“COVERED INVESTMENT FUND” RESEARCH BEGINS JANUARY 14, 2019

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U.S. Investment Management Alert

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The Securities and Exchange Commission ("SEC") has traditionally recognized the value of market and issuer research to the investment decision-making process. The federal securities laws regulate issuer and market communications under general antifraud and specific rules. Congress adopted the Fair Access to Investment Research Act ("FAIR Act") in 2017 to place research about "covered investment funds" on equal regulatory footing with the publication and distribution of research historically permitted for public operating companies. Congress directed the SEC in the FAIR Act to adopt implementing rules, and the SEC adopted Rule 139b under the Securities Act of 1933 ("1933 Act") for this purpose. This rule became effective on January 14, 2019.

Rule 139b covers two types of research reports—issuer-specific reports and industry reports. This Alert: (i) describes the scope of the new SEC rule for covered investment fund "research reports"; (ii) summarizes the current regulatory landscape that would be expected to apply in coordination with the rule; and (iii) discusses the conditions for issuer-specific and industry research reports to rely on the rule.

SCOPE

Who Is Impacted By Rule 139b?

Broker-Dealers

Rule 139b applies to certain broker-dealers that seek to publish and distribute research reports about covered investment funds for which they may be, or may be deemed to be, participating in an offering. Broker-dealers relying on this non-exclusive safe harbor may permissibly publish and distribute eligible research reports without the report being deemed to be an impermissible offer to sell, or an offer for sale, of a security in violation of Section 5 of the 1933 Act. [1]

Rule 139b, however, does not extend to a research report published and distributed by a covered investment fund itself, directly or indirectly, by an "affiliate" of the fund, or by a broker-dealer that is an adviser to the fund or that is an "affiliated person" of an adviser to the fund. [2] The FAIR Act itself included this limitation on the scope of the Rule 139b safe harbor, and the SEC incorporated it in its implementing regulations to prevent issuers from circumventing Section 5 (*e.g.*, by issuing research reports in lieu of prospectuses) and to mitigate the potential for a broker-dealer's conflict of interest with respect to a covered investment fund resulting in a biased research report. These affiliate and affiliated person restrictions are technical and would require careful consideration to ensure compliance.

Under Rule 139b, to determine "affiliates" of an investment fund, a broker-dealer must look to, among other things, the definition of "affiliate" in Rule 405 under the 1933 Act, which makes any person that directly or

indirectly controls a fund, is controlled by a fund, or is under the common control of a fund an affiliate. Control for these purposes, and as defined by Rule 405, means the direct or indirect power to direct or cause the direction of the management and policies of a fund whether through the ownership of voting securities, by contract, or otherwise. Thus, for example, an "affiliate" of an investment fund would almost surely include its adviser and could include a broker-dealer that provided it with seed funding, even if the broker-dealer was not otherwise affiliated with the fund's sponsor or adviser.

The safe harbor also is not available to a broker-dealer that is an "affiliated person," as defined in Section 2(a)(3) of the Investment Company Act of 1940 ("1940 Act"), of any adviser to the covered investment fund. Section 2(a)(3) provides an extremely technical and broad definition of "affiliated person." Among other things, the definition includes any investment adviser to an investment company (*i.e.*, investment fund), including a third-party sub-adviser. The affiliation of a third-party sub-adviser raises the question whether an affiliated broker-dealer of the sub-adviser would be captured in the affiliation restrictions, and the SEC did clarify the potential effects the affiliation restrictions may have on broker-dealers affiliated with third-party sub-advisers. Additionally, a broker-dealer that owns as little as five percent of the voting equity of an investment fund's adviser or third-party sub-adviser would be an "affiliated person" of each, as the case may be, and, therefore, also unable to rely on the Rule 139b safe harbor.

Participation by an investment fund or its adviser in the review of a research report also could disqualify reliance on the safe harbor on the theory that, if either played such a prominent role in reviewing or approving the research, the fund or adviser could be deemed to have *indirectly* published and distributed the research report. Alternatively, a reading of the SEC's analysis in the adopting release to Rule 139b suggests that a fund's or an affiliate's participation in the review and approval of material for a report could "entangle" the fund or affiliate in the production of the report or otherwise cause them to "adopt" the report outside of the protection of the safe harbor. By invoking the doctrines of entanglement and adoption from other areas of the federal securities laws, the rule divorces the fund and its adviser from the research report publication and distribution process, which runs counter to the traditional process by which funds and their advisers develop, produce, and distribute fund marketing materials. Thus, the effect of the SEC's guidance presumably is to mitigate the potential for covered research reports becoming primarily another type of fund marketing or advertising.

Covered Investment Funds

Although a "covered investment fund" may not permissibly publish and distribute a research report about its securities or its industry sector in reliance on the safe harbor, or otherwise participate in the publication of such a report, it is obviously impacted by Rule 139b because it can be the subject of a Rule 139b report, individually or collectively as part of an industry. The safe harbor defines a "covered investment fund" to include: (i) an investment company (or series or class thereof) that has filed a registration statement under the 1933 Act, which the SEC has declared effective; (ii) a business development company ("BDC") that that has filed a registration statement under the 1933 Act, which the SEC has declared effective; and (iii) a trust or other person (1) that is issuing securities in a registered offering that are listed for trading on a national securities exchange; (2) whose assets consist primarily of commodities, currencies, or derivatives that reference commodities or currencies; and (3) whose registration statement discloses that its securities are purchased or redeemed for a ratable share of its assets.

Stated less technically, an eligible research report may cover mutual funds, closed-end funds, exchange-traded funds ("ETFs"), currency and commodity exchange-traded products ("ETPs"), and BDCs. A "covered investment fund," however, would exclude investment companies that are solely registered pursuant to the 1940 Act (and not the 1933 Act), such as certain master funds in a master-feeder structure. Nevertheless, according to SEC estimates, more than 11,000 issuers, representing over $20 trillion in market value, theoretically could become the subject of research reports under the Rule 139b regulatory regime, although the market-value conditions of the rule discussed below may reduce the potential universe of investment funds that may be practicably covered.

What Is a "Research Report?"

The federal securities laws currently include various definitions of the term "research report." Rule 139b defines a "research report" to mean a written communication (a writing, printing, graphic communication, or radio or television broadcast) that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security of an issuer, regardless if the communication provides sufficient information on which to base an investment decision. The Rule 139b definition parallels similar definitions in Rules 137, 138, and 139 under the 1933 Act. These 1933 Act rules form the historical basis for the permissible publication and distribution of research reports on operating companies. Rule 139b is modeled after Rule 139, with adjustments in recognition of differences between investment funds and operating companies.

The definition prescribed by Rule 139b, however, differs from that prescribed elsewhere. For example, this definition in Rule 139b contrasts with the definition in Regulation Analyst Certification ("Regulation AC") under the Securities Exchange Act of 1934 ("1934 Act") and with the definition prescribed by the debt and equity research rules of the Financial Industry Regulatory Authority ("FINRA"). Regulation AC defines a "research report" to mean a written communication (including electronic communications) that includes an analysis of a security or an issuer, which conveys information *reasonably sufficient for an investor to base an investment decision*. Similarly, FINRA Rules 2241 (equity research rule) and 2242 (debt research rule) define a "research report" as a report that includes, among other things, information sufficient to form the basis of an investment decision. Rule 139b expressly omits this "reasonable basis" condition, thus arguably covering a broader universe of securities and market analysis than Regulation AC and the FINRA research rules may cover. The SEC, however, stated its expectation that most covered investment fund research reports would be expected to trigger compliance with FINRA's research rules, and Regulation AC, presumably because the report would be expected to form the basis for an investment decision. In light of the SEC's position, consideration of conflicts disclosure prescribed by Regulation AC and FINRA research rules may need to be incorporated in research reports in reliance on Rule 139b, as discussed below.

EXISTING REGULATORY LANDSCAPE AND INTERPLAY WITH RULE 139B

Regulation AC

Regulation AC was adopted in 2003 and regulates primarily the publication and distribution of research by certain market participants—namely, investment banks and their research analysts, which may have investment-banking and sales and trading business relationships with issuers they cover in the research process. At its core, Regulation AC is intended to manage conflicts of interest in the research process by requiring prominent certifications in research reports subject to Regulation AC regarding the independence of the analyst's views contained in the report. More specifically, Regulation AC requires express certification that no part of the

compensation of the analyst primarily responsible for preparing the report was, is, or will be, directly or indirectly, related to the specific recommendation or views contained in the research report; or, if part or all of the analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views contained in the research report, the certification must disclose the source and amount of the analyst's compensation, the purpose of compensation, and the conflicts of interest that the compensation may raise—namely that such a compensation structure may influence the recommendation in the research report.

Regulation AC principally governs the debt and equity research functions of broker-dealers and their research analysts. It may be read to extend, however, to affiliates of a broker-dealer that provide debt and equity research, particularly to the extent that the affiliate and broker-dealer have overlapping officers or research employees. To the extent that an authoring broker-dealer does not trigger the affiliation restrictions, Rule 139b does not expressly prohibit a broker-dealer, and presumably its research analysts by extension, from publishing and distributing eligible research reports simply because the broker-dealer receives revenue-sharing and similar distribution payments, or the analyst receives bonuses or compensation that may be tied to his or her research activities. Regulation AC may require that the report's content be supplemented to include appropriate conflicts disclosure.

If, however, an authoring broker-dealer reasonably concludes that a research report could not form a reasonable basis to make an investment decision, notwithstanding the SEC's position otherwise, Regulation AC would not be specifically triggered, although considerations under general antifraud and/or FINRA rules may require conflicts disclosure in any event, particularly disclosures relevant to compensation paid to an authoring broker-dealer or its research analyst. Thus, an authoring broker-dealer would need to consider and evaluate potential conflicts raised by compensation structures to determine the extent to which conflicts may need to be disclosed, either as expressly prescribed by Regulation AC, or disclosed more generally to comply with principles of antifraud disclosure or relevant FINRA rules, as discussed below.

FINRA Rules

FINRA also has adopted comprehensive regulations governing the equity and debt research process that, like Regulation AC, are intended to manage potential conflicts of interest raised by a full-service broker-dealer's research, trading, and investment-banking activities. FINRA's research rules are technical and require complex structural compliance to ensure the independence of the research process. Thus, an evaluation of these research rules would be a necessary predicate to engaging in the investment fund research process to ensure conflicts are vetted and disclosed, as well as that the process ensures the independence of the research to the extent required.

Even if a Rule 139b research report may be viewed as not providing a reasonable basis on which to make an investment decision, which would trigger application of FINRA's research rules, other FINRA rules would nonetheless apply to the report. For example, covered investment fund research reports would be subject to FINRA's advertising rules (FINRA Rule 2210), which require fair and balanced communications to the public and that public communications be based on fair dealing and good faith. The general content standards incorporate FINRA's basic business conduct rule of just and equitable principles of trade and high standards of commercial honor (FINRA Rule 2010). Arguably, these general principles of fair dealing would call for conflicts disclosure, even in the absence of specific conflicts disclosure prescribed by Rule 139b or other regulations, such as FINRA's research rules or Regulation AC. Further, of course, the general antifraud provisions throughout the federal

securities laws would require disclosure of all material information and prohibit the omission of material information in covered investment fund research reports.

Investment Company Communications

The permissible publication and distribution of fund information has long pre-dated the FAIR Act and the adoption of Rule 139b. Investment company communications are regulated under general antifraud, and specific regulations pursuant to the 1933 Act, the 1940 Act, the Investment Advisers Act of 1940 ("Advisers Act"), and FINRA advertising rules to the extent fund shares are distributed by a FINRA member firm. For instance, Section 34(b) of the 1940 Act, [3] Section 206 of the Advisers Act, and Rule 206(4)-1 under the Advisers Act generally apply to all forms of communications distributed by an investment company or its adviser, including fund advertisements and sales literature. These requirements generally require that fund materials not mislead or omit material facts. A fund distributor seeking to publish and distribute investment company research would need to keep these investment company-specific principles in mind, but further must not impermissibly entangle the fund or its adviser(s) in the research process, such that the affiliation restrictions of Rule 139b are violated and as a consequence the fund and/or adviser(s) are viewed as indirectly publishing and distributing the research outside of protection from potential Section 5 violations.

Rule 482 under Regulation C of the 1933 Act also figures prominently in the existing regulatory regime for investment company communications. Section 5(b)(1) of the 1933 Act prohibits the delivery of any prospectus in connection with any security for which a registration statement has been filed unless the prospectus complies with Section 10 of the 1933 Act. Advertising that satisfies Rule 482 under the 1933 Act is deemed to be an "omitting prospectus," the effect of which means that an investment company may distribute a Rule 482 advertisement after the registration statement has been filed, but before it has been declared effective. For an open-end fund seeking to publish performance information, Rule 482 prescribes the precise method by which performance must be uniformly presented. Rule 139b incorporates the requirements of Rule 482's standardized performance to the extent an open-end investment company research report includes performance information. [4] Similarly, a research report containing performance for a closed-end fund would need to comply with Form N-2, the registration form for a closed-end fund that prescribes the permissible method of presenting performance information.

CONDITIONS OF RULE 139B

Rule 139b applies to issuer-specific and industry research reports and prescribes conditions for both. For purposes of Rule 139b, an issuer-specific research report constitutes a report about one specific unaffiliated covered investment fund. An industry report, by contrast, would be a report regarding multiple covered investment funds of the same type or same investment focus, which are covered uniformly, giving no fund(s) greater prominence over others. Alternatively, an industry report could be a comprehensive list of investment funds currently recommended by the publishing broker-dealer (excluding any that triggered the safe harbor's affiliation restrictions), so long as the report gives no greater prominence to one fund or funds over others included in the report.

The Safe Harbor Applies to Seasoned Issuers

Similar to the 1933 Act's safe harbor for operating companies (Rule 139), Rule 139b prescribes for issuer-specific and industry reports conditions restricting research to seasoned issuers based on the fund's reporting pursuant to

the 1940 Act or, if not 1940 Act registered, the public reporting provisions of the 1934 Act (Section 13 or Section 15(d)). For issuer-specific research reports, the safe harbor adds a 12-month minimum reporting period (and timely filing condition), either under the reporting provisions of the 1940 Act or the public company reporting provisions of the 1934 Act, and specific market value measures, similar in concept to the public-float requirements for operating companies in Rule 139, to ensure a significant market following for the particular fund. Rule 139b, therefore, currently sets the market value or net asset value, depending on the construct of the fund, at $75 million. [5] The market value condition is subject to a quarterly "re up" to ensure eligibility of continued coverage. These conditions effectively make new funds and/or small funds ineligible for coverage in reliance on Rule 139b and place a heavy duty on an authoring broker-dealer to ensure a fund's eligibility for coverage.

The Safe Harbor Applies Solely to Broker-Dealers That Publish and Distribute Research in the Regular Course of Business and at Specified Times during the Coverage Process

The safe harbor requires a broker-dealer authoring an issuer-specific or industry research report to publish and distribute the report in its "regular course of business." This condition applies to issuer-specific and industry reports, but does not explicitly require that the authoring broker-dealer have established a traditional research department. The SEC stated expressly that a broker-dealer that published "research reports" pursuant to Rule 482 or that has otherwise previously published research in reliance on Rule 139 would satisfy the "regular course of business" condition to the extent research was prepared in reliance on Rule 139b. Further, according to the SEC, the "regular course of business" requirement also could be satisfied if a broker-dealer, at the time of reliance on the safe harbor, had published at least one previous report or one report following a discontinuance of coverage.

In addition to imposing the "course of business" requirement on broker-dealers publishing research reports, broker-dealers generally may not avail themselves of the safe harbor with respect to issuer-specific research reports that represent the initiation of coverage or re-initiation of coverage following discontinuance. An exception to this limitation is available for any report pertaining to a covered investment fund that has a class of securities in substantially continuous distribution. This exception should allow for reports that rely on Rule 139b to cover open-end funds, such as mutual funds and ETFs, and other types of funds that conduct offerings that functionally engage in a continuous offering, such as potentially to interval or tender-offer closed-end investment companies or certain ETPs. [6]

CONFORMING RULES AND AMENDMENTS

Rule 24b-4 under the 1940 Act

The SEC also adopted Rule 24b-4 under the 1940 Act to clarify that an authoring broker-dealer's "research report" in reliance on Rule 139b will not be subject to the filing requirements prescribed by Section 24(b) of the 1940 Act to the extent that the report is subject to content standards of FINRA Rule 2210, noted above.

Regulation M under the 1934 Act

The SEC also adopted conforming amendments to Rule 101 of Regulation M to recognize an exception for research reports published and distributed by a "distribution participant" in reliance on Rule 139b from the prohibitions of Rule 101 during the distribution period of an issuer's securities.

NOTES

[1] The safe harbor protects a research report from being an offer for sale or an offer to sell a security for purposes of Section 5(c) of the 1933 Act, but requires that the covered investment fund in the first instance have an effective registration statement. Inasmuch as Section 5(c) of the 1933 Act applies to the period of an offering that precedes the filing of a registration statement, however, it is not altogether clear how the Section 5(c) protection is intended for research reports authored in reliance on Rule 139b. Purportedly, Rule 139b also protects the delivery of eligible research from being deemed a non-conforming prospectus for purposes of Section 10 of the 1933 Act, inasmuch as the SEC expressly stated in regard to an analogous rule (Rule 139) that a broker-dealer's publication and distribution of eligible research reports would not be a non-conforming prospectus in violation of Section 5 of the 1933 Act.

[2] The affiliation restrictions do not necessarily prohibit a third-party distributor of a fund's shares (or one who may become a distributor) from publishing and distributing a research report about the fund, although other provisions of the securities laws may require disclosure of potential conflicts relevant to a third-party distributor's research, as discussed below.

[3] Rule 34b-1 under the 1940 Act applies to supplemental sales literature for investment companies and, like Rule 482 discussed below, prescribes standardized performance requirements.

[4] A report could include non-standardized performance, but only if standardized performance, as required by Rule 482, were also included and deviations between the two explained.

[5] With few potential exceptions, only traditional mutual funds are permitted to base this calculation on net asset value.

[6] Although many ETPs operate in a manner that is substantially the same as ETFs, because they are not registered investment companies, SEC rules preclude them from registering an unlimited number of shares (like ETFs do). As a result, when registering, ETPs must specify (and pay for) a specific number of shares to be registered; and, when they run out of shares, they must register (and pay for) additional shares. Certain large ETPs qualify to register additional shares pursuant to filings that go automatically effective. Smaller ETPs, however, do not. Accordingly, from time to time, these ETPs have been required to suspend sales of their shares. *See, e.g.*, John Spence, *Fueling a Losing Bet*, Market Watch (Jan. 4, 2010) ("Over the summer the [United States Natural Gas Fund L.P.] temporarily halted the creation of new shares as it waited for regulatory approval to issue new shares after it ran out. "), https://www.marketwatch.com/story/natural-gas-etf-burned-investors-in-2009-2010-01-04. Under Rule 139b, if such an ETP is the subject of an issuer-specific research report, its suspension of share sales may jeopardize the ability of the report's publishing broker-dealer to rely on the rule as it may call into question whether the ETP (*i.e.*, the covered investment fund) fits within the allowance for funds engaged in a continuous offering.

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