

SEC Expands Safe Harbor to Promote Research on Investment Funds

On November 30, 2018, the Securities and Exchange Commission (the “Commission”) adopted a new rule¹ establishing a non-exclusive research report safe harbor (“Rule 139b”) for unaffiliated brokers or dealers that publish or distribute research reports² regarding qualifying investment funds. The Commission took this action in furtherance of the mandate of the Fair Access to Investment Research Act of 2017 (the “FAIR Act”). The FAIR Act required that the Commission expand the Rule 139 safe harbor for research reports in order to cover research reports on investment funds.

The research safe harbor is now available to research reports regarding qualifying mutual funds, exchange-traded funds, registered closed-end funds, business development companies (“BDCs”)³ and similar covered investment funds. Under the new safe harbor, the publication or distribution of a research report would not be deemed to constitute an “offer” under the Securities Act of 1933, as amended (the “Securities Act”), of the qualifying covered investment fund’s securities. The safe harbor is available even if the broker-dealer is participating in or may participate in a registered offering of the covered investment fund’s securities. Adoption of this safe harbor reduces obstacles that previously prevented investors from accessing research reports on investment funds.

Issuer-Specific Research Reports

An unaffiliated broker-dealer may release an issuer-specific research report in reliance on the Rule 139b safe harbor if the covered investment fund meets the specified reporting history and timeliness

requirements. Consistent with the condition in Rule 139, the covered investment fund must be subject to the public company reporting requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), for at least 12 months prior to reliance on the safe harbor, and must also have timely filed its periodic reports (including those on Forms 10-K and 10-Q) with the Commission during such time period.

The public reporting history and timeliness requirements prevent the safe harbor from being extended to research reports relating to newly public funds and require the relying broker-dealer to confirm the timeliness of the covered investment fund’s Exchange Act filings. In the adopting release, the Commission acknowledged that a broker-dealer may rely on the lack of a Form 12b-25 filing (Notification of a Late Filing) as confirmation that a fund’s filings are timely unless the broker-dealer is actually aware through other means that the issuer has not in fact made timely Exchange Act filings.

The covered investment fund must also have a minimum public market value (or net asset value for mutual funds) of at least \$75 million (consistent with Form S-3’s eligibility requirement). BDCs and closed-end funds are not permitted to satisfy the float requirement using a net asset value calculation. The requirement must be satisfied upon the initiation of research coverage and quarterly thereafter so long as the broker-dealer is continuing to issue research on the fund. Importantly, the adopted rule does not require that the market value or net asset value be calculated to exclude affiliate holdings for most covered investment funds.⁴ Unfortunately, the

presence of a minimum public float requirement prevents the safe harbor from being used in the case of smaller public issuers and non-traded BDCs and, as a consequence, impedes an investor's fair access to investment research covering such issuers.⁵

Consistent with Rule 139, the research report must be published or distributed by the broker-dealer in its regular course of business. The Commission noted that a broker-dealer can satisfy the regular course of business requirement if at the time of reliance on the safe harbor it has previously distributed or published at least one research report about the covered issuer or its securities. However, unlike Rule 139, the research report may represent the initiation or re-initiation of research covering the investment fund so long as such fund's securities are in substantially continuous distribution. The Commission's adopting release notes that the substantially continuous distribution threshold is an analysis based on a given issuer's particular facts and circumstances without providing any meaningful additional clarity.

Industry Research Reports

Similar to the issuer-specific research report requirement, the Rule 139b safe harbor requires each covered investment fund that is included in an industry research report to be subject to the public reporting requirements of the Exchange Act (or Section 30 of the Investment Company Act of 1940, as amended, for registered investment companies). The regular course of business requirement for issuer-specific research reports described above similarly applies to industry research reports.

The industry research report safe harbor is also conditioned on certain content requirements. In particular, industry research reports either must include similar information about a substantial number of covered investment funds of the same type or investment focus or alternatively contain a comprehensive list of covered investment fund securities currently recommended by the broker-dealer. The industry research report is required to include similar information about a substantial number of issuers either of the same type (e.g.,

exchange traded-funds or mutual funds that are large cap funds, bond funds, balanced funds or money market funds) or investment focus (e.g., primarily invested in the same industry or sub-industry, or the same country or geographic region).

Also, the industry research report safe harbor is conditioned on a presentation requirement. Under Rule 482b, analysis of any covered investment fund included in an industry research report cannot be given materially greater space or prominence in the publication than that given to any other covered investment fund issuer or its securities.

If fund performance information is included in a research report, it must be presented in accordance with certain standardized presentation requirements dependent on the type of investment fund covered. For research reports that include registered open-end fund performance, the Commission requires that fund performance be presented according to the presentment and timeliness requirements of Rule 482 (closed-end funds may comply with the requirements of Form N-2 instead of Rule 482).

A broker-dealer cannot include any covered investment fund that is an affiliate of the broker-dealer or for which the broker-dealer serves as an investment adviser in an industry research report. Additionally, a broker-dealer may not selectively apply the Rule 139b safe harbor to certain aspects of an industry research report. The safe harbor must apply to the entirety of the report.⁶

Small Business Credit Availability Act

In addition to the change described above, the Commission is also expected to adopt BDC-related communication and disclosure reforms in the near term. On March 23, 2018, Congress passed the Small Business Credit Availability Act (the "Act"). Included in the Act are various changes to the federal securities laws and regulations that are intended to provide BDCs with the ability to rely on more flexible communication and offering rules currently only available to operating companies. Among the changes contemplated by the Act were changes to the research safe harbors. The changes to the research safe harbors in Rules 138 and 139 were broader than

those adopted in Rule 139b. It will be interesting to see whether the Commission reviews these again.

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Endnotes

- ¹ See the adopting release (“Adopting Release”) at <https://www.sec.gov/rules/final/2018/33-10580.pdf>.
- ² The term “research report” in Rule 139b is defined as a written communication that includes information, opinions or recommendations with respect to securities of an issuer or an analysis of a security of an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.
- ³ Section 2(a)(3) of the Securities Act of 1933, as amended (the “Securities Act”), already provides a safe harbor for broker-dealers with respect to research reports about “emerging growth companies,” as defined in Section 2(a)(19) of the Securities Act. See footnote 6 of the Adopting Release.
- ⁴ Unlike Rule 139, Rule 139b does not permit affiliates of covered investment funds to rely on the safe harbor.
- ⁵ If a smaller issuer does not satisfy the public float requirement, a broker-dealer participating in a securities offering may consider a Rule 482 communication.
- ⁶ Broker-dealers that are unable to rely on Rule 139b for the entirety of the research report may consider a Rule 482 communication that is styled as an industry report.

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