-Action Letter (Oct. 25, 1990), 1990 SEC No-Act. LEXIS 1413.

44. 15 U.S.C.S. § 80a-34(a) (2002).

The text summarizes the current, not the original, wording of paragraph (a). The paragraph was adopted in 1940 as part of the Investment Company Act; its current wording resulted from an amendment of the paragraph in 1999 and became effective in May 2001. Ch. 686, title I, § 35, 54 Stat 840 (1940); Gramm-Leach-Bliley Act, Pub. L. No. 106-102, title II, §§ 214, 225, 113 Stat. 1338, 1398, 1402 (1999). The ability of paragraph (a) to reach fund names was neither created nor limited by the amendment, since from the time it was enacted the paragraph has prohibited that which “in any manner whatsoever” suggests a registered investment company or a security it issues is guaranteed, sponsored, recommended or approved by the United States or any agency or officer of the United States.

45. See the text accompanying note 84 *infra*.

46. National Securities Markets Improvement Act of 1996, Pub. L.No. 104-290, § 208, 110 Stat. 3416, 3432. The amendment to section 35(d) was effective in April 1997. *Id.* at § 210, 110 Stat. 3436.

thorized, by rule, regulation, or order, to define such names or titles as are materially deceptive or misleading.⁴⁷

As enacted in 1940, paragraph (d) prohibited registered investment companies from employing names that the Commission concluded were materially deceptive or misleading, but the Commission was required to issue an order declaring a name to be in violation of the paragraph and, if the order was ignored by the party responsible for the violation, to obtain a court injunction against continued use of the name.⁴⁸ The 1996 amendment of the paragraph removed the requirement that the Commission act on a case-by-case basis to suppress an offending name, and empowered the Commission to implement the paragraph with rules to which the names of registered investment companies must conform.

One point worthy of mention is that neither the original version of section 35(d) adopted in 1940 nor its 1996 amendment subjected the name of an investment vehicle to regulation if the vehicle need not register with the Commission. The Act designates the activities that cause an investment vehicle to be an investment company and then excludes from the status of investment company a list of investment vehicles having particular attributes.⁴⁹ From its enactment in 1940, section 35(d) has been limited to investment entities that are defined as investment companies by the Act and that are therefore required to be registered with the Commission.

Prior to the 1996 amendment, two categories of substantive actions were taken by the Commission under section 35(d), and each will be reviewed. The two categories are:

- A. Decisions by the staff of the Commission on requests for no-action letters, and rulings by the commissioners on applications, dealing with the names of particular funds.
- B. Positions of the staff on the portfolio composition of mutual funds that have certain types of names.

As the two categories suggest, actions under section 35(d) are almost entirely actions of the Commission, *i.e.*, actions of the staff or the commissioners.⁵⁰ Litigation by fund investors under section 35(d) is not considered in this article because it is scarce: Section 35(d) does not explicitly establish a private cause of action for shareholders of funds

47. 15 U.S.C. § 80a-34(d) (2000).

48. Ch. 686, § 35(d), 54 Stat. 840 (1940).

49. 15 U.S.C. § 80a-3 (2000).

50. No-action letters, although decisions by the staff and not binding on the commissioners, are generally accepted as authoritative statements of Commission positions. Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 923-24 and 943 (1998).

who are materially deceived or misled by the names of the funds, and the courts have thus far been unwilling to hold that the section contains an implicit private right of action,⁵¹ although a large body of judicial decisions on the question does not yet exist.

a. *Names of Particular Funds*

Before section 35(d) was amended in 1996, the names of specific funds were the subject of decisions by the Commission staff in replying to requests for no-action letters and by the commissioners in ruling on applications. We begin with these decisions and the two different issues they involve: (i) the conditions under which section 35(d) is violated by a similarity in the names of two or more funds; (ii) the conditions under which section 35(d) is violated by the connotation(s) of a word or words in the name of a single fund.

If two or more funds have names that are the same or similar, the funds may be confused with each other. When such confusion occurs, the names will be materially misleading, and section 35(d) will be breached.⁵² The breach will be eliminated (or, in the case of a proposed name, avoided) if the name is confined to one fund, namely, the fund that possesses the prior and superior claim to the name.⁵³ In *Capital Liquidity*, a no-action letter issued in 1975, the staff stated that funds can "use the same generic terms in their names without violating [s]ection 35(d) provided that the words in the names appear in different order or . . . there are other distinguishing words in the names."⁵⁴ Thus, fund names are permitted to be similar when the sim-

51. *Young v. Nationwide Life Ins. Co.*, 2 F. Supp.2d 914, 928 (S.D. Tex. 1998). See also *Olmsted v. Pruco Life Ins. Co.*, 283 F.3d 429, 434 (2nd Cir. 2002) (recent decisions by the United States Supreme Court have reduced the latitude of lower federal courts to find an implicit private cause of action in a statute).

In re Alliance North American Government Income Trust, Inc. Securities Litigation, No. 95 Civ. 0330, 1996 U.S. Dist. LEXIS 14209, at *9-11 (S.D. N.Y. Sept. 26, 1996), involved a suit by shareholders of a fund alleging *inter alia* that the name of the fund violated section 35(d). The court rejected the claim that the name breached the section, but the issue of whether the section authorized a private cause of action was not discussed; the court simply assumed that a private cause of action existed.

In limited circumstances, the name of a fund may violate section 10(b) and Rule 10b-5 of the Securities Exchange Act. *Young v. Nationwide Life Ins. Co.*, *supra*, at 919-22. Common-law actions alleging fraud and/or negligence in the use of fund names also seem to be rare. See *id.* at 928.

52. In the Matter of Atomic, Chemical & Electronic Shares, Inc., Investment Company Act Release No. 2,335 (April 6, 1956), 1956 SEC LEXIS 452; Government Securities Management Co., SEC No-Action Letter (Jan. 30, 1976), 1976 SEC No-Act. LEXIS 225.

53. In the Matter of Atomic-Electronics Fund, Inc., Investment Company Act Release No. 2,076 (Dec. 30, 1954), 1954 SEC LEXIS 97.

54. *Capital Liquidity*, SEC No-Action Letter (March 28, 1975), 1975 SEC No-Act. LEXIS 628, at *1.

ilarity is the result of words that are “generic” but only (1) if the sequence of the generic words is not the same or (2) if the names are differentiated by other words. Thus, the staff did not believe that section 35(d) was breached by the names “Capital Liquidity” and “Liquid Capital Income.” In the view of the staff, the names employed generic words – the concepts of “capital,” “liquid,” and “income” – in a “particular context” that prevented the words from being deceptive or misleading.⁵⁵ The nature of the context was not specified, however. In another case, the staff found acceptable the name “Kemper Income and Capital Preservation Fund” even though the name “Capital Preservation Fund” was already in use. Both names employed a generic term, *viz.*, “capital preservation,” but the staff approved the former name because it contained words (*viz.*, “Kemper Income and”) that distinguished it from the latter name.⁵⁶

Other cases have applied the principle that section 35(d) is breached by name similarities that confuse investors, including name similarities that cause investors to believe funds are associated with one another. These cases furnish additional illustrations of similarities that violate, and similarities that do not violate, section 35(d):

- Because the name “Minnesota Tax-Exempt Income Trust” was already being used, the staff concluded that section 35(d) would be breached by the name “Minnesota Tax-Exempt Bond Fund” but not by the name “Tax Exempt Bond Fund for Minnesotans.”⁵⁷
- On their face, the names “Fund for U.S. Government Securities” and “Fund for Government Investors” were acceptable to the staff under section 35(d). The probability that, because of their names, the funds would be confused with each other was evidently believed to be very low.⁵⁸

All of the preceding decisions on name similarities were rendered in the 1970s, and according to publicly available documents, the Commission has taken no further action on this topic during the last quarter of a century. However, the extent to which the staff has informally resolved questions involving name similarities is unknown. While the large increase in the number of equity and fixed-income funds during the 1980s and 1990s may have overwhelmed the ability of the Com-

55. *Id.*

56. Bayrock and Kemper Funds, SEC No-Action Letter (Nov. 21, 1974), 1974 SEC No-Act. LEXIS 847, at *1-2.

57. Minnesota Fund Management, Inc., SEC No-Action Letter (March 12, 1978), 1978 SEC No-Act. LEXIS 885; Minnesota Fund Management, Inc., SEC No-Action Letter (April 15, 1978), 1978 SEC No-Act. LEXIS 1289, at *1.

58. Fund for U.S. Government Securities, Inc., SEC No-Action Letter (April 27, 1975), 1975 SEC No-Act. LEXIS 803, at *1.

mission to deal with name similarities, the possibility also exists that the Commission encountered relatively few problematic name similarities – and could handle them informally — because the no-action letters reviewed above furnished adequate guidance to funds in selecting names that would avoid investor confusion. For example, under the principles already identified,⁵⁹ two fund families are able to use the phrase “Short-Term Corporate Bond” for individual funds without violating section 35(d) because the name of the fund family would appear in the name of its fund. Thus, fund family ABC would be permitted to offer the “ABC Short-Term Corporate Bond Fund” and fund family XYZ would be permitted to offer the “XYZ Short-Term Corporate Bond Fund,” since the two funds would be differentiated by the name of the fund family.

We turn next to the names of individual funds that contain one or more words the connotation(s) of which may cause the names to breach section 35(d). Unfortunately, there is no recent statement and explanation of the test to be applied. However, based on United States Supreme Court interpretations of the Act, whether word connotations are materially deceptive or misleading is determined by the likely effect of the connotations on the reader, and the intent of the person choosing the word(s) as not pertinent. Specifically, a name would be materially deceptive and misleading if, when used for a fund, there is “a substantial likelihood that a reasonable [person] would consider it important in deciding” whether to invest in the fund and would receive an incorrect impression of the nature of the fund.⁶⁰ The name need not be characterized by a substantial probability that it will induce a reasonable person to invest. Rather, “a substantial likelihood that, under all the circumstances, the [name] would have assumed actual significance in the deliberations of the reasonable” investor will produce a violation of section 35(d) if the name is deceptive or misleading.⁶¹ Thus, a name suggesting that a fund offers a par-

59. See Capital Liquidity, SEC No-Action Letter (March 28, 1975), 1975 SEC No-Act. LEXIS 628, at *1, and the text accompanying note 54 *supra*.

60. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). According to the Court, the standard of materiality involves an “objective” assessment of the meaning and weight of one or more words to a reasonable investor. *Id.* at 445. Since investors’ actual interpretations are irrelevant, the test of materiality is not “subjective.”

The Commission subsequently incorporated into the Securities Act the definition of materiality adopted by *TSC Industries* under the Securities Exchange Act. See Rule 405 at 17 C.F.R. § 230.405(2004). Adoption of Integrated Disclosure System, Securities Act Release No. 6383 (March 3, 1982), 1982 SEC LEXIS 2191.

61. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). *Accord*, *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988). Section 35(d) thus involves a two-part test: (1) whether the fund name deceives or misleads; and (2) whether the deceptive or misleading effect of the name

ticular advantage to a specific type of individual is unacceptable if the advantage is not present.⁶² Moreover, the level of sophistication of the potential investor must be considered in assessing the risk that a word or words in a name will produce a misunderstanding.⁶³ To illustrate, the name "National Retirement Planning Funds" was deemed acceptable by the staff under section 35(d), because the investment company bearing the name was marketed to entities (retirement plans) possessing expertise in securities; however, the staff implied that the name might not be acceptable if the investment company were marketed to individuals in the public at large.⁶⁴ In addition, the word "account" in the name of a money market fund entitled "Money Market Account" was found not to violate section 35(d) on the grounds that, because the nature of these funds was generally understood, the word was unlikely to lead investors to believe they were making a deposit in a bank or savings or loan association.⁶⁵ However, other words have been found to violate section 35(d) because they presented a danger that funds with these words in their names would be confused with accounts at government-insured financial institutions: The unacceptable words were "Mutual Savings" in the name "CNA Mutual Savings Fund";⁶⁶ the word "savings" in the name "Sav-

is material, *i.e.*, whether the fund name is likely to carry weight with a reasonable person in reaching a decision on whether to invest in the fund.

The test in *TSC Industries* and in *Basic* supersedes the test in *Civil and Military Investors Mutual Fund, Inc. v. Sec. & Exch. Comm'n*, 288 F.2d 156 (D.C. Cir. 1961). In deciding whether a fund name satisfied section 35(d), the court in the latter case examined what "the name in question implies" and "the expectations raised by the name" and ruled that section 35(d) is violated if the foregoing "may have a harmful tendency to mislead and deceive prospective investors." *Id.* at 158. However, the court did not require "a substantial likelihood" the name be an important consideration in the investment decision of a reasonable person.

In *Liquidity Accounts, Inc.*, SEC No-Action Letter (Dec. 5, 1974), 1974 SEC No-Act. LEXIS 939, at *1, the staff asserted that "a substantial probability" existed the fund name in question "would have a tendency" to mislead investors and hence concluded that section 35(d) would be violated. The staff appears to have omitted the second part of the test under section 35(d), *viz.*, that there be a substantial likelihood a reasonable person will assign weight to the name of the fund when considering the fund as a possible investment.

62. *Civil and Military Investors Mutual Fund, Inc. v. Sec. & Exch. Comm'n*, 288 F.2d 156, 158 (D.C. Cir. 1961).

63. In the Matter of *Civil and Military Investors Mutual Fund, Inc.*, Investment Company Act Release No. 2723 [1957-1961 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,595, at 50,298, 50,299 (June 9, 1958), available at 1958 SEC LEXIS 405.

64. *Nat'l Retirement Planning Funds, Inc.*, SEC No-Action Letter (Sept. 26, 1976), 1976 SEC No-Act. LEXIS 2160, at *1.

65. *Mutual of Omaha Money Market Account, Inc.*, SEC No-Action Letter (Oct. 10, 1979), 1979 SEC No-Act. LEXIS 3589, at *1-2.

66. *CNA Money Instruments, Inc.*, SEC No-Action Letter (Nov. 29, 1974), 1974 SEC No-Act. LEXIS 899.

ings and Equity Mutual Fund”;⁶⁷ the word “thrift” in the name “Ben Franklin Thrift Shares”;⁶⁸ the word “saves,” which blended “save” and “invest” but which the staff thought signified “safest” and a government-protected savings account;⁶⁹ and the words “insured” or “guaranteed” together with the words “United States” or “U.S. Government,” because a combination of the former and latter words could produce the belief that the investment was backed by the federal government.⁷⁰

b. *Names Suggesting the Composition of Fund Portfolios*

Many fund names can lead investors to assume that the portfolios of the funds emphasize certain types of securities or certain types of issuers. For example, the name “Convertible Bond Fund” signifies a portfolio consisting mainly of convertible bonds, the name “Large Cap Stock Fund” indicates a portfolio devoted primarily to equities of issuers with the highest market capitalizations, and the name “Real Estate Securities Fund” suggests a portfolio comprised chiefly of securities of issuers that develop, own and/or manage real property. Unfortunately, however, the expectations that fund names have produced regarding fund portfolios have not always been warranted even though the expectations were reasonable. The problem seems to have arisen when names were based on marketing considerations and were selected either by ignoring, or by failing to understand, the investment character of the funds.⁷¹

Of course, not all fund names connote a particular type of portfolio security or issuer, but when a fund has a name with such a connotation, what proportion of its assets should be invested in the indicated

67. Wright Investors' Service, SEC No-Action Letter (March 14, 1974), 1974 SEC No-Act. LEXIS 1785.

68. Ben Franklin Thrift Shares, Inc., SEC No-Action Letter (Sept. 1, 1973) 1973 SEC No-Act. LEXIS 168.

69. National Securities & Research Corp., SEC No-Action Letter (Jan. 21, 1974), 1974 SEC No-Act. LEXIS 1331.

70. Generic Comment Letter, SEC No-Action Letter (Oct. 25, 1990), 1990 SEC No-Act. LEXIS 1413. The staff indicated that section 35(a) as well as section 35(d) would be violated by the word combination.

Because of the word “safe,” a proposed fund could not be named “The First Safe Fund.” The First Safe Fund, SEC No-Action Letter (Jan. 9, 1972), 1972 SEC No-Act. LEXIS 159. The staff concluded that both section 35(d) and section 35(a) would be breached: Section 35(d) would be violated because the word “safe” implied safety both of the amount invested and of the return on the investment; section 35(a) would be violated because the portfolio of the fund would include government and municipal bonds and the word “safe” therefore implied the fund carried a government guarantee.

71. Amy Dunkin & Jeff Laderman, *Fundspeak: A Crash Course*, Bus. Wk., March 22, 1993, at 96.

type of security or issuer? The question concerned the Commission under the original version of section 35(d), *i.e.*, before the section was revised in 1996. Specifically, in 1972, the staff set the minimum at eighty percent when a given type of security or industry is suggested by a fund name, *i.e.*, a name that suggests the fund will invest in a type of security or issuer was required to commit at least eighty percent of its assets to that type of security or issuer.⁷² In 1983, the staff partially modified its position for open-end funds. While the eighty percent minimum was maintained for money market and tax-exempt funds, the minimum for other kinds of open-end funds with names indicating portfolio emphases on particular types of securities or industries was reduced to sixty-five percent.⁷³ Although these requirements were formally suspended in 1998, they continued to be used by the staff when reviewing registration statements of open-end funds.⁷⁴ The requirements were replaced in 2002 by the standards in Rule 35d-1 (discussed *infra*).

Further applications of section 35(d), prior to its revision in 1996, involved staff decisions on words in fund names. The staff concluded that:

- A fund with the word “balanced” in its name must devote at least twenty-five percent of its assets to fixed-income senior securities.⁷⁵
- A fund whose name employs the noun “capitalization” (or “cap”) preceded by the adjective “small,” “mid,” or “large” must commit at least sixty-five percent of its assets to securities of the type named and must state in its prospectus the criterion it employs to establish the level of market capitalization.⁷⁶
- A fund identifying a country in its name must invest at least sixty-five percent of its assets in that country.⁷⁷
- A minimum of sixty-five percent of the assets of a fund is expected to be devoted to issuers in three or more nations when the fund name contains the word “international,” “global” or “world.” The United States cannot be one of the nations when

72. Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7,221, 37 Fed. Reg. 12,790 (June 9, 1972), 1972 SEC LEXIS 1494, at *5.

73. Registration Form Used by Open-End Management Investment Companies; Guidelines, Investment Company Act Release No. IC-13436, 48 Fed. Reg. 37,928, at app. B (Aug. 22, 1983).

74. Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. IC-23064, 63 Fed. Reg. 13,916, 13,940 (March 23, 1998); Release No. IC-24828, *supra* note 9, at 8510 n.6.

75. Guidelines for the Preparation of Form N-8B-1, *supra* note 72, at *35.

76. Registrant, SEC No-Action Letter (Feb. 25, 1994), 1994 SEC No-Act. LEXIS 470, at *11.

77. Generic Comment Letter, SEC No-Action Letter (Jan. 3, 1991), 1991 SEC No-Act. LEXIS 1451, at *8.

No detailed criteria were furnished, however, as to the nature or the magnitude of the ties that must exist between the country and the issuers whose securities are in the portfolio of the fund.

the word “international” is in the name but can be when either “global” or “world” is in the name.⁷⁸

The Commission decisions reviewed to this point were made under the original version of section 35(d), *i.e.*, the version adopted in 1940. In 1996, Congress amended the 1940 version of the section, and in doing so, it conferred rulemaking authority on the Commission to implement the statutory ban on materially deceptive and misleading names.⁷⁹ We therefore turn to the rule the Commission has promulgated under the current version of section 35(d).

c. Rule 35d-1

At the present time, just one rule – Rule 35d-1⁸⁰ — has been adopted to implement amended section 35(d), and the Rule, which supersedes prior inconsistent Commission decisions, can apply to any investment company that is registered with the Commission. Thus, the name of an open-end fund, as well as the name of a closed-end fund and a unit investment trust, can be governed by the Rule. However, while any registered investment company may find that its name is within the scope of the Rule, a name will be affected by the Rule only if the name suggests that the portfolio of the company, the company itself, or the securities issued by the company possess certain characteristics. In the words of the Commission: “Investment companies are not required to adopt names that describe their investment policies. Those investment companies that do not adopt such a name are not subject to the [Rule].”⁸¹ Nonetheless, more than four out of five registered investment companies were estimated by the Commission to have names covered by the Rule.⁸²

Rule 35d-1 requires that “in normal circumstances” a registered investment company must have no less than eighty percent of the value of its portfolio assets⁸³ in, as applicable, (1) the “particular type of investment” or “particular industry or group of industries” indicated by the name of the company; or (2) investments that are “tied eco-

78. *Id.*

79. See the paragraph in the text that accompanies notes 46 to 48 *supra*.

80. 17 C.F.R. § 270.35d-1 (2004). The Rule was proposed in 1997. Investment Company Names, Investment Company Act Release No. IC-24828, 62 Fed. Reg. 10, 955 (March 10, 1997). The final version of the Rule was announced in 2001, and investment companies covered by the Rule were required to comply with it no later than July 31, 2002. Release No. IC-24828, *supra* note 9, at 8514.

81. Release No. IC-24828, *supra* note 9, at 8511.

82. *Id.*, at 8517 n.63.

83. Under the Rule, “assets” are the total of net assets and any borrowed amounts intended for investment. 17 C.F.R. § 270.35d-1(d)(2) (2004).

nominally” to the country or region identified by the name of the company. Furthermore, an investment company whose name suggests its distributions are exempt from federal income tax, or from federal and state income tax, normally must have eighty percent or more of the value of its assets in investments that generate income exempt from the tax(es) identified or must own investments eighty percent or more of the income from which is exempt from the tax(es) identified. Finally, a name is impermissible if it indicates that either the investment company or the securities issued by the investment company are “guaranteed, sponsored, recommended, or approved” by the government of, or by an agency or instrumentality of, the United States.⁸⁴

A number of points will aid in understanding the Rule. First, compliance with the Rule does not ensure that a fund name is acceptable under section 35(d). A particular name may materially deceive or mislead investors, and hence violate section 35(d), even though the portfolio of the fund using the name has devoted to the type of security or issuer that is indicated by the name the percentage of assets mandated by the Rule. For funds whose names subject them to the requirements of the Rule, in short, adherence to the quantitative standard established by the Rule is a necessary condition to satisfy section 35(d), but conformity with the standard will not in all cases suffice to avoid a breach of the section. As an illustration, the Commission has stated that an index fund ought to devote to the index it tracks more than the percentage of assets set by the Rule as a minimum.⁸⁵

Second, insofar as the Rule applies to funds whose names signify a focus on one or more investment types, industries, nations or geographic areas, the Rule mandates the acquisition of suitable “investments” rather than suitable “securities.” The word “investments” was chosen, and the word “securities” was rejected, in formulating the final version of the Rule so that a fund could acquire “a synthetic in-

84. 17 C.F.R. § 270.35d-1(a) (2004).

A registered investment company whose portfolio securities are based on loans or mortgages provided by entities that have been chartered or sponsored by Congress (e.g., the Federal Home Loan Mortgage Corporation) may, without violating the Rule, adopt a name that contains a word suggestive of the U.S. government (e.g., the word “federal” or the word “government”) even though the entities represented in the portfolio, the securities issued by these entities, and the loans and mortgages underlying the securities issued by these entities are not backed by the full faith and credit of the United States. To satisfy the Rule, the investment company must *inter alia* devote a minimum of eighty percent of the value of its assets to investments indicated by its name. In addition, the prospectus of the investment company needs to have a conspicuous, thorough explanation of the nature of the investments made by the company. Investment Company Institute, SEC No-Action Letter (Oct. 17, 2003), 2003 SEC No-Act. LEXIS 729.

85. Release No. IC-24828, *supra* note 9, at 8511.

strument in the eighty percent basket if it has economic characteristics similar to the securities included in that basket.”⁸⁶

Third, for a fund whose name identifies a nation or geographic region, the Rule does not list criteria for determining whether investments are “tied economically” to the nation or region – indeed, the final version of the Rule omitted three specific criteria that appeared in the proposed Rule⁸⁷ — and only requires the fund to state in its prospectus the criteria employed in making this determination.

Fourth, a fund name that specifies a geographic location may be acceptable under the Rule even though less than eighty percent of the value of the assets of the fund are devoted to issuers of securities within that geographic location. The acceptability of such a name (*e.g.*, a name that specifies the city or state where the fund has its headquarters) will evidently depend on (1) whether or not the name was intended to indicate the geographic area in which the fund invests and (2) whether the name has been in use of a sufficiently long period that investors understand the portfolio of the fund includes investments in other locations.⁸⁸

Fifth, the Rule applies to names that suggest types of investments⁸⁹ but not to names that indicate investment objectives or investment strategies.⁹⁰ Examples of words or phrases that activate the portfolio requirements of the Rule — *i.e.*, that designate types of investments — are “large capitalization,” “utilities,” and “health care.”⁹¹ However, words such as the preceding that signify types of investments may be difficult to differentiate from words that signify investment objectives or strategies. The two categories are not separated by a line that is readily visible and easily drawn in all cases. For a fund name containing a particular word or phrase, the category that is appropriate for the name may depend on the meaning of other words or phrases in the name. Accordingly, categorizing a given name – as a type of investment or as an investment objective or strategy – may involve considerable uncertainty.

Illustrations of the point in the prior paragraph may be helpful: The staff has taken the position that the phrase “high yield,” when used by

86. Release No. IC-24828, *supra* note 9, at 8511, 8512. The “synthetic instrument” must nonetheless qualify as a security because an investment company by definition has a portfolio comprised of securities. 15 U.S.C. § 80a-3 (2000).

87. Release No. IC-24828, *supra* note 9, at 8512.

88. *Id.* at 8512 n.22.

89. *Id.* at 8514.

90. Investment Company Institute, SEC No-Action Letter (Dec. 4, 2001), 2001 SEC No-Act. LEXIS 824, at *13-14 [hereinafter ICI Letter].

91. *Id.* at *10; Release No. IC-24828, *supra* note 9, at 8510.

itself, signifies a type of investment (*viz.*, bonds whose credit quality is rated lower than investment grade) but that “high yield,” when employed in conjunction with “tax exempt” or “tax-free,” refers to an investment strategy. More investment-grade than noninvestment-grade tax-exempt bonds are issued and traded, the staff explained, and high-yield tax-exempt bond funds therefore traditionally invest in bonds whose credit quality on average surpasses that of bonds acquired by high-yield taxable bond funds. Since the practice is well established (and presumably recognized by investors), the term “high yield” in the name “high-yield tax-free bond fund” indicates the fund plans to acquire tax-free debt instruments whose yield exceeds that of other tax-exempt bond funds. In this context, then, the phrase “high yield tax-free” does not specify a type of investment but, rather, denotes an investment objective or strategy.⁹²

Another word whose connotation is dependent on context is “income.” In a fund name, “income” can signify an investment objective, or it can signify a type of investment. Whether a fund name falls into the former category or into the latter category is determined by the meaning of other words, if any, that accompany “income” in the name:

When used by itself, the term “income” in a fund’s name generally suggests that the fund emphasizes the achievement of current income and does not suggest a type of investment. For example, . . . the term “equity income” suggests that a fund focuses its investments in equities and has an investment objective or strategy of achieving current income. By contrast, a term such as “fixed income” suggests investment in a particular type of investment . . .⁹³

In sum, a fund name is outside the scope of Rule 35d-1 to the extent the name points to an investment strategy or objective, and a name is within the Rule to the extent it contains a word indicating a type of investment. A further, heretofore unmentioned point must not be overlooked, however: Even when no word in a name is covered by the Rule, the name can violate section 35(d). The question of when such a name breaches the section is raised by the “Dividend Growth Fund” at a prominent fund family. The words “dividend growth” would probably not subject the fund name to Rule 35d-1 because the words seem to express an investment strategy.⁹⁴ However, while the name “Dividend Growth Fund” indicates an emphasis on issuers whose dividends have risen over time, decisions on portfolio securities

92. ICI Letter, *supra* note 90, at *11-12.

93. *Id.* at *13-14.

94. See Release No. IC-24828, *supra* note 9, at 8514.

by the fund in question have apparently been based on changes in the earnings, not in the dividends, of issuers. The portfolio manager of the fund has considered dividends only “to screen companies’ financial health and their ‘ability to finance future growth.’”⁹⁵

What in section 35(d) permits a breach of the section by a fund when the name of the fund is outside Rule 35d-1? The first sentence of section 35(d) prohibits a registered investment company from incorporating in its name a word that “the Commission finds” would materially deceive or mislead investors, and the second sentence of the section authorizes the Commission to identify such words “by rule, regulation, or order.”⁹⁶ By including the first sentence, Congress required action by the Commission before a name can be deemed to violate the section. The second sentence, in listing the actions available to the Commission, uses both (1) the singular (*i.e.*, “rule,” “regulation,” “order”) and (2) the disjunctive (*i.e.*, “or”). The phrasing of the second sentence is unfortunate. If construed literally, the sentence would severely constrain the Commission and impede its ability to regulate fund names: The language of the second sentence suggests that section 35(d) is capable of being implemented by just one rule or by just one regulation or by just one order.

In securities law, a regulation is normally a set of connected rules,⁹⁷ and section 35(d), by authorizing a regulation, allows related rules on fund names to be adopted. The section also furnishes the Commission with the authority to issue an order dealing with a fund name. Assuming that the exact wording of section 35(d) is followed, a fund with a name such as the previously mentioned “Dividend Growth Fund” can violate the section even when the Commission has excluded the name from Rule 35d-1 – but only if the Commission, having adopted Rule 35d-1, is able to act by order and/or by one or more additional rules (which may form a regulation). However, since the three forms of action (rule, regulation, order) that Congress authorized the Commission to take are expressed in the singular and separated by “or,” a literal interpretation of section 35(d) leads to the conclusion that the

95. Virginia Munger Kahn, *The Dividend Gains New Respect*, N.Y. TIMES, Feb. 24, 2002, § 3, at 10.

96. 15 U.S.C. § 80a-34(d) (2000). The full text of section 35(d) appears in the text accompanying note 47 *supra*.

97. At least one securities regulation (Regulation CE) consists of a single rule. 17 C.F.R. § 230.1001 (2004). The designation “CE” was selected for the regulation because it is shorthand for “coordinated exemptions.” Exemption for Certain California Limited Issues, Securities Act Release No. 33-7285, 61 Fed. Reg. 21,356, 21356 n.1 (May 9, 1996). The Commission classified the one rule as a regulation apparently for the purpose of elevating the rule to parity with another regulation (Regulation D) that, like the rule, exempts transactions from section 5 of the Securities Act. *See id.* at 21,357.

Commission, after promulgating Rule 35d-1, cannot adopt another rule or issue an order under the section, and may even be precluded from revising Rule 35d-1: Application of the section as worded restricts the Commission to a single order, to a single rule, or to a single regulation. Section 35(d) would accordingly prevent a fund name that is not covered by Rule 35d-1 from being found materially deceptive or misleading and hence in breach of the section unless the section is interpreted to allow the Commission to take further actions.

Section 35(d), of course, cannot be construed as it is written. A construction of the section that conformed to its exact wording would prevent companion rules from being added to Rule 35d1 (perhaps to create a regulation), but additional rules may be needed in the future — along with orders to deal with individual cases. Congress, unless it furnishes a clear indication to the contrary, must be presumed to want a government agency on which it confers regulatory powers to respond effectively to changed circumstances and unique situations that are within the concepts in the legislation. Furthermore, because Congress cannot continually revise a statute, the necessity of this presumption has grown over time as change — social, economic and technological — has intensified and society has become more complex. Thus, the Act, like securities statutes in general, “must be broadly construed in order to insure the investing public a full measure of protection.”⁹⁸ This principle applies to section 35(d) of the Act, since the legislative history of the section furnishes no reason to believe that Congress, when it amended the section in 1996, wanted to cabin the SEC. On the contrary, a congressional committee report on the amendment that was adopted suggests Congress hoped the amendment would expand Commission efforts to regulate fund names.⁹⁹ The committee report also explains that the amendment authorizes the Commission “to adopt *rules*” governing fund names.¹⁰⁰ That the plural rather than the singular of “rule” was employed indicates that, in authorizing the Commission to regulate fund names, Congress did not expect the Commission to act just once.

In the interpretation of a federal statute, the United States Supreme Court has stressed, “[t]he ultimate question is one of congressional intent,”¹⁰¹ and the interpretation of particular words is determined by

98. *Prudential Ins. Co. v. Sec. & Exch. Comm'n*, 326 F.2d 383, 386 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964).

99. See COMMERCE COMM., NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996, H.R. REP. NO. 104-622, at 50 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3913.

100. *Id.* at 17, *reprinted in* 1996 U.S.C.C.A.N. at 3879 (italics added).

101. *Pinter v. Dahl*, 486 U.S. 622, 653 (1988) (*quoting Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979)).

the purpose of Congress in enacting the statute.¹⁰² Available evidence of legislative intent regarding the 1996 version of section 35(d) indicates that the Commission was given versatile powers to suppress fund names that can materially deceive or mislead investors, and the wording of the second sentence of the section appears attributable to an unthinking or ill-judged choice of language. Therefore, Rule 35d-1 need not be the final pronouncement by the Commission on fund names, and the Commission can, by means of further rules and by means of orders, take action on names that do not violate Rule 35d-1 and deem them unacceptable under section 35(d).

V. NAMES NOT COVERED BY SECTION 35(D)

Since social capital is a basic aspect of society, another type of fund name should be considered here. Fund names of this type seem simply to have been ignored, and because the names are neither materially deceptive nor materially misleading, section 35(d) does not apply to them. Such fund names can be denominated “cute” or “catchy,” and they are adopted by funds for their tendency to be remembered easily, to attract attention, and/or to evoke favorable imagery. Cute and catchy names are potentially able to influence, and hence manipulate, investors, but they do not distort, hide, or misrepresent their funds’ investment strategies or securities portfolios. Rather, cute and catchy names simply furnish no information on these matters. As a result, such names are neither materially deceptive nor misleading, and are outside the scope of section 35(d) and beyond the authority of the Commission to regulate.

An understanding of the issue may be aided by four examples of cute and catchy fund names that have recently been used or that are currently in use. In alphabetical order, they are:

- “Global Interactive Couch Potato Fund.” The Fund, whose name was changed in January 2000 to “Global Growth Fund,” invested primarily in securities issued by enterprises that supplied technology-based products and services for electronic as well as traditional forms of communications, entertainment, and publishing.¹⁰³

102. *Welch v. Schneider National Bulk Carriers*, 676 F. Supp. 571, 575 (D. N.J. 1987).

103. GABELLI GLOBAL SERIES FUNDS, INC., PROSPECTUS (Global Interactive Couch Potato® Fund) (May 1, 1997), at 5 (on file with author) [hereinafter COUCH POTATO FUND PROSPECTUS]; GABELLI GLOBAL GROWTH FUND, ANNUAL REPORT (Dec. 31, 2003), at 9, <http://www.gabelli.com/funds/products/442.html> (last visited Feb. 15, 2005). For descriptions of the types of issuers considered for the portfolio before and after the change in fund name, compare COUCH POTATO FUND PROSPECTUS, *supra*, with GABELLI GLOBAL SERIES FUNDS, INC., PROSPECTUS (Global Growth Fund), at 5 (May 1, 2004), <http://www.gabelli.com/funds/prosps/442.html> (last visited Feb. 15, 2005).

- “Nifty Fifty Fund.” The portfolio of the Fund is composed chiefly of the common stock of roughly fifty “growth” issuers that are thought to have the greatest potential for long-term capital appreciation.¹⁰⁴
- “Thermostat Fund.” The Fund divides essentially all of its assets between stocks and bonds, with the representation in the portfolio of each type of security determined by a formula that is tied to the Standard & Poor’s 500 Stock Index: The proportion of the portfolio devoted to stocks varies inversely with the Index, and the proportion of the portfolio devoted to bonds varies directly with the Index. Thus, the representation of stocks automatically decreases, and the representation of bonds automatically increases, as the Index rises.¹⁰⁵ The goal of the Thermostat Fund, according to its fund family, is to provide a simple, continuously operating mechanism by which securities investors can deal with “hot and cold markets”¹⁰⁶ and anticipate reversals in the direction of securities prices.
- “Vice Fund.” The Fund invests mainly in equity securities issued by businesses that derive at least one-fourth of their income “from products often considered socially irresponsible.” Gambling, liquor, tobacco, and weapons/defense are expressly identified by the Fund as industries appropriate for its portfolio.¹⁰⁷

104. ENGEMANN ASSET MANAGEMENT, PROSPECTUS (Phoenix-Engemann Nifty Fifty Fund) (May 1, 2004), at 1, <http://www.phoenixinvestments.com> (last visited Feb. 15, 2005).

105. COLUMBIA THERMOSTAT FUND, PROSPECTUS (March 1, 2003), at 2-3 (on file with author).

106. Martha Graybow, *U.S. Fund Firms Try to Woo Back Investors*, YAHOO! NEWS (March 6, 2003) (on file with author).

107. VICE FUND, PROSPECTUS (Aug. 15, 2002), at 1 (on file with the author) [hereinafter VICE FUND PROSPECTUS].

The Fund has committed itself to investing eighty percent of its net assets (under normal market conditions) in equities of issuers that provide “socially irresponsible” products or services. *Id.* at 2. The Fund will thus comply with Rule 35d-1, but a persuasive argument can be made that the Fund is not required to do so because its name does not come under the Rule. The pertinent provision of Rule 35d-1 is paragraph (a)(2), which applies to “a name suggesting that the Fund focuses its investments . . . in a particular industry or group of industries.” 17 C.F.R. § 270.35d-1(a)(2)(2004). Two words in paragraph (a)(2) —*viz.*, “suggesting” and “particular” — determine whether the Vice Fund is covered. In the context of the paragraph, “suggest” means “to call up the thought of [a thing] by association or natural connexion of ideas,” and “particular” means “pertaining or relating to a single definite thing . . . or set of things, as distinguished from others.” 17 OXFORD ENGLISH DICTIONARY 142 (2d ed. 1989); 11 OXFORD ENGLISH DICTIONARY 270 (2d ed. 1989). A name therefore “suggests” a “particular” referent only if the members of society generally associate the name with that referent. Since numerous industries may be deemed “socially irresponsible,” the scope of Vice Fund investments is unclear: The activities that are denominated “vice” in a society differ between groups and change over time, because the referents of “vice” vary with social values. Indeed, the prospectus of the Vice Fund states that its list of industries (gambling, liquor, tobacco, and weapons/defense) is “not exclusive.” VICE FUND PROSPECTUS, *supra*, at 1. The Fund thus acknowledges that the list can include other industries. However, a fund name is unlikely to “suggest[] . . . investments in a particular . . . group of industries” —*i.e.*, a fund name is unlikely to be covered by paragraph (a)(2) —

The Vice Fund merits further examination. The Fund, an open-end investment company, began seeking investors publicly in August 2002 and promptly attracted the attention of the broadcast and print media. In less than four months, the Fund pointed out in a letter to its shareholders, “[t]he Fund has been featured in Time Magazine, The Wall Street Journal, Investor’s Business Daily, Financial Times, Barron’s, SmartMoney Magazine, Business 2.0 Magazine, The New York Times, and many others. It has also been on ABC News Good Morning America, MSNBC, CNNfn, Bloomberg TV, Bloomberg Radio, and BBC Radio.”¹⁰⁸

Interest in the Fund on the part of the mass media is notable, because in 2002, open-end mutual funds that invest in equities experienced net redemptions for the first time in fourteen years; specifically, net redemptions from open-end equity funds in 2002 amounted to roughly \$28 billion.¹⁰⁹ However, the disenchantment with equities on the part of numerous investors did not seem to curb the attention paid to the Vice Fund by the broadcast and print media or, presumably, by some segments of the public. Given investor dissatisfaction at this time with equities in general,¹¹⁰ the media and public notice of the Vice Fund is probably explainable in part by the name of the Fund. Since the publicity garnered by the Fund may have increased, and almost certainly did not decrease, the number of its investors, the Fund unquestionably chose a name that was advantageous to it.

Whether an investment company benefits from its name, however, is not relevant or important to the purpose of section 35(d). The critical role of social capital in a society requires that, with regard to fund names and other matters, the interests of investment companies must be secondary to the interests of the public. Section 35(d) forbids certain types of fund names — *viz.*, names that are found by the Commission to be materially deceptive or misleading — because the public welfare is damaged by such names and Congress responded accord-

unless the name readily identifies the industries it encompasses. The referents of the name “Vice Fund” appear too uncertain to subject the name to Rule 35d-1.

108. VICE FUND PROSPECTUS (Sept. 30, 2002), at 3 (on file with author) [hereinafter VICE FUND REPORT]. The subscription period for Vice Fund shares started on August 15, 2002 and continued to August 30, 2002. See “Subscription Period Note” in VICE FUND PROSPECTUS, *supra* note 107. The Fund commenced operations on August 30, 2002, and the letter to shareholders is dated November 29, 2002. VICE FUND REPORT, *supra*, at 3, 10.

109. MUTUAL FUND FACT BOOK, *supra* note 8, at 118.

110. For example, a national survey conducted in November 2002 asked a sample of adults having “investable assets” of at least \$10,000 whether stocks or bonds were “more promising right now” as investments. Just 29% of respondents favored stocks. Roper Center, Public Opinion Online, accession no. 419511 (LEXIS, News Library, Rpoll File).

ingly. Since cute and catchy names do not deceive or mislead investors, they are currently permissible under section 35(d), but whether they ought to remain outside the section merits discussion.

Should Congress rewrite section 35(d) and ban cute and catchy names? The question is not easily answered, because an answer requires a choice between two strongly held cultural values in the United States — on the one hand, that persons should be protected when they are unable to take care of themselves; and on the other hand, that individuals should accept the consequences of their decisions unless the decisions stemmed from fraud, duress, or undue influence.¹¹¹ In terms of whether cute and catchy names ought to be forbidden by law, these values directly conflict and lead to opposite conclusions. According to the first value, law should prohibit cunning organizers of an investment vehicle from exploiting investors who are, by virtue of their intellectual ability or training, incapable of protecting themselves from economic injury. According to the second value, however, law should not place restrictions on conduct about which individuals can acquire complete and accurate information. In the latter situation, individuals are able to shield themselves from economic harm, and the second value imposes a responsibility on them to do so.

The result of the conflict between the two values may be indecision regarding whether to revise section 35(d). However, if American society is to operate effectively, the conflict cannot be permitted to thwart action that safeguards social capital — and, where necessary and possible, action that strengthens it. Investment companies, especially mutual funds, are too important to the financial well-being of Americans, and practices should therefore not be legally permissible if they damage the confidence and trust of the public. Assuming that an amendment of section 35(d) is warranted because cute and catchy names cause such damage — a question that cannot be answered until suitable empirical research is done — what should be substituted for the current version of the section?

To prohibit cute and catchy names, section 35(d) could be rewritten to identify explicitly such names or a generic class that includes such names. Doing so, of course, would pattern the section on its present version in that value-based concepts would continue to be employed. The key concepts of the current section — “deceiving” and “misleading” — implicate social values held by Americans: Deceptive and

111. Undue influence is defined as “unfair persuasion” of a person by another person (1) when the latter dominates the former or (2) when the former is reasonable in assuming that the latter, given the nature of their relationship, will not intentionally jeopardize his/her welfare. RESTATEMENT (SECOND) OF CONTRACTS § 177(1) (1981).

misleading activities are inconsistent with ideals in the United States, and even if these activities escape punishment by the legal system, they are disapproved socially.¹¹² The section could be amended to prohibit names that are “materially manipulative,” a term that can cover not only cute and catchy names but also names that are materially deceptive or misleading. Written in this way, however, section 35(d) would continue to utilize a concept (*i.e.*, “manipulative”) having distinct value connotations.¹¹³

Section 35(d) may preserve and enhance social capital more effectively if it assesses the acceptability of fund names with a criterion that focuses on *reactions* to the names by potential investors. Specifically, a name would be illegal under the revised section if the name by itself substantially increases the percentage of potential investors who invest in the fund that uses the name. The preceding criterion would be both more encompassing and more precise. The present standard for section 35(d) would be included in, but would only be a part of, the proposed standard: A materially deceptive or misleading fund name could be expected to enlarge unacceptably the fraction of potential investors who become fund investors, and a cute or catchy name could, too. Moreover, the proposed revision would furnish a standard of greater precision, since it would be measured in quantitative units of one-hundred (assuming decimals are not used).

Let me more fully explain the substitute standard with three points. First, the standard for the legality of a fund name under section 35(d) as revised would be whether the name *per se* raises the probability of an investment in the fund by one-fourth or more. A fund name would be illegal when *ceteris paribus* the name produces investments in the fund by a number of investors that is at least twenty-five percent larger than the number that would invest if the fund had a benign name, *i.e.*, a name that did no more than (accurately) describe the

112. Deceptive conduct and misleading conduct constitute dishonesty. The rejection of dishonesty in American society is indicated by data from two surveys of national samples of adults: A survey conducted in 1994 found that ninety-nine percent of respondents believed that “good character” requires a person to be honest. A survey conducted in 1987 reported that ninety-four percent of respondents considered honesty in another person to be “extremely important” for that person to be “a friend.” Roper Center, Public Opinion Online, accession nos. 224480, 112473 (LEXIS, News Library, Rpoll File).

113. The definition of “manipulate” includes “to manage by dexterous contrivance or influence; *esp.* to treat unfairly or insidiously for one’s own advantage.” 9 OXFORD ENGLISH DICTIONARY 319 (2d ed. 1989). Social values are necessarily involved in judgments that a particular result or process is unfair or insidious. *See* *Schad v. Arizona*, 501 U.S. 624, 637 (1991) (determinations of fairness require an examination of “history and wide practice as guides to fundamental values”); 19 OXFORD ENGLISH DICTIONARY 13 (2d ed.1989) (definition of “unfair”); 7 OXFORD ENGLISH DICTIONARY 1026 (2d ed.1989) (definition of “insidious”).

nature of the portfolio.¹¹⁴ The standard would accordingly be concerned with the effect of the name on investor behavior and not with the purpose of those who selected the name. Second, “potential investors” under the standard would be persons who, regardless of their level of formal education (years of school), have little or no knowledge about investing in securities and/or little or no ability to analyze particular securities investments.¹¹⁵ The preservation of social capital requires that law on this topic be concerned with, to quote the SEC, “the effect which the name may have not only on the sophisticated and informed investor, but also on the unwary and the ignorant.”¹¹⁶ Third, whether a name satisfies the standard would be determined by well-designed empirical research, not speculation, on how potential investors respond to the name. Since the standard would deem a fund name unlawful only if the name increased by a minimum of one-fourth the number of persons who become investors in the fund, the standard necessitates quantitative behavioral science research the data from which are analyzed with a multivariate statistical technique (*e.g.*, multiple regression). Decisions by the judiciary or by the Commission on whether a particular fund name is lawful would not be grounded in the fictitious “reasonable” person,¹¹⁷ because decisions based on the “reasonable” person cannot empirically establish (1) the percentage of potential investors who would decide to invest in a fund if the fund used a particular name, (2) the percentage of potential investors who would decide to invest in the fund if another, innocuous name were used, and (3) the difference between the former and latter percent-

114. A different percentage can be selected, of course, but twenty-five percent is not unreasonable. If one-hundred investors would be obtained by a fund with a benign name, the name that is in question would violate the revision of section 35(d) if the name produced one-hundred and twenty-five or more investors.

The standard might be stated either in *percentages* or in *percentage points*, but percentages are more equitable since the relative impact of a particular number of percentage points varies (inversely) with the size of the percentage that is the base from which the change occurs. The proposed revision of section 35(d) would thus determine the acceptability of a fund name in terms of increases in percentages and not in terms of increases in percentage points.

115. Such investors are thus the antithesis of persons to whom an issuer can offer unregistered securities under the private placement exemption of section 4(2) of the Securities Act. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 4.24[1] (4th ed. 2002).

116. In the *Matter of Civil and Military Investors Mutual Fund, Inc.*, Investment Company Act Release No. 2723 [1957-1961 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,595, at 50,298, 50,299 (June 9, 1958), available at 1958 SEC LEXIS 405.

117. The “reasonable person” standard has a long history, apparently entering Anglo-Saxon jurisprudence in 1837. *Robinson v. Lindsay*, 598 P.2d 392 (Wash. 1979) (attributing to Vaughan v. Menlove, 132 Eng. Rep. 490 (1837), the first use of the term “reasonable man of ordinary prudence”). Since the “reasonable person” standard is firmly established in American law, considerable resistance can be expected to replacing it with a different standard.

ages.¹¹⁸ Decisions on a fund name would instead be determined using quantitative data that are obtained by observing the behavior of potential investors and that are analyzed with rigorous statistical tests capable of estimating the impact of the fund name.

The type of research that might be conducted to ascertain whether a fund name meets the proposed standard can be illustrated with the following: Assume that an investment company named the “Homeland Securities Fund” is planned and that it will acquire both equities and bonds with the stated purpose of producing an increase in capital and a moderate amount of income. Further assume that, under normal market conditions, the Fund will devote a minimum of half of its assets to issuers that are based in the United States and the remainder of its assets to issuers that are based outside the United States but that derive more than half of their revenues from business operations in the United States. Finally, assume that all of the securities in the portfolio of the Fund will be either registered with the SEC or acquired and sold in transactions that, although occurring in the United States, do not necessitate registration of the securities.

Given the nature of the hypothetical investment company, a benign name for the company would be “Growth and Income Fund.” The latter name would not be governed by Rule 35d-1 because it signifies an investment objective.¹¹⁹ The name “Homeland Securities Fund” would also not be subject to the Rule unless, as seems unlikely, the name is construed as suggesting that the portfolio will consist of investments that are “tied economically” to the United States.¹²⁰ Moreover, apart from Rule 35d-1, the name “Homeland Securities Fund” would be acceptable under section 35(d) – *i.e.*, would not be deceptive or misleading – because the composition of the portfolio would be consistent with the name.¹²¹ In short, the name “Homeland Securities Fund” would not be encompassed by section 35(d) as currently worded and implemented. However, given the establishment of the federal Office, and then the federal Department, of Homeland Secur-

118. In all but clear-cut cases applying the “reasonable person” standard, juries rather than judges are responsible for deciding how a reasonable investor would have behaved. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976). Among the difficulties posed by the reasonable person standard is that jurors (and judges) are unlikely to be representative of investors in their states, let alone of investors in the nation as a whole.

119. ICI Letter, *supra* note 90, at *14.

120. 17 C.F.R. § 270.35d-1(a)(3) (2004). Even if the name were so construed, however, the Fund would easily be able to satisfy the Rule, which only requires an investment company whose name identifies a country or geographic region to include in its prospectus a statement of the criteria it will use in choosing investments. *Id.*

121. Release No. IC-24828, *supra* note 9, at 8514.

ity,¹²² the concept of “Homeland Security” could carry over to the words “Homeland Securities” in the name of the fund. Thus, because of its name, the Homeland Securities Fund could attract investors who believe the net asset value of Fund shares will not be depressed by acts of terrorism and/or will be raised by spending to combat terrorism.

If the suggested change is made in section 35(d), a registered investment company that plans to call itself the “Homeland Securities Fund” or use another name that is not neutral would be responsible for paying the cost of research to prove that the name increases the number of investors by less than twenty-five percent over a benign name that would be suitable for the fund.¹²³ The research, which would be conducted by a qualified behavioral scientist who has no ties to the investment company, may include a study in which data are obtained from individuals who come to the investigators’ worksite (a “laboratory” study); if a prohibited effect is found and the investment company still wanted to use the proposed name, a survey of a sample of individuals drawn from a broader population would be needed. The two research designs may yield different results. The former places the participants who are being studied in an environment that, for them, is artificial, and the findings of the study may not accurately reflect the behavior of potential investors in their normal settings. Nonetheless, a laboratory study may possess the ability to determine the maximum effect of a particular name, and if the maximum is found to be less than twenty-five percent, a survey (which can be expected to cost substantially more) might not be necessary. On the other hand, if the laboratory study indicated that a name will raise the number of investors by twenty-five percent or more, a sample survey would be required of potential investors in the geographic area(s) and/or demographic group(s) that will be targeted in the marketing efforts of the fund. A survey, by obtaining data from potential investors in a setting (*e.g.*, their homes) where they are exposed to many familiar stimuli, may yield an estimate of investor response to a fund name that is lower than the estimate derived from research carried out

122. The Office of Homeland Security was created in 2001 by Executive Order No. 13,228, 66 Fed. Reg. 51,812 (Oct. 10, 2001). The Department of Homeland Security was created by the Homeland Security Act of 2002, which Act became effective January 2003. Pub. L. No. 107-296, 116 Stat. 2135 (2002).

123. The SEC could develop a list of neutral names that can serve as a base for ascertaining the increase in the number of investors who would be attracted by the name in question. An investment company whose name was on the list would not need to conduct the research being described. Only an investment company whose name was not on the list would be required to undertake the research.

in a setting that is artificial for the participants.¹²⁴ If so, the survey estimate could determine the acceptability of the name.

Written standards to serve as guidelines for the research — standards approved by the SEC — may be prudent in order to ensure studies of high quality. Aspects of the research that may be appropriate for written standards are (1) the population studied, (2) the sampling procedure utilized, and (3) the proportion of individuals in the sample from whom data are acquired. Standards for these aspects would increase the likelihood that the results of the research can be generalized to a universe that is definable, larger, and pertinent. Thus, a survey ought to apply a form of probability sampling to a specifiable, broad and relevant population, and ought to obtain data from a high percentage of the individuals in the sample.¹²⁵ While probability sampling and a large population will almost always be impractical for a laboratory study, the procedure by which individuals are included in such a study must not generate participants who choose themselves. Unfortunately, laboratory studies seem typically to be performed with participants who happen to be available and who are therefore generally self-selected. These participants, however, are very likely to possess attributes that are absent in individuals not in the study and that can affect the behavior(s) of interest. In laboratory research, therefore, some procedure for obtaining participants is needed in order to furnish confidence that the findings of the research are applicable to a substantial group of potential investors.

VI. CONCLUSION

This article has explored one section of the Investment Company Act, but its approach is applicable generally to legislation and administrative agency rules promulgated for legislation. I have suggested that, in formulating and evaluating statutes and agency rules, the legal system would more effectively serve the interests of society if it drew on concepts and empirical research in the social and behavioral sciences. Whether due to inertia and/or to a lack of information, how-

124. Compare Stephen Ansolabehere *et al.*, *Does Attack Advertising Demobilize the Electorate?*, 88 AM. POL. SCI. REV. 829, 833 (1994) with Stephen D. Ansolabehere *et al.*, *Replicating Experiments Using Aggregate and Survey Data: The Case of Negative Advertising and Turnout*, 93 AM. POL. SCI. REV. 901, 904 (1999) (laboratory experiment on election campaign advertising found that both positive advertising and negative advertising affected expressed voting intentions, but sample surveys revealed no impact from positive advertising).

125. Probability sampling includes different types of sampling procedures in which every member of the population being studied has a known, nonzero chance of being chosen for the sample. Simple random sampling — popularly known as “random sampling” — is one form of probability sampling. EARL R. BABBIE, *SURVEY RESEARCH METHODS* 91-106 (1973).

ever, participants in the legal system infrequently take advantage of other disciplines.¹²⁶ The problem extends to, and may be in part caused by, law schools in the United States: Few law school courses demand the study of the social and behavioral sciences, and the scholarship of law school faculty members commonly disregards or misunderstands the methodological aspects, statistical techniques, and findings of empirical research conducted in these disciplines.¹²⁷ Accordingly, even if a large proportion of legislators were law school graduates,¹²⁸ regulatory law would be unlikely to make use of the social and behavioral sciences.

Law is a vehicle that serves the needs of society, and since social life requires trust in others,¹²⁹ law must preserve and promote trust.¹³⁰ Unfortunately, this simple but essential sociological concept – trust – seems to be acknowledged in the legal profession only in the context of publicly salient scandals such as those that have occurred in the business sector during the last few years. The legal criteria that are currently applicable to the names of mutual funds – “materially deceptive,” “materially misleading,” and “reasonable person” – arise from and endorse widely held social values; by embodying such values, the criteria reinforce trust in society and hence the commitment of individuals to society. Nonetheless, the same ends might be attained more fully and/or more efficiently with an alternative approach, and the social and behavioral sciences may suggest such an approach.

The criteria that presently determine the acceptability of fund names are highly subjective, and they are therefore difficult to apply in a coherent manner. However, the legal system, to be regarded as

126. J. Alexander Tanford, *The Limits of a Scientific Jurisprudence: The Supreme Court and Psychology*, 66 *IND. L. J.* 137, 145 (1990).

127. Lee Epstein & Gary King, *Empirical Research and the Goals of Legal Scholarship: The Rules of Inference*, 69 *U. CHI. L. REV.* 1 (2002).

128. The vast majority of legislators are at the state and local level. Data from the National Conference of State Legislatures indicate that only about one in six state legislators is a lawyer, but the proportion of state legislators who hold a law degree, while unknown, is higher. George B. Shepherd, *Defending the Aristocracy: ABA Accreditation and the Filtering of Political Leaders*, 12 *CORNELL J. L. & PUB. POL'Y* 637, 663 n.108 (2003).

129. FRANCIS FUKUYAMA, *TRUST* (1995).

130. The Supreme Court of the United States has recognized that fairness in the conduct of government (including statutes and the behavior of government officers and employees) is a “fundamental principle” mandated by the federal Constitution. *E.g.*, *Butz v. Economou*, 438 U.S. 478, 495 (1978). A belief in the fairness of government appears generally to be an antecedent or component of trust in society. *Cf.* J. Barton Cunningham & James MacGregor, *Trust and the Design of Work: Complementary Constructs in Satisfaction and Performance*, 53 *HUM. REL.* 1575 (2000) (perceptions by individuals of the fairness of the management of their group is an element of trust, which affects satisfaction with and commitment to the group).

fair, must employ its standards consistently — or, at least, must be widely thought to employ its standards consistently.¹³¹ As a result, current criteria for fund names possess a disadvantage that should not be ignored. The standard proposed in this article is more likely to be deemed fair and serve the interests of society, because the proposed standard would not depend on subjective criteria. Rather, the proposed standard would employ a fixed quantitative criterion and require quantitative data, gathered through well-designed studies, on the reactions of investors.

In this regard, “cute” and “catchy” fund names expose a defect in section 35(d) as currently worded. Cute and catchy names have the potential to attract many investors for whom the named funds are inappropriate, but these names are presently outside the scope of section 35(d) because the prohibition of the section is limited to fund names that are materially deceptive or misleading. If section 35(d) is revised, a revision that incorporates the standard suggested in this article would, by avoiding subjective criteria, permit greater consistency of application. The proposed standard would not be entirely free of uncertainty and disagreement — scientific methods never are — but the degree of uncertainty and the frequency of disagreement would be reduced by it. The proposed standard would thus promote perceptions of fairness, increase trust, and allow the legal system more effectively to preserve the social order.

131. *E.g.*, *In re Ingersoll*, 710 N.E. 2d 390, 397 (Ill. 1999); *United States v. Hamilton*, 708 F.2d 1412, 1415 (9th Cir. 1983).