

CLIENT ALERT

# SEC Adopts Safe Harbor for Covered Investment Fund Research Reports

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On November 30, 2018, the Securities and Exchange Commission (the “**SEC**”) adopted a non-exclusive safe harbor that allows broker-dealers participating in securities offerings of unaffiliated mutual funds, exchange-traded funds, closed-end funds, business development companies, commodity exchange-traded products<sup>1</sup> and other SEC registered, publicly traded funds<sup>2</sup> (“**Funds**”) to publish and distribute research reports regarding the unaffiliated Funds without the reports being deemed to be an offer for sale or offer to sell the Funds’ securities.<sup>3</sup> The safe harbor is codified as Rule 139b under the 1933 Act and implements the Fair Access to Investment Research Act of 2017.<sup>4</sup> The SEC also adopted a new Rule 24b-4 under the Investment Company Act of 1940, as amended (the “**1940 Act**”), to facilitate implementation of the safe harbor and made conforming changes to Rule 101 of Regulation M<sup>5</sup> under the Securities Exchange Act of 1934, as

<sup>1</sup> This category of Fund requires the issuer to be a trust or other person (i) issuing securities that are registered under the Securities Act of 1933, as amended (the “**1933 Act**”), and listed for trading on a national securities exchange, (ii) the assets of which consist primarily of commodities, currencies or derivative instruments that reference commodities or currencies or interests in such assets, and (iii) that provides in its registration statement that a class of its securities are purchased or redeemed subject to conditions or limitations for a ratable share of its assets.

<sup>2</sup> The safe harbor does not apply to issuer-specific research reports regarding investment funds that are not actively traded.

<sup>3</sup> Covered Investment Fund Research Reports, SEC Rel. Nos. 33-10580; 34-84710; IC-33311 (Nov. 30, 2018) (“**Adopting Release**”).

<sup>4</sup> See Fair Access to Investment Research Act of 2017, Public Law No. 115-66, 131 Stat. 1196 (2017) (the “**FAIR Act**”).

<sup>5</sup> The amendment adds Rule 139b to the exception contained within Rule 101(b)(1) of Regulation M to permit the publication or dissemination of any information, opinion or recommendation during the applicable restricted period by a distribution participant or an affiliated purchaser of such person.

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amended (the “**Exchange Act**”), and to Form 12b-25. The rules and modifications become effective 30 days following the date of publication in the *Federal Register*.

Although the new rules provide some relief over the current requirements – most notably, relief from the filing requirements of the Financial Industry Regulatory Authority (“**FINRA**”)<sup>6</sup> — they impose a number of conditions that may limit their flexibility and use. One of the most significant constraints is a requirement that any quotation of Fund performance be presented in accordance with the standardized performance requirements set forth in Rule 482 under the 1933 Act (for open-end funds) and the instructions to item 4.1(g) of Form N-2 (for closed-end funds).

### **FAIR Act**

Since the adoption of Rule 139 under the 1933 Act in 1970, broker-dealers participating in registered offerings of securities of operating company issuers have been able to rely on a safe harbor contained in Rule 139 to publish and distribute research regarding the issuers whose securities are the subject of the offering without violating the prospectus delivery provisions of Section 5 of the 1933 Act. Because Rule 139 does not extend to registered funds, broker-dealers engaged in the offer and sale of Fund securities that elect to publish research on those Funds have been forced to treat independent research on the Funds as “marketing materials” under Rule 482 under the 1933 Act or to ensure that the research is accompanied or preceded by a prospectus in order to comply with the 1933 Act prospectus delivery requirements.

The FAIR Act directed the SEC to adopt rule amendments to extend the current safe harbor for research reports under Rule 139 to “covered investment fund research reports.” New Rule 139b provides a safe harbor so that Fund research does not constitute an offer for sale or an offer to sell a Fund security for purposes of Sections 2(a)(10) and 5(c) of the 1933 Act or a Section 10(b) prospectus (such as materials published pursuant to Rule 482 under the 1933 Act), even if the broker-dealer that authored the report is participating in the offering of the Fund securities.

The FAIR Act further directed the SEC to adopt rule amendments to provide that a Fund research report generally would not be subject to the filing requirements of Section 24(b) of the 1940 Act, or the rules and regulations thereunder, except where such report is not otherwise subject to the content standards in the rules of any self-regulatory organization (“**SRO**”) related to research reports. New Rule 24b-4 exempts Fund research published in accordance with Rule 139b from the requirements of Section 24(b) of the 1940 Act, provided the research complies with the content provisions of SRO rules,

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<sup>6</sup> The SEC contemplates that FINRA could change its rules to require Fund research to be filed with FINRA. The SEC also notes that the exclusion from filing under current FINRA rules requires the purpose of the Fund research report to be “to provide research and analysis,” suggesting that materials deemed to be “advertisements” would not be eligible to rely on the exclusion.

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such as FINRA Rule 2210(d)(1).<sup>7</sup> As a result of the exemption, Fund research reports published under Rule 139b are not required to be filed with FINRA.<sup>8</sup> However, as a result of the content requirements, Fund research reports may not present related performance information or pre-inception index performance unless the research is provided only to institutional investors and may not include projections or predict performance of an investment strategy (although publication of price targets in compliance with FINRA standards should be acceptable).

### Rule 139b

In adopting Rule 139b, the SEC expressed concern that Funds and broker-dealers might use research reports to circumvent the prospectus delivery requirements of the 1933 Act. As a result, the conditions imposed on Fund research are primarily aimed at mitigating this risk and differ depending upon whether Fund research reports are focused on a specific issuer (an “**Issuer-Specific Research Report**”) or on a category or grouping of Funds (an “**Industry Report**”).

#### *Conditions for Publication of Issuer-Specific Research Reports*

Rule 139b defines “research report” as a written communication, as defined in Rule 405 under the 1933 Act, that includes information, opinions or recommendations with respect to securities of an issuer or an analysis of a security or issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision. In order for a broker-dealer to rely on Rule 139b with respect to Fund research, the research report must satisfy the following conditions:

- The research report may not be prepared, endorsed, approved or published by the Fund or an affiliate of the Fund that is the subject of the research report;
- The broker-dealer publishing or distributing the research report may not be an affiliate of the Fund or an investment adviser to the Fund (or an affiliated person<sup>9</sup> of such investment adviser);
- The broker-dealer’s publication of research must be “in the regular course of business”;
- For Funds whose securities are not in substantially continuous distribution (e.g., most exchange-listed, closed-end funds), the research may not represent the initiation (or re-initiation) of publication of research about the Fund or its securities; and

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<sup>7</sup> Fund research reports published by broker-dealers would also be subject to the requirements of FINRA Rule 2241 as well as to other applicable securities laws, including disclosure obligations under Section 17(b) of the 1933 Act and, although the SEC does not mention it in the Adopting Release, presumably to Regulation AC.

<sup>8</sup> Under Rule 24b-3 under the 1940 Act, materials filed with FINRA are deemed to have been filed with the SEC.

<sup>9</sup> An “affiliated person” of an investment adviser is defined by reference to Section 2(a)(3) of the 1940 Act.

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- The Funds described in the research report must:
  - have at least \$75 million in market value (or aggregate net asset value for mutual funds) of voting and non-voting securities outstanding (“**Float Threshold**”);
  - have launched at least 12 months prior to commencement of research coverage; and
  - have been current in their required SEC filings.<sup>10</sup>

Commenters had sought clarification on whether a Fund would be permitted to provide information or confirm factual matters covered by a research report to an unaffiliated broker-dealer without thereby making Rule 139b unavailable to the broker-dealer publishing the report. In response, the SEC noted that, depending on the facts and circumstances, Fund research that includes materials authorized or approved by the Fund, its affiliates, the Fund’s investment adviser or an affiliated person of the Fund’s investment adviser may inappropriately circumvent the requirements of Rule 139b.

In response to objections by commenters to the proposed rule and the underlying conditions set out in the proposing release,<sup>11</sup> the SEC noted that it elected largely to retain the proposed conditions, adding that the conditions were consistent with those applicable to research regarding operating company issuers set forth in Rule 139. In particular, the SEC noted that the Float Threshold, which commenters had suggested was too high, was appropriate because Fund “issuers with a public float of less than \$75 million generally do not have a market following that would add to the mix of information in the marketplace.”<sup>12</sup>

In the final rule, the SEC agreed to make select changes to the conditions in order to make it easier for broker-dealers to rely on the safe harbor. These modifications include the following:

- The Float Threshold is not required to be calculated net of affiliate holdings for 1940 Act registered funds (but must be calculated net of affiliate holdings for commodity- or currency-based exchange-traded funds).
- The Float Threshold only needs to be satisfied upon initiation (or re-initiation) of research coverage and thereafter once per quarter, rather than on a continuous basis (as was proposed).
- A broker-dealer may rely on the lack of a Form 12b-25 filing as confirmation that a Fund has filed all of the required SEC filings on a timely basis, absent actual knowledge that the issuer is not current.

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<sup>10</sup> For Funds registered under the 1940 Act, the reports are those filed on Forms: N-CSR; N-SAR; N-Q; N-PORT; N-MFP; and N-CEN. For Funds that are not registered under the 1940 Act, the reports are those required by Section 13 or Section 15(d) of the Exchange Act, as applicable.

<sup>11</sup> See Covered Investment Fund Research Reports, SEC Release Nos. 33-10498; 34-83307; IC-33106 (May 23, 2018).

<sup>12</sup> Adopting Release at 28.

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In order to rely on the safe harbor, broker-dealers must publish Fund research reports “in the regular course of business.” In the case of Funds whose shares are not in substantially continuous distribution (such as most exchange-traded, closed-end funds), research reports must not represent the initiation (or re-initiation) of research coverage with respect to that Fund or its securities. The SEC clarified that a broker-dealer could satisfy the regular-course-of-business condition either (i) by publishing research reports on a Fund when such broker-dealer is not participating in the offering of such Fund, or (ii) if, at the time of reliance on Rule 139b, it has distributed or published at least one research report about the Fund or its securities in reliance on another legal basis, such as Rule 482 under the 1933 Act.

While research reports would not be required to be published by a traditional “research department” in order to satisfy the condition, the SEC indicated that publication by a research department would be a factor that would suggest compliance with the regular-course-of-business requirement. Other factors that would evidence compliance with the condition include the following:

- Whether the broker-dealer has a compliance structure in place with relevant policies and procedures governing publication of research and distribution of Fund advertisements;
- Whether the broker-dealer has a research department with research analysts covering particular issuers or industries;
- Whether the broker-dealer maintains policies and procedures governing its research protocols; and
- Whether the broker-dealer regularly publishes or distributes research on any other type of company or business other than covered investment funds.

### *Conditions for Publication of Industry Reports*

Rule 139b allows for publication of research reports covering multiple Funds. The Industry Reports may not include any Funds affiliated with the broker-dealer publishing the report or for which the broker-dealer is an investment adviser or an affiliated person of the investment adviser. However, Industry Reports may include Funds that do not meet the Float Threshold. Industry Reports must satisfy the following conditions in order for the broker-dealer publishing the report to be able to rely on the safe harbor:

- Each Fund included in the report must be subject to reporting requirements under the 1940 Act or Section 13 or 15(d) under the Exchange Act;
- The report must (i) include similar information regarding a substantial number of Funds of the same type or investment focus, or (ii) contain a comprehensive list of Fund securities currently recommended by the broker-dealer (in each case other than affiliated Funds);

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- The analysis with respect to any one Fund must be given no greater prominence than that of any other Fund;
- The broker-dealer must publish the research report in the regular course of business (applying similar principles as those which apply to Issuer-Specific Research Reports); and
- With respect to a research report that includes a Fund that does not have a class of securities in substantially continuous distribution (e.g., most exchange-listed, closed-end funds), the broker-dealer must include similar information about such issuer or its securities in similar reports at the time of publication or distribution of the research report.

### *Performance Information*

As proposed, Rule 139b would not have required the presentation of standardized performance information. However, upon further consideration, the SEC determined to require Fund performance information to be presented in accordance with standardized presentation requirements. As a result, if research reports show performance information, such performance information generally must be shown consistent with the requirements of Rule 482, for mutual funds and ETFs, and in accordance with the instructions to item 4.1(g) of Form N-2, for closed-end funds. Although Rule 139b only addresses the use of other measures of performance in respect to closed-end fund research, because the Rule contemplates publication of performance consistent with Rule 482 and publication of non-standardized performance is authorized under Rule 482(d)(5), presentation of non-standardized performance should be allowed for Fund research relating to open-end funds and ETFs as well.

### **Rule 24b-4**

New Rule 24b-4 under the 1940 Act provides that research regarding Funds is not required to be filed with the SEC or FINRA pursuant to Section 24(b) of the 1940 Act, unless such research report is otherwise not subject to the content standards in SRO rules relating to research reports. Thus, in order to rely on Rule 24b-4, the research report generally must be subject to the content requirements of FINRA Rule 2210, which governs communications with the public.

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If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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