SECURITIES AND EXCHANGE COMMISSION
17 CFR Parts 230, 242, and 270

Release Nos. 33-10498; 34-83307; IC-33106; File No. S7-11-18

RIN 3235-AM24

Covered Investment Fund Research Reports

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: As directed by Congress pursuant to the Fair Access to Investment Research Act of 2017, the Commission is proposing new rule 139b under the Securities Act of 1933. If adopted, the proposal would establish a safe harbor for an unaffiliated broker or dealer participating in a securities offering of a "covered investment fund" to publish or distribute a "covered investment fund research report." If the conditions for the safe harbor are satisfied, this publication or distribution would be deemed *not* to be an offer for sale or offer to sell the covered investment fund's securities for purposes of sections 2(a)(10) and 5(c) of the Securities Act of 1933. The Commission is also proposing new rule 24b-4 under the Investment Company Act of 1940. Proposed rule 24b-4 would exclude a covered investment fund research report from the coverage of section 24(b) of the Investment Company Act (or the rules and regulations thereunder), except to the extent the research report is otherwise not subject to the content standards in self-regulatory organization rules related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards. We are also proposing a conforming amendment to rule 101 of Regulation M.

DATES: Comments should be received by **[insert date 30 days after publication in the Federal Register]**.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment forms (http://www.sec.gov/rules/proposed.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-11-18 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-11-18. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (http://www.sec.gov/rules/proposed.shtml). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Room 1580, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct

electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by e-mail.

FOR FURTHER INFORMATION CONTACT: Asaf Barouk, Attorney-Adviser, John Lee, Senior Counsel; Amanda Hollander Wagner, Branch Chief; or Brian McLaughlin Johnson, Assistant Director, at (202) 551-6792, Investment Company Regulation Office, Division of Investment Management; Steven G. Hearne, Senior Special Counsel, at (202) 551-3430, Division of Corporation Finance; Laura Gold or Samuel Litz, Attorney-Advisers; or John Guidroz, Branch Chief, at (202) 551-5777, Office of Trading Practices, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission is proposing for comment new rule 139b [17 CFR 230.139b] under the Securities Act of 1933 [15 U.S.C. 77a *et seq*.]; new rule 24b-4 [17 CFR 270.24b-4] under the Investment Company Act of 1940 [15 U.S.C. 80a-1 *et seq*.]; and a conforming amendment to rule 101 [17 CFR 242.101(a)] of Regulation M [17 CFR 242.100–242.105].

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I. INTRODUCTION AND BACKGROUND

A. Introduction

As directed by the Fair Access to Investment Research Act of 2017,[1] we are proposing new rule 139b under the Securities Act of 1933 (the "Securities Act").[2] Proposed rule 139b includes certain conditions that, if satisfied, would provide that a broker's or dealer's (a "broker-dealer's") publication or distribution of a covered investment fund research report will be deemed for purposes of sections 2(a)(10) and 5(c) of the Securities Act not to constitute an offer for sale or offer to sell a security that is the subject of an offering of the covered investment fund, even if the broker-dealer is participating or may participate in a registered offering of the covered investment fund's securities.[3] Proposed rule 139b would establish a new safe harbor for unaffiliated broker-dealers' publication or distribution of covered investment fund research reports similar to the existing safe harbor under rule 139 applicable to research reports about other issuers or their securities.[4]

We are also proposing new rule 24b-4 under the Investment Company Act of 1940 (the "Investment Company Act"),[5] which would exclude a covered investment fund research report

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1 Fair Access to Investment Research Act of 2017, Public Law No. 115-66, 131 Stat. 1196 (2017) (the "FAIR Act").

2 15 U.S.C. 77a *et seq.*

3 *See infra* text accompanying notes 32–34 (discussing our general approach in modeling proposed rule 139b after rule 139 [17 CFR 230.139], and noting that we propose this approach in furtherance of the FAIR Act's directive to revise rule 139 to extend the current safe harbor available under rule 139 to broker-dealers' publication or distribution of covered investment fund research reports); *see also* proposed addition to rule 139(a) ("For purposes of the [FAIR Act], a safe harbor has been established for covered investment fund research reports, and the specific terms of that safe harbor are set forth in Rule 139b . . . .").

4 *See infra* notes 11–15 and accompanying text.

5 15 U.S.C. 80a-1 *et seq.*

from the filing requirements of section 24(b) of the Investment Company Act (or the rules and regulations thereunder), except to the extent that such report is otherwise not subject to the content standards in self-regulatory organization ("SRO") rules related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards.[6] This proposed rule would have the effect of reducing the filing requirements currently applicable to certain communications that, by operation of the FAIR Act and proposed rule 139b, would now be deemed "covered investment fund research reports."[7]

Additionally, in light of the proposal of rule 139b, we are proposing a conforming amendment to rule 101 of Regulation M. This amendment would permit distribution participants, such as brokers or dealers, to publish or disseminate any information, opinion, or recommendation relating to a covered security if the conditions of proposed rule 139b (or, alternatively, the conditions of rule 138[8] or rule 139 under the Securities Act) are satisfied.[9] The proposed conforming amendment is intended to align the treatment of research under proposed rule 139b with the treatment of research under rules 138 and 139 for purposes of Regulation M.[10]

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6 As discussed below, we are proposing this rule pursuant to section 2(b)(4) of the FAIR Act (mandating that the Commission shall "provide that a covered investment fund research report shall not be subject to section 24(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–24(b)) or the rules and regulations thereunder, except that such report may still be subject to such section and the rules and regulations thereunder to the extent that it is otherwise not subject to the content standards in the rules of any self-regulatory organization related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards"). *See infra* section II.D.1.

7 *See infra* notes 184–187 and accompanying text.

8 17 CFR 230.138.

9 *See infra* section II.E.

10 *See id.*

Rule 139 currently provides a safe harbor for the publication or distribution of research reports concerning one or more issuers by a broker-dealer participating in a registered offering of one of the covered issuers' securities.[11] Specifically, rule 139 provides that a broker-dealer's publication or distribution of research reports—whether about a particular issuer or multiple issuers, including within the same industry—that satisfy certain conditions under the rule are "deemed for purposes of sections 2(a)(10) and 5(c) of the [Securities] Act not to constitute an offer for sale or offer to sell."[12] A broker-dealer's publication or distribution of a research report in reliance on rule 139 would therefore not be deemed to constitute an offer that otherwise could be a non-conforming prospectus in violation of section 5 of the Securities Act.[13] Although the

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[11] The term "research report" in rule 139 under the Securities Act is defined as "a written communication, as defined in Rule 405, that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision." 17 CFR 230.139(d); *see infra* section II.A.2 for a discussion of the term "research report."

There are differences in how other rules and regulations define the term "research report," including Regulation Analyst Certification ("Regulation AC") under the Securities Act and the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78a *et seq*. *Compare* 17 CFR 242.500–505 (A "research report" as defined under Regulation AC is limited to an analysis of a security or an issuer, and information within the report must be "reasonably sufficient upon which to base an investment decision;" whereas, under rule 139, a "research report" includes not only an analysis of a security or an issuer, as in Regulation AC, but also, information, opinions, or recommendations regarding securities of an issuer, irrespective of the information within the report being "reasonably sufficient upon which to base an investment decision."); Financial Industry Regulatory Authority ("FINRA") rule 2241 (defining "research report"); and FINRA rule 2242 (defining "debt research report"). *See also* discussion of Regulation AC *infra* at notes 57–58. We note that research reports published or distributed by broker-dealers in reliance on the rule 139 safe harbor may also be subject to other rules and regulations under the federal securities laws, including but not limited to Regulation AC, as well as SRO rules governing their content and use, including but not limited to FINRA rules 2210, 2241, and 2242.

[12] Rule 139(a) under the Securities Act [17 CFR 230.139(a)].

[13] Sections 5(a) and 5(c) of the Securities Act generally prohibit any person (including broker-dealers) from using the mails or interstate commerce as a means to sell or offer to sell, either directly or indirectly, any security unless a registration statement is in effect or has been filed with the Commission as to the offer and sale of such security, or an exemption from the registration provisions applies. *See* 15 U.S.C. §77e(a) and (c). Section 5(b)(1) of the Securities Act requires that any "prospectus" relating to a security to which a registration statement has been filed must comply with the requirements of section 10 of the Securities Act. *See* 15 U.S.C.

Commission has previously requested comment as to whether to extend rule 139 to cover investment company research reports,[14] the rule's safe harbor currently is not available for a broker-dealer's publication or distribution of research reports pertaining to specific registered investment companies or business development companies.[15]

B. FAIR Act

The FAIR Act directs us to propose and adopt rule amendments that would extend the current safe harbor available under rule 139 to a "covered investment fund research report."[16] The FAIR Act also directs that these amendments shall be "upon such terms, conditions, or requirements as the Commission may determine necessary or appropriate in the public interest, for the protection of investors, and for the promotion of capital formation."[17]

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§77e(b)(1). Section 5(b)(2) of the Securities Act requires that any sale of securities (or delivery after sale) must be accompanied or preceded by a prospectus meeting the requirements of section 10(a) of the Securities Act. *See* 15 U.S.C. §77e(b)(2).

[14] *See* Securities Offering Reform, Securities Act Release No. 8501 (Nov. 3, 2004) [69 FR 67391 (Nov. 17, 2004)] ("Securities Offering Reform Proposing Release").

[15] For example, rule 139 is available for research reports regarding issuers that meet the registrant requirements for securities offerings on Form S-3 or Form F-3. *See* rule 139(a)(1)(i)(A)(*1*). To the extent that commodity- or currency-based trusts or funds (as defined in section I.B below) register their securities offering pursuant to the Securities Act and meet the eligibility requirements of Form S-3 or F-3, as well as the other conditions of rule 139, the rule 139 safe harbor would be currently available for a broker-dealer's publication or distribution of research reports pertaining to these issuers.

However, covered investment funds that are registered investment companies and business development companies are not able to register their securities offerings on Form S-3 or Form F-3. Registered investment companies register their securities offerings on forms such as Forms N-1A, N-2, N-3, N-4, and N-6. Publicly-traded business development companies register their securities offerings on Form N-2. However, section 2(a)(3) of the Securities Act 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. Broker-dealers may therefore currently rely on the section (2)(a)(3) safe harbor with respect to research reports about business development companies that are emerging growth companies.

[16] *See* section 2(a) of the FAIR Act.

[17] *See id.*

Under the FAIR Act, a "covered investment fund research report" is generally a research report published or distributed by a broker-dealer about a covered investment fund or any of the covered investment fund's securities.[18] The term "covered investment fund" under the FAIR Act includes registered investment companies and business development companies.[19] The term also includes other persons issuing securities in an offering registered under the Securities Act (i) whose securities are listed for trading on a national securities exchange, (ii) whose assets consist primarily of commodities, currencies, or derivative instruments that reference commodities or currencies or interests in the foregoing, and (iii) whose registration statement reflects that its securities are purchased or redeemed, subject to certain conditions or limitations, for a ratable share of its assets (such exchange-listed funds or trusts, "commodity- or currency-based trusts or funds").[20] However, a "covered investment fund research report" excludes research reports published or distributed by the covered investment fund *itself*, any affiliate of the covered investment fund, or any broker-dealer that is an investment adviser (or an affiliated person of the investment adviser) to the covered investment fund.[21]

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[18] *See id.* at section 2(f)(3). *But see infra* note 21 and accompanying text (noting that the definition of "covered investment fund research report" excludes research reports published or distributed by the covered investment fund or any affiliate of the covered investment fund, or any research report published or distributed by any broker or dealer that is an investment adviser (or an affiliated person of an investment adviser) for the covered investment fund).

[19] *See id.* at section 2(f)(2)(A).

[20] *See id.* at section 2(f)(2)(B).

[21] The FAIR Act definition of "covered investment fund research report" uses the term "affiliate" in connection with a covered investment fund and "affiliated person" in connection with an investment adviser. *See* section 2(f)(3) of the FAIR Act.

The FAIR Act includes a definition for the term "affiliated person," but not "affiliate." Because the FAIR Act directs the Commission to revise rule 139 under the Securities Act, we interpret the reference to the term "affiliate" in the definition of "covered investment fund research report" to refer to the term "affiliate" as it

The FAIR Act directs us to address the application of certain aspects of current rule 139 to covered investment fund research reports. For example, one of the conditions for using the rule 139 safe harbor for research reports about a specific issuer is that the broker-dealer's publication or distribution of the research report must "not represent the initiation of publication of research reports about such issuer or its securities or reinitiation of such publication following discontinuation of publication of such research reports."[22] Because many covered investment funds continuously offer their shares for sale (as opposed to engaging in an offering over a discrete period of time), it is difficult for a broker-dealer participating in such a continuous offering to satisfy this condition. In light of this, the FAIR Act prescribes that our extension of the rule 139 safe harbor, with respect to research reports in an offering of covered investment funds that are in "substantially continuous distribution," cannot be conditioned on whether the

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would be interpreted under rule 139, which we believe is by reference to rule 405 under the Securities Act. (We believe this to be the case because, for example, rule 139 is available for research reports regarding issuers that register their securities on Form S-3 or F-3 (or that meet the registrant requirements to register their securities offerings on Form S-3 or Form F-3) and that meet the minimum float provisions of General Instruction I.B.1 of such forms. *See* rule 139(a)(1)(i)(A)*(1)(i)*. General Instruction I.B.1, in turn, refers to the definition of "affiliate" in Securities Act rule 405.) Under rule 405, the term "affiliate" means an affiliate of, or person affiliated with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified. *See* rule 405 under the Securities Act [17 CFR 230.405]. The FAIR Act defines "affiliated person" as having the meaning given the term in section 2(a) of the Investment Company Act. *See* section 2(f)(1) of the FAIR Act. Section 2(a) of the Investment Company Act defines an "affiliated person" as: (A) any person directly or indirectly owning, controlling, or holding with power to vote, five per centum or more of the outstanding voting securities of such other person; (B) any person five per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

[22] *See* rule 139(a)(1)(iii) [17 CFR 230.139(a)(1)(iii)].

broker-dealer's publication or distribution of such research reports constitutes initiation or reinitiation of research about the covered investment fund or its securities.[23]

The FAIR Act also permits us to impose conditions on covered investment fund research reports that are similar to the conditions imposed under rule 139.[24] We may set a minimum public float requirement for covered investment funds but may not require a minimum public float that is greater than what is required under rule 139 (currently, $75 million).[25] Similarly, we may set a reporting history requirement for covered investment funds, but may not require a reporting history period for longer than what is required under rule 139 (currently, the 12 months preceding the time of the broker-dealer's first reliance on the rule 139 safe harbor).[26] Moreover, as noted above, we may impose additional conditions that we determine to be necessary or appropriate in the public interest, for the protection of investors, and for the promotion of capital formation.[27]

Finally, the FAIR Act includes provisions concerning the ability of SROs to impose requirements on the use and filing of covered investment fund research reports.[28] First, the FAIR Act directs us to provide that covered investment fund research reports will not be subject

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[23] *See* section 2(b)(1) of the FAIR Act.

[24] *See infra* notes 25–27.

[25] *See* section 2(b)(2)(B) of the FAIR Act.

[26] *Id.* at section 2(b)(2)(A).

[27] *See supra* note 17 and accompanying text.

[28] *See* sections 2(b)(3)–(4), 2(c)(2) of the FAIR Act; *see also* discussion at text accompanying notes 29–31 *infra*.

to section 24(b) of the Investment Company Act and the rules and regulations thereunder,[29] except to the extent that such reports are otherwise not subject to the content standards in the rules of any SRO related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards.[30] The FAIR Act also requires us to provide that SROs: (i) cannot prohibit the ability of a broker-dealer to publish or distribute a covered investment fund research report solely because the broker-dealer is participating in a registered offering or other distribution of any securities of the covered investment fund; and (ii) cannot prohibit the ability of a broker-dealer to participate in a registered offering or other distribution of securities of the covered investment fund solely because the broker-dealer has published or distributed a research report about that covered investment fund or its securities.[31]

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[29] Section 24(b) of the Investment Company Act makes it unlawful for any registered open-end company (or any registered unit investment trust, any registered face-amount certificate company, or any underwriter of any of the preceding companies), in connection with a public offering of any security of which such company is an issuer, to transmit, among other things, sales literature addressed to or intended for distribution to prospective investors unless the sales literature is filed with the Commission. *See* 15 U.S.C. 80a-24(b). Rule 24b-3 under the Investment Company Act deems these materials to have been filed with the Commission if filed with FINRA. *See* 17 CFR 270.24b-3.

[30] *See* section 2(b)(4) of the FAIR Act. However, the FAIR Act also includes a provision clarifying that the Act will not be construed as limiting an SRO's authority to require the filing of communications with the public "the purpose of which is not to provide research and analysis of covered investment funds." *See* section 2(c)(2) of the FAIR Act. In addition, the FAIR Act provides that the Act does not limit SROs' authority to examine or supervise a member's practices in connection with its publication or distribution of covered investment fund research reports for compliance with applicable provisions of the federal securities laws and SRO rules related to research reports, including rules governing communications with the public. *See* section 2(c)(2) of the FAIR Act.

[31] *See* section 2(b)(3) of the FAIR Act.

II. DISCUSSION

In the sections that follow, we discuss in detail the scope and conditions of proposed rule 139b, the operation and effect of proposed rule 24b-4,[32] and the proposed conforming amendment to rule 101 of Regulation M.

Proposed rule 139b's framework is modeled after and generally tracks rule 139. However, proposed rule 139b differs from rule 139 in certain respects. Some of these differences are specifically directed or contemplated by the FAIR Act.[33] Other differences, while not specifically directed by the FAIR Act, clarify and tailor the provisions of rule 139 more directly or specifically to the context of broker-dealers' publication or distribution of covered investment fund research reports.[34] For the reasons described below, we believe that the provisions of proposed rule 139b that differ from the provisions of rule 139, and that are not specifically contemplated in the FAIR Act, are necessary or appropriate in the public interest, for the protection of investors, and for the promotion of capital formation.

A. Scope of Proposed Rule 139b

Proposed rule 139b would establish a safe harbor for the publication or distribution of "covered investment fund research reports" by unaffiliated broker-dealers (as described below) participating in a securities offering of a "covered investment fund." Under the safe harbor, such publication or distribution would be deemed not to constitute an offer for sale or offer to sell the

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[32] This discussion appears in section II.D *infra*.

[33] *See, e.g.*, *infra* section II.A.1 (discussing the "affiliate exclusion" (defined below)).

[34] *See, e.g.*, *infra* section II.B.1.a (discussing reporting history and timeliness requirements for issuer-specific reports).

covered investment fund's securities for purposes of sections 2(a)(10) and 5(c) of the Securities Act. The safe harbor would be available even if the broker-dealer is participating or may participate in a registered offering of the covered investment fund's securities. We are proposing to define the term "covered investment fund research report," as well as the "covered investment fund" and "research report" components of this definition.

1. Definition of "Covered Investment Fund Research Report"

Under the FAIR Act, the term "covered investment fund research report" means "a research report published or distributed by a broker or dealer about a covered investment fund or any securities issued by the covered investment fund, but does not include a research report to the extent that the research report is published or distributed by the covered investment fund or any affiliate of the covered investment fund, or any research report published or distributed by any broker or dealer that is an investment adviser (or an affiliated person of an investment adviser) for the covered investment fund" (the "affiliate exclusion").[35] Proposed rule 139b incorporates this same definition verbatim.[36]

The FAIR Act's affiliate exclusion prohibits two separate categories of research reports from being deemed to be "covered investment fund research reports" that a broker-dealer may publish or distribute under the contemplated safe harbor. The first category covers research reports published or distributed by the covered investment fund or any affiliate of the covered

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[35] *See* section 2(f)(3) of the FAIR Act.

[36] *See* proposed rule 139b(c)(3); *see also supra* note 21 (discussing the terms "affiliate" and "affiliated person" in the FAIR Act definition of "covered investment fund research report"); proposed rule 139b(c)(5) (defining the term "investment adviser" for purposes of the proposed rule).

investment fund. We believe this exclusion would prevent such persons from indirectly using the safe harbor to avoid the applicability of the Securities Act prospectus requirements and other provisions applicable to written offers by such persons.

The second category covers research reports published or distributed by any broker or dealer that is an investment adviser (or an affiliated person of an investment adviser) for the covered investment fund. This second exclusion addresses the concern that a broker-dealer that is a fund's adviser or an affiliated person of a fund's adviser may have financial incentives that could give rise to a conflict of interest. For example, a broker-dealer that is an affiliated person of a fund's adviser may have an incentive to promote the covered investment fund's securities relative to other securities because sales of the covered investment fund's securities would benefit not only the fund, but also could benefit the broker-dealer.[37] This second exclusion therefore helps to establish a certain level of independence in the activity of publishing and distributing covered investment fund research reports and therefore could help mitigate these potential conflicts of interest.

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[37] We note that broker-dealers may have incentives to recommend certain covered investment funds to clients even when the broker-dealer is not the fund's investment adviser (or an affiliated person of the investment adviser). For example, when a covered investment fund's investment adviser has entered into revenue sharing arrangements with a broker-dealer, the broker-dealer may have incentives to recommend to its clients the purchase of this fund's securities relative to the securities of other covered investment funds (whose investment advisers have not entered into revenue sharing agreements with the broker-dealer). We also note that certain covered investment fund research reports also may be subject to additional rules and regulations under the federal securities laws, as well as certain SRO rules, that are designed to help address certain conflicts of interest and abuses identified with analyst research. *See, e.g.*, Sarbanes-Oxley Act of 2002, Public Law No. 107-204, 116 Stat. 745 (2002) ("Sarbanes-Oxley Act"), Regulation AC, and FINRA rules 2210, 2241, 2242. The Sarbanes-Oxley Act, Regulation AC, and a global research analyst settlement required structural changes and increased disclosures in connection with certain abuses identified with analyst research. *See* section 501 of the Sarbanes-Oxley Act; Regulation Analyst Certification, Securities Act Release No. 8193 (Feb. 20, 2003) [68 FR 9481 (Feb. 27, 2003)] ("Regulation AC Adopting Release"); Global Research Analyst Settlement, Litigation Release No. 18438 (Oct. 31, 2003) ("Lit. Rel. No. 18438"); 2010 Modifications to Global Research Analyst Settlement, Litigation Release No. 21457 (Mar. 19, 2010) ("Lit. Rel. No. 21457").

We believe that it would be inappropriate for any person covered by the affiliate exclusion, or for any person acting on its behalf, to publish or distribute a research report indirectly that the person could not publish or distribute directly under the proposed rule.[38] For example, if a broker-dealer were to publish or distribute a research report that included materials that were specifically authorized or approved by a person covered by the affiliate exclusion, expressly for the purpose of inclusion in a research report, this could inappropriately circumvent the affiliate exclusion in proposed rule 139b. In this case, the person covered by the affiliate exclusion would be publishing or distributing communications indirectly through the third-party broker-dealer that otherwise would have to be included in a statutory prospectus meeting the requirements of section 10 of the Securities Act. One of the factors to consider in evaluating whether a research report has been published or distributed by a person covered by the affiliate exclusion is the extent of such person's involvement in the preparation, distribution, or publication of the research report.[39]

We request comment on the proposed definition of "covered investment fund research report."

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[38] *See, e.g.*, section 48(a) of the Investment Company Act [15 U.S.C. 80a-47(a)]; section 208(d) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-8(d)].

[39] Such determinations would necessarily be based on the extent to which a person covered by the affiliate exclusion, or any person acting on its behalf, has been involved in the preparation of the information or explicitly or implicitly endorsed or approved the information. The Commission has referred to these as the entanglement theory and the adoption theory, respectively, and these are helpful guideposts in establishing whether a research report about a covered investment fund may be deemed published or distributed by the fund. *See* Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)] ("Securities Offering Reform Adopting Release") (noting that "[l]iability under the entanglement theory depends upon the level of pre-publication involvement in the preparation of the information"). *See* Use of Electronic Media, Securities Act Release No. 7856 (Apr. 28, 2000) [65 FR 25843 (May 4, 2000)] (interpretive release on the use of electronic media); Asset-Backed Securities, Securities Act Release No. 8518 (Dec. 22, 2004) [70 FR 1506 (Jan. 5, 2005)] (adopting asset-backed securities regulations).

- Should we define "covered investment fund research report" as specified in the FAIR Act, as proposed? Why or why not? What modifications, if any, to this definition do commenters recommend? Solely for purposes of the proposed affiliate exclusion, should we use a definition of "affiliate" that differs from the definition of this term in rule 405 under the Securities Act? If so, should we interpret the term "affiliate" in this context to mean an "affiliated person" as defined in the Investment Company Act? If not, what other definition should we use?
- Should we include a provision in rule 139b specifying that the affiliate exclusion would make the safe harbor unavailable if a broker-dealer were to publish or distribute a research report that includes materials that were specifically authorized or approved by a person covered by the affiliate exclusion (or a person acting on its behalf) for purposes of inclusion in a research report? Why or why not? If not, is the guidance discussed above on this point[40] appropriate and helpful to the public in understanding the proposed affiliate exclusion? Is there any other guidance that we should provide that would be helpful to promote clarity with respect to the proposed affiliate exclusion?
- Broker-dealers may have incentives—in particular, arising from the compensation arrangements between registered investment companies and their distributing broker-dealers—to recommend certain covered investment funds to clients even

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[40] *See supra* paragraph accompanying notes 38–39.

when the broker-dealer is not the fund's investment adviser (or an affiliated person of the investment adviser).[41] While certain covered investment fund research reports may be subject to additional rules and regulations under the federal securities laws, as well as certain SRO rules, that are designed to help address certain conflicts of interest,[42] these additional rules and regulations would not necessarily be applicable with respect to all covered investment fund research reports under proposed rule 139b.[43] Moreover, while these rules and regulations address conflicts of interest, certain of the conflicts they address may not be prevalent in the investment company context (*e.g.*, FINRA rules 2241 and 2242 address, among other things, investment-banking-related conflicts). Are we correct that there are conflicts of interest that could arise with respect to broker-dealers' publication or distribution of covered investment fund research reports (in particular, research reports about registered investment company issuers) that would *not* be mitigated by proposed rule 139b's exclusion of research reports published or distributed by a broker-dealer that is an investment adviser for the covered investment fund (or an affiliated person of the adviser)? If not,

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41 *See supra* note 37 and accompanying text; *see also infra* paragraphs accompanying notes 262–269.

42 *See id.*

43 For example, as discussed above, there are differences in how the FAIR Act and proposed rule 139b, and other rules and regulations, define the term "research report," and therefore the scope of other rules and regulations that govern broker-dealers' publication and distribution of research reports does not correspond in every respect to the scope of proposed rule 139b. *See infra* section II.A.2 (discussing the definition of "research report" in proposed rule 139b); *see supra* note 11 (discussing the differences in the definition of "research report" in Regulation AC and FINRA rules 2241 and 2242).

why not? If so, how should we address these conflicts? Should we add restrictions or conditions to the safe harbor to further mitigate potential conflicts? If so, what types of additional restrictions or conditions would be appropriate? For example, should we require a broker-dealer to describe in a research report the revenue-sharing or other distribution arrangements it has with a covered investment fund as a condition to relying on the proposed safe harbor? Should the existence of a revenue-sharing agreement or other particular type of distribution arrangement disqualify a broker-dealer from being able to publish or distribute a research report about a covered investment fund in reliance on the proposed safe harbor? If so, what types and why?

- Alternatively, should we require broker-dealers that rely on proposed rule 139b to maintain policies and procedures designed to mitigate conflicts that are raised by the distribution of covered investment funds (in particular, covered investment funds that are registered investment companies) and not addressed by the Commission's rules or SRO rules (such as FINRA rules 2241 and 2242)? To the extent that Commission and SRO rules do not require disclosure of conflicts of interest in covered investment fund research reports, should we require broker-dealers that rely on the proposed rule 139b safe harbor to disclose conflicts of interest in a salient way in covered investment fund research reports? If so, what should the content and format requirements be with respect to such disclosure?

2. Definition of "Research Report"

We are proposing to define the term "research report" in rule 139b as a written communication, as defined in rule 405 under the Securities Act, that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.[44] This definition is identical to the corresponding definition of "research report" in rule 139.[45] We are not proposing to include a definition of "research report" in rule 139b that is identical to that in the FAIR Act for two reasons, discussed in more detail below. First, we believe that the definition we propose is consistent with the FAIR Act, because we would interpret it to have the same meaning as the definition of "research report" in the FAIR Act.[46] Second, we believe that proposing a definition of "research report" in rule 139b that is identical to the existing definition of "research report" in rule 139 would reduce potential interpretive confusion for market participants who are familiar with the rule 139 definition.

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[44] *See* proposed rule 139b(c)(6).

Rule 405 defines "written communication" to mean that "[e]xcept as otherwise specifically provided or the context otherwise requires, a written communication is any communication that is written, printed, a radio or television broadcast, or a graphic communication as defined in [rule 405]." 17 CFR 230.405.

[45] *See* rule 139(d) [17 CFR 230.139(d)]. Rule 139 defines "research report" to mean "a written communication, as defined in Rule 405, that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision." *See* rule 139(d) [17 CFR 230.139(d)]. A "written communication," as defined in rule 405, includes a "graphic communication." As further defined in rule 405, a "graphic communication" includes all forms of electronic media, including electronic communications except those, which at the time of the communication, originate in real-time to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means. *See* rule 405 [17 CFR 230.405].

[46] *See infra* notes 49-50 and accompanying text.

The FAIR Act defines the term "research report" as having the meaning given to that term under section 2(a)(3) of the Securities Act but specifies that the term "shall not include an oral communication."[47] Section 2(a)(3) of the Securities Act, in turn, defines "research report" to mean "a written, electronic, or oral communication that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision."[48]

The proposed rule 139b definition of "research report" tracks the FAIR Act definition of "research report," except that while it does include "electronic communications," it does not expressly reference that term. For the following reasons, we believe that this difference would have no effect on the types of communications that would qualify as research reports under the proposed safe harbor. Current Commission rules make clear that all electronic communications (other than telephone and other live communications) are graphic and, therefore, written communications for purposes of the Securities Act.[49] Therefore, the proposed rule 139b definition's reference to a "written communication," as defined in rule 405, would include a

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47 *See* section 2(f)(6) of the FAIR Act.

48 15 U.S.C. 77b(a)(3).

49 *See* Securities Offering Reform Adopting Release, *supra* note 39, at nn.96–97 and accompanying text; *infra* note 50. Among other things, the Securities Offering Reform Adopting Release amended the definition of "research report" in rule 139 to make clear that it continues to apply to information, opinions, or recommendations contained in written communications. *See id.*, at text following n.363.

As the Commission noted in the Securities Offering Reform Adopting Release, the intention of addressing electronic communications under the Securities Act is "to encompass new technologies … [and] promote consistent understanding of what constitutes such a communication in view of the technological developments." *See* Securities Offering Reform Adopting Release, *supra* note 39, at 44732.

"graphic communication," which in turn would include electronic communications (other than telephone and other live communications).[50]

By using the same definition of "research report" in rule 139 and proposed rule 139b we avoid creating ambiguity that may result if market participants are unable to understand, based on the text of the rules, that the term "research report," though defined in two different ways, would be interpreted identically.

We request comment on the proposed definition of "research report."

- Should we use the definition of "research report" in rule 139 as we have proposed rather than as specified in the FAIR Act? Is our proposed approach appropriate? Is defining "research report" as proposed consistent with section 2(f)(6) of the FAIR Act? Would the proposed definition of "research report" have the intended result of assuring that the definitions of "research report" under the FAIR Act and rule 139b would be interpreted identically? Why or why not?
- Instead of using the rule 139 definition of "research report," as proposed, would it be preferable for the Commission to incorporate the FAIR Act definition of "research report" into proposed rule 139b? If so, why?
- What, if any, additional modifications to the proposed definition of "research report" would promote clarity? Should we incorporate any additional modifications to the proposed definition for any other purpose?

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[50] *See supra* note 45 (discussing the current definition of "research report" in rule 139, which references a "written communication" as defined in rule 405, which definition in turn incorporates the term "graphic communication").

3. Definition of "Covered Investment Fund"

The FAIR Act defines the term "covered investment fund" to include registered investment companies, business development companies, and certain commodity- or currency-based trusts or funds.[51] We are proposing to define the term "covered investment fund" in rule 139b in substantially the same manner as the FAIR Act, with the addition that we propose to specify in this definition that the term "investment company" includes "a series or class thereof."[52]

We request comment on the proposed definition of "covered investment fund."

- Should we define "covered investment fund" substantially the same as this term is defined in the FAIR Act as proposed? Why or why not? Should we specify in the definition, as proposed, that the term "investment company" includes a "series or class thereof"? What modifications, if any, to this definition do commenters recommend?
- Are there any types of funds, trusts, or other pooled investment vehicles that would not be included within the proposed definition of "covered investment fund" that we should consider including in the definition? If so, why?

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[51] *See supra* notes 19–20 and accompanying text. Based on the definition in section 2(f)(2) of the FAIR Act, the term "covered investment fund" would not include an investment company that is registered solely under the Investment Company Act, such as certain master funds in a master-feeder structure. *See id.*

[52] *See* proposed rule 139b(c)(2). This approach reflects the approach taken in other Commission rules that define the term "fund" to include a separate series of an investment company. *See, e.g.*, rule 22e-4(a)(4) under the Investment Company Act [17 CFR 270.22e-4(a)(4)]; rule 22c-1(a)(3)(v)(A) under the Investment Company Act [17 CFR 270.22c-1(a)(3)(v)(A)] (effective Nov. 19, 2018).

4. Non-Exclusivity of Safe Harbor

Broker-dealers publishing or distributing research reports for some covered investment funds, such as commodity- or currency-based trusts or funds that have a class of securities registered under the Exchange Act, may be able to rely on existing rule 139.[53] We do not intend for proposed rule 139b to preclude a broker-dealer from relying on existing rule 139 where appropriate. In order to clarify that a broker-dealer may rely on existing research safe harbors, proposed rule 139b provides that the rule does not affect the availability of any other exemption or exclusion from sections 2(a)(10) or 5(c) of the Securities Act that may be available to a broker-dealer.[54] A broker-dealer therefore would be able to rely on proposed rule 139b to publish or distribute a covered investment fund research report or could choose to rely instead on any other available exemption or exclusion from sections 2(a)(10) or 5(c) of the Securities Act, including those provided by rules 137,[55] 138, and 139, as applicable.

We request comment on the non-exclusivity provision in proposed rule 139b.

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[53] Section 803(b)(2)(F) of the Small Business Credit Availability Act, which was enacted on March 23, 2018 as sections 801-803 of the 2018 Consolidated Appropriations Act, directs the Commission to amend rules 138 and 139 to specifically include a business development company as an issuer to which those rules apply. Section 803(b) of the Small Business Credit Availability Act directs the Commission to make these revisions to rules 138 and 139, as well as the other rule revisions that section 803(b)(2) of the Act describes, within one year of enactment, and these revisions would be addressed in a Commission action that is separate from the proposal that this release describes.

[54] *See* proposed rule 139b(a) (providing, in part, that the rule does not affect the availability of any other exemption or exclusion from sections 2(a)(10) or 5(c) of the Act available to the broker or dealer); *see also* proposed addition to rule 139(a) (for purposes of the Fair Access to Investment Research Act of 2017 [115 P.L. 66, 131 Stat. 1196 (2017)], a safe harbor has been established for covered investment fund research reports, and the specific terms of that safe harbor are set forth in Rule 139b (§230.139b)).

[55] 17 CFR 230.137.

- Should other exemptions, exclusions, or safe harbors from sections 2(a)(10) or 5(c) of the Securities Act for research reports, such as rules 137, 138, or 139, continue to be available to broker-dealers as proposed? Why or why not? Should we make any additional clarifications? If so, what clarifications should we make?

B. Conditions for the Safe Harbor

The Commission has previously acknowledged the value of research reports in providing the market and investors with information about reporting issuers.[56] To mitigate the risk of research reports being used to circumvent the prospectus requirements of the Securities Act,[57] the Commission has placed conditions on a broker-dealer's publication or distribution of research reports.[58] Under rule 139, these conditions include restrictions on who may rely on the rule and on the issuers to which the research may relate, as well as a requirement that such reports be published in the regular course of a broker-dealer's business. These conditions vary

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[56] *See* Securities Offering Reform Adopting Release, *supra* note 39.

For example, the Commission has recognized that, for companies that are well-followed, the research-report-related rules "enhance the efficiency of the markets by allowing a greater number of research reports to provide a continuous flow of essential corporate information into the marketplace." *See* Research Reports, Securities Act Release No. 6550 (Sept. 19, 1984) [49 FR 37569 (Sept. 25, 1984)] ("1984 Adopting Release").

[57] *See supra* note 13 and accompanying text (noting that the rule 139 safe harbor permits a broker-dealer to publish or distribute a research report without this publication or distribution being deemed to constitute an offer that otherwise could be a non-conforming prospectus in violation of section 5 of the Securities Act).

See, also, e.g., Securities Offering Reform Adopting Release, *supra* note 39 (discussing how the Sarbanes-Oxley Act, Regulation AC, and a global research analyst settlement required structural changes and increased disclosures in the early 2000s in connection with certain abuses identified with analyst research); discussion at *supra* note 37 (discussing certain rules and regulations under the federal securities laws, as well as certain SRO rules, that are designed to help address certain conflicts of interest and abuses identified with analyst research).

[58] Many research reports that broker-dealers publish or distribute in reliance on the rule 139 safe harbor may also be subject to other federal securities rules and regulations under the Exchange Act and SRO rules governing their content and use. *See supra* note 57.

depending on whether a research report covers a specific issuer ("issuer-specific research reports") or a substantial number of issuers in an industry or sub-industry ("industry research reports").

Consistent with the FAIR Act's directive to revise rule 139 to extend the rule's safe harbor to covered investment fund research reports, proposed rule 139b seeks to address concerns that could accompany broker-dealers' publication or distribution of these research reports. Rule 139b proposes conditions for both issuer-specific reports and industry research reports that must be satisfied in order for a broker-dealer to rely on the safe harbor.[59] The conditions are intended to track the conditions already in place under rule 139 to the extent practicable. We believe that any deviations from the requirements of rule 139 are consistent with the FAIR Act's directives.[60] Tracking the requirements in rule 139 to the extent practicable also provides efficiencies for broker-dealers familiar with the requirements of rule 139.

1. Issuer-Specific Research Reports

a. Reporting History and Timeliness Requirements

In order for a broker-dealer to include a covered investment fund in a research report published or distributed in reliance on the proposed safe harbor, we propose that the fund must meet certain reporting history requirements. Specifically, we are proposing that any such covered investment fund must have been subject to relevant requirements under the Investment Company Act and/or the Exchange Act to file certain periodic reports for at least 12 calendar

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[59] Proposed rule 139b(a)(1)–(2).

[60] *See supra* paragraph accompanying notes 32–34.

months prior to a broker-dealer's reliance on proposed rule 139b.[61] We also are proposing that any such covered investment fund must have filed certain periodic reports in a timely manner during the immediately preceding 12 calendar months. Specifically, covered investment funds that are registered investment companies would need to have been subject to the reporting requirements of the Investment Company Act for a period of at least 12 calendar months prior to reliance on the proposed rule and to have filed in a timely manner all required reports, as applicable, on Forms N-CSR,[62] N-SAR,[63] N-Q,[64] N-PORT,[65] N-MFP,[66] and N-CEN[67] during the immediately preceding 12 months.[68] If the covered investment fund is *not* a registered

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61 Proposed rule 139b(a)(1)(i)(A). We believe that this proposed condition also gives effect to FAIR Act section 2(e), which makes the safe harbor contemplated by the FAIR Act unavailable with respect to broker-dealers' publication or distribution of research reports about closed-end registered investment companies or business development companies during these covered investment fund issuers' first year of operation. *See* section 2(e) of the FAIR Act ("The safe harbor under subsection (a) [of the FAIR Act] shall not apply to the publication or distribution by a broker or a dealer of a covered investment fund research report, the subject of which is a business development company or a registered closed-end investment company, during the time period described in section 230.139(a)(1)(i)(A)*(1)* of title 17, Code of Federal Regulations, except where expressly permitted by the rules and regulations of the Securities and Exchange Commission under the Federal securities laws."); *see also infra* note 74 and accompanying text (discussing rule 139(a)(1)(i)(A)*(1)*).

62 17 CFR 249.331 and 17 CFR 274.128.

63 17 CFR 249.330 and 17 CFR 274.101.

64 17 CFR 249.332 and 17 CFR 274.130.

65 17 CFR 274.150. Form N-PORT will be filed with the Commission on a monthly basis, but only information reported for the third month of each fund's fiscal quarter on Form N-PORT will be publicly available (and not until 60 days after the end of the fiscal quarter). *See* Investment Company Reporting Modernization, Investment Company Act Release No. 32314 (Oct. 13, 2016) [81 FR 81870 (Nov. 18, 2016)] ("Reporting Modernization Release"). Therefore, we would consider Form N-PORT to have been timely filed for purposes of the proposed timeliness requirement if the public filing of Form N-PORT every third month is timely filed.

66 17 CFR 274.201.

67 17 CFR 249.330 and 17 CFR 274.101.

68 Proposed rule 139b(a)(1)(i)(A)*(1)*. Form N-SAR will be rescinded on June 1, 2018, which is the compliance date for Form N-CEN. Form N-Q will be rescinded May 1, 2020. Larger fund groups will begin submitting reports on Form N-PORT by April 30, 2019, and smaller fund groups by April 30, 2020. *See* Reporting Modernization Release, *supra* note 65; Investment Company Reporting Modernization, Investment Company Act Release No. 32936 (Dec. 8, 2017) [82 FR 58731 (Dec. 14, 2017)]. At the time of these compliance dates,

investment company, it would need to have been subject to the reporting requirements under section 13 or 15(d) of the Exchange Act for a period of at least 12 calendar months and to have filed all required reports in a timely manner on Forms 10-K[69] and 10-Q[70] and 20-F[71] during the immediately preceding 12 months.[72] The proposed reporting history requirements are consistent with current rule 139.[73] The timeliness component of the proposed requirement also tracks rule 139.[74]

As the Commission has previously recognized in the context of Form S-3 and F-3 issuers, satisfaction of the applicable reporting history and public float requirements suggests the presence of a sufficiently broad market following for the issuer's securities and, consequently, an

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covered investment funds would no longer be required to file reports N-SAR and N-Q, and filing these reports would not be required as a condition to rely on the rule 139b safe harbor. Accordingly, we propose that rule 139b, if adopted, would be amended effective May 1, 2020 by removing the reference to Form N-Q. *See infra* section VII (instruction 4 under Text of Proposed Rules and Amendments).

69 17 CFR 249.310.

70 17 CFR 249.308a.

71 17 CFR 249.220f.

72 Proposed rule 139b(a)(1)(i)(A)*(2)*.

73 Rule 139(a)(1)(i)(A)*(2)* [17 CFR 230.139(a)(1)(i)(A)*(2)*] ("As of the date of reliance on this section, has filed all periodic reports required during the preceding 12 months on Forms 10-K (§ 249.310 of this chapter), 10-Q (§ 249.308a of this chapter), and 20-F (§ 249.220f of this chapter) pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d))."). In addition, the reporting history requirement is also a consequence of rule 139(a)(1)(i)(A)*(1)*, which requires that an issuer included in an issuer-specific research report (other than a foreign private issuer) either must have filed a registration statement on Form S-3 or Form F-3, or met the registrant requirements of Form S-3 or Form F-3, as eligibility to register on these forms incorporates a reporting history requirement. Rule 139(a)(1)(i)(A)*(1)*-(B)*(1)* [17 CFR 230.139(a)(1)(i)(A)*(1)* and 17 CFR 230.139(a)(1)(i)(B)*(1)*]. In order to be eligible for registration on Form S-3 or Form F-3, the registrant must have been subject to the requirements of section 12 or 15(d) of the Exchange Act and have filed all materials required to be filed pursuant to section 13, 14 or 15(d) for a period of at least 12 calendar months immediately preceding the filing of the Form S-3 or Form F-3. *See* General Instruction I.A.3(a) to Form S-3 and General Instruction I.A.2 to Form F-3.

74 The timely reporting component in rule 139 is a consequence of the rule 139 requirement that issuers be eligible to register on Form S-3 or Form F-3. *See supra* note 73 (discussing rule 139(a)(1)(i)(A)*(1)*); *see also* General Instruction I.A.3(b) to Form S-3 and General Instruction I.A.2 to Form F-3 (each providing that the registrant must have filed the reports specified in the instruction "in a timely manner").

adequate mix of information to inform investors as to material risks.[75] Consistent with this view, we believe the proposed reporting history and timely reporting requirements would facilitate investors' analysis of issuer-specific covered investment fund research reports and aid them in making informed investment decisions.[76] The Commission believes that it is appropriate to require a 12-month reporting history for covered investment fund issuers that may be included in issuer-specific research reports, rather than a shorter duration.[77] As under rule 139, this approach would provide investors with publicly-available information about the issuers included in a research report for a full year. The proposed approach also has the benefit of maintaining consistency between rule 139b and the long-established reporting history conditions of rule 139.[78]

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[75] *See, e.g.*, Revisions To The Eligibility Requirements For Primary Securities Offerings On Forms S-3 and F-3, Securities Act Release No. 8878 (Dec. 19, 2007) [72 FR 73533 (Dec. 27, 2007)] ("S-3 Revisions Adopting Release"); Securities Offering Reform Proposing Release, *supra* note 14.

[76] *See, e.g.*, Securities Offering Reform Proposing Release, *supra* note 14.

[77] As noted above, the FAIR Act specifically contemplates that we set a reporting history requirement for covered investment fund issuers that may be included in covered investment fund research reports, but we may not require a reporting history period for longer than what is required under rule 139(a)(1)(i)(A)*(1)*. *See supra* note 26.

The reporting history period required under rule 139(a)(1)(i)(A)*(1)* is currently the preceding 12 months from the time of the broker-dealer's reliance on the rule 139 safe harbor. Rule 139(a)(1)(i)(A)*(1)* requires that an issuer included in an issuer-specific research report (other than a foreign private issuer) either must have filed a registration statement on Form S-3 or Form F-3, or met the registrant requirements of Form S-3 or Form F-3, as eligibility to register on these forms incorporates a reporting history requirement. Under these eligibility requirements, the registrant must have been subject to the requirements of section 12 or 15(d) of the Exchange Act and have filed all materials required to be filed pursuant to section 13, 14 or 15(d) for a period of at least 12 calendar months immediately preceding the filing of the Form S-3 or Form F-3. *See* discussion at *supra* note 73.

In addition, rule 139(a)(1)(i)(A)*(2)* separately requires that, as of the date of reliance on the rule 139 safe harbor, the registrant must have filed all periodic reports required during the preceding 12 months on Forms 10-K, 10-Q, and 20-F. *See id.*

[78] *See supra* paragraph accompanying notes 32–34.

We recognize, however, that in the context of covered investment funds that are open-end registered investment companies, use of a reporting history of only 12 months could result in certain performance and other information that may be relevant to investors not yet being available in the fund's prospectus at the time the broker-dealer publishes or distributes a research report on that fund. This is because the disclosure requirements for a registered investment company, or a series thereof, are based in part on how long the fund has been operational. For example, for a newly-registered covered investment fund that is an open-end registered investment company, a bar chart pursuant to Item 4 of Form N-1A is not required to be included in the fund's prospectus until the fund has been operational for one full calendar year.[79] We note, however, that other information for such a fund, such as principal investment strategies and estimated expenses, would be available at the time the fund launches. We request comment below on whether—and if so, how—the proposed reporting history and timeliness requirements could be more tailored to covered investment funds.

We request comment on the proposed reporting history and timeliness requirements.

- Are the proposed reporting requirements an appropriate condition for issuer-specific covered investment fund research reports whose publication or distribution would be covered under the rule 139b safe harbor?

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[79] For example, under the requirements of Form N-1A, a fund that launched on January 4 and has an August 31 fiscal year-end would not be required to include a bar chart, which reflects calendar year-end information, until almost three years after launch (less a few days). However, other performance information about such a fund would be required to appear in reports filed on Form N-PORT (which will be made public quarterly, *see supra* notes 65, 68) and the fund's annual reports, and also could appear in rule 482 advertisements.

- Should the proposed reporting requirements for issuer-specific covered investment fund research reports track the existing reporting requirements for issuer-specific reports under rule 139 (*e.g.*, the length of reporting history, required reports, and timeliness component)? If not, how should they differ? Is the proposed requirement for a 12-month periodic reporting history the right amount of time in the context of covered investment funds? For example, should the reporting history requirement instead provide that an issuer that is a registered open-end investment company must have filed a prospectus reflecting at least a full calendar year of performance information prior to the time that a broker-dealer relies on the proposed safe harbor, and would this approach be consistent with section 2(b)(2)(A) of the FAIR Act? Under proposed rule 139b, issuers that are registered investment companies must have timely filed reports on Forms N-CSR, N-SAR, N-Q, N-PORT, N-MFP, and N-CEN, as applicable,[80] for the immediately preceding 12 calendar months, and issuers that are not registered investment companies must have timely filed reports on Forms 10-K and 10-Q or 20-F for the immediately preceding 12 calendar months, in order to be included in a research report for whose publication or distribution the proposed safe harbor would be available. Should we require a different set of periodic reports to be timely filed, other than what we propose? For example,

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[80] *See supra* note 68 (noting that we are proposing to remove references to Form N-Q on the date that Form N-Q is rescinded).

should the requirement be based on a limited subset of the reports? Why or why not?

b. Minimum Public Market Value Requirement

In order for broker-dealers to use the proposed rule 139b safe harbor to publish or distribute issuer-specific research reports, we also are proposing that the covered investment fund that is the subject of a report must satisfy a minimum public market value threshold at the date of reliance on the proposed rule (the "minimum public market value requirement"). Specifically, we are proposing that the aggregate market value of a covered investment fund,[81] or the net asset value in the case of a registered open-end investment company (other than an exchange-traded fund ("ETF")),[82] must equal or exceed the aggregate market value required by General Instruction I.B.1 to Form S-3.[83] This amount is currently $75 million.[84] Proposed rule

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[81] The aggregate market value is the aggregate market value of voting and non-voting common equity held by non-affiliates of the covered investment fund. *See* proposed rule 139b(a)(1)(i)(B).

[82] *See* proposed rule 139b(a)(1)(i)(B), proposed rule 139b(c)(4) (defining "exchange-traded fund" for purposes of the proposed rule to have the meaning given the term in General Instruction A to Form N-1A).

[83] Because the proposed rule refers to General Instruction I.B.1 to Form S-3, we would generally consider that, pursuant to these instructions, aggregate market value would be "computed by use of the price at which the common equity was last sold, or the average of the bid and asked prices of such common equity, in the principal market for such common equity as of a date within 60 days prior to the date of filing." General Instruction I.B.1 to Form S-3. The definition of "market price" in the General Instructions of Form N-1A contemplates valuing an ETF's shares similarly. *See* General Instruction A to Form N-1A.

For a registered open-end investment company other than an ETF, net asset value would be computed using the investment company's current net asset value, as used in determining its share price. *See* rule 22c-1 under the Investment Company Act [17 CFR 270.22c-1] (requiring registered open-end investment companies, their principal underwriters, and dealers in the investment company's shares (and certain others) to sell and redeem the investment company's shares at a price determined at least daily based on the current net asset value next computed after receipt of an order to buy or redeem).

For covered investment funds that are not actively traded (such as non-traded closed-end funds and non-traded business development companies), we anticipate that, for purposes of proposed rule 139b, net asset value and aggregate market value would be calculated based on the fund's last publicly-disclosed share price (for non-traded business development companies, this would be the common equity share price).

139b also specifies that both aggregate market value and net asset value would be calculated net of the value of shares held by affiliates.[85] The proposed minimum public market value requirement generally tracks the minimum public float and aggregate market value requirements under rule 139, modified as appropriate to apply to covered investment fund issuers.[86] As discussed above, the FAIR Act specifically permits us to set a minimum public float requirement for covered investment funds, as long as the minimum public float is not greater than what is required by rule 139.[87]

Historically, the Commission has used public float as an approximate measure of a security's market following, through which the market absorbs information that is reflected in the price of the security.[88] We continue to view as significant the relationship between public float, information dissemination to the market, and following by investment institutions.[89] In the

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84 General Instruction I.B.1 to Form S-3.

85 *See* proposed rule 139b(a)(1)(i)(B) (specifying for purposes of this provision that "aggregate market value" is the aggregate market value of voting and non-voting common equity held by non-affiliates of the covered investment fund, and that "net asset value" is calculated subtracting the value of shares held by affiliates).

This requirement tracks the minimum public float requirement under rule 139, as discussed below. *See infra* note 86 and accompanying text. As guidance, for purposes of this calculation, we believe that shares held by affiliates generally should be determined with reference to the security ownership information listed in the covered investment fund's registration statement. *See, e.g.*, Item 11(m) of Form S-1; Item 18 of Form N-1A.

86 *See* proposed rule 139b(a)(1)(i)(B); rule 139 (a)(1)(i)(A)*(1)(i)* and (B)*(2)(i)* [17 CFR 230.139(a)(1)(i)(A)*(1)(i)* and 230.139(a)(1)(i)(B)*(2)(i)*]. For registered open-end investment companies other than ETFs, the proposed threshold is expressed in terms of net asset value rather than aggregate market value, to reflect market structure differences between registered open-end investment companies (other than ETFs) and all other covered investment funds.

87 *See supra* note 25 and accompanying text.

88 *See, e.g.*, S-3 Revisions Adopting Release, *supra* note 75; *see also* Securities Offering Reform Proposing Release, *supra* note 14 (discussing public float of a certain level as a factor indicating that an issuer has a demonstrated market following).

89 *See, e.g.*, S-3 Revisions Adopting Release, *supra* note 75.

context of covered investment funds, we would expect market information to be most limited for new funds (which the reporting history and timeliness requirements could help to address) and for funds that are marketed to a niche segment of investors (which the minimum public market value requirement could help to address).[90] The proposed public market value requirement is designed to protect investors by excluding research reports on covered investment funds with a relatively small amount of total assets, and hence a limited market following. We believe that it is appropriate to include a $75 million public market value requirement for issuers that may be included in issuer-specific research reports, rather than some lower threshold. The proposed minimum public market value threshold is the same as the parallel threshold in rule 139, which we believe would increase compliance efficiencies among broker-dealers relying on the rule 139 and proposed rule 139b safe harbors.[91] Moreover, a significantly lower minimum public market value threshold may not adequately protect investors, as we expect the information environment to be more limited for smaller funds than for larger funds.[92]

We request comment on the proposed minimum public market value requirement.

- Is the proposed minimum public market value requirement an appropriate restriction for issuer-specific covered investment fund research reports whose publication or distribution would be covered under the proposed rule 139b safe harbor?

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90 *See infra* section III.C.2.c.

91 *See infra* discussion following note 299.

92 *See infra* section III.C.6.a.

- Should the proposed minimum public market value requirement track the minimum float requirements under rule 139? Why or why not? If so, is tying the proposed minimum public market value requirement to the Form S-3 General Instruction I.B.1 appropriate, as in rule 139? Why or why not? Should the aggregate market value threshold be lower? Are there other requirements we should consider? Why or why not?
- Is it appropriate for the proposed requirement to refer to "aggregate market value" for covered investment funds, and "net asset value" in the case of a registered open-end investment company (other than an ETF)? Should the proposed requirement instead refer to "net asset value" for ETFs? Is there another measure of market value that is more appropriately tailored for covered investment fund research reports?
- Should we include different or more specific instructions about how covered investment funds would compute aggregate market value and net asset value? For example, should we specify that an ETF's aggregate market value be calculated with reference to the definition of "market price" in Form N-1A rather than General Instruction I.B.1 of Form S-3?[93] Should we include more specific instructions about how a covered investment fund that is not actively traded should compute aggregate market value and net asset value?[94]

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[93] *See supra* note 83.

[94] *See id.*

- Would the proposed minimum public market value requirement promote the dissemination into the market of an appropriate amount of research about covered investment funds? Conversely, would it unduly impede analyst coverage of covered investment fund issuers, and could this in turn affect the market following for these issuers? Is the approach we are proposing consistent with section 2(b)(2)(B) of the FAIR Act?

c. Regular-Course-of-Business Requirement

The proposed rule also would condition eligibility for the safe harbor on a broker-dealer's publication or distribution of research reports "in the regular course of its business"[95] (the "regular-course-of-business" requirement).

Although the proposed regular-course-of-business requirement is generally similar to the existing provisions of rule 139, it differs in one respect as required by the FAIR Act. Rule 139 provides, in addition to the requirement that a broker-dealer "publish[] or distribute[] research reports in the regular course of its business," that such publication or distribution may not represent either the initiation of publication of research reports about the issuer or its securities or the reinitiation of such publication following a discontinuation thereof (the "initiation or reinitiation" requirement).[96] The FAIR Act, however, provides that the safe harbor shall not apply the "initiation or reinitiation" requirement to a report concerning a covered investment

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95 Proposed rule 139b(a)(1)(ii).

96 Rule 139(a)(1)(iii) [17 CFR 230.139(a)(1)(iii)].

fund with a class of securities "in substantially continuous distribution."[97] Proposed rule 139b reflects this requirement by incorporating the "initiation or reinitiation" requirement from current rule 139 but specifying that it applies only to research reports regarding a covered investment fund that does not have a class of securities in substantially continuous distribution.[98] Determining whether a class of securities is in substantially continuous distribution would be based on an analysis of the relevant facts and circumstances. We request comment below on whether there are any types of covered investment funds or classes of securities that raise particular questions as to the presence or absence of a "substantially continuous distribution." We also request comment as to whether market participants would benefit from further Commission guidance on this point.

Since rule 139 was first adopted, the regular-course-of-business requirement has been a condition for a broker-dealer's publication or distribution of research reports in reliance on the rule.[99] We believe requiring that research reports be published or distributed in the regular course of a broker-dealer's business, consistent with the requirements of rule 139, could reduce the potential that covered investment fund research reports will be used to circumvent the prospectus requirements of the Securities Act. Moreover, we are concerned about certain potential consequences of broker-dealers' ability, under proposed rule 139b, to publish or distribute communications as research reports that have traditionally been viewed by the

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97 Section 2(b)(1) of the FAIR Act.

98 *See* proposed rule 139b(a)(1)(ii).

99 *See* Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933, Securities Act Release No. 5105 (Nov. 19, 1970) [35 FR 18456 (Dec. 4, 1970)] ("1970 Adopting Release").

investing public as advertisements or sales material related to registered investment companies or business development companies. The safe harbor provided under rule 139 is currently not available for a broker-dealer's publication or distribution of research reports pertaining to specific registered investment companies or business development companies.[100] Therefore, a research report about a covered investment fund that is a registered investment company currently must comply with the requirements of Securities Act rule 482.[101] Given the definition of "research report" under the FAIR Act,[102] however, certain communications that are currently treated as covered investment fund advertisements under Securities Act rule 482 also could fall under the proposed rule 139b definition of "research report."

Investors, particularly retail investors, may be unaware of the differences in regulatory status and purpose among the various types of communications regarding registered investment companies and business development companies. This may result in investors not being able to readily discern what constitutes a research report and what constitutes an advertisement about these issuers. Context helps investors evaluate and weigh the information presented to them. For example, investors likely know that advertising directly promotes sales of a particular product. A broker-dealer publishing or distributing a research report, on the other hand, may do so with multiple purposes for multiple audiences. While a research report may have the effect of

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[100] *See supra* notes 11–15 and accompanying text.

[101] 17 CFR 230.482. An investment company advertisement that complies with rule 482 is deemed to be a section 10(b) prospectus (also known as an "advertising prospectus" or "omitting prospectus") for purposes of section 5(b)(1) of the Securities Act. As a section 10(b) prospectus, an investment company advertisement is subject to liability under section 12(a)(2) of the Securities Act, as well as the antifraud provisions of the federal securities laws.

[102] Section 2(f)(6) of the FAIR Act.

promoting sales of the securities of the issuer that the research report features, it may serve a number of market functions as well, such as promoting market trading, educating a particular audience, or providing a service to clients.[103]

We believe that broker-dealers that publish or distribute research reports in the regular course of business are more likely to publish analysis that investors recognize as research. For example, these broker-dealers are more likely to have compliance structures in place, with relevant policies and procedures, governing their publication of research and (as applicable) their distribution of registered investment company advertisements. Similarly, if a broker-dealer were to publish or distribute research reports in the regular course of its business, the broker-dealer may be more likely to have a research department with research analysts who regularly cover particular issuers or industries. This commitment in resources and infrastructure makes it more likely that the market recognizes the broker-dealer as a provider of research-related communications. A research report published or distributed by a research analyst in the research department at a broker-dealer that regularly covers that issuer or industry would therefore be a factor indicating that the regular-course-of-business requirement has been satisfied for purposes of proposed rule 139b.[104] Additional factors may include whether the broker-dealer maintains policies and procedures governing its research protocols and whether the broker-dealer regularly

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[103] *See infra* section III.C.1.b.

[104] We believe it is appropriate to include the regular-course-of-business requirement because it is important that the broker-dealer have a history of publishing or distributing a particular type of research. If a broker or dealer begins publishing research about a different type of security around the time of a public offering of an issuer's security and does not have a history of publishing research on those types of securities, such publication or distribution could be viewed as a way to provide information about the publicly-offered securities in circumvention of the provisions of section 5 of the Securities Act. *See* Securities Offering Reform Adopting Release, *supra* note 39.

publishes or distributes research on any other type of company or business other than covered investment funds.

We request comment on the proposed regular-course-of-business requirement.

- Is the proposed regular-course-of-business requirement appropriate in the context of covered investment fund research reports?
- Would the proposed regular-course-of-business requirement allow an appropriate flow of analyst-generated information to the market?
- Should we define "regular course of business" in proposed rule 139b more specifically in the context of research reports on registered investment companies or business development companies? Today, due to the unavailability of rule 139, we understand that broker-dealers are generally not in the business of publishing and distributing what we consider issuer-specific research reports on registered investment companies or business development companies (although some broker-dealers have published and distributed communications styled as "research reports" in compliance with rule 482, and some broker-dealers have published and distributed research reports on other issuers in reliance on the rule 139 safe harbor). Does this raise questions as to how to apply a regular-course-of-business requirement to research reports regarding these issuers that we should address in the proposed rule or through additional Commission guidance? If so, what further definitions or guidance should we consider? Would the proposed regular-course-of-business requirement promote the publication or distribution of research reports on covered investment funds that investors recognize as research?

- What facts and circumstances suggest that a covered investment fund has a class of securities in "substantially continuous distribution"? Are there any types of covered investment funds that raise specific questions about whether or not they have a class of securities in substantially continuous distribution, either generally or in particular circumstances? For example, do all open-end management investment companies, and those closed-end interval funds that make periodic repurchase offers pursuant to rule 23c-3, have a class of securities in substantially continuous distribution, while other closed-end investment companies do not? Why or why not? Are there other types of funds with a class of securities in substantially continuous distribution, or are there specific circumstances that should definitively constitute substantially continuous distribution? Would market participants benefit from Commission guidance as to how one would make a determination that a covered investment fund has a class of securities in substantially continuous distribution?
- Alternatively, should we define the term "substantially continuous distribution" in rule 139b, and if so, how? Should this definition include certain types of funds (*e.g.*, open-end management investment companies, closed-end interval funds that make periodic repurchase offers pursuant to rule 23c-3, and other types of funds that are engaged in continuous offerings pursuant to Securities Act rule 415(a)(1)(ix) or others that conduct continuous offerings as shelf takedowns pursuant to rule 415(a)(1)(x))? If so, what funds and under what circumstances? Are there any specific factors that we should incorporate in proposed rule 139b in

order to determine whether a covered investment fund is in substantially continuous distribution?

- Because a safe harbor is generally not currently available for broker-dealers' publication or distribution of covered investment fund research reports,[105] should the proposed regular-course-of-business requirement be modified to address how broker-dealers that have not previously published or distributed research reports could satisfy this requirement? If we were to modify the proposed regular-course-of-business requirement to incorporate factors indicating that a broker-dealer has created a history of publishing or distributing research reports in the regular course of business, what should these factors be, and why? Alternatively, should rule 139b provide a "start-up" period to allow broker-dealers to establish a regular course of business of publishing research reports? For example, should the rule provide that a broker-dealer that could not satisfy the regular-course-of-business requirement could nonetheless rely on rule 139b for a specified period of time (*e.g.*, one year) to establish a regular course of business of publishing research reports? Without such a provision, would the regular-course-of-business requirement pose challenges for broker-dealers that had not previously published research reports because of the absence of an applicable safe harbor? If we do not modify the proposed requirement in this

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[105] *See supra* notes 11–15 and accompanying text.

way, should we provide further guidance regarding broker-dealers that have not previously published or distributed research reports?

- Should the proposed regular-course-of-business requirement incorporate any more specific requirements regarding the person(s) preparing a covered investment fund research report (*e.g.*, a requirement that the person who prepares the research report must be employed by the broker-dealer to prepare research in the normal course of his or her duties)?

2. Industry Research Reports

Our proposed conditions for industry research reports parallel those set forth in rule 139 and are intended to provide appropriate parameters to address the risk of circumvention of the prospectus requirements of the Securities Act.[106]

a. Reporting Requirement

Under the proposed safe harbor, each covered investment fund included in an industry research report must be subject to the reporting requirements of section 30 of the Investment Company Act (or, for covered investment funds that are not registered investment companies under the Investment Company Act, the reporting requirements of section 13 or section 15(d) of the Exchange Act). This proposed reporting requirement generally tracks an existing requirement for industry research reports under rule 139[107] but has been modified so that it

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[106] *See supra* notes 57–58 and accompanying text; *see also* paragraph accompanying notes 32–34.

[107] *See* rule 139(a)(2)(i) [17 CFR 230.139(a)(2)(i)] ("The issuer is required to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 or satisfies the conditions in paragraph (a)(1)(i)(B) of this section.").

would be applicable to industry research reports that include covered investment fund issuers. Like the parallel provision of rule 139, the proposed reporting requirement helps assure that there is publicly available information about the relevant issuers and that investors are able to use such information in making their investment decisions.

We request comment on the reporting requirement in proposed rule 139b.

- Is the proposed reporting requirement appropriate? Why or why not?
- As discussed above, proposed rule 139b's framework, including its scope and conditions, generally tracks rule 139.[108] Therefore, as in rule 139, the conditions applicable to industry and issuer-specific research reports differ. For example, as proposed, rule 139b (like rule 139) would not require the issuers included in an industry research report to satisfy the minimum market value thresholds discussed in section II.B.1.b above. Is there any reason we should extend all of the conditions for issuer-specific research reports (or a subset of these conditions, to the extent they are not already reflected in proposed rule 139b) to industry reports, even if this approach would diverge from the approach taken in rule 139? Are the concerns underlying the proposed conditions for broker-dealers' publication or distribution of covered investment fund research reports the same for issuer-specific research reports and industry research reports? Are there any other concerns specific to industry research reports that we should consider?

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[108] *See supra* paragraph accompanying notes 32–34.

b. Regular-Course-of-Business Requirement

We are also proposing that a broker-dealer be required to publish or distribute research reports in the regular course of its business in order to rely on the proposed safe harbor.[109] The proposed regular-course-of-business requirement for industry research reports similarly applies to issuer-specific research reports,[110] and it also tracks an existing requirement for industry research reports under rule 139.[111]

Like the parallel provision in rule 139, the proposed regular-course-of-business requirement for industry research reports includes a "similar information" requirement. To satisfy this requirement, at the time a broker-dealer publishes or distributes an industry research report, the broker-dealer would have to include similar information, in similar reports, about the issuer covered in the industry report (or its securities).[112] However, unlike rule 139, we are proposing that the "similar information" requirement apply only to circumstances in which a broker-dealer is publishing or distributing a research report regarding a covered investment fund that does not have a class of securities in substantially continuous distribution. As discussed above, the FAIR Act provides that the safe harbor shall not apply the "initiation or reinitiation" requirement to a research report concerning a covered investment fund with a class of securities

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[109] Proposed rule 139b(a)(2)(iv) (the broker or dealer publishes or distributes research reports in the regular course of its business and, at the time of the publication or distribution of the research report (in the case of a research report regarding a covered investment fund that does not have a class of securities in substantially continuous distribution) is including similar information about the issuer or its securities in similar reports).

[110] *See supra* section II.B.1.c.

[111] *See* rule 139(a)(2)(v) [17 CFR 230.139(a)(2)(v)].

[112] Proposed rule 139b(a)(2)(iv).

"in substantially continuous distribution."[113] We believe that the proposed "similar information" requirement is akin to the proposed "initiation or reinitiation" requirement, in that both would have the effect of limiting a broker-dealer's ability to rely on the proposed safe harbor to publish or distribute a research report about a particular covered investment fund if the broker-dealer had not previously published research on that issuer. Therefore, as in the proposed "initiation or reinitiation" requirement, we are proposing to exclude covered investment funds from the "similar information" requirement if they have a class of securities in substantially continuous distribution.[114]

As discussed above, we believe that the proposed regular-course-of-business requirement could reduce the possibility that broker-dealers' publication or distribution of covered investment fund research reports may be used to circumvent the prospectus requirements of the Securities Act. We also believe that broker-dealers that publish or distribute research reports in the regular course of business are more likely to publish reports incorporating analysis that investors recognize as research and to have appropriate compliance structures in place governing their publication of research.[115] We continue to believe, in the context of proposed rule 139b as well as in rule 139, that a regular-course-of-business requirement is equally appropriate for issuer-specific research reports and industry research reports.

We request comment on the proposed regular-course-of-business requirement.

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[113] *See supra* notes 97–98 and accompanying text.

[114] *See id*.

[115] *See supra* section II.B.1.c.

- Is the proposed regular-course-of-business requirement appropriate? Why or why not?
- In the context of covered investment fund research reports, would the proposed "similar information" requirement unduly restrict broker-dealers' ability to rely on the proposed safe harbor? Why or why not?
- Would any of the questions, concerns, or issues discussed above with respect to the proposed regular-course-of-business requirement in the context of issuer-specific research reports be equally applicable in the context of industry research reports? Why or why not?

c. Content Requirements for Industry Research Reports

The proposed rule would also condition eligibility for the safe harbor for industry research reports on certain content requirements. Specifically, under the proposed rule, industry research reports either must include similar information about a substantial number of covered investment fund issuers of the same type or investment focus (the "industry representation requirement"),[116] or alternatively contain a comprehensive list of covered investment fund securities currently recommended by the broker or dealer (the "comprehensive list requirement").[117]

Industry Representation Requirement

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[116] Proposed rule 139b(a)(2)(ii)(A).

[117] Proposed rule 139b(a)(2)(ii)(B).

The proposed industry representation requirement imposes a requirement similar to one contained in rule 139 to covered investment fund research reports.[118] The Commission has stated that "where a publication covers a broad range of companies in an industry and is issued not on a sporadic but on a regular schedule, the possibility that such a publication could condition the market is lessened."[119] Furthermore, the possibility of market conditioning is lessened "where research reports discussing the registrant contain similar information, opinions or recommendations with respect to a substantial number of other companies in the registrant's industry."[120] We believe that these observations are applicable today in the context of covered investment fund industry research reports, and therefore we propose that rule 139b include an industry representation requirement.

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[118] Rule 139 requires an industry research report to include "similar information with respect to a substantial number of issuers in the issuer's industry or sub-industry." Rule 139(a)(2)(iii) [17 CFR 230.139(a)(2)(iii)]. *See infra* note 121 and accompanying text.

[119] Research Reports, Securities Act Release No. 6492 (Oct. 6, 1983) [48 FR 46801 (Oct. 14, 1983)] ("1983 Proposing Release"); *see also supra* notes 57–58 and accompanying text (discussing the role of rule 139 in helping to mitigate the risk that research reports might be used to circumvent the prospectus requirements of the Securities Act). *See also* The Regulation of Securities Offerings, Securities Act Release No. 7607A (Nov. 13, 1998) [63 FR 67174 (Dec. 4, 1998)] (proposal to modernize and clarify the regulatory structure for offerings under the Securities Act of 1933).

We note that, in some cases, concerns about market conditioning in the context of research reports about covered investment funds may be substantially similar to these concerns in the context of operating company issuers. For example, for covered investment funds that are not in continuous distribution, "gun-jumping" concerns, *i.e.*, the failure to comply with restrictions on communications when a securities offering is being contemplated or is in process (similar to those that are applicable to operating companies) could be applicable. For covered investment funds that are in continuous distribution, on the other hand, we understand the role of the conditions of rule 139b more generally as to help mitigate the risk that research reports could be used to circumvent the Securities Act's prospectus requirements.

[120] *See* 1983 Proposing Release, *supra* note 119. As a corollary, the Commission has noted that "The opportunity for the abuses Section 5 was enacted to correct may still be present, however, where a research report covers only a few companies constituting a sub-industry group or where an entire industry is composed of a small number of companies." *See id.*

Accordingly, we are proposing to replicate the language from rule 139's industry representation requirement in rule 139b, with modifications designed to apply the language to the covered investment fund context. Under rule 139's corresponding requirement, an industry research report must include "similar information with respect to a substantial number of issuers in the issuer's industry or sub-industry."[121] When this section of rule 139 first was proposed, the Commission explained that the term "industry" in this context refers to a broad category of similar businesses, such as the airline or steel industries.[122] In adopting the rule, the Commission added "sub-industry" to the rule text in order to clarify that the safe harbor would apply to research reports covering a smaller number of companies in a particular industry.[123] While operating companies are typically grouped based on their business category, entities that are included in the definition of "covered investment fund" are typically grouped based either on their type or investment focus.[124] Therefore, the proposed industry representation requirement would require an industry research report to include similar information about a substantial number of issuers either of the same type (*e.g.*, ETFs or mutual funds that are large cap funds, bond funds, balanced funds, money market funds, etc.) or investment focus (*e.g.*, primarily

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121 Rule 139(a)(2)(iii) [17 CFR 230.139(a)(2)(iii)].

122 1983 Proposing Release, *supra* note 119.

123 1984 Adopting Release, *supra* note 56.

124 *See* Investment Company Names, Investment Company Act Release No. 24828 (Jan. 17, 2001) [66 FR 8509 (Feb. 1, 2001)] (registered investment companies are typically categorized based on industry (*e.g.*, sector funds or country or geographic region)).

invested in the same industry or sub-industry, or the same country or geographic region).[125] We believe that this proposed requirement tracks rule 139 to the extent practicable and appropriate.

Comprehensive List Requirement

Under the proposed rule, a broker-dealer's publication or distribution of an industry research report that conforms to the comprehensive list requirement, rather than the industry representation requirement, also would be eligible for the rule's safe harbor.[126] Rule 139 contains a similar provision,[127] and we are proposing to replicate the language from rule 139's comprehensive list requirement in rule 139b, with some modifications owing to the difference in context and the FAIR Act's affiliate exclusion.[128]

Like the proposed industry representation requirement, the proposed comprehensive list requirement is designed to result in industry research reports that cover a broad range of investment companies or securities.[129] We are proposing that a comprehensive list of recommended issuers appearing in an industry research report could not include any covered investment fund issuer that is an affiliate of the broker-dealer, or for which the broker-dealer serves as investment adviser (or is an affiliated person of the investment adviser), as this could

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125 Proposed rule 139b(a)(2)(ii)(A).

126 Proposed rule 139b(a)(2)(ii)(B).

127 Rule 139(a)(2)(iii) [17 CFR 230.139(a)(2)(iii)].

128 Proposed rule 139b(a)(2)(ii)(B).

129 1983 Proposing Release, *supra* note 119. We note that when the Commission originally adopted rule 139 in 1970, this rule *only* provided a safe harbor for research reports that included "a comprehensive list of securities, opinions or recommendations concerning the issuer" and did not provide a parallel safe harbor for issuer-specific research reports. *See* 1970 Adopting Release, *supra* note 99.

implicate the proposed affiliate exclusion.[130] As discussed in the context of the proposed industry representation requirement, we believe that including a broad range of issuers in a research report lessens concerns over market conditioning.[131] At the same time, the proposed comprehensive list requirement would permit a different presentation of research about multiple covered investment funds than the industry representation requirement would permit.[132] We understand that the two types of presentations could serve different research needs.

We request comment on the proposed content requirements for industry research reports.

- Are the proposed industry representation requirement and the proposed comprehensive list requirement appropriate? Why or why not?
- How would the publication or distribution of industry research reports help investors, and do commenters anticipate that industry research reports would be published or distributed more or less frequently than issuer-specific research reports? Do commenters anticipate that broker-dealers would be more likely to publish or distribute industry research reports that comply with the industry

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130 *See* proposed rule 139b(a)(2)(ii)(B) (excluding from the comprehensive list securities of a covered investment fund that is an affiliate of the broker or dealer, or for which the broker or dealer serves as investment adviser (or for which the broker or dealer is an affiliated person of the investment adviser)); *see also supra* section II.A.1.

131 *See supra* notes 119–120 and accompanying text.

132 Under proposed rule 139b, a "comprehensive list" research report would have to include a list of all of the broker's currently-recommended covered investment fund securities, whereas an "industry representation" report would not be required to list each currently-recommended security (but instead could cover a more limited number of issuers as long as a "substantial number" of covered investment fund issuers of the same type or investment focus were included). *See also* requests for comment *infra* at the end of this section II.B.2.c (requesting comment on how these types of research reports might be used and the content that would be included in each type of research report).

representation requirement, or alternatively the comprehensive list requirement, or both, in relying on the proposed rule 139b safe harbor?

- Are there other conditions that we should consider in addition to the proposed industry representation requirement and the proposed comprehensive list requirement? For example, should we require that there must be a minimum number of funds included in an industry research report for it to qualify under the industry representation requirement, particularly in light of the fact that there may be only a few funds that track a particular sub-industry or geographic region or country? If so, what should that minimum number be? Is there another approach to industry research report content requirements that would be more appropriately tailored to covered investment fund research reports?
- The proposed industry representation requirement would be based on the "type" or "investment focus" of the issuers covered in the research report. Are these the appropriate terms to achieve comparisons of similar entities in industry research reports? Why or why not? Are there other more appropriate terms that could be used to specify subsets of covered investment funds that would be included in industry research reports (*e.g.*, category, asset class, strategy, topic, or investment policy)? Should we include more specific definitions for the terms "type" and "investment focus" in rule 139b, and if so, what should these definitions be? Should we instead identify categories that can qualify for the industry report provisions, such as "legal structure" (*e.g.*, ETF, mutual fund, business development company, interval fund), "asset class" (*e.g.*, international equity,

domestic equity, international fixed income, domestic fixed income), "investment focus" (*e.g.*, sector, industry, sub-industry, geographic region), or "strategy" (*e.g.*, passive, active, market-cap-weighted, smart beta, capital preservation, capital appreciation)?

- The proposed comprehensive list requirement would require the research report to contain a list of covered investment funds that are "currently recommended" by the broker-dealer. Is it clear what is meant by the terms "comprehensive list" and "currently recommended" under proposed rule 139b? Would broker-dealers seeking to rely on the proposed safe harbor understand that we interpret these terms in the context of rule 139b to have the same meaning as they do in the context of rule 139? For example, would the term "currently recommended" be interpreted as meaning "available for sale by the broker-dealer," "given a 'buy' recommendation by the broker-dealer," or something else? Should we further define either of the terms "comprehensive list" or "currently recommended" as they appear in rule 139b (or, within rule 139b, as these terms apply to certain types of covered investment funds such as registered investment companies), and if so, how?
- Do commenters anticipate that, if a broker-dealer were to rely on the proposed rule 139b safe harbor to publish or distribute research reports that meet the proposed comprehensive list requirement, there would be a sufficient number of "currently recommended" covered investment funds to produce an appropriately broad array of funds included in the report given the affiliate exclusion?

- We are proposing that a comprehensive list could not include any covered investment fund issuer that is an affiliate of the broker-dealer, or for which the broker-dealer serves as investment adviser (or is an affiliated person of the investment adviser), as this could implicate the proposed affiliate exclusion. Should rule 139b instead provide that a comprehensive list of recommended issuers could include issuers that are affiliates of the broker-dealer that is publishing or distributing the research report under certain circumstances? If so, what information, if any, should a broker-dealer be permitted to include about affiliated issuers such that the list can be described as "comprehensive" while continuing to address the goals of the affiliate exclusion? For example, should the rule provide that these issuers could be included in a comprehensive list if the research report were to identify which issuers in the list, if any, were affiliated with the broker-dealer? In addition, or in the alternative, should we permit these issuers to be included in a comprehensive list if disclosure about the affiliated issuers were limited, for example, to basic identifying information such as the name of the covered investment fund, its type and investment focus, and its ticker symbol (if applicable)? As another example, should the rule require that if a comprehensive list includes affiliated issuers and includes performance information, the performance information must be presented in accordance with rule 482 in order to address the concern that the broker-dealer may be

incentivized to present more favorably the performance of its affiliated covered investment funds?[133]

d. Presentation Requirement for Industry Research Reports

Proposed rule 139b also would condition the safe harbor for industry research reports on a presentation requirement. Under the proposed rule, analysis of any covered investment fund issuer or its securities included in an industry research report could not be given materially greater space or prominence in the publication than that given to any other covered investment fund issuer or its securities.[134]

The proposed presentation requirement tracks a parallel "no greater space or prominence" requirement in rule 139.[135] The Commission has stated that the "no greater space or prominence" language is necessary to mitigate the risk of conditioning the market[136] but also that the materiality standard within this presentation requirement provides flexibility.[137] We believe that the concerns underlying the rule 139 presentation requirements apply equally in the context of covered investment fund research reports. We believe that, if the proposed rule were to permit a broker-dealer to rely on the safe harbor even if it were to publish or distribute an industry research report that gives materially greater space or prominence to one issuer than to others, this would create an avenue for circumventing the conditions associated with issuer-specific research

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133 *See infra* section II.C.

134 Proposed rule 139b(a)(2)(iii).

135 Rule 139(a)(2)(iv) [17 CFR 230.139(a)(2)(iv)].

136 1983 Proposing Release, *supra* note 119.

137 *Id*.

reports. The industry should already be familiar with this long-established and well-understood condition, and therefore we believe implementing a similar presentation condition for industry research reports on covered investment funds would be straightforward.

We request comment on the proposed presentation requirement for industry research reports.

- Is the proposed presentation requirement appropriate for covered investment fund industry research reports? Why or why not?
- Is the proposed presentation requirement sufficiently clear? Should we provide guidance as to what compliance with this requirement would entail?
- Would this requirement unduly restrict design flexibility for research reports, or impede broker-dealers' ability to provide material information in research reports?
- Should we consider additional presentation requirements for covered investment fund research reports? Is there another approach that would be more appropriately tailored?

C. Presentation of Performance Information in Research Reports about Registered Investment Companies

Specific statutory provisions and rules apply to advertising the performance of registered investment companies.[138] An advertisement about a covered investment fund that is a registered

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[138] *See, e.g.*, section 24(g) of the Investment Company Act [15 U.S.C. 80a–24(g)] (directing the Commission to adopt rules or regulations that permit registered investment companies to use prospectuses that (i) include information the substance of which is not included in the statutory prospectus, and (ii) are deemed to be permitted by section 10(b) of the Securities Act); rule 34b-1 under the Investment Company Act [17 CFR

investment company is deemed a section 10(b) prospectus (also known as an "advertising prospectus" or "omitting prospectus") for purposes of section 5(b)(1) of the Securities Act so long as it complies with rule 482.[139] Therefore, under the current regulatory framework, a broker-dealer's publication or distribution of a research report that complies with the requirements of rule 482 would not be deemed a non-conforming prospectus in violation of section 5 of the Securities Act.[140]

Given the breadth of the definition of "research report" under the FAIR Act (and the definition of "research report" that we propose under rule 139b), certain communications by broker-dealers that historically have been treated as advertisements for registered investment companies under rule 482 now could be considered covered investment fund research reports subject to the proposed rule 139b safe harbor.[141] Among other things, rule 482 requires standardized presentation of performance data included in registered open-end investment company advertisements.[142] Alternatively, if other performance measures are presented, they

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270.34b-1] (requiring that, in order not to be misleading, investment company sales literature must include certain information, including with respect to performance information by incorporating certain related provisions of rule 482 of the Securities Act); rule 156 of the Securities Act [17 CFR 230.156] (providing guidance on what statements or omissions of material fact may be misleading in investment company sales literature); rule 482 of the Securities Act [17 CFR 230.482] (setting forth that for an investment company advertisement to be deemed a prospectus under section 10(b) of the Securities Act, it must meet certain requirements thereunder, including with respect to standardized performance information presentation).

139 *See supra* note 101 and accompanying text.

140 *See supra* notes 13, 101 and accompanying text. FINRA content standards also would generally require a member's publication or distribution of such a communication (to the extent it presents performance data as permitted by rule 482) to include certain of the standardized performance information specified under rule 482. *See* FINRA rule 2210(d)(5)(A).

141 *See supra* note 102 and accompanying text.

142 *See* rule 482(d)(1)–(4) (for open-end investment companies other than money market funds) and rule 482(e) (for money market funds).

must be accompanied by certain standardized performance data.[143] Because a broker-dealer's publication or distribution of a covered investment fund research report under proposed rule 139b would be deemed not to constitute an offer for purposes of sections 2(a)(10) and 5(c) of the Securities Act, a covered investment fund research report would no longer need to be deemed to be a section 10(b) prospectus (such as an advertising prospectus under rule 482) for purposes of section 5(b)(1) of the Securities Act. In addition, some communications that previously were considered supplemental sales literature that must be accompanied or preceded by a statutory prospectus under rule 34b-1 under the Investment Company Act now could be considered covered investment fund research reports (which need not be preceded or accompanied by a statutory prospectus).[144] Rule 34b-1 incorporates many of the rule 482 requirements relating to performance disclosure and makes these requirements applicable to supplemental sales literature.[145] We are concerned that this shift in regulatory treatment of research reports about registered investment companies could result in investor confusion if a communication were not easily recognizable as research as opposed to an advertising prospectus or supplemental sales literature. Although there are multiple provisions in proposed rule 139b that aim to limit the risk

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[143] *See* rule 482(d)(5). These other performance measures are not subject to any prescribed method of computation, but must reflect all elements of return and be accompanied by quotations of standardized measures of total return as provided for in paragraphs (d)(3) and (d)(4) of the rule. Rule 482(d)(5) also includes other requirements for the inclusion of non-standardized performance data, such as presentation and prominence requirements.

[144] *See* rule 34b-1 under the Investment Company Act. Rule 34b-1 provides that any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by section 24(b) of the Investment Company Act will have omitted to state a fact necessary in order to make the statements made therein not materially misleading unless it includes certain specified information.

[145] *See* rule 34b-1(b)(1)–(2).

that broker-dealers could use the proposed safe harbor to circumvent the prospectus requirements of the Securities Act,[146] there could be circumstances where, under the proposed rule, broker-dealers could publish or distribute communications that historically have been viewed as registered investment company advertisements or selling materials.

Research reports published under rule 139 are not required to present performance information in any particular fashion. To the extent the rules we are proposing today diverge from rule 139, these differences are designed to implement the FAIR Act or tailor existing provisions of rule 139 to the context of covered investment fund research reports. Therefore, unlike registered open-end investment company advertisements that must comply with the requirements of Securities Act rule 482, covered investment fund research reports would not be required to present investment performance data in a standardized manner.[147] However, we have long recognized that investors tend to consider investment performance to be a particularly significant factor in evaluating or comparing investment companies.[148] The Commission has previously identified a number of circumstances in which performance could be disclosed in a

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146 *See, e.g.*, *supra* sections II.A.1 (affiliate exclusion) and II.B.1.c (regular course of business requirement). Certain covered investment fund research reports that meet the definition of "research report" in Regulation AC would be subject to the requirements of Regulation AC. Similarly, covered investment fund research reports that meet the definition of "research report" in FINRA rule 2241 or the definition of "debt research report" in FINRA rule 2242 would be subject to the content requirements in those rules as applicable. *See supra* note 58; *infra* section II.D.1.

147 *See supra* notes 142–143 and accompanying text.

148 As the Commission has previously noted "[a]lthough there are many factors other than performance that an investor should consider in deciding whether to invest in a particular fund, many investors consider performance to be one of the most significant factors when evaluating mutual funds." *See* Amendments to Investment Company Advertising Rules, Securities Act Release No. 8101 (May 17, 2002) [67 FR 36712 (May 24, 2002)] ("Rule 482 Amendments Proposing Release") (proposing release for amendments to investment company advertising rules).

misleading manner.[149] If a broker-dealer publishes or distributes a covered investment fund research report in reliance on the safe harbor—and presents performance information in a manner inconsistent with rule 482—retail investors could be confused about the comparability of the performance to that presented in the prospectuses, sales literature, and advertisements of the fund and its competitors.[150] In addition, the possibility exists that the requirements of rule 482 or rule 34b-1 could be circumvented by recasting registered investment company advertisements or selling materials as research reports. We request comment below as to whether, in light of these concerns, it would be appropriate to require that covered investment fund research reports that include performance information present that information in accordance with the requirements in rule 482 or rule 34b-1.

In addition, all covered investment fund research reports under the proposed safe harbor would remain subject to the antifraud provisions of the federal securities laws.[151] The Commission has previously articulated guidance on factors to be weighed in considering whether

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[149] *See id.* (such circumstances include: advertising performance without providing adequate disclosure of unusual circumstances that have contributed to performance; advertising performance without providing adequate disclosure of the performance period, that more current performance information is available, or that more current performance may be lower than advertised performance; and advertising performance based on selective dates or time periods in order to showcase fund performance as of those specific dates or time periods without providing disclosure that would permit an investor to evaluate the significance of the performance).

[150] Additional conditions that might lessen potential investor confusion are if a research report that presents performance information other than in accordance with the provisions of rule 482 were to: 1) adequately explain how the performance presentation differs from that which would be required under rule 482, and/or 2) include a statement noting that the document is a research report, and is not an investment company advertisement that is subject to the requirements of rule 482. We request comment on these and other conditions below.

[151] *See* section 2(c)(1) of the FAIR Act (stating "Nothing in this Act shall be construed as in any way limiting—(1) the applicability of the antifraud or antimanipulation provisions of the Federal securities laws and rules adopted thereunder to a covered investment fund research report, including section 17 of the Securities Act of 1933 (15 U.S.C. 77q), section 34(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–33(b)), and sections 9 and 10 of the Securities Exchange Act of 1934 (15 U.S.C. 78i, 78j)").

statements involving a material fact in registered investment company advertisements and sales literature, which are also subject to the antifraud provisions of the federal securities laws, could be misleading.[152] This guidance provided factors to be weighed when determining whether fund performance in sales literature is adequately disclosed.[153] The guidance factors in rule 156[154] are informative in evaluating whether any presentations of registered investment company performance in these research reports could be misleading because they reflect principles (such as providing information to investors that is informative and that does not create unrealistic investor expectations[155]) that would help guide this analysis.

Rule 139 includes an instruction on the use of projections of an issuer's sales and earnings.[156] This instruction provides that a projection "constitutes an analysis or information

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[152] *See* Amendments to Investment Company Advertising Rules, Securities Act Release No. 8294 (Sept. 29, 2003) [68 FR 57759 (Oct. 6, 2003)] ("Amendments to Investment Company Advertising Rules Adopting Release"); *see also* rule 156 under the Securities Act [17 CFR 230.156].

[153] *See* Amendments to Investment Company Advertising Rules Adopting Release, *supra* note 152.

[154] Rule 156(b) under the Securities Act provides guidance factors concerning misleading statements in investment company sales literature including: (i) statements and omissions generally (including in light of general economic or financial conditions or circumstances), (ii) representations about past or future investment performance, and (iii) statements involving a material fact about an investment company's characteristics or attributes.

For example, rule 156(b)(2) provides guidance on whether investment performance representations may be misleading by highlighting the following situations: "(i) [p]ortrayals of past income, gain, or growth of assets convey an impression of the net investment results achieved by an actual or hypothetical investment which would not be justified under the circumstances, including portrayals that omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading; and (ii) [r]epresentations, whether express or implied, about future investment performance, including: (A) [r]epresentations, as to security of capital, possible future gains or income, or expenses associated with an investment; (B) [r]epresentations implying that future gain or income may be inferred from or predicted based on past investment performance; or (C) [p]ortrayals of past performance, made in a manner which would imply that gains or income realized in the past would be repeated in the future."

[155] *See* Rule 482 Amendments Proposing Release, *supra* note 148.

[156] *See* "Instruction" to rule 139 [17 CFR 230.139].

falling within the definition of research report" and includes certain conditions associated with the use of projections.[157] We are not incorporating this or a similar instruction in proposed rule 139b for a number of reasons. FINRA content standards governing communications with the public generally prohibit a broker-dealer from using performance projections.[158] In addition, rule 156 notes as guidance that statements and illustrations about a registered fund's future performance in sales literature could be misleading depending on the context in which they are made, and lists considerations to weigh in making this evaluation. The projection instruction in rule 139—which refers to "sales" and "earnings"—also appears inapplicable to covered investment funds. A covered investment fund's returns will be based on the returns of the fund's investments and fund expenses, among other factors, as opposed to "earnings" and "sales."

We request comment on whether we should adopt any additional conditions in rule 139b or issue guidance to help mitigate the potential for investor confusion regarding research reports about registered investment companies.

- Do commenters anticipate that certain issuer-specific covered investment fund research reports could be confused with registered investment company advertisements and sales materials? If so, what additional conditions could prevent investor confusion, including, for example, legends?

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[157] *See id.* The instruction provides that, when a broker or dealer publishes or distributes projections of an issuer's sales or earnings in reliance on rule 139(a)(2), it must: 1) have previously published or distributed projections on a regular basis in order to satisfy the "regular course of its business" condition; 2) at the time of publishing or disseminating a research report, be publishing or distributing projections with respect to that issuer; and 3) for purposes of rule 139(a)(2)(ii), include projections covering the same or similar periods with respect to either a substantial number of issuers in the issuer's industry or sub-industry or substantially all issuers represented in the comprehensive list of securities contained in the research report.

[158] *See* FINRA rule 2210(d)(1)(F).

- If commenters anticipate that certain covered investment fund research reports could be confused with registered investment company advertisements and sales materials, what additional conditions or guidance factors would help mitigate investor confusion? For example, should we incorporate any of the rule 156 guidance factors, which are weighed in considering whether statements in investment company sales literature could be misleading? Why or why not? Alternatively, should we provide any additional guidance regarding considerations to be weighed in considering whether research reports about registered investment companies (including any performance information presented in these research reports) could be misleading? Should any additional guidance be limited either to issuer-specific research reports or to industry research reports?
- Do commenters anticipate that broker-dealers would include performance information in covered investment fund research reports about registered open-investment investment companies in a manner inconsistent with the requirements for the presentation of total return or yield in rule 482 ("non-482 performance information")?[159] We request that commenters provide specific examples of non-482 performance information that they would consider using in a

[159] As discussed above, rule 482 also permits the inclusion of performance measures in an open-end registered investment company advertisement that are not subject to any prescribed method of computation, provided (among other things) that these other performance measures are accompanied by certain standardized performance data. *See supra* note 143 and accompanying text.

research report about an open-end investment company, and why they would use this information.

- What, if any, risks could result from including non-482 performance information in covered investment fund research reports about registered open-end investment companies? For example, would the variability of non-482 performance information result in investor confusion? Would the inclusion of non-482 performance information result in any of the concerns that the provisions of rule 482 are meant to address, such as disclosing performance without providing adequate disclosure of unusual circumstances that have contributed to performance; without providing adequate disclosure of the performance period (including information about current performance); or without disclosing important context that would permit an investor to evaluate performance (such as the fact that the performance is based on selective dates or time periods)?[160] Would the ability of a covered investment fund to include non-482 performance information incentivize broker-dealers to recast registered investment company advertisements or selling materials as research reports that they could publish or distribute under proposed rule 139b, instead of meeting the requirements of rule 482? To what extent would any such risks be mitigated by regulations that are currently in effect, for example, the rule 156 guidance factors discussed above, or

[160] *See* Rule 482 Amendments Proposing Release, *supra* note 148.

other factors (such as the applicable content standards in SRO rules, such as FINRA rule 2210[161])?

- If we were to permit non-482 performance information to appear in covered investment fund research reports about registered open-end investment companies, as proposed, what benefits could result? Would any benefits of the ability to include the non-482 performance information be diminished if the broker-dealer were also required to include the standardized information required by rule 482?[162]
- If commenters anticipate that the potential risks of including non-482 performance information in covered investment fund research reports would outweigh the benefits, what action should we take to mitigate these risks? Would these risks be mitigated if we were to incorporate any of the requirements of rule 482 directly into rule 139b?[163] Why or why not? If so, which requirements? For example, should we incorporate a provision in rule 139b stating that, where a registered open-end investment company's total return or yield is presented in a covered investment fund research report, the presentation must be consistent with the requirements for the presentation of total return or yield in rule 482? Should

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[161] *See infra* section II.D.1.

[162] *See supra* note 159.

[163] Rule 34b-1, which governs the use of registered investment company supplemental sales literature as discussed above, also incorporates many of the rule 482 requirements relating to performance disclosure, and a related alternative approach could be to reference the performance presentation requirements of rule 34b-1 in rule 139b. *See supra* note 144.

we include in rule 139b only certain of the requirements in rule 482, such as those listed in paragraph (d)(5) and (e) of rule 482 for the presentation of other, non-482 conforming performance information measures?

- Should we incorporate a requirement in rule 139b relating to the timeliness of performance data about registered investment companies, similar to timeliness of performance requirements for advertising prospectuses under rule 482[164] or supplemental sales literature under rule 34b-1?[165] If so, why? Would unaffiliated broker-dealers have any difficulty obtaining this information in order to comply with such a requirement? Would the inclusion of performance data in covered investment fund research reports entail the same concerns about timeliness that rules 482 and rule 34b-1 are designed to address? Why or why not?
- Alternatively, should we incorporate a provision in rule 139b requiring that a research report must include certain disclosures or disclaimers when performance information about registered open-end investment companies is presented as non-482 performance information? For example, should we require that a research report about a registered investment company must incorporate disclosure stating that the document is a research report and is not subject to the Commission's regulations applicable to sales and advertising? If a covered investment fund research report about a registered open-end investment company

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[164] Rule 482(g) [17 CFR 230.482(g)].

[165] Rule 34b-1(b)(2) [17 CFR 270.34b-1(b)(2)].

includes non-482 performance information, should we require that the research report must disclose the website address for that registered open-end investment company (including a hyperlink for research reports in electronic format), to facilitate investor access to total return or yield disclosure that is presented in a manner consistent with the requirements in rule 482? Should we require that the methodology used to calculate the registered open-end investment company's total return or yield be disclosed, if the research report includes non-482 performance information?

- Should we include an instruction in rule 139b on the use of projections that is similar to the instruction on the use of projections in rule 139? Why or why not? If we were to include such an instruction, would the instruction in rule 139 be appropriate to include in rule 139b, or should it be modified in any way? As discussed above, we recognize that the guidance factors set forth under rule 156 of the Securities Act address future investment performance, and similarly, certain SRO rules that would apply to covered investment fund research reports prohibit the prediction or projection of performance.[166]

[166] *See supra* paragraph accompanying notes 156–158.

D. Role of Self-Regulatory Organizations

1. SRO Content Standards and Filing Requirements for Covered Investment Fund Research Reports

SRO Content Standards

The FAIR Act contemplates that SRO content standards applicable to research reports would apply to covered investment fund research reports.[167] Specifically, the FAIR Act provides that, unless covered investment fund research reports are subject to the content standards in the rules of any SRO related to research reports, these research reports may still be subject to the filing requirements of section 24(b) of the Investment Company Act for the review of investment company sales literature.[168] As discussed in more detail below, we are proposing rule 24b-4 to implement this provision of the FAIR Act. Proposed rule 24b-4 provides that a covered investment fund research report about a registered investment company will not be subject to section 24(b) of the Investment Company Act (or the rules and regulations thereunder), except to the extent the research report is otherwise not subject to the content standards in SRO rules

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[167] *See* section 2(b)(4) of the FAIR Act ("a covered investment fund research report shall not be subject to section 24(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–24(b)) or the rules and regulations thereunder, except that such report may still be subject to such section and the rules and regulations thereunder to the extent that it is otherwise not subject to the content standards in the rules of any self-regulatory organization related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards.").

This provision is relevant only to covered investment funds that are investment companies subject to section 24(b) of the Investment Company Act. For example, registered closed-end investment companies, business development companies, and commodity- or currency-based trusts or funds are covered investment funds that are not subject to section 24(b) of the Investment Company Act. A covered investment fund that is not subject to section 24(b) of the Investment Company Act would have no obligations under that section even if research reports concerning the covered investment fund were not subject to the content standards in the rules of any self-regulatory organization related to research reports.

[168] *See id.*

related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards.[169]

Currently, the SRO content standards relevant to communications that would be considered covered investment fund research reports under proposed rule 139b include the applicable content standards of FINRA rules 2210, 2241(c)(1), and 2242(c)(1).[170] FINRA's rule governing communications with the public (FINRA rule 2210) contains general content standards that apply broadly to member communications,[171] including broker-dealer research reports. These general content standards require, among other things, that all member communications "must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service."[172]

The FAIR Act does not explicitly refer to specific content standards in SRO rules. It refers more generally to "the content standards in the rules of any self-regulatory organization related to research reports, including those contained in the rules governing communications

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169 *See* proposed rule 24b-4.

170 *See infra* note 174 (discussing the scope of these rules in more detail, including noting that the scope of certain provisions of FINRA rule 2210, and the scope of FINRA rules 2241(c)(1) and 2242(c)(2) generally, apply only to a certain subset of communications that would be considered covered investment fund research reports under proposed rule 139b).

171 *See* FINRA rule 2210(d)(1).

172 *See* FINRA rule 2210(d)(1)(A). FINRA rule 2210's general content standards also provide, among other things, that FINRA members may not "make any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication" nor "publish, circulate or distribute any communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading." *See* FINRA rule 2210(d)(1)(B).

with the public regarding investment companies or substantially similar standards."[173] In order to provide clarity and facilitate consistent and predictable application of proposed rule 24b-4, we interpret section 2(b)(4) of the FAIR Act as excluding covered investment fund research reports from section 24(b) of the Investment Company Act so long as they continue to be subject to the general content standards in FINRA rule 2210(d)(1) (or substantially similar SRO rules). Accordingly, by operation of proposed rule 24b-4, covered investment fund research reports under proposed rule 139b that otherwise would be subject to section 24(b) of the Investment Company Act would *not* be subject to that section so long as they remain subject to the general content standards of FINRA rule 2210(d)(1).[174] This interpretation is consistent with our belief

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[173] Section 2(b)(4) of the FAIR Act.

[174] A subset of communications that would fall within the definition of "covered investment fund research report" under proposed rule 139b also would be subject to additional content-related requirements under FINRA rules that are applicable to certain research reports, but that are more narrowly applicable than the general content standards of FINRA rule 2210(d)(1). However, under our interpretation, whether or not these additional content standards apply to any given covered investment fund research report would not determine the applicability of section 24(b) to that research report under proposed rule 24b-4. A different interpretation could lead to results that we believe could be inconsistent with section 2(b)(4) of the FAIR Act (*i.e.*, if only communications that are subject to additional FINRA content standards discussed in this footnote (*e.g.*, those applicable to retail communications) were excluded from section 24(b) filing requirements).

Additional FINRA content-related requirements include the content standards of FINRA rule 2210 that apply only to retail communications (or retail communications and correspondence, as those terms are defined in FINRA rule 2210(a)). *See, e.g.*, FINRA rules 2210(d)(2) (Comparisons), 2210(d)(3) (Disclosure of Member's Name). Accordingly, covered investment fund research reports that would meet the definition of institutional communications would not be subject to some of the content standards of FINRA rule 2210.

These additional requirements also include the content standards incorporated in FINRA rules 2241 and 2242, which apply to certain research reports defined in these FINRA rules. The scope of FINRA rules 2241 and 2242 only includes research reports or debt research reports as defined in these rules, and the definitions of "research report" and "debt research report" in these rules are different than the definitions of "research report" set forth in rule 139 and proposed rule 139b. Under FINRA rule 2241, "research report" is defined as: "any written (including electronic) communication that includes an analysis of equity securities of individual companies or industries (other than an open-end registered investment company that is not listed or traded on an exchange) and that provides information reasonably sufficient upon which to base an investment decision. . . ."; similarly, under FINRA rule 2242, "debt research report" is defined as: "any written (including electronic) communication that includes an analysis of a debt security or an issuer of a debt security and that provides

that it is important for SRO content standards to continue to apply to covered investment fund research reports, especially if, as discussed below, research reports about registered investment companies would no longer be required to be filed pursuant to section 24(b) of the Act or rule 497 under the Securities Act,[175] and therefore would no longer be subject to routine review.[176]

Filing Requirements for Covered Investment Fund Research Reports

The FAIR Act, as implemented by proposed rule 24b-4, would modify the filing requirements that currently apply to certain broker-dealer communications regarding registered investment companies. As discussed above, research reports about registered investment companies have historically not been included within the scope of rule 139.[177] Therefore, a research report or other communication about a covered investment fund that is a registered investment company, particularly one that contains performance information, would ordinarily have to comply with rule 482.[178] Today, registered investment company sales literature,

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information reasonably sufficient upon which to base an investment decision, excluding communications that solely constitute an equity research report as defined in [FINRA] rule 2241(a)(11). . . ." *See* FINRA rules 2241(a)(11), 2242(a)(3).

175 *See infra* discussion at notes 177–181 and accompanying text.

176 Broker-dealer communications that are excluded from, or otherwise not subject to FINRA's filing requirements may still be reviewed by FINRA, for example, through examinations, targeted sweeps or spot-checks. FAIR Act section 2(c)(2) provides that nothing in the Act shall be construed as in any way limiting "the authority of any self-regulatory organization to examine or supervise a member's practices in connection with such member's publication or distribution of a covered investment fund research report for compliance with applicable provisions of the Federal securities laws or self-regulatory organization rules related to research reports, including those contained in rules governing communications with the public." *See also, e.g.*, FINRA rule 2210(c)(6) ("In addition to the foregoing requirements, each member's written (including electronic) communications may be subject to a spot-check procedure. Upon written request from [FINRA's Advertising Regulation] Department, each member must submit the material requested in a spot-check procedure within the time frame specified by the Department.").

177 *See supra* notes 11–15 and accompanying text.

178 *See* FINRA rule 2210(d)(5) (providing that non-money market fund open-end management company performance data as permitted by rule 482 in retail communications and correspondence must disclose

including rule 482 omitting prospectus advertisements, are required to be filed with the Commission under section 24(b) of the Investment Company Act[179] and rule 497 under the Securities Act.[180] Rule 24b-3 under the Investment Company Act and rule 497(i) deem these materials to have been filed with the Commission if filed with FINRA.[181]

As discussed in the Economic Analysis below, we anticipate that certain communications that historically have been treated as investment company sales literature, including rule 482 "omitting prospectus" advertisements, would be published or distributed by a broker-dealer as covered investment fund research reports pursuant to the rule 139b safe harbor.[182] Such communications that previously had been subject to the filing requirements of section 24(b) no longer would be subject to these requirements by operation of proposed rule 24b-4 because they would be subject to the general content standards of FINRA rule 2210(d)(1).[183]

FINRA rule 2210 requires the filing of certain communications, including retail communications that promote or recommend a specific registered investment company or family

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standardized performance information and, to the extent applicable, certain sales charge and expense ratio information); *see also supra* note 140.

179 *See supra* note 29.

180 17 CFR 230.497. Rule 497 generally requires investment company prospectuses, including investment company advertisements deemed to be a section 10(b) prospectus pursuant to rule 482, to be filed with the Commission.

181 *See supra* notes 29, 180.

182 *See infra* section III.C.3.

183 *See supra* notes 11–15 and accompanying text.

A communication that previously had been subject to the filing requirements of rule 497 also would no longer be subject to the rule 497 filing requirements if it were published or distributed by a broker-dealer as a covered investment fund research report, because it would no longer be considered to be a section 10(b) prospectus. *See supra* paragraph accompanying notes 141–146.

of registered investment companies.[184] However, FINRA provides a number of exclusions from the filing requirements.[185] For example, with respect to research reports (as that term is defined in FINRA rule 2241),[186] FINRA currently excludes from filing those that concern only securities that are listed on a national securities exchange, other than research reports required to be filed with the Commission pursuant to section 24(b) of the Investment Company Act.[187] Because covered investment fund research reports would no longer be required to be filed with the Commission pursuant to section 24(b), proposed rule 24b-4 could have the effect of narrowing the types of communications that would be filed with FINRA (under current FINRA rule 2210) regarding registered investment companies.

We note, however, that the FAIR Act's rules of construction provide that the Act shall not be construed as limiting the authority of an SRO to require the filing of communications with the public if the purpose of such communications "is not to provide research and analysis of covered investment funds."[188] Therefore, even if the exclusion of covered investment fund research reports from the provisions of section 24(b) affects the applicability of the filing

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184 *See* FINRA rule 2210(c)(3) (broker-dealers must file, within 10 business days of first use or publication, retail communications that promote or recommend a specific registered investment company or family of registered investment companies). *See generally*, FINRA rule 2210(c)(1)–(3). In addition to these FINRA filing requirements, as discussed above, such communications would be required to be filed with the Commission (and are deemed to have been filed with the Commission if filed with FINRA). *See supra* notes 179–181 and accompanying text.

185 *See generally* FINRA rule 2210(c)(7).

186 *See supra* note 11.

187 *See* FINRA rule 2210(c)(7)(O) (excluding "[r]esearch reports as defined in Rule 2241 that concern only securities that are listed on a national securities exchange, other than research reports required to be filed with the Commission pursuant to Section 24(b) of the Investment Company Act").

188 *See* section 2(c)(2) of the FAIR Act.

requirements or exclusions under FINRA rule 2210 with respect to covered investment fund research reports, it would not affect FINRA's authority to require the filing of a communication that is included in the FAIR Act's definition of "covered investment fund research report" but whose purpose is not to provide research and analysis. In addition, a covered investment fund research report would continue to be subject to FINRA recordkeeping requirements applicable to communications with the public, even if the broker-dealer would not be required to file the research report with FINRA or the Commission.[189]

We request comment on issues relating to SRO content standards for covered investment fund research reports.

- Should we implement FAIR Act section 2(b)(4) through proposed rule 24b-4? Are there any modifications to the proposed rule that we should consider?
- Do commenters believe that we should incorporate any of the SRO content standards currently applicable to research reports into rule 139b? If so, which ones and why?

2. SRO Limitations

The FAIR Act directs us to provide that SROs may not maintain or enforce any rule that would (i) "prohibit the ability of a member to publish or distribute a covered investment fund research report solely because the member is also participating in a registered offering or other distribution of any securities of such covered investment fund;" or (ii) "prohibit the ability of a

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[189] *See* FINRA rule 2210(b)(4)(A) (requiring members to maintain all retail communications and institutional communications for the retention period required by Exchange Act rule 17a-4(b) and in a format and media that comply with Exchange Act rule 17a-4).

member to participate in a registered offering or other distribution of securities of a covered investment fund solely because the member has published or distributed a covered investment fund research report about such covered investment fund or its securities."[190] These limitations on an SRO and any rules relating to research reports that an SRO might adopt would not affect the safe harbor provided by proposed rule 139b. To provide additional context for the proposed safe harbor, however, and in light of Congress's direction that we provide these limitations in implementing the rulemaking required by the FAIR Act, we have set forth these SRO limitations in proposed rule 139b.[191]

E. Conforming Amendment

Rule 101 of Regulation M under the Exchange Act[192] prohibits any person who participates in a distribution from attempting to induce others to purchase securities covered by the rule during a specified period. It provides an exception for certain research activities—namely, the publication or dissemination of any information, opinion, or recommendation—if the conditions of Securities Act rule 138 or rule 139 are satisfied. In light of our proposal of Securities Act rule 139b, we are proposing a corresponding change to the exception contained within rule 101(b)(1) of Regulation M to permit the publication or dissemination of any information, opinion, or recommendation so long as the conditions of proposed rule 139b are satisfied. The proposed conforming amendment is intended to align the treatment of research

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[190] Section 2(b)(3) of the FAIR Act.

[191] *See* proposed rule 139b(b).

[192] 17 CFR 242.101(a).

under proposed rule 139b with the treatment of research under rules 138 and 139 for purposes of Regulation M.

In the absence of the conforming amendment, rule 101 could prevent the publication or dissemination of a covered investment fund research report under the proposed rule 139b safe harbor by a broker-dealer that is participating in a distribution that is covered by Regulation M. We believe that such a result would be contrary to the mandate of the FAIR Act. As such, the proposed conforming amendment is intended to harmonize treatment of research under the Securities Act and Exchange Act rules.

We request comment on the proposed conforming amendment to Regulation M.

- Is the proposed conforming amendment appropriate?
- Are there other conforming amendments to Regulation M or any of our other rules appropriate for consideration based on the FAIR Act? If so, what rules should be amended and why?

III. ECONOMIC ANALYSIS

A. Introduction

We are mindful of the costs and benefits of our rules. Section 2(b) of the Securities Act, section 3(f) of the Exchange Act, and section 2(c) of the Investment Company Act state that when the Commission is engaging in rulemaking under such titles and is required to consider or determine whether an action is necessary or appropriate in (or, with respect to the Investment Company Act, consistent with) the public interest, the Commission shall consider, in addition to

the protection of investors, whether the action will promote efficiency, competition, and capital formation.[193] Additionally, Exchange Act section 23(a)(2) requires us, when making rules or regulations under the Exchange Act, to consider, among other matters, the impact that any such rule or regulation would have on competition and states that the Commission shall not adopt any such rule or regulation which would impose a burden on competition that is not necessary or appropriate in furtherance of the Exchange Act.[194]

The economic analysis proceeds as follows. We begin with a discussion of the baseline used in the analysis. We then discuss the proposed rules' costs and benefits, as well as their effects on efficiency, competition, and capital formation compared to the baseline. Where possible, we attempt to quantify the economic effects we discuss. However, we cannot produce reasonable estimates for most of the effects. In such cases we instead provide qualitative economic assessments.

B. Baseline

The Commission's economic analysis evaluates the costs and benefits of the proposed rule relative to a baseline that represents the best assessment of relevant markets and market participants in the absence of the proposed rule. In this section, we begin by characterizing the relevant market structure and participants.[195] We then proceed to describe the relevant regulatory structure.

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[193] 15 U.S.C. 77b(b), 15 U.S.C. 78c(f), 15 U.S.C. 80a-2(c), and 15 U.S.C. 80b-2(c).

[194] 15 U.S.C. 78w(a)(2).

[195] To characterize the baseline, we rely on data from year-end 2017 where possible; however, in some cases, timing issues related to data availability require us to rely on data from prior periods.

1. Market Structure and Market Participants

The proposed rules would directly affect broker-dealers, but their indirect effects would extend to covered investment funds, other producers of research on covered investment funds, and consumers of information about covered investment funds.[196]

a. Covered Investment Funds

The "covered investment fund" definition in the FAIR Act and proposed rule 139b has the effect of capturing five common types of investment vehicles: mutual funds, ETFs, certain currency and commodity exchanged traded products ("ETPs"),[197] closed-end funds, and BDCs.[198] As shown in Figure 1, the universe of covered investment funds is large. At the end of 2017, there were 11,924 such entities, including 9,564 mutual funds, 1,629 ETFs and ETPs, 596 closed-end funds, and 135 BDCs.[199] The total public market value of covered investment funds exceeds $20 trillion. Of this total, $17 trillion is held through shares issued by open-end mutual funds, $3 trillion through shares of ETFs and ETPs, $317 billion through shares of closed-end funds, and $27 billion through shares of BDCs.[200]

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196 The proposed rules, through their effects on capital formation, may also affect securities issuers more broadly. *See infra* section III.C.5.

197 Exchange-traded trusts with assets consisting primarily of commodities, currencies, or derivative instruments that reference commodities or currencies, commonly referred to as currency ETPs and commodity ETPs, and which are not registered under the Investment Company Act; *see* proposed rule 139b(c)(2)(ii).

198 *See supra* section II.A.3.

199 Mutual fund, ETF, and ETP statistics based on data from CRSP mutual fund database (2017Q3). Closed-end fund statistics based on data from CRSP monthly stock file (Dec. 2017). BDC statistics based on Commission's listing of registered BDCs. Securities and Exchange Commission, Business Development Company Report: January 2012 – September 2017 (Sept. 19, 2017), *available at* https://www.sec.gov/open/datasets-bdc.html.

200 *See supra* note 199. Market value of BDC shares based on information obtained from Compustat and Audit Analytics.

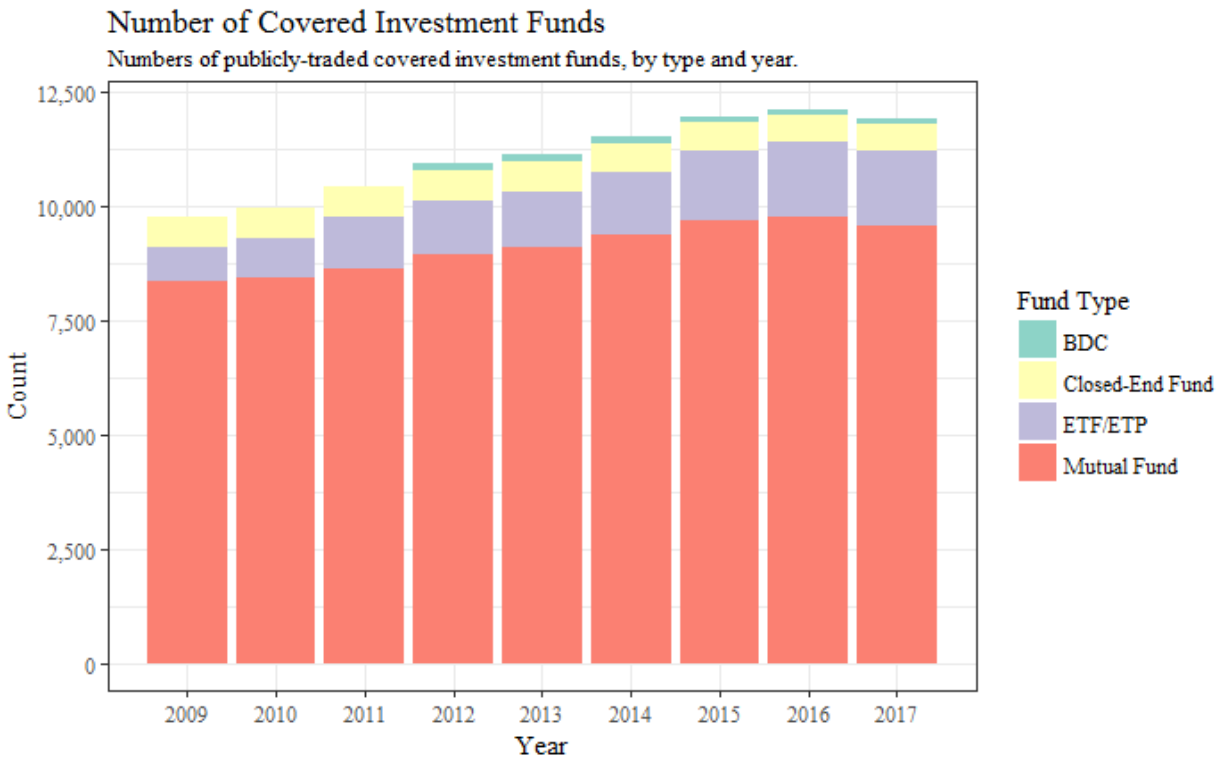

Figure 1: Numbers of publicly-traded covered investment funds, by type and year. Counts based on CRSP mutual fund database, CRSP monthly stock file, and Commission's listing of BDC registrants; see supra note 199. BDC data begins in 2013.

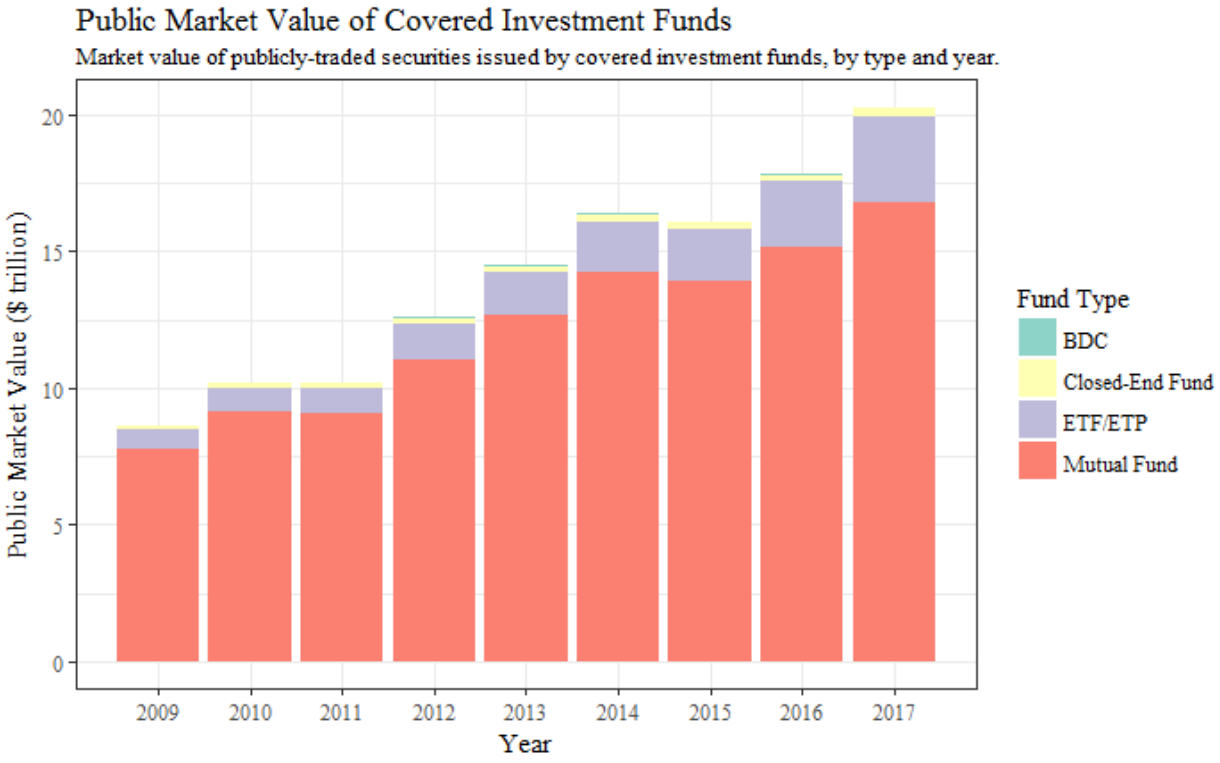

Figure 2: Market value of publicly-traded securities issued by covered investment funds. Valuation data based on CRSP mutual fund database, CRSP monthly stock file, Compustat, and Audit Analytics; *see supra* note 200.

Covered investment fund shares represent a significant fraction of investment assets held by U.S. residents. Approximately one-third of U.S. corporate equity issues, one-quarter of U.S. municipal securities, one-fifth of corporate debt, one-fifth of U.S. commercial paper, and one-tenth of U.S. treasury and agency securities are held through covered investment funds.[201] Mutual funds comprise the bulk (84%) of covered investment funds.[202] Nearly half of U.S.

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[201] *See* Investment Company Institute, 2017 Investment Company Fact Book (2017), *available at* http://www.icifactbook.org/ ("ICI Fact Book").

[202] *See supra* note 200.

households hold mutual fund shares[203] and the vast majority (89%) of mutual fund shares are held through retail accounts (*i.e.* accounts of retail investors, or households).[204] Consequently, at least 75% of the public market value of all covered investment funds are held through retail accounts. By analyzing institutional holdings from year-end 2016 Form 13F filings we estimate that across ETF and ETPs, the mean institutional holding[205] was 50%.[206] For BDCs, we estimate the mean institutional holding was 33%, while for closed-end funds, we estimate the mean institutional holding was 23%. Based on these figures, we further estimate that shares representing 87% of the public market value of all covered investment funds are held through retail accounts. [207]

As depicted in Figure 3, the covered investment fund market is dynamic. In 2017, 638 covered investment funds were created, while 853 were closed or merged into other covered

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[203] *See* Investment Company Institute, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet* (2017), *available at* https://www.ici.org/pdf/per23-07.pdf.

[204] Percentage by value. *See* ICI Fact Book, *supra* note 201, at 30. Excluding money market funds ("MMF"), mutual fund shares held in retail accounts make up an even larger fraction (95%) of mutual fund shares.

[205] We calculated "institutional holding" as the sum of shares held by institutions (as reported on Form 13F filings) divided by shares outstanding (as reported in CRSP).

[206] Year-end 2016 Form 13F filings were used to estimate institutional ownership. Closed-end funds were matched to reported holdings based on CUSIP. We note that there are long-standing questions around the reliability of data obtained from 13F filings. *See* Anne M. Anderson, & Paul Brockman, *Form 13F (Mis)Filings*, SSRN Scholarly Paper. Rochester, NY: Social Science Research Network (Oct. 15, 2016), *available at* https://papers.ssrn.com/abstract=2809128. *See also* Securities and Exchange Commission, Office of Inspector General, Office of Audits, Review of the SEC's Section 13(f) Reporting Requirements (2010).

[207] Staff calculated the percentage of net asset value held by institutions reported on Form 13F for ETFs, ETPs and BDCs as public market value of shares held by institutions divided by public market value of all shares. Mutual funds shares are generally not required to be reported on Form 13F. We estimate institutional ownership of non-MMF mutual funds using ICI Fact Book estimate (95%). *See supra* note 204 and accompanying text.

investment funds.[208]

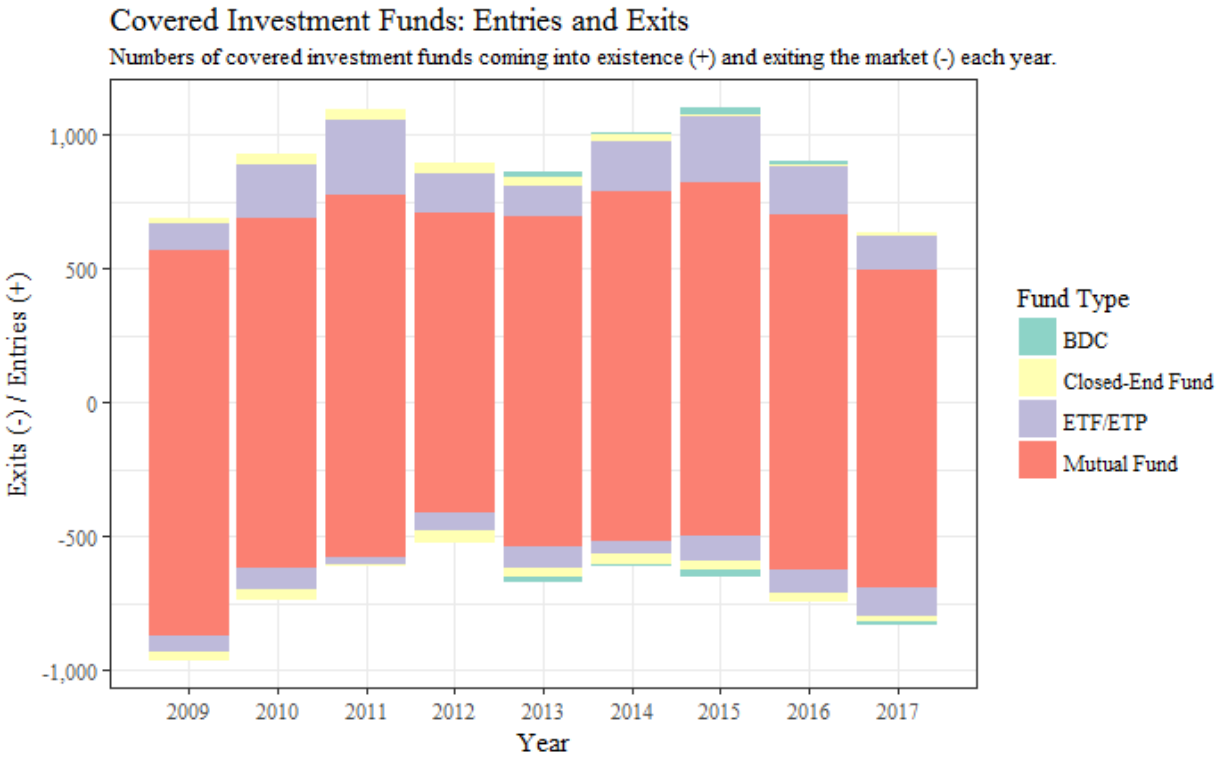

Figure 3: Entries and exits of covered investment funds. Counts based on CRSP mutual fund database, CRSP monthly stock file, and Commission's listing of BDC registrants; see supra note 199. BDC data begins in 2013.

We are requesting comments on our characterization of the covered investment fund market and data to help us further describe this market and current market practices.

- Do commenters agree with our characterization of the covered investment fund market? Do commenters agree with our characterization of ownership patterns? Are there ways to improve our estimates?

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[208] *See supra* note 199.

- Do commenters believe that our estimates of institutional ownership of covered investment funds are accurate? If not, are there ways to improve our estimates? Do commenters believe that our estimates of institutional ownership of different types of covered investment fund shares (*e.g.*, mutual funds, ETFs, ETPs, BDCs) include shares held in street name where the beneficial owners are retail investors?
- Do commenters believe that our estimates of institutional holdings of covered investment funds represent securities held for investment or securities held for other purposes *(e.g.* market-making inventory, proprietary trading)?

b. Broker-Dealers

The broker-dealers directly affected by the proposed rules are those who participate in registered offerings of covered investment funds while at the same time publishing or distributing information about those funds. The Commission does not have comprehensive data on the number or characteristics of broker-dealers currently publishing and distributing communications about covered investment funds, the extent of their communications, and their distribution arrangements with covered investment funds. Therefore we rely on inferences based on the data that are available[209] and make certain assumptions when characterizing the baseline.

[209] We rely here primarily on broker-dealers' quarterly FOCUS reports.

We believe that broker-dealers that do not derive revenues from the distribution of covered investment funds are less likely to be directly affected by the proposed rules.[210] As discussed above, registered investment companies represent the vast majority of covered investment funds.[211] Broker-dealers report revenues from the distribution of investment company shares in regulatory filings,[212] and we use this to estimate broker-dealers' revenues from distribution of covered investment funds. We estimate that for the 3,882 broker-dealers active in 2017, revenues related to distribution of covered investment funds exceeded $28 billion, or 9% of total broker-dealers' revenues. Of these 3,882 broker-dealers, 1,417 reported revenues from the distribution of investment company shares. These 1,417 "affected" broker-dealers accounted for 74% of total broker-dealer revenues and 59% of total broker-dealer assets.[213] As shown in Figure 4, among the affected broker-dealers, the importance of revenues from the distribution of covered investment funds varies widely.[214] However, in aggregate, these revenues accounted for 13% of affected broker-dealers' total revenues.[215] For comparison, among the affected broker-dealers, revenues from brokerage trading commissions and account

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[210] We believe that broker-dealers that do not participate in the distribution of covered investment funds are less likely to publish or distribute research reports about such funds and—to the extent that they do—may not derive significant benefits from the safe harbor of proposed rule 139b.

[211] *See supra* section III.B.1.a.

[212] The sum of FOCUS Supplemental Statement of Income items: 13970 ("revenues from sales of investment company shares"), 11094 ("12b-1 fees"), and 11095 ("mutual fund revenue other than concessions or 12b-1 fees").

[213] We describe these dealers as "affected," but note that the degree to which they are affected will vary based on individual characteristics. Other things being equal, we expect broker-dealers that are currently more active in the marketing of covered investment funds would be more affected.

[214] This suggests that the degree to which the "affected" broker-dealers are affected by the proposed rule will also vary widely.

[215] Estimates are based on staff analysis of FOCUS filings.

management accounted for 9%, and 20% of total revenues, respectively, while revenues from propriatery trading and underwriting accounted for 4% and 8% of total revenues, respectively.

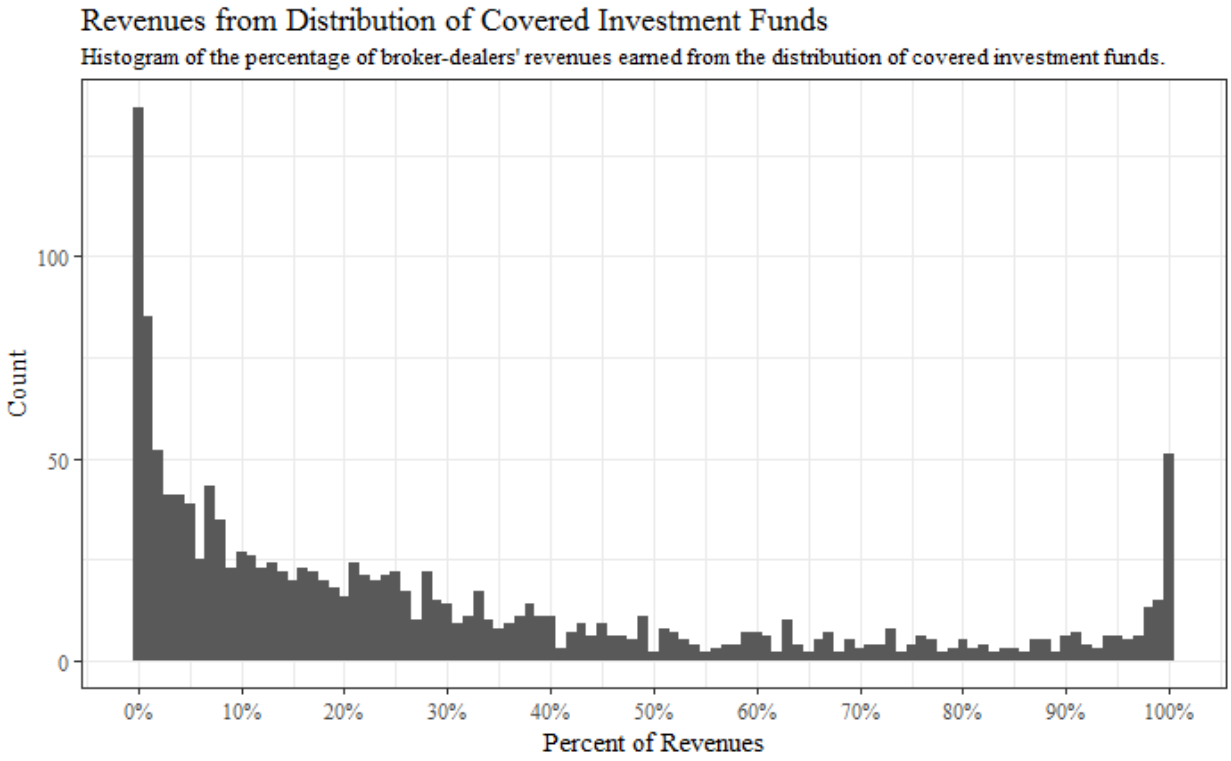

Figure 4: Affected Broker-Dealers' Revenues from Distribution of Covered Investment Funds (estimated). Histogram of the percentage of broker-dealer revenue attributable to distribution of covered investment funds (proxied by commissions on sales of investment company shares).

We are seeking comment on our assumptions used in characterizing this market.

- Do commenters agree with our estimates of the immediately-affected broker-dealers based on revenue from sales of investment company shares? If not, what other proxy would be more appropriate?

c. Research on Covered Investment Funds

The Commission does not have comprehensive data on broker-dealers that publish or distribute research reports on entities that would be included within the definition of "covered investment fund" under proposed rule 139b.[216] The Commission estimates that in 2017, there were 1,417 broker-dealers that reported revenues from the distribution of covered investment funds.[217] We assume that these broker-dealers would have incentives to publish or distribute research reports about covered investment funds. However, due to the large number of covered investment funds, we do not expect that many broker-dealers' in-house research departments (if they have such departments) are currently capable of providing research on a large percentage of covered investment funds.

As discussed above, "research reports" pertaining to most covered investment funds are not specifically addressed in existing Commission or SRO rules.[218] Consequently, it is not possible to identify which broker-dealer communications under the baseline would be considered "research reports" as defined in proposed rule 139b. However, we understand that some broker-dealers have published and distributed communications styled as "research reports" in compliance with rule 482 under the Securities Act.[219] FINRA member firms—the vast majority[220] of broker-dealers—file these communications with FINRA.[221] The number of

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216 *See supra* section III.B.1.b.

217 *See id.*

218 *See supra* note 174 and accompanying text.

219 *See supra* note 101.

220 Based on staff analysis of FOCUS filings, we estimate that as of year-end 2016, there were 3,882 registered broker-dealers, 3,755 of which were members of FINRA.

communications filed with FINRA help to provide a baseline estimate of the number of communications currently published or distributed by broker-dealers that could potentially be considered "research reports" under proposed rule 139b. FINRA staff have reported reviewing 47,707 filings subject to rule 482 in 2017. FINRA staff reviewed an additional 8,528 communications that are subject to Investment Company Act rule 34b-1, for a total of 56,235 communications.[222] There are several factors that limit our ability to extrapolate from these estimates the number of communications that broker-dealers currently publish or distribute that would satisfy the definition of "covered investment fund research report" under proposed rule 139b. First, these data do not reflect the affiliate exclusion incorporated in the proposed rule 139b definition of "covered investment fund research report," which would have the effect of excluding from the proposed safe harbor research reports that are published or distributed by persons covered by the affiliate exclusion.[223] Second, the data do not include communications about entities that would be considered "covered investment funds," but that do not need to comply with the requirements of rule 482 (*e.g.*, commodity- or currency-based trusts or funds). Third, for those communications that are currently filed as rule 482 advertising prospectuses or rule 34b-1 supplemental sales literature, we are uncertain what percentage of these

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[221] *See supra* note 181 and accompanying text.

[222] Under rule 34b-1, "sales literature" required to be filed by section 24(b) shall have omitted to state a fact necessary in order to make the statements made therein not materially misleading unless the sales literature includes certain specified information. *See* rule 34b-1 [17 CFR 270.34b-1]; *see also supra* notes 144-145 and accompanying text.

Of the 47,707 filings subject to rule 482, 229 were also subject to rule 34b-1. These 229 are not included in the 8,528 figure. Statistics provided by FINRA.

[223] *See supra* note 36 and accompanying text.

communications brokers dealers would continue to structure as rule 482 advertising prospectuses or rule 34b-1 supplemental sales literature, as opposed to publishing or distributing them as covered investment fund research reports under the proposed rule 139b safe harbor.

We have also analyzed the number of "research reports" as defined under FINRA rules 2241 and 2242 that FINRA staff reviewed in 2017. However, for reasons discussed below, we also believe that these data have limited value in assessing the number of covered investment fund research reports whose publication or distribution could be eligible for the safe harbor under proposed rule 139b. FINRA reviewed 354 filings in 2017 that were identified as "research reports" as defined in FINRA rules 2241 and 2242. However, the definitions of "research report" and "debt research report" under FINRA rules 2241 and 2242, respectively, do not correspond in every respect to the term "research report" as defined in the FAIR Act and proposed rule 139b.

Under FINRA rule 2241, the term "research report" includes any written communication that includes an analysis of equity securities (other than mutual fund securities) and that provides information reasonably sufficient upon which to base an investment decision.[224] Under FINRA rule 2242, the term "debt research report" includes any written communication that includes an analysis of a debt security or an issuer of a debt security and that provides information reasonably sufficient upon which to base an investment decision.[225] As discussed above, the FAIR Act and proposed rule 139b definition of "research report" would not require a

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[224] *See* FINRA rule 2241(a)(11).

[225] *See* FINRA rule 2242(a)(3).

communication to provide information reasonably sufficient upon which to base an investment decision.[226] Also, unlike the definition of "research report" in FINRA rule 2241, the FAIR Act and proposed rule 139b definitions of "research report" would include communications about mutual funds. Thus, while the number of "research reports" as defined in FINRA rules 2241 and 2242 that FINRA staff has historically reviewed provides an estimate of a subset of communications currently being styled as research reports whose publication or distribution could be eligible for the proposed rule 139b safe harbor, this number would represent only a small portion of the complete universe of research reports whose publication or distribution could be eligible for this safe harbor. We also understand that the reported number of "research reports" as defined in FINRA rules 2241 and 2242 that FINRA staff has historically reviewed also could relate to research reports for securities products other than entities that would be considered "covered investment funds" (*e.g.*, certain stocks, bonds, or master limited partnership interests).

In addition to broker-dealers, various firms that are independent of the offering process currently provide data and analysis on different subsets of the covered investment fund universe (*e.g.*, through subscription services or through licensing agreements with broker-dealers). Because data and analysis provided by these firms play an important role in investors' information environment under the baseline, these firms would be affected by changes to the competitive environment resulting from the proposed rules.[227] We understand that

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[226] *See supra* note 44 and accompanying text.

[227] *See infra* section III.C.5.

communications styled as research reports on covered investment funds distributed by broker-dealers may rely on information obtained from these independent sources. In particular, we understand that information that is commonly provided by these independent firms may include: (1) information obtained from regulatory filings, such as narrative descriptions of fund objectives, information about key personnel, performance history, fees, and top holdings; (2) statistics and other information derived from public, proprietary, and licensed data sources, such as risk exposures (*e.g.*, geographic, sectoral), quantitative characteristics (*e.g.*, beta, correlations, tracking error), and peer group; and (3) fund ratings. The fund ratings that independent firms may provide are generally based on methodologies proprietary to each firm.[228]

We are seeking comment on our characterization of the market for research reports on covered investment funds.

- What other data are available on broker-dealers' current publication or distribution of research reports on entities that would be included within the definition of "covered investment fund" under proposed rule 139b? On the scope of their coverage? On their consumers?
- Do commenters agree with our characterization of the data and analysis on covered investment funds that is provided by independent (non-broker-dealer) research firms?

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[228] *See, e.g.*, Zacks Investment Research, *ETF Rank Guide* (Mar. 12, 2013), *available at* https://www.zacks.com/stock/news/94561/zacks-etf-rank-guide; Morningstar, *Morningstar's Two Rating for Assessing a Fund* (2014), *available at* http://corporate1.morningstar.com/Documents/UK/Landing/Morningstars-Two-Ratings-For-Assessing-A-Fund/ ; and McGraw Hill Financial, *S&P Capital IQ's Mutual Fund Ranking Methodology*, *available at* https://marketintelligence.spglobal.com/documents/products/Mutual_Fund_Methodology_v2.pdf.

Are there significant gaps or limitations to the information and analysis on covered investment funds provided by such firms?

2. Regulatory Structure

a. Current Legal and Regulatory Framework Applicable to Statements Included in Covered Investment Fund Research Reports

As discussed above, the rule 139 safe harbor is currently not available for broker-dealers that publish or distribute research reports about most covered investment funds.[229] A broker-dealer's publication or distribution of a covered investment fund research report could therefore be deemed to constitute an offer that otherwise could be a non-conforming prospectus whose use in the offering may violate section 5 of the Securities Act.[230] We understand that some broker-dealers currently publish and distribute communications styled as "research reports" regarding covered investment funds in compliance with rule 482 under the Securities Act.[231] Unlike research reports covered under the rule 139 safe harbor, broker-dealers' publication or distribution of rule 482 advertisements could subject the broker-dealer to liability under section

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229 Among covered investment funds, only issuers that register their offerings under the Securities Act (certain commodity and currency ETPs eligible to use Form S-3) qualify for inclusion in research reports under the rule 139 safe harbor. *See supra* note 11-15 and accompanying text.

230 *See supra* note 13 and accompanying text.

231 Research reports regarding covered investment funds could also be distributed today as "supplemental sales literature" under rule 34b-1 under the Investment Company Act. However, research reports distributed under rule 34b-1 would need to be preceded or accompanied by a statutory prospectus. *See supra* note 144 and accompanying text.

12(a)(2) of the Securities Act [232] In addition, rule 482 advertisements are subject to requirements on the standardized presentation of performance information.[233]

Additionally, certain SRO rules governing content standards may apply to communications that would be considered covered investment fund research reports under proposed rule 139b or advertisements styled as "research reports" under rule 482. These include FINRA rule 2210 which contains general content standards that apply broadly to member communications.[234] In addition, covered investment fund research reports pertaining to funds other than open-end registered investment companies that are not listed or traded on an exchange (*i.e.*, ETFs, ETPs, closed-end funds, and BDCs) may be subject to FINRA rules 2241 and 2242 governing content standards of "research reports" as defined by FINRA.[235]

Exposure to liability under section 12(a)(2) of the Securities Act, rule 482 requirements on the standardized presentation of performance information, and the various aforementioned FINRA rules impose costs on broker-dealers. These include conduct costs resulting from additional liability (*e.g.* foregoing publication of certain reports), and compliance costs

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[232] Section 12(a)(2) provides express remedies to the person purchasing the security (*i.e.*, a private right of action) for material misstatements and omissions made by any seller of the security. It also provides a different standard for claims for damages than under Exchange Act rule 10b-5, which requires proof of scienter in the representations made. *See* 15 U.S.C. 77l(a)(2); *see also* rule 10b-5 [17 CFR 240.10b-5].

[233] Research reports that are published or distributed as rule 34b-1 supplemental sales literature also would be subject to requirements relating to the standardized presentation of performance information, because rule 34b-1 incorporates many of the rule 482 requirements relating to performance disclosure. *See supra* notes 231, 145.

[234] *See* FINRA rule 2210(d)(1).

[235] *See supra* note 174 (discussing the scope of these rules in more detail, including noting that the scope of FINRA rules 2241(c)(1) and 2242(c)(2) generally apply only to a subset of communications that would be considered covered investment fund research reports under proposed rule 139b).

associated with the relevant content standards. We are not able to quantify these costs and are seeking comments on our characterization of these costs:

- What do commenters view as the most significant costs associated with distributing and publishing research reports on covered investment funds under existing regulation? Can commenters quantify these costs?

b. Current Filing Requirements

As discussed above, the rule 139 safe harbor currently is not available for broker-dealers' publication and distribution of research reports about specific registered investment companies and BDCs.[236] Therefore, a research report or other communication about a covered investment fund that is a registered investment company would have to comply with the requirements of Securities Act rule 482.[237] Today, registered investment company sales material, including rule 482 "omitting prospectus" advertisements as well as supplemental sales literature,[238] are required to be filed with the Commission under section 24(b) of the Investment Company Act.[239] Broker-dealers that are FINRA members are also subject to certain additional filing requirements under current FINRA rule 2210.[240]

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[236] *See supra* note 15.

[237] *See* FINRA rule 2210(d)(5) (providing that non-money market fund open-end management company performance data as permitted by rule 482 in retail communications and correspondence must disclose standardized performance information and, to the extent applicable, certain sales charge and expense ratio information); *see also supra* note 178.

[238] *See supra* note 231.

[239] Rule 24b-3 under the Investment Company Act deems these materials to have been filed with the Commission if filed with FINRA. *See supra* note 29.

[240] FINRA rule 2210's filing requirements include a number of exclusions, including an exclusion for certain research reports, except that broker-dealers are required to file research reports with FINRA if they are also

C. Costs and Benefits

In this section, we first consider the overarching costs and benefits associated with the FAIR Act's statutory mandates. Second, we evaluate the costs and benefits of the specific proposed provisions and their relation to the overarching considerations resulting from the statutory mandate. Next, we discuss the effects on efficiency, competition, and capital formation of the proposed rules. We conclude with a discussion of alternatives considered.

1. FAIR Act Statutory Mandate

a. Benefits

We believe that the proposed expansion of the rule 139 safe harbor (as mandated by the FAIR Act) will generally reduce broker-dealers' costs of publishing and distributing research reports about covered investment funds. These cost reductions are expected because under the proposed rules a broker-dealer could publish or distribute covered investment fund research reports without reliance on rule 482 or rule 34b-1 and without being required to file these reports under section 24(b) of the Investment Company Act and the rules and regulations thereunder.[241] Broker-dealers publishing or distributing covered investment fund research reports in reliance on the expanded safe harbor would not be subject to the liability provisions of section 12(a)(2) of the Securities Act,[242] the content requirements of rule 482 or rule 34b-1, or the filing

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required to be filed with the Commission pursuant to section 24(b) of the Investment Company Act. *See supra* notes 167–169, and accompanying text.

241 *See supra* section II.D.1.

242 *See supra* note 232.

requirements of section 24(b) of the Investment Company Act.[243] Thus, they would be expected to incur lower costs associated with liability under section 12(a)(2), lower conduct costs, and lower compliance costs (including fewer content and filing requirements).[244] Because of these cost reductions, we expect publication and distribution of such reports to increase. First, we expect that certain broker-dealers that had previously published and distributed communications under rule 482 that could be styled as "research reports" would aim to meet the conditions of the expanded safe harbor and increase their supply of covered investment fund research as a result. Second, we expect some broker-dealers that have previously not published or distributed such reports (due to the activity being deemed too costly or subject to too many restrictions), to begin doing so. We believe that the aforementioned effects will generally benefit broker-dealers and advisers to covered investment funds if, as we expect, they increase broker-dealers' sales of covered investment funds.

Because there is limited historical experience dealing specifically with broker-dealers' research reports on covered investment funds, there is little in the way of direct empirical evidence on the value of such reports to investors. Prior research on the informativeness of broker-dealers' research on operating companies suggests that broker-dealers can produce research that positively contributes to the information content of market prices,[245] and—perhaps

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243 *See supra* section II.D.1.

244 We note, however, that we would not expect any lower costs of compliance for any research reports that currently are structured as rule 34b-1 supplemental sales literature (and are not rule 482 advertising prospectuses), because supplemental sales literature is not an "offer" to which prospectus liability under section 12(a)(2) of the Securities Act would attach.

245 *See, e.g.*, Brad M. Barber, Reuven Lehavy, & Brett Trueman, *Ratings changes, ratings levels, and the predictive value of analysts' recommendations*, 39 Financial Management 2, 533–553 (2010) (broker-dealers'

more importantly—that broker-dealers may enjoy a comparative advantage in its production.[246] However, other studies have questioned the investment value of such research to investors[247] or its continued relevance.[248]

We are cautious in drawing implications from these findings to broker-dealers' research on covered investment funds. While analysts researching operating companies generally endeavor to identify mispricing—to forecast the idiosyncratic component of firms' future returns—covered investment funds represent portfolios of securities, and many covered investment funds are priced at net asset value ("NAV").[249] Although individual securities within

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research analysts' upgrades (downgrades) elicit positive (negative) price reactions, respectively). *See also* Scott E. Stickel, *The Anatomy of the Performance of Buy and Sell Recommendations*, 51 Financial Analysts Journal 5, 25–39 (Sept. 1, 1995) (broker-dealers' research provides new information, particularly for smaller firms, where information is less generally available). *See also* Kent L. Womack, *Do Brokerage Analysts' Recommendations Have Investment Value?*, 51 The Journal of Finance 1, 137–167 (1996) (price reactions are permanent and exhibit post-announcement drift).

246 *See*, Boris Groysberg, Paul Healy & Craig Chapman, *Buy-Side vs. Sell-Side Analysts' Earnings Forecasts*, 64 Financial Analysts Journal 4, 25–39 (July 1, 2008) (informativeness of broker-dealers' sell-side research is superior to that of buy-side firms).

247 *See* Brad Barber, Reuven Lehavy, Maureen McNichols & Brett Trueman, *Can Investors Profit from the Prophets? Security Analyst Recommendations and Stock Returns*, 56 The Journal of Finance 2, 531–563 (Apr. 1, 2001) (investors hoping to exploit research analysts' recommendations must trade frequently and these transaction costs often exceed the gains from trading); *see also* Xi Li, *The persistence of relative performance in stock recommendations of sell-side financial analysts*, Journal of Accounting and Economics 40.1-3, 129–152 (2005). *See also* Narasimhan Jegadeesh, Joonghyuk Kim, Susan D. Krische & Charles M. C. Lee, *Analyzing the Analysts: When Do Recommendations Add Value?*, 59 The Journal of Finance 3, 1083–1124 (2004) (significant portion of investment value may be attributable to previously documented trading signals, with little incremental value attributable to the broker-dealer research). *See also* Yongtae Kim & Minsup Song, *Management Earnings Forecasts and Value of Analyst Forecast Revisions*, 61 Management Science 7, 1663–1683 (2015) (past estimates of the informativeness of analyst recommendations may be confounded by the impact of forecasts issued by management).

248 *See* Oya Altınkılıç, Robert S. Hansen & Liyu Ye, *Can analysts pick stocks for the long-run?*, 119 Journal of Financial Economics 2, 371–398 (Feb. 2016) (reductions in transactions costs and increases in computational speed reduced the amount of new information available for analysts to discover).

249 Closed-end funds, for example, are not priced on a NAV basis and their (mis-) pricing has long served as a puzzle in the finance literature. *See, e.g.*, Charles M.C. Lee, Andrei Schleifer, & Richard H. Thaler, *Investor*

a covered investment fund's portfolio may be individually viewed as "mispriced" by a research analyst, diversification effects will tend to drown out such effects at the fund level and minimize idiosyncratic variation in investors' return on their investment in the fund. Therefore, any "investment value"[250] of research on covered investment funds would likely be rooted in analysts' ability to predict broader market movements. Such ability is generally believed to be rather rare.[251] We therefore believe that the value to investors of information in broker-dealers' research reports will largely be limited to the synthesis or discovery of factual information about fund characteristics, fees, or other transactions costs. For example, investors may find analysts' views of a fund's management, objectives, risk exposures, tracking error, volatility, tax efficiency, fees, or other fund characteristics to be valuable. Such analysis could be valuable a source of information for investors evaluating relative fund performance.[252]

We believe that the quantity of information available to potential investors of covered investment funds would increase as a result of broker-dealers' increased publication and distribution of covered investment fund research reports. The proposed rules will also allow for greater flexibility in the type of information that broker-dealers may communicate to

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Sentiment and the Closed-End Fund Puzzle, 46 The Journal of Finance 1 (Mar. 1991). Similar pricing issues may arise in BDCs.

250 We mean this in the sense of providing a signal about future investment performance.

251 *See, e.g.*, Kent Daniel , Mark Grinblatt, Sheridan Titman, & Russ Wermers, *Measuring Mutual Fund Performance with Characteristic-Based Benchmarks*, 52 The Journal of Finance 3, 1035–1058 (July 1997).

252 *See, e.g.*, W. J. Armstrong, Egemen Genc & Marno Verbeek, *Going for Gold: An Analysis of Morningstar Analyst Ratings*, Management Science (Aug. 2017).

customers.[253] To the extent that this new information is valuable, it will benefit investors by providing them with additional information to help shape investment decisions. Finally, we believe that important negative information about a covered investment fund, such as high fees, high risk exposure, or an inefficient portfolio strategy will be more likely to be publicized as a result of increased competition among information providers, with attendant benefits to investors.[254]

We request comment generally on the benefits that we anticipate may arise from proposed rule 139b and proposed rule 24b-4 as a result of the FAIR Act's statutory mandate.

- Do commenters generally agree with our assessment of the cost reductions that we expect to result from the proposed rules?
- To what extent would broker-dealers rely on the proposed rule 139b safe harbor to publish or distribute communications that are currently structured as rule 482 advertising prospectuses or rule 34b-1 supplemental sales literature? What would motivate broker-dealers to instead use the proposed rule 139b safe harbor? For example, would broker-dealers expect to incur significantly lower legal and compliance costs and lower costs related to potential litigation due to covered investment fund research reports' lack of prospectus liability under section 12(a)(2) of the Securities Act under the safe harbor? Alternatively, would

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[253] Currently such communications would be subject to rule 482 requirements, including standards on the presentation of performance information. *See supra* section II.C.

[254] *See* Matthew Gentzkow & Jesse M. Shapiro, *Media Bias and Reputation*, 114 Journal of Political Economy 2, 280–316 (Apr. 1, 2006).

the primary cost savings arise in other ways (for example, because covered investment fund research reports would not be subject to section 24(b) filing requirements, including filing and review by FINRA, and would not be subject to the content requirements of rule 482 or rule 34b-1)? What other factors could determine whether a broker-dealer that is currently publishing or distributing communications under rule 482 or rule 34b-1 might continue to do so, even if these communications could fall within the definition of a "covered investment fund research report"?

- Have we appropriately captured the potential benefits that the proposed rule could generate for investors?

b. Costs

Prior experience and academic research suggests that, unchecked, broker-dealers' conflicts of interest can lead to bias in research reports,[255] and that such bias has the potential to adversely affect investor welfare.[256] Broker-dealers' financial incentives to sell covered

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[255] *See* Amitabh Dugar & Siva Nathan, *The Effect of Investment Banking Relationships on Financial Analysts' Earnings Forecasts and Investment Recommendations**, 12 Contemporary Accounting Research 1, 131–160 (Sept. 1, 1995) ("Dugar and Nathan Article") (affiliated analysts issue more optimistic earnings forecasts and investment recommendations about companies with which their firms had an investment banking relationship). *See also* Hsiou-wei Lin & Maureen F. McNichols, *Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations*, 25 Journal of Accounting and Economics 1, 101–127 (Feb. 26, 1998) ("Lin and McNichols Article") (affiliated analysts are more optimistic in their long-term growth forecasts and investment recommendations).

[256] *See* Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 The Review of Financial Studies 4, 653–686 (July 2, 1999) ("Michaely and Womack Article") (stock recommendations of affiliated analysts perform worse prior to, at the time of, and subsequent to the recommendation); *see also* Patricia M.Dechow, Amy P. Hutton & Richard G. Sloan, *The Relation between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings**, 17 Contemporary Accounting Research 1, 1–32 (Mar. 1, 2000). *See also* Lit. Rel. No. 18438, *supra* note 37 (The court issued an Order approving a $1.4 billion global settlement of the SEC enforcement actions against

investment funds could undermine the objectivity of the information they produce about such funds, and the existence of the proposed safe harbor could increase opportunities for broker-dealers to promote funds from which they derive the most financial benefits. If such conflicts are unrecognized by or unknown to investors, they could reduce investor welfare. Although market mechanisms[257] as well as existing regulation[258] may limit the extent of such actions, there is the potential that they could nonetheless impose costs on investors—particularly retail investors.[259]

The potential for conflicts of interest to lead to actions that impose costs on investors depends in large part on the strength of the underlying incentives. In the context of broker-dealers' research on covered investment funds, the greatest conflicts of interest are faced by broker-dealers serving as investment advisers to covered investment funds, who—due to asset-based management fees—have strong incentives to increase demand for the funds that they advise. Because the FAIR Act by its terms,[260] and also proposed rule 139b,[261] would not extend the safe harbor to a broker-dealer that is publishing or distributing a research report about a

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several investment firms and certain individuals alleging undue influence of investment banking interests on securities research); *see also* Deutsche Bank Securities Inc. and Thomas Weisel Partners LLC Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking, SEC Press Release 2004-120 (Aug. 26, 2004). The settlement was an action in response to conflicts of interest that certain broker-dealers were found to have failed to manage in an adequate or appropriate manner and was modified in 2010 to remove certain requirements where FINRA and NYSE rules addressed the same concerns. *See* Lit. Rel. No. 21457, *supra* note 37.

257 *See infra* section III.C.1.b(2).

258 *See infra* section III.C.1.b(1).

259 *See infra* section III.C.1.b(2).

260 *See* section 2(f)(3) of the FAIR Act.

261 *See* proposed rule 139b(a).

covered investment fund for which the broker-dealer serves as an investment adviser (or where the broker-dealer is an affiliated person of the investment adviser), we believe that there would be limited potential for the greatest conflicts of interest to impose costs on investors.

Other conflicts of interest may nevertheless arise from incentives in fund distribution arrangements.[262] Distributing broker-dealers may receive compensation from sales loads, 12b-1 fees,[263] shelf space fees, or other revenue sharing agreements, all of which create financial incentives for broker-dealers to promote and sell funds and potentially to promote and sell particular funds or share classes.[264] Associated persons of broker-dealers (*i.e.* analysts) may face similar conflicts of interests arising from incentives in their compensation agreements.[265] Finally, broker-dealers may have fewer direct or non-pecuniary incentives.[266] However, in all of

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[262] *See* Susan E. K. Christoffersen, Richard Evans & David K. Musto, *What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives*, 68 The Journal of Finance 1, 201–235 (Feb. 1, 2013) (where brokers' compensation arrangements with funds are found to drive their customers' fund flows).

[263] *See* rule 12b-1 under the Investment Company Act [17 CFR 270.12b-1].

[264] *See infra* note 278 (noting that the Commission has historically charged broker-dealers with violating sections 17(a)(2) and (3) of the Securities Act for making recommendations of more expensive mutual fund share classes while omitting material facts).

[265] Such conflicts of interest arising from incentives in compensation agreements involving research analyst issuing research reports covered by FINRA Rule 2241 are mitigated by FINRA rules 2241(b)(2)(C), (E), (F), and (K). Additionally, section 501(a)(2) of Regulation AC (17 CFR 242.501(a)(2)) requires specific disclosure regarding research analyst compensation in order to mitigate the conflicts of interest that can arise based on analyst compensation arrangements.

[266] For example, although it is prohibited conduct, a broker-dealer may have a financial incentive to provide coverage for, or to promote, a fund based on an understanding that the fund will participate in offerings underwritten by the broker-dealer. *See, e.g.*, FINRA rule 2241(b)(2) (requiring that a member's written policies and procedures must be reasonably designed to, among other things, "prevent the use of research reports or research analysts to manipulate or condition the market or favor the interests of the member"); *see also* NASD Fines U.S. Bancorp Piper Jaffray and Managing Director $300,000, FINRA News Release (June 25, 2002) *available at* http://www.finra.org/newsroom/2002/nasd-fines-us-bancorp-piper-jaffray-and-managing-director-300000 (announcing settlement with U.S. Bancorp Piper Jaffray and one of its managing directors in which the NASD found that the firm violated a NASD (now FINRA) rule requiring all firms and associated persons to adhere to high standards of commercial honor and just and equitable principles of trade when it threatened to discontinue

these cases, the risk that such conflicts of interest could result in actions that negatively impact information communicated to investors are mitigated by the fact that a broker-dealer will bear the costs of such actions, but generally may be unable to fully appropriate the benefits.[267]

It is difficult for us to quantify the aforementioned costs in the context of this proposal. We are not aware of any studies directly examining the role that conflicts of interest play in broker-dealers' research reports on covered investment funds in U.S. markets, or of any data that would support a quantitative analysis of an expanded safe harbor in this context.[268] As with the potential benefits discussed above, we are limited to characterizing the potential costs qualitatively. While we believe that expanding the rule 139 safe harbor to broker-dealers' publication or distribution of covered investment fund research reports has the potential to impose costs on retail investors, existing regulations, specific provisions of the rules that we are proposing,[269] and certain market mechanisms would reduce these costs.

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research coverage of a company if the company did not select it as lead underwriter for an upcoming offering). *But see also* note 43.

Rule 12b-1(h)(1) prohibits funds from compensating a broker-dealer for promoting or selling funds shares by directing brokerage transactions to that broker. *See* rule 12b-1(h)(1) under the Investment Company Act [17 CFR 270.12b-1(h)(1)]; *see also* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591 (Sept. 2, 2004) [69 FR 54727 (Sept. 9, 2004)].

267 For example, if a broker-dealer firm publishes biased research about a fund, some of the gains (*i.e.* compensation from sales of that fund) may accrue to other broker-dealer firms (*i.e.* other broker-dealer firms that distribute the same fund) while the costs of the action (*i.e.*, reputation costs, litigation risk, and risk of regulatory action) will be borne entirely by the broker-dealer firm that published the biased research.

268 Authors have examined the impact of conflicts of interest on mutual fund research in China, providing evidence consistent with bias arising from conflicts of interest in that market, though differences between Chinese and U.S. markets and corresponding regulatory frameworks make it difficult to apply inferences drawn from experience in Chinese markets to U.S. markets. *See* Y. Zeng, Q. Yuan & J. Zhang, *Blurred stars: Mutual fund ratings in the shadow of conflicts of interest*, Journal of Banking & Finance 60, 284–295 (2015).

269 *See infra* section III.C.2.

(1) Existing Regulation

Rules and regulations have been implemented to address potential conflicts of interest that may arise with broker-dealers specifically in the context of research reports.[270] As discussed in detail above,[271] the definition of "research report" for purposes of Regulation AC and FINRA rule 2241 is narrower than the definition of "research report" for purposes of the FAIR Act and proposed rule 139b. However, to the extent a research report meets both the definition of a research report under proposed rule 139b and the definition of research report as defined in Regulation AC, Regulation AC would be applicable to that research report (and, if it meets the definition of "research report" in FINRA rule 2241, FINRA rule 2241 also would apply if the research report otherwise were within the scope of rule 2241[272]). These rules may help promote objective and reliable research.[273]

Additionally, as described above, FINRA rule 2210 contains general content standards that apply broadly to member communications, including broker-dealer research reports. These general content standards require, among other things, that all member communications "must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a

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[270] *See supra* note 37.

[271] *See supra* notes 11, 21, 43, and 174.

[272] *See supra* note 174.

[273] *See* Regulation AC Adopting Release, *supra* note 37. Several studies have analyzed bias in broker-dealers' research following the Global Settlement and subsequent regulatory changes, in particular at sanctioned banks. *See* O. Kadan, L. Madureira, R. Wang, & T. Zach, *Conflicts of interest and stock recommendations: The effects of the global settlement and related regulations* 22 The Review of Financial Studies 10, 4189–4217 (2009). *See also*, S. A. Corwin, S. A. Larocque & M. A. Stegemoller, *Investment banking relationships and analyst affiliation bias: The impact of the global settlement on sanctioned and non-sanctioned banks*, 124 Journal of Financial Economics 3, 614–631(2017).

sound basis for evaluating the facts in regard to any particular security or type of security, industry or service."[274]

If a broker-dealer recommends[275] a covered investment fund to its customers, additional obligations under the federal securities laws and FINRA rules would apply. As a general matter, broker-dealers must deal with their customers fairly[276]—and, as part of that obligation, have a reasonable basis for any recommendation.[277] Furthermore, when making recommendations, broker-dealers may be generally liable under the antifraud provisions if they do not give "honest and complete information" or disclose any material adverse facts or conflicts of interest, including any economic self-interest.[278]

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[274] *See supra* section II.D.1.

[275] *See, e.g.*, Additional Guidance on FINRA's New Suitability Rule, FINRA Regulatory Notice 12-25 (May 2012), at Q.2 and Q.3 (regarding the scope of "recommendation") and n.25.

[276] *See, e.g.*, Duker & Duker, Exchange Act Release No. 2350 (Dec. 19, 1939), at 2 (Commission opinion) ("Inherent in the relationship between a dealer and his customer is the vital representation that the customer be dealt with fairly, and in accordance with the standards of the profession.").

[277] *See* Mac Robbins & Co., Exchange Act Release No. 6846 (July 11, 1962), at 3 ("[T]he making of representations to prospective purchasers without a reasonable basis, couched in terms of either opinion or fact and designed to induce purchases, is contrary to the basic obligation of fair dealing borne by those who engage in the sale of securities to the public."), *aff'd sub nom., Berko v. SEC*, 316 F.2d 137 (2d Cir. 1963). A broker-dealer's recommendation must also be suitable for the customer. *See, e.g.*, J. Stephen Stout, Exchange Act Release No. 43410 (Oct. 4, 2000), at 11 (Commission opinion) ("As part of a broker's basic obligation to deal fairly with customers, a broker's recommendation must be suitable for the client in light of the client's investment objectives, as determined by the client's financial situation and needs."); *see also* FINRA Rule 2111.05(b) ("The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile, as delineated in Rule 2111(a).").

[278] *See, e.g.*, *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970). Generally, under the antifraud provisions, whether a broker-dealer has a duty to disclose material information to its customer is based upon the scope of the relationship with the customer, which is fact intensive. *See, e.g.*, *Conway v. Icahn & Co., Inc.*, 16 F.3d 504, 510 (2d Cir. 1994) ("A broker, as agent, has a duty to use reasonable efforts to give its principal information relevant to the affairs that have been entrusted to it."). For example, where a broker-dealer processes its customers' orders, but does not recommend securities or solicit customers, then the material information that

(2) Market Mechanisms

We believe that by facilitating production of information on covered investment funds, the FAIR Act's mandates will contribute to competition among information providers,[279] which we believe can mitigate the effects of conflicts of interest on research reports.[280] With respect to broker-dealers' research on operating companies, analysts' career concerns[281] have also been found to have similar effects, and, in principle, broker-dealers' reputations could as well.[282] However, we do not believe that analyst career concerns or broker-dealer reputation will play as significant a role in the context of covered investment fund research reports. Research reports about operating companies have traditionally been provided to institutional investors as part of a

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the broker-dealer is required to disclose is generally narrow, encompassing only the information related to the consummation of the transaction. *See, e.g.*, *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999). The Commission has historically charged broker-dealers with violating sections 17(a)(2) and (3) of the Securities Act for making recommendations of more expensive mutual fund share classes while omitting material facts. *See, e.g.*, In re IFG Network Sec., Inc., Exchange Act Release No. 54127 (July 11, 2006), at 15 (Commission opinion) (registered representative violated 17(a)(2) and (3) by omitting to disclose to his customers material information concerning his compensation and its effect upon returns that made his recommendation that they purchase Class B shares misleading; "The rate of return of an investment is important to a reasonable investor. In the context of multiple-share-class mutual funds, in which the only bases for the differences in rate of return between classes are the cost structures of investments in the two classes, information about this cost structure would accordingly be important to a reasonable investor.").

279 *See infra* section III.C.5.

280 *See* Harrison Hong & Marcin Kacperczyk, *Competition and Bias*, 125 The Quarterly Journal of Economics 4, 1683–1725 (Nov. 1, 2010) (reduction in (analyst) competition resulting from mergers reduces analyst coverage and increases bias in the remaining coverage).

281 *See* Harrison Hong & Jeffrey D. Kubik, *Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts*, 58 *The Journal of Finance* 1, 313–351 (2003) (analysts' reputation plays a role in the analyst's career outcome); *see also* Andrew R. Jackson, *Trade Generation, Reputation, and Sell-Side Analysts*, 60The Journal of Finance 2, 673–717 (Apr. 1, 2005) *see also* Lily Fang & Ayako Yasuda, *The Effectiveness of Reputation as a Disciplinary Mechanism in Sell-Side Research*, 22 The Review of Financial Studies 9, 3735–3777 (Sept. 1, 2009) ("Fang and Yasuda Article")

282 For a discussion of the role of reputation in financial intermediation, *see* Thomas J. Chemmanur & Paolo Fulghieri, *Investment Bank Reputation, Information Production, and Financial Intermediation*, 49 The Journal of Finance 1, 57–79 (1994) ("Chemmanur and Fulghieri Article"). *See also* Fang and Yasuda Article, *supra* note 281 (analyst reputation mitigates bias, but institutional reputation does not).

bundle of services provided by full-service brokerages.[283] In this setting, broker-dealers benefit from institutional customers that are willing to pay for broker-dealers' additional services (*e.g.*, research).[284] They are also generally capable of producing similar reports, and so can evaluate the quality of broker-dealers' research.[285] Thus, institutional investors can provide market discipline: broker-dealers' provision of low-quality or misleading information could plausibly be discovered and lead to the loss of valuable customer relationships. We do not believe that similar mechanisms would be as effective in the covered investment fund context. We expect broker-dealers to publish and distribute covered investment fund research reports on funds that they distribute to their customers.[286] With retail investors, information asymmetries are greater: retail investors do not generally possess the capabilities to replicate an analyst report or evaluate its quality.[287] Moreover, the problem of evaluating the performance of analysts is harder in the context of covered investment funds.[288] Because institutional investors are not major investors

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283 *See* Mehran, Hamid, and René M. Stulz, *The Economics of Conflicts of Interest in Financial Institutions*, 85 Journal of Financial Economics 2, 267–296 (Aug. 1, 2007) ("Mehran and Stulz Article").

284 Institutional customers are valuable in that they are willing to pay for brokers-dealers' additional services (*e.g.* research). Payments for such services need not be direct and be reflected in (relatively) higher brokerage commissions. *See* Michael A. Goldstein, Paul Irvine, Eugene Kandel & Zvi Wiener, *Brokerage Commissions and Institutional Trading Patterns*, 22 The Review of Financial Studies 12, 5175–5212 (Dec. 1, 2009).

285 *See id. See also* Ulrike Malmendier & Devin Shanthikumar, *Are Small Investors Naive about Incentives?*, 85 Journal of Financial Economics 2, 457–489 (Aug. 1, 2007) ("Malmendier and Shanthikumar Article") (institutions account for bias in analyst's recommendations while retail investors do not).

286 *See supra* section III.B.1.c.

287 *See* Mehran and Stulz Article, *supra* note 283.

288 Traditional analyst research reports on operating companies largely focus on firm-specific factors, and thus are more akin to "stock picking" than "market timing": they attempt to forecast the idiosyncratic component of firms' future returns. Covered investment funds represent portfolios of securities and diversification effects reduce the amount of idiosyncratic variation in their returns. Thus, abstracting from fees, "fund picking" is more akin to "market timing" than "stock picking." Market timing is a skill that is relatively rare and econometrically difficult to detect. *See, e.g.*, Kent Daniel, Mark Grinblatt, Sheridan Titman & Russ Wermers.

in covered investment funds,[289] we believe they are unlikely to provide market discipline in this context,[290] and we do not believe that individual retail investors could be similarly effective in this role. Thus, we believe that in the context of covered investment fund research reports, providing market discipline would largely fall on retail investors' investment advisers.

We also acknowledge that bias resulting from conflicts of interest need not adversely impact investors if investors disregard,[291] discount,[292] or de-bias [293] the recommendations of conflicted analysts.[294] We believe however, that retail investors who are primary clientele for covered investment funds are less likely to be aware of potential bias in analysts' recommendations,[295] may fail to de-bias or otherwise condition their trades based on the

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Measuring Mutual Fund Performance with Characteristic-Based Benchmarks, 52 The Journal of Finance 3, 1035–1058 (July 1997).

289 *See supra* section III.B.1.a

290 *See* Alexander Ljungqvist, Felicia Marston, *et al.*, *Conflicts of Interest in Sell-Side Research and the Moderating Role of Institutional Investors*, 85 Journal of Financial Economics 2, 420–456 (Aug. 1, 2007) (securities of interest to institutional investor receive coverage that is less biased).

291 *See* Dugar and Nathan Article, *supra* note 255.

292 *See* Michaely and Womack Article, *supra* note 256.

293 *See* Lin and McNichols Article, *supra* note 255.

294 Institutional market participants generally attribute bias in sell-side analysts' research reports to conflicts of interest. *See* Michaely and Womack Article, *supra* note 256.

295 *See* Michael B. Mikhail, Beverly R. Walther & Richard H. Willis, *When Security Analysts Talk, Who Listens?*, 82 The Accounting Review 5, 1227–1253 (2007) ("Mikhail Walther and Willis Article"). *See also* Diane Del Guercio & Paula A. Tkac, *Star Power: The Effect of Morningstar Ratings on Mutual Fund Flow*, 43 Journal of Financial and Quantitative Analysis 4, 907–936 (Dec. 2008) (retail investors in mutual funds are very sensitive to fund rankings). *See* Christopher R. Blake & Matthew R. Morey, *Morningstar Ratings and Mutual Fund Performance*, 35 The Journal of Financial and Quantitative Analysis 3, 451–483 (2000) (mutual fund ranking have little predictive power for future performance).

credibility of the recommendation,[296] and could thus be led to invest in underperforming securities.[297]

We request comment generally on the costs that we anticipate may arise from proposed rule 139b and proposed rule 24b-4 as a result of the FAIR Act's statutory mandate.

- Do commenters generally agree with our assessment of the costs that we expect to result from the proposed rules?
- Do commenters expect conflicts of interest to materially affect research reports on covered investment funds? If so, in what way? If not, why not?

2. Proposed Rule 139b

As discussed above, proposed rule 139b conditions eligibility for the safe harbor on satisfaction of several conditions.[298] These conditions are generally modeled on and resemble similar provisions in rule 139 (with differences from rule 139 that the FAIR Act specifically directs, or that tailor the provisions of rule 139 more directly or specifically to the context of

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[296] *See id.* and Malmendier and Shanthikumar Article, *supra* note 285.

[297] *See* Mikhail Walther and Willis Article, *supra* note 295. *See also* Malmendier and Shanthikumar Article, *supra* note 285. *See also* Amanda Cowen, Boris Groysberg & Paul Healy, *Which Types of Analyst Firms Are More Optimistic?*, 41 Journal of Accounting and Economics 1, 119–146 (Apr. 1, 2006) (finding that analysts at retail brokerage firms are more optimistic than those serving only institutional investors). *See* Xuanjuan Chen, Tong Yao & Tong Yu, *Prudent Man or Agency Problem? On the Performance of Insurance Mutual Funds*, 16 Journal of Financial Intermediation 2, 175–203 (Apr. 1, 2007) (underperformance of mutual funds sponsored by insurance companies is attributed to inadequate monitoring by less sophisticated retail customers who are subject to cross-selling efforts by their insurer). *See also* Daniel Bergstresser, John M. R. Chalmers, and Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 Review of Financial Studies 10, 4129–4156 (Oct. 2009) (broker-sold mutual funds deliver lower risk-adjusted returns (even before subtracting distribution fees) than direct-sold funds). *See also* Diane Del Guercio & Jonathan Reuter, *Mutual Fund Performance and the Incentive to Generate Alpha*, 69 The Journal of Finance 4, 1673–1704 (Aug. 1, 2014) (underperformance of actively managed mutual funds is attributed to the underperformance of funds sold by brokers; the authors find little evidence for underperformance in the subset of funds that are sold directly to investors).

[298] *See supra* section II.B.

covered investment fund research reports).[299] We believe that modeling proposed rule 139b on rule 139 will benefit market participants through regulatory consistency and reduced opportunities for investor confusion. We address these conditions in turn in the sections that follow.

a. Affiliate Exclusion

Under the affiliate exclusion proposed in rule 139b,[300] a broker-dealer who is an affiliate of a covered investment fund (or is an investment adviser or an affiliated person of the investment adviser to a covered investment fund), would not be eligible for the safe harbor of proposed rule 139b when publishing or distributing a research report about that covered investment fund. The economic benefit of the affiliate exclusion is that it reduces the potential for retail investors to receive research reports containing information that was published, distributed, authorized, or approved by persons whose financial incentives create the greatest conflicts of interest.[301] The primary cost of the affiliate exclusion will be borne by broker-dealers that both distribute covered investment funds and act as investment advisers to such funds (or do so through affiliated persons). These broker-dealers will be unable to provide research reports to their customers on funds that they (or their affiliated persons) advise.[302] In addition, we believe that smaller broker-dealers, and broker-dealers without significant research departments and who would want to rely on pre-publication materials distributed by a covered

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299 *See supra* paragraph accompanying notes 32–34.

300 *See* section 2(f)(3) of the FAIR Act. *See supra* section II.A.1.

301 *See supra* section III.C.1.b.

302 *See supra* note 21.

investment fund, its adviser, or affiliated persons, would also be significantly affected by the proposed rules.

We expect covered investment funds and their investment advisers to engage in a broad range of marketing activities to support the distribution of fund shares (particularly in the case of redeemable securities such as those issued by mutual funds), and that funds and their advisers prepare and distribute materials to distributing broker-dealers intended to increase sales. As discussed in section II.A.1, we note that, if a broker-dealer were to publish or distribute a research report that were to include pre-publication materials that were specifically authorized or approved by a person covered by the affiliate exclusion for purposes of inclusion in a research report, this could inappropriately circumvent the affiliate exclusion. This guidance reduces the potential for retail investors to receive research reports containing materials from persons whose financial incentives create the greatest conflicts of interest.[303]

The proposed affiliate exclusion is also likely to limit the benefits of the proposed rule for certain broker-dealers. Many broker-dealers distributing covered investment fund securities do not have sizeable research departments, and we understand that very few broker-dealers operate at a scale that would allow for comprehensive coverage of the covered investment funds that they distribute. The proposed affiliate exclusion could have the effect of limiting broker-dealers' ability and willingness to publish and distribute research reports about the funds they distribute: in order to rely on the rule to publish or distribute a covered investment fund research report,

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[303] Persons covered by the affiliate exclusion may have strong financial interests to increase sales of associated covered investment funds. *See supra* paragraph accompanying note 260.

these broker-dealers would need to conduct their own research in-house or to rely on independent third-party service providers for their information.

We are also seeking commenters' views on our analysis:

- Will the proposed affiliate exclusion reduce the potential for investors to receive research reports that were affected by significant conflicts of interest?
- Will smaller broker-dealers, or broker-dealers without significant research departments, be most impacted by the proposed affiliate exclusion (and our guidance on the proposed affiliate exclusion)? If not, which broker-dealers would be most affected, and why?
- Are there additional benefits associated with the content and presentation standards that we have not considered?
- Are there additional costs associated with content and presentation requirements that we have not considered?

b. Regular-Course-of-Business Requirement

Under proposed rule 139b, research reports (both issuer-specific research reports and industry research reports) would need to be published or distributed by the broker-dealer in the "regular course of its business" in order to rely on the safe harbor.[304] For issuers that do not have a class of securities in "substantially continuous distribution," issuer-specific research reports that represent the initiation of publication of research reports about the issuer or its securities or reinitiation following discontinuation of publication of such research reports would be deemed to

[304] *See supra* sections II.B.1.c and II.B.2.b.

not satisfy the regular-course-of-business requirement.[305] The regular-course-of-business requirement being proposed under rule 139b is similar to that of rule 139, except that, as directed by the FAIR Act, rule 139b specifies that the "initiation or reinitiation requirement" only applies to research reports regarding a covered investment fund that does not have a class of securities in substantially continuous distribution.[306]

Given the breadth of the definition of "research report" under the FAIR Act (and the definition of "research report" that we propose under rule 139b), certain communications that are currently treated as covered investment fund advertisements under Securities Act rule 482 could fall under the proposed rule 139b definition of "research report."[307] Investors, particularly retail investors, may be unaware of the differences in regulatory status and purpose among the various types of communications regarding registered investment companies and business development companies. This may result in investors not being able to readily discern what constitutes a research report and what constitutes an advertisement about these issuers.[308] We believe that broker-dealers that publish or distribute research reports in the regular course of business are more likely to publish analysis that investors recognize as research.[309] Therefore, in principle we expect this requirement to benefit investors by reducing opportunities for communications published or distributed under the safe harbor to cause confusion about their intended purpose.

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[305] *See supra* note 96 and accompanying text.

[306] *See* section 2(b)(1) of the FAIR Act; *see also supra* discussion at note 98.

[307] *See supra* note 102 and accompanying text.

[308] *See supra* paragraph accompanying note 103.

[309] *See supra* paragraph accompanying note 104.

However we also believe that establishing whether a research report is published in the "regular course of business" could, in practice, prove uniquely challenging in the covered investment funds context.[310]

First, in the context of covered investment funds, the distinction between communications intended as sales materials and those intended as research could be difficult to discern. Research reports about debt and equity securities have traditionally been provided to institutional customers as part of the broker-dealer's collection of services.[311] Institutional customers are generally capable of producing similar reports, and so can more readily evaluate the quality of broker-dealers' research.[312] In these circumstances, broker-dealers have a compelling business rationale for producing high-quality research as distinct from sales materials.

In contrast, we expect covered investment fund research reports to be produced by broker-dealers that distribute covered investment funds to retail customers.[313] With retail investors, information asymmetries are greater: retail investors do not generally possess the capabilities to produce an analyst report or evaluate its quality, and some may have difficulty

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310 *See supra* requests for comment in section II.B.1.c (requesting comment on the application of the regular-course-of-business requirement in the context of broker-dealers' publication or distribution of covered investment fund research reports and unique concerns relevant to this context (*e.g.*, whether the proposed requirement should be modified to address broker-dealers that have not previously published or distributed covered investment fund research reports)).

311 *See* Mehran and Stulz Article, *supra* note 283.

312 *See id; see also* Malmendier and Shanthikumar Article, *supra* note 285.

313 *See supra* section III.B.1.c.

differentiating between research and sales literature.[314] Moreover, the problem of evaluating the performance of research analysts is harder in the context of covered investment funds.[315] Thus, we believe that cultivating a reputation for high-quality research is less likely to serve as the primary business rationale for broker-dealers' publication and distribution of research reports on covered investment funds. Rather, we expect that facilitating the marketing of covered investment funds to customers (so as to increase revenues derived from distribution arrangements) will motivate these activities. In this setting, the distinction between different types of communications is not as clear.

Second, we note that the information environment surrounding covered investment funds further complicates establishing whether publishing research reports about covered investment funds is undertaken in the regular course of business. In the context of research reports about operating companies, a research analyst "following" an operating company continually monitors that company so as to provide timely forecasts and recommendations. Because of differences in the nature of covered investment funds and operating companies, we believe that the same is less likely to hold for a research analyst "following" a covered investment fund.[316] We believe that

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[314] *See* Mehran and Stulz Article, *supra* note 283.

[315] Traditional analyst research reports on operating companies largely focus on firm-specific factors, and thus are more akin to "stock picking" than "market timing": they attempt to forecast the idiosyncratic component of firms' future returns. Covered investment funds represent portfolios of securities and diversification effects reduce the amount of idiosyncratic variation in their returns. Thus, abstracting from fees, "fund picking" is more akin to "market timing" than "stock picking." Market timing is a skill that is relatively rare and econometrically difficult to detect. *See, e.g.*, Kent Daniel, Mark Grinblatt, Sheridan Titman & Russ Wermers. *Measuring Mutual Fund Performance with Characteristic-Based Benchmarks*, 52 The Journal of Finance 3, 1035–1058 (July 1997).

[316] The regular course of business requirement generically would require "research reports" to be published or distributed in the regular course of a broker-dealer's business and would not be limited to covered investment

the opportunities for acquiring idiosyncratic information relevant to future returns of covered investment funds are generally more limited: covered investment funds represent portfolios of securities and diversification effects reduce the value of idiosyncratic (*i.e.*, firm-specific) information.[317] Consequently, we expect research analysts "following" covered investment funds to focus instead on information related to fund characteristics (*e.g.*, fees, portfolio composition, or index tracking strategy) and on developments at the sector- or macro-level. Because we do not expect the arrival of such information to be as frequent, we expect that the inclusion of new analysis in research reports about covered investment funds could be more rare than in the context of operating company research reports. Consequently, the publication or distribution of covered investment fund research reports could occur relatively infrequently, or could be driven largely by market-wide factors. This could make it more difficult to establish whether a covered investment fund research report is published in the regular course of business.

Due to the aforementioned distinctions in the information environment and business rationale, we believe that the regular-course-of-business requirement in the context of proposed rule 139b may be more challenging to apply in practice than the regular-course-of-business requirement in the context of rule 139. Accordingly, the potential benefits of this requirement in proposed rule 139b may be limited. The effects of the regular-course-of-business requirement would be clearer in cases where, in the case of issuer-specific research reports, the proposed bright-line "initiation or reinitiation" requirement applies (*i.e.*, where the covered investment

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fund research reports. We request comment about what the regular course of business requirement means in the context of covered investment fund research reports. *See supra* section II.B.1.c (requests for comments).

317 *See supra* notes 250−251 and accompanying text.

fund does not have a class of securities in substantially continuous distribution). For such cases, the regular-course-of-business requirement as proposed would condition the availability of the safe harbor on the research report not representing the initiation or reinitiate of coverage by the broker-dealer publishing or distributing said research report. As the universe of covered investment funds is dominated by funds with a class of securities that could be considered to be in substantially continuous distribution,[318] the bright-line test of the regular course of business requirement would impact only a small subset of funds.

We are also seeking commenters' views on our analysis:

- Is our assessment of the difficulties associated with establishing whether research reports about covered investment funds are published in the regular course of business accurate? If not, what factors will be indicative of the regular-course-of-business requirement having been satisfied?
- Are there additional benefits associated with this requirement that we have not considered?
- Are there additional costs associated with this requirement that we have not considered?

c. Reporting History and Minimum Market Value Requirements for Issuers appearing in Issuer-specific Research Reports

Under proposed rule 139b, a broker-dealer's publication or distribution of issuer-specific research reports would not qualify for the safe harbor unless the covered investment fund

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[318] *See supra* note 98 and accompanying text.

included in the report satisfies a minimum public market value threshold of $75 million.[319] Issuers would also be required to have been subject to the reporting requirements of the Investment Company Act (for covered investment funds that are registered investment companies) or the reporting requirements under section 13 or 15(d) of the Exchange Act (for covered investment funds that are not registered investment companies) for a period of at least 12 calendar months prior to reliance on the proposed rule as well as to have timely filed all required reports during the preceding 12 months.[320]

The covered investment funds market is dynamic.[321] In 2016, more than six hundred covered investment funds entered the market, while more than seven hundred exited. The entry and exit of covered investment funds creates a situation in which a younger covered investment fund may not be widely followed by market participants.[322] Thus, for covered investment funds, the universe of young—and potentially less-followed—issuers is large. Moreover, securities issued by covered investment funds may not be subject to significant levels of market scrutiny. Unlike securities issued by operating companies (that generally have diverse groups of investors, including institutional investors, money managers, arbitrageurs, activist investors, and short

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319 *See* proposed rule 139b(a)(1)(i)(B).

320 Including Forms N-CSR, N-SAR, N-Q, N-PORT, N-MFP, and N-CEN as applicable for registered investment companies, and Forms 10-K, 10-Q, and 20-F as applicable for covered investment funds that are not registered investment companies. *See* proposed rule 139b(a)(1)(i)(A).

321 *See supra* section III.B.1.a.

322 In contrast, there were fewer than one hundred U.S. IPOs for operating companies in 2016. *See* Jay Ritter, Initial Public Offerings: Updated Statistics (Aug. 8, 2017), *available at* https://site.warrington.ufl.edu/ritter/files/2017/08/IPOs2016Statistics.pdf.

sellers), covered investment funds are primarily held by retail investors.[323] As covered investment fund shares are not a major component of institutional investors' portfolios, we believe that they are less likely to garner wide-spread attention from the types of sophisticated institutional investors most capable of subjecting them to scrutiny.[324]

We believe that in the context of covered investment funds, where we expect limited market discipline from institutional investors and where large numbers of new funds are created each year, the information available to investors could be sparse. In such an environment, a single "research report" about a covered investment fund could have a disproportionate effect on retail investors' beliefs about the fund and—in the case of a biased research reports—have a negative effect on investor welfare. We believe that conditioning the availability of the safe harbor on the aforementioned reporting history and market valuation requirements would help restrict the availability of the safe harbor in situations where we expect the information environment to be most limited: for new funds and for funds with niche markets. Moreover, we believe modeling the reporting history and minimum public market valuation requirements on those in rule 139 reduces regulatory complexity and opportunities for investor confusion.

Because young and small covered investment funds are relatively common, the costs associated with these conditions on the availability of a safe harbor may be significant. In particular, as shown in Table 1, the $75 million minimum public market valuation condition would limit the availability of the safe harbor with respect to broker-dealers' publication or

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[323] *See supra* section III.B.1.a.

[324] *See supra* note 290.

distribution of research reports for approximately one-third of all covered investment funds.[325] Research reports about nearly half of extant ETFs, ETPs and BDCs would not qualify for the safe harbor.[326] Availability of the safe harbor would be least impacted for research reports on open end-mutual funds and closed-end funds.[327]

Although young and small funds represent a very small fraction of covered investment fund assets, they are relatively large in number.[328] Because nearly one-third of covered investment funds would not satisfy the eligibility criteria for the proposed safe harbor, we believe that those funds would be less likely to receive coverage by broker-dealers insofar as the inability to rely on the proposed safe harbor reduces broker-dealers' willingness to publish and distribute research reports.

Table 1: Covered investment funds with public market value less than $75 million, and the fraction of covered investment fund assets held by these funds. For each covered investment fund type, we report the percentage of funds of that type with a public market value below $75 million and the percentage of covered investment fund assets held in funds with public market values below $75 million. Mutual fund, ETF, and ETP statistics based on data form CRSP mutual fund database (2017Q3). Closed-end fund statistics based on data from CRSP monthly stock file (Dec. 2017). BDC statistics based on Commission's listing of registered BDCs, and regulatory filings (2016) compiled by Compustat and Audit Analytics.

Covered Investment Fund Type	Funds with public market value < $75 million	
	Number of Funds	Fund Assets
Open-end	30%	<1%
Closed-end	12%	<1%
ETFs and ETPs	41%	<1%
BDC	42%	1%
Total	31%	<1%

[325] 31% of all covered investment funds have public market valuations less than $75 million.

[326] 41% of ETF and ETPs and 42% of BDCs have public market valuations less than $75 million. *See* Table 1.

[327] 30% of open-end mutual funds and 12% of closed-end funds have public market valuations less than $75 million. *See* Table 1.

[328] *See* Table 1.

We are also seeking commenters' views on our analysis:

- Are there additional benefits associated with these requirements that we have not considered?
- Are there additional costs associated with these requirements that we have not considered?

d. Reporting Requirement for Issuers Appearing in Industry Reports

Under proposed rule 139b an industry research report could only include covered investment funds that are required to file reports pursuant to section 30 of the Investment Company Act (or, for covered investment funds that are not registered investment companies under the Investment Company Act, required to file reports pursuant to section 13 or section 15(d) of the Exchange Act).[329] As discussed above, these proposed conditions generally track parallel conditions under rule 139, but have been modified so that they would be applicable with respect to covered investment fund issuers. We do not expect these conditions to have economic effects beyond marginally improving economic efficiency by more closely aligning regulations with their intended context.

We are also seeking commenters' views on our analysis:

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[329] Proposed rule 139b(a)(2)(i). As discussed previously, each issuer included in an issuer-specific research report also would be required to be subject to these reporting requirements, as well as the requirement to have filed in a timely manner all of the periodic reports required to be filed during the preceding 12 months. *See supra* section II.B.1.a. We note that this condition limits industry reports published or distributed in reliance on rule 139b to covered investment funds that file their reports pursuant to section 30 of the Investment Company Act or section 13 or section 15(d) of the Exchange Act.

- Are there additional benefits associated with these requirements that we have not considered?
- Are there additional costs associated with these requirements that we have not considered?

e. Content and Presentation Requirements for Industry Research Reports

Under proposed rule 139b, the content and presentation standards for industry research reports of rule 139 would be tailored to the context of covered investment funds. Under proposed rule 139b (and rule 139), issuers appearing in industry research reports are subject to fewer conditions than issuers that are subjects of issuer-specific research reports.[330] We believe that in the absence of content and presentation requirements such as those we propose today, an industry research report could be used to circumvent the conditions associated with the safe harbor available for issuer-specific research reports. We therefore believe that the proposed content and presentation standards have benefits similar to those of the parallel content and presentation requirements in rule 139, and provide meaningful limits for issuer-specific research reports.[331]

We believe the compliance costs imposed by these requirements on the production of industry research reports would be low, particularly as broker-dealers are already familiar with similar conditions in rule 139, making implementation of presentation conditions for industry research reports on covered investment funds less burdensome.

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[330] *See supra* section II.B.2.

[331] *See supra* notes 118–119, and paragraph accompanying note 136.

We are also seeking commenters' views on our analysis:

- Do commenters believe that there are there additional benefits associated with the content and presentation standards that we have not considered?
- Do commenters believe that there additional costs associated with content and presentation requirements that we have not considered?
- Do commenters agree with our assessment of the compliance costs? Are there certain types of broker-dealers for which these compliance costs will be higher (or lower)?

3. Proposed Rule 24b-4

Proposed rule 24b-4 would exclude a covered investment fund research report from the coverage of section 24(b) of the Investment Company Act and the rules and regulations thereunder, except to the extent that such report is not subject to the content provisions of SRO rules related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards. As discussed above, this proposed rule is meant to implement section 2(b)(4) of the FAIR Act, which we interpret to exclude covered investment fund research reports from section 24(b) of the Investment Company Act so long as they continue to be subject to the general content standards in FINRA rule 2210(d)(1).[332] For covered investment fund research reports that are published or distributed by FINRA member firms, all such research reports would be subject to the content standards of FINRA rule 2210(d)(1), and thus we would interpret these

[332] *See supra* note 174 and accompanying text.

research reports to be excluded from the Commission's filing requirements under the proposed rule.[333]

As discussed above, where covered investment fund research reports would no longer be required to be filed with the Commission pursuant to section 24(b), proposed rule 24b-4 could have the effect of narrowing the types of communications regarding registered investment companies that would be filed with FINRA (under current FINRA rule 2210).[334] However, we believe that administrative processes related to handling regulatory reviews of communications subject to filing requirements impose costs on broker-dealers, which in turn can reduce their willingness to publish and distribute such communications. Consequently, although we do not believe that limiting these filing requirements as required by the FAIR Act represents a first-order economic effect of the proposed rules, we believe that doing so will reduce administrative costs for broker-dealers publishing or distributing covered investment fund research reports. At the same time, as discussed above, we believe that eliminating these filing requirements may have the result that some communications that are currently subject to FINRA's filing requirements would no longer be subject to routine review.[335] While these communications may still be reviewed by FINRA—for example, through examinations, targeted sweeps, or spot-checks—we believe that an effect of the FAIR Act, as implemented through proposed rule 24b-4, may be to reduce the monitoring by FINRA and the Commission of

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[333] *See id.*

[334] *See id.*

[335] *See supra* section II.D.1.

broker-dealers' communications with customers for compliance with the applicable rules and regulations.[336]

We are seeking comments on the costs and benefits of proposed rule 24b-4:

- Do commenters agree with our characterization of the costs and benefits? Are there additional costs and benefits that we should consider?
- Do commenters expect non-FINRA member firms to publish or distribute covered investment fund research reports that would not be subject to the content standards of FINRA rule 2210(d)(1)?

4. Proposed Amendment to Rule 101 of Regulation M

As discussed above, rule 101 of Regulation M prohibits a person who participates in a distribution from attempting to induce others to purchase securities covered by the rule during a specified period.[337] However, rule 101 provides an exception for research activities that satisfy the conditions of Securities Act rule 138 or rule 139. The proposed conforming amendment would expand this exception to include research activities that satisfy the conditions of proposed rule 139b. We believe that broker-dealers would generally be unable to make use of the proposed rule 139b safe harbor absent the proposed conforming amendment. Consequently, we do not consider its effects separately.

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[336] *But see supra* note 188 and accompanying text (noting that the FAIR Act's rules of construction provide that the Act shall not be construed as limiting the authority of an SRO to require the filing of communications with the public if the purpose of such communications "is not to provide research and analysis of covered investment funds"); *see also* section 2(c)(2) of the FAIR Act.

[337] *See supra* section II.E.

5. Effects on Efficiency, Competition, and Capital Formation

The primary effects on economic efficiency and capital formation resulting from proposed rules 139b and 24b-4 obtain from the statutory mandates of the FAIR Act. Because financial intermediaries such as broker-dealers are generally assumed to possess some comparative advantage in the production of information about securities, efficiency considerations would—in the absence of significant market imperfections—dictate that broker-dealers should be active in the production of such information. To the extent that the increase in broker-dealers' production of research reports about covered investment funds—that we expect to occur as a result of the FAIR Act's statutory mandates[338]—is valuable to investors, we expect it to increase allocative efficiency, with attendant positive consequences on capital formation. As noted earlier, the existence of the safe harbor could provide increased opportunities for broker-dealers to publish and distribute research on funds from which they derive financial benefits.[339] To the extent that this could limit the value investors derive from research reports that broker-dealers publish and distribute, any potential gains to efficiency and improvements to capital formation could be reduced (or eliminated).

Beyond the aforementioned broader effects on efficiency and capital formation resulting from the FAIR Act's statutory mandates, we believe that the specific conditions on the availability of the safe harbor in proposed rule 139b will generally further economic efficiency and facilitate capital formation by reducing the potential for retail investors to receive research

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338 *See supra* section III.C.1.a.

339 *See supra* section III.C.1.b.

reports whose publication or distribution may be motivated by these financial incentives that could cause a conflict of interest. We believe that the affiliate exclusion and related guidance will have the largest impact because it addresses the greatest conflicts of interests in this context: those arising from broker-dealers in investment advisory relationships.[340] In addition, we believe that the Commission's various tailoring of the proposed rules to the covered investment fund context will yield marginal efficiency improvements from reductions in regulatory ambiguity.

With respect to competition, we believe that expansion of the rule 139 safe harbor will increase competition in the market for research reports on covered investment funds. Under the baseline, the market for research reports on covered investment funds is dominated by a small number of independent research firms, with few broker-dealers producing original research about such funds.[341] We believe that the availability of the safe harbor will encourage some broker-dealers to publish proprietary research on covered investment funds. However, due to the high costs associated with maintaining research departments capable of covering the large covered investment fund universe,[342] we believe that most broker-dealers will continue to rely on content licensed from independent firms.[343] We also believe that there are competitive implications stemming from the guidance we have given to address possible circumvention of the proposed affiliate exclusion.[344] This guidance may have the effect of placing smaller

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340 *See supra* section III.C.2.a.

341 *See supra* section III.B.1.c.

342 *See supra* section III.B.1.a.

343 We expect that broker-dealers that choose to publish research on covered investment funds will generally not license it to their competitors.

344 *See supra* section III.C.2.a.

broker-dealers— who may not operate at a scale large enough to sustain a research department—at a competitive disadvantage. These smaller broker-dealers may find that they are unable to compete with larger broker-dealers in the provision of "original" research about covered investment funds.

We are seeking comments on our analysis of the proposed rules' effects on efficiency, competition, and capital formation:

- Are there other significant effects on efficiency, competition, or capital formation that we have not considered?
- What competitive effects, if any, would the proposed reporting history and minimum market value requirements have on smaller covered investment funds? Do commenters believe these requirements would adversely affect the type and amount of analysis available to investors on these funds?

6. Alternatives Considered

We considered several alternative approaches to implementing the FAIR Act mandates that could satisfy the requirements of the FAIR Act. We summarize these here.

a. Conditions on Issuers Appearing in Issuer-Specific Research Reports

As discussed above, we believe that conditioning the availability of the safe harbor on the proposed $75 million minimum public market value requirement would promote investor protection by limiting research reports to issuers that have a demonstrated market following.[345]

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[345] *See supra* section II.B.1.b.

However, we acknowledge that it would mean that research reports about significant numbers of smaller covered investment funds would not qualify for inclusion in research reports under the safe harbor. We believe that this will reduce the effect of the proposed rules on the availability of research reports about smaller covered investment funds.[346]

Depending on the distribution of covered investment funds' public market values, a somewhat lower threshold could significantly increase the number of covered investment funds that qualify for inclusion in research reports without materially increasing the number of qualifying funds without a demonstrated market following and thus undermining investor protection. Conversely, a significantly higher threshold could further promote investor protection without significantly decreasing the number of qualifying funds (however, as discussed below, we did not consider this alternative because the FAIR Act prevents us from conditioning the availability of the safe harbor on a minimum public market value requirement that is greater than what is required under rule 139).

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[346] *See supra* section III.C.2.c.

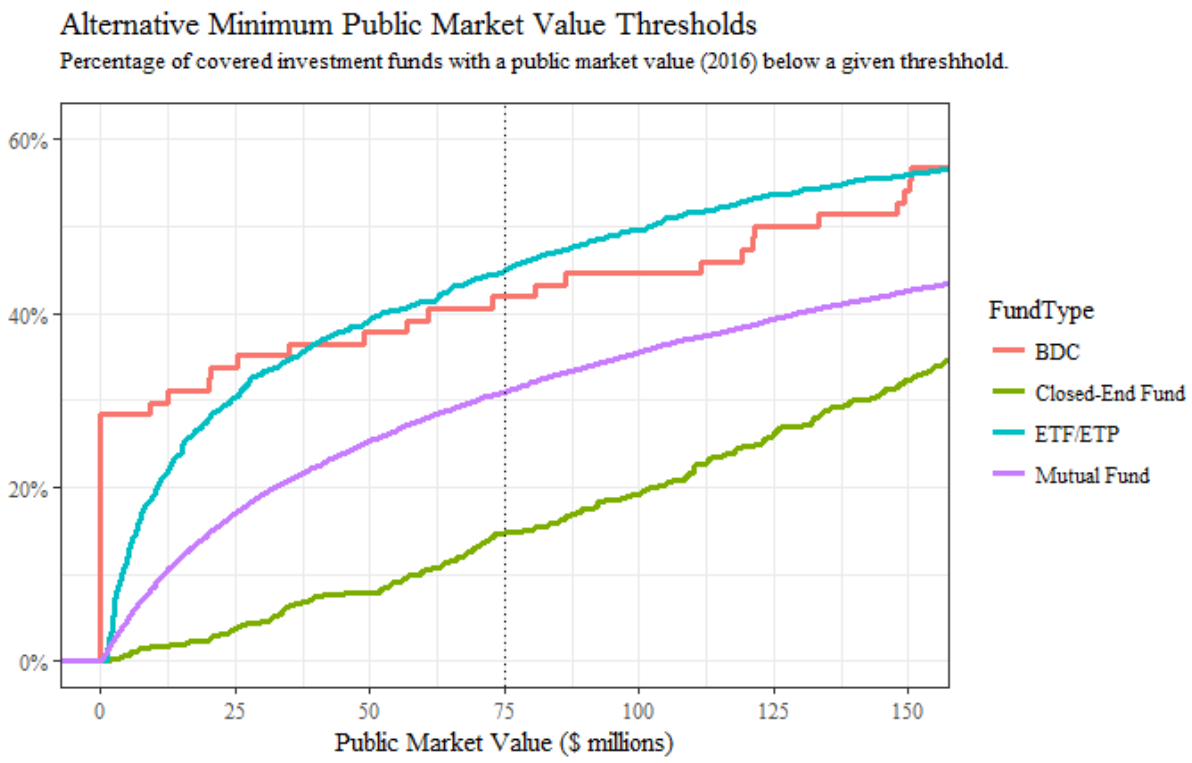

Figure 5: Percentage of covered investment funds with a public market value (2016) below a given threshold.

We have considered a range of alternative minimum public market values thresholds. Figure 5 plots the percentage of covered investment funds whose public market valuations would fall under each alternative threshold. As shown in the figure, material increases in the availability of the safe harbor are only achievable through large reductions to the threshold. This is due to large numbers of funds being very small: as shown in Figure 6, over 600 covered investment funds have a public market valuation of $5 million or less. However, we do not believe that a significantly lower threshold would be effective at promoting investor protection because, as discussed above in section III.C.2.c, we expect the information environment to be more limited for smaller funds than for larger funds.

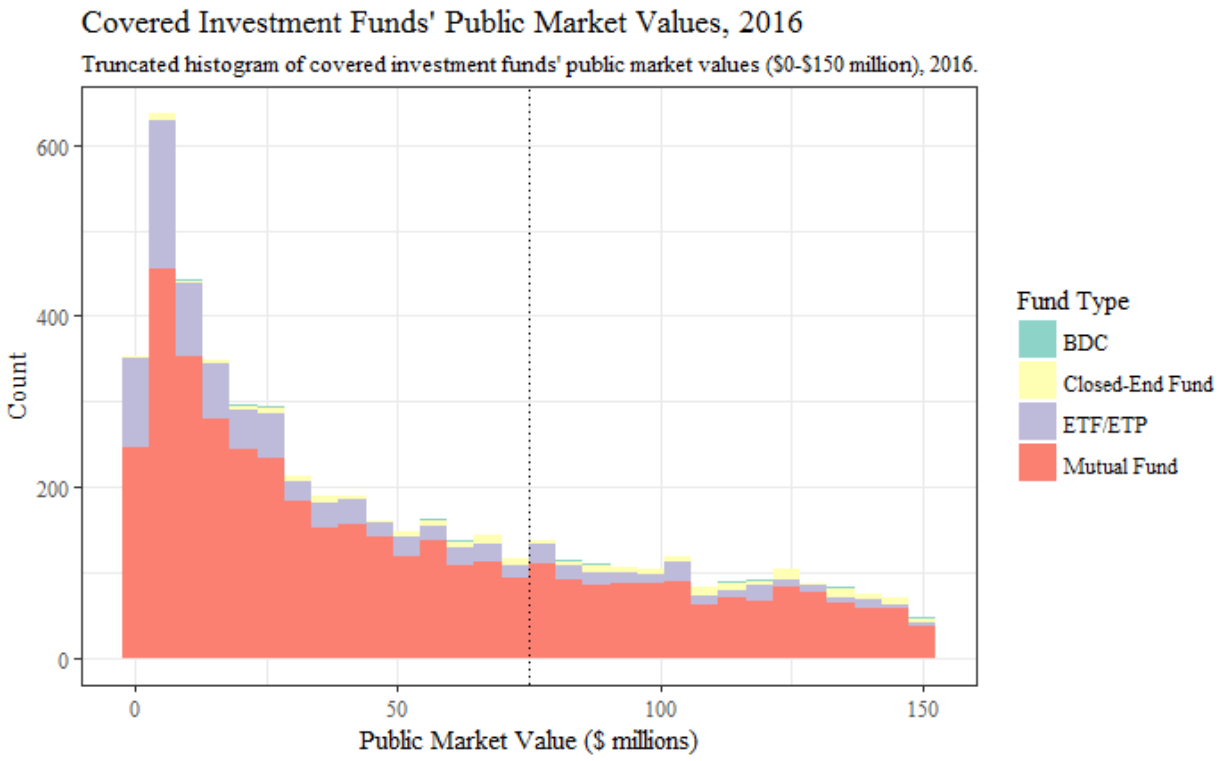

Figure 6: Truncated histogram of covered investment funds' public market values ($0–$150 million), 2016.

The FAIR Act prevents us from conditioning the availability of the safe harbor on a minimum public market value requirement that is greater than what is required under rule 139.[347] This effectively prevents us from conditioning the availability of the safe harbor for research reports on the subject covered investment fund having a public float of more than $75 million. Consequently, we do not consider higher minimum public market value thresholds. We seek information from commenters to assist us in assessing the economic impacts of a lower minimum threshold.

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[347] *See supra* note 25 and accompanying text.

- Would a public float threshold of less than $75 million for covered investment funds appropriately exclude those funds with a market following that is too small to permit investors to evaluate covered investment fund research reports? What factors should govern such an alternative threshold and where should it be set?

b. Conditions on Issuers Appearing in Industry Research Reports

(1) Applying uniform conditions on issuers appearing in issuer-specific and industry research reports

With respect to conditions affecting the availability of the safe harbor for industry research reports, we considered applying to industry research reports the same requirements as would apply to issuer-specific research reports. As with the restrictions on issuer-specific research reports, similarly restricting industry research reports could help ensure that funds included in research reports are well-followed, and could restrict the availability of the safe harbor in situations where we expect the information environment to be most limited: for new funds and for funds with niche markets.

In the context of research reports about covered investment funds, cost-benefit considerations for including additional conditions on industry reports differ slightly from those that apply in the context of traditional research reports about equity and debt securities. In the context of research reports about equity and debt securities, analysis of an industry, in the case of operating companies, may require the discussion of specific firms within that industry. For example, a discussion about a mature industry (*e.g.*, automobiles) may require discussion of a disruptive new entrant (*e.g.*, autonomous vehicle start-up). In the context of the rule 139 safe harbor, the new entrant may not satisfy the reporting history and minimum float requirements. This would reasonably prevent an issuer-specific research report about the new entrant from

qualifying for the safe harbor. However, it would not further the goal of facilitating coverage of the industry to limit the safe harbor for industry reports to reports that do not discuss the new entrant: analysis of the industry may require discussion of specific issuers that would not qualify for inclusion in issuer-specific research reports.

In the context of covered investment funds, a similar rationale would not apply as broadly. The proposed rule 139b content requirements for industry research reports would reference covered investment fund issuers of the same "type or investment focus," rather than the issuers' "industry or sub-industry" (*i.e.*, a broad category of similar businesses).[348] Although it is clear that an industry research report about some covered investment fund types (*e.g.*, emerging growth bonds) may have reasons to include a discussion of issuers that may not be eligible for inclusion in issuer-specific reports (*e.g.*, best-performing new fund), it is not clear that such reasons would rise to the level of requiring the discussion of such issuers. Unlike the effects of an operating company issuer's on its "industry," the effects of a covered investment fund issuer on its fund "type" is very limited.

(2) Allowing affiliates to appear in comprehensive list of recommended issuers

We considered providing that a comprehensive list of recommended issuers may include issuers that are affiliates of the broker-dealer that is publishing or distributing the research report under certain circumstances, including: if affiliates were identified; if disclosure about the affiliated issuers were limited; or if any performance information included in a list that includes

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[348] *See supra* section II.B.2.c.

affiliated issuers were presented in accordance with rule 482.[349] Generally, we believe that including such provisions would benefit broker-dealers that play a significant role both as investment advisers to, and as distributors of, covered investment funds. However, as discussed above, we believe that broker-dealers publishing or distributing research reports about affiliated funds would have the potential for the most significant conflicts of interest.[350] Moreover, permitting affiliated funds to be included in such comprehensive lists could result in confusion: broker-dealers would be able to offer recommendations for affiliated funds in industry research reports, but there would be no safe harbor enabling them to publish or distribute issuer-specific research reports (which could provide the basis for such recommendations) as a result of the affiliate exclusion.

In proposed rule 139b, we have chosen not to incorporate these alternative conditions on issuers appearing in industry research reports. As discussed above, we are proposing that a comprehensive list of recommended issuers appearing in an industry research report could not include any covered investment fund that is an affiliate of the broker-dealer, or for which the broker-dealer serves as investment adviser (or is an affiliated person of the investment adviser), as this could implicate the proposed affiliate exclusion.[351] However we are seeking comment on the economic effects of such alternative conditions.

- Do commenters believe that the value of industry research reports about covered investment funds would be adversely affected if discussion of funds

[349] *See id.*

[350] *See supra* section III.C.1.b.

[351] *See supra* note 130 and accompanying text.

not satisfying the conditions applicable to issuer-specific research reports was precluded? If so, under what circumstances?

- Do commenters believe that the value of industry research reports about covered investment funds would be improved if different conditions were applied to issuers appearing in such reports? If so, which conditions?
- Do commenters believe that allowing affiliated funds to appear in comprehensive lists of recommended issuers would have additional costs or benefits?
- Do commenters believe that conflicts of interests resulting from an advisory relationship would be likely to affect industry research reports featuring a comprehensive list?
- Do commenters believe that allowing the inclusion of affiliated funds in industry research reports featuring a comprehensive list, when proposed rule 139b would not permit a broker-dealer relying on the safe harbor to publish or distribute an issuer-specific research report about an affiliated fund, would result in investor confusion?

c. Approach to Regular-Course-of-Business Requirement

As discussed in section III.B.3.b, in principle we expect a regular-course-of-business requirement to reduce opportunities for the safe harbor to be used in ways that lead to investor confusion. However, we also believe that in the context of covered investment funds, establishing whether a report is published in the "regular course of business" could present more challenges than in the rule 139 context of research reports about the securities of operating

companies.[352] Thus, we considered various alternative approaches to the proposed regular-course-of-business requirements.[353] Specifically, we have considered that this requirement be defined more specifically to address, for example, circumstances in which a broker-dealer has not previously published or distributed research reports.[354] For example, we considered whether rule 139b should provide a "start-up" period to allow broker-dealers to establish a regular course of business of publishing research reports.[355] We have also considered requiring that the regular-course-of-business requirement incorporate more specific requirements regarding the persons preparing such reports (*e.g.*, that they must be employed by a broker-dealer to prepare such research in the regular course of his or her duties).[356]

Conditioning availability of the safe harbor on a broker-dealer's having published research reports for a given period of time, or on the broker-dealer having operated for some amount of time, could lead to the publication of reports that are more likely to be recognized as research.[357] Moreover, we believe that broker-dealers with a longer operating history and those who have published research reports—relying on the existing rule 139 safe harbor or otherwise without relying on the safe harbor—will have made greater investments in their reputations. Such investments increase the reputational costs associated with the publication of research

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[352] *See supra* section II.B.2.b.

[353] *See supra* section II.B.1.c (requests for comments).

[354] *See id*.

[355] *See id.*

[356] *See id.*

[357] *See id*.

reflecting conflicts of interest, which as discussed above could mitigate the effects of conflicts of interest on research reports.[358]

In proposed rule 139b, we have chosen not to incorporate these alternative approaches to the regular-course–of-business requirement. While we note the potential benefits of the approaches outlined above in enhancing the value that covered investment fund research reports may provide investors, we also understand that these alternatives may restrict the flow of relevant information to investors, and we are not proposing more prescriptive approaches to the regular-course-of-business requirement at this time. However, we are seeking comment on the economic effects of such alternative conditions.

- Do commenters believe that these alternative approaches to the regular-course-of-business requirement would result in additional costs and benefits that we have not considered? What is the magnitude of these costs and benefits?

d. Presentation of Performance Information

Given the definition of "research report" under the FAIR Act (and the definition of "research report" that we propose under rule 139b), certain communications by broker-dealers that historically have been treated as advertisements for registered investment companies under rule 482 now could be distributed as covered investment fund research reports under the

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358 *See* Chemmanur and Fulghieri Article, *supra* note 282; *see also supra* section III.C.1.b. However, we note that the efficacy of an institutional reputation mechanism has not found empirical support in related settings. *See* Fang and Yasuda Article, *supra* note 281 (where sell-side research analysts' reputation mitigates manifestation of conflicts of interest from underwriting relationships, while institutional reputation does not).

proposed rule 139b safe harbor.[359] Rule 482 imposes restrictions on the presentation of performance data included in registered open-end investment company advertisements.[360] A covered investment fund research report that is published or distributed by a broker-dealer in reliance on the proposed rule 139b safe harbor would not need to adhere to rule 482's requirements.

The above shift in the regulatory treatment of communications about registered investment companies could result in investors receiving communications about covered investment funds where the character of the communication (*i.e.*, bona fide research versus advertising) is unclear and presentation of performance data is not subject to the restrictions of rule 482. Conflicts of interest resulting from broker-dealers' financial incentives could affect the manner in which performance data is presented in research reports, potentially leading to misleading presentation of performance data. In addition, investors could be confused if performance is presented differently in an advertisement and in a research report, particularly if the research report doesn't adequately disclose the methodologies used to produce the

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[359] *See supra* note 141 and accompanying text. Similarly, "research reports" regarding covered investment funds that broker-dealers today might publish or distribute as "supplemental sales literature" under Investment Company Act rule 34b-1 (which must be preceded or accompanied by a statutory prospectus) could be distributed as covered investment fund research reports under proposed rule 139b. *See supra* note 144 and accompanying text.

[360] As discussed above, rule 482 requires standardized presentation of performance data that is included in registered open-end fund advertisements. Alternatively, if other performance measures are presented, they must be accompanied by certain standardized performance data. *See supra* notes 142–143 and accompanying text.

Research reports that are published or distributed as rule 34b-1 supplemental sales literature also would be subject to requirements relating to the standardized presentation of performance information, because rule 34b-1 incorporates many of the rule 482 requirements relating to performance disclosure. *See supra* note 145 and accompanying text.

performance that could explain the differences. Retail investors, in particular, may be unable to assess the non-standardized performance figures when considering their investment decisions.

While proposed rule 139b does not require that the performance of issuers included in covered investment fund research reports be presented in any particular fashion, we believe that certain guidance factors would assist a broker-dealer in evaluating whether any presentation of registered investment company performance in research reports could be misleading.[361] These include consideration of the factors discussed in rule 156.[362] We also note above that, if a covered investment fund research report were to substantially resemble a rule 482 advertisement, but present performance information in a manner inconsistent with the provisions of rule 482, retail investors may not be able to readily discern what constitutes a research report and what constitutes an advertisement.[363]

We have also considered the alternative approach of incorporating certain performance presentation standards of rule 482 and/or the guidance factors of rule 156 (concerning misleading statements in investment company sales literature) in the text of rule 139b.[364] We also considered incorporating certain performance presentation requirements for when other performance measures that are not subject to any prescribed method of communication appear in covered investment fund research reports.[365] We also considered requiring that the methodology

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361 *See supra* section II.C.

362 *See id.*

363 *See id.*

364 *See* rule 482(d)(1)–(4).

365 *See* rule 482(d)(5).

used to calculate the registered investment company's total return or yield be disclosed if these performance measures are not presented in a research report in a manner that is consistent with the requirements in rule 482. We also considered requirements relating to nonrecurring fees,[366] and requirements on the timeliness of performance data,[367] similar to the requirements for these items in rule 482.[368] In addition, we considered incorporating the factors set forth in rule 156 (or a subset thereof) into the rule.[369]

We also considered a requirement in proposed rule 139b to incorporate general narrative disclosure into a research report about a registered investment company, aimed at reducing potential investor confusion. For example, we could have required such research reports to incorporate a legend stating that the document is a research report and is not subject to the Commission's regulations applicable to sales and advertising. We also could have required such a research report to incorporate similar disclosure without requiring that it be structured as a legend (which would require the disclosure of similar concepts but would not require any particular wording).

A main benefit associated with an alternative incorporating some or all of the aforementioned provisions into proposed rule 139b is reduced potential for confusion between (i) registered investment company advertisements and selling materials covered by rule 482 and

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366 *See* rule 482(b)(3)(ii).

367 *See* rule 482(g).

368 *See*, *e.g.*, rules 482(b)(3)(ii) and (g).

369 *See supra* section II.C (request for comments).

(ii) advertisements or selling materials being recast as research reports.[370] Additionally, incorporating some or all of the aforementioned provisions into proposed rule 139b would reduce potential for investor confusion resulting from divergent standards in the presentation of performance data.

Because fees can represent a significant drag on investment returns,[371] because different performance measures may be more or less favorable at different times, and because retail investors are known to be sensitive to past performance data,[372] we believe that the manner in which past performance data is presented can be an important factor driving investors' investment decisions. As discussed above, even unaffiliated broker-dealers may have incentives, stemming from funds' distribution arrangements, to promote a covered investment fund, or to promote certain funds over others.[373] When broker-dealers publish or distribute research reports on covered investment funds, their choices with respect to how fees are disclosed, which performance measures are quoted, and for what time periods could be affected by these considerations. This in turn can adversely affect investors, particularly non-sophisticated investors. To the extent that any of the alternative approaches discussed above would limit opportunities for selective performance disclosure, this would curtail opportunities to circumvent the requirements of rule 482.

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370 *See supra* note 150 and accompanying text.

371 *See, e.g.*, Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 The Journal of Finance 1, 57–82 (Mar. 1997).

372 *See* Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 The Journal of Finance 5, 1589–1622 (Oct. 1, 1998).

373 *See supra* section III.C.1.b.

If opportunities for selective performance disclosure were limited, this also could reduce investor confusion, because there would be fewer opportunities for the performance disclosure in registered investment company advertisements and research reports to diverge. There also could be less potential for investor confusion when comparing research reports about different covered investment funds, or obtained from different broker-dealers. These results would benefit investors. The extent of the benefit would depend on these measures' effectiveness in ensuring consistent disclosure and/or alerting investors to factors that could influence their understanding of the disclosure in a research report. The extent of the benefit also would depend on the audience who will be reading research reports about registered investment companies. As discussed above, we assume that retail investors would generally be less likely to be able to identify sources of bias (and disregard or discount bias) in communications about covered investment funds than institutional investors and therefore could benefit from limitations on selective performance disclosure.[374]

The most significant costs associated with this alternative would likely result from its effect on the content of broker-dealers' research reports. An alternative that limits the prominence afforded to performance measures that are calculated using a methodology that differs from that required under rule 482 could adversely affect broker-dealers' ability to provide valuable analysis. For example, a broker-dealer who wishes to center its analysis on a fund's risk-adjusted returns would be limited in how such information could be presented in the report

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[374] *But see* discussion *infra* in this section III.C.6.d, discussing the potential benefits of allowing non-standardized information in the total mix of information available to investors, particularly for sophisticated investors.

even though certain audiences for research reports could consider this information to be particularly relevant. Investors' access to potentially relevant and useful analysis could be limited by alternatives such as those discussed in this section.

We believe that broker-dealers' direct compliance costs under these alternative provisions would generally be minimal. For example, if we were to incorporate rule 482's requirements on the presentation of performance data into proposed rule 139b, we expect that broker-dealers that publish research reports would have processes and systems that could produce charts and tables of the rule-specified performance measures using timely data.[375]

In proposed rule 139b, we have chosen not to incorporate additional provisions relating to the presentation of performance data, as this approach promotes flexibility for broker-dealers to make different types of information and analysis available to investors. We are seeking commenters' views on these alternative provisions.

- Do commenters believe that the safe harbor under proposed rule 139b would be used to publish or distribute communications that have traditionally been considered registered investment company advertisements or sales materials subject to rule 482? To what extent? If not, why not? Would this practice to be more prevalent for certain types of broker-dealers or research reports about certain types of registered investment companies? Do commenters believe that imposing additional requirements on the presentation of performance information

[375] We believe that most broker-dealers that would publish such reports are currently distributing advertisement under rule 482, which are subject to similar requirements. *See supra* section II.D.1.

in research reports that are published or distributed in reliance on the proposed rule 139b safe harbor would result in additional costs and benefits that we have not considered? What is the magnitude of these costs and benefits? If we were to issue guidance relating to the presentation of performance in research reports about registered investment companies that are published or distributed in reliance on the proposed rule 139b safe harbor, would this result in additional costs and benefits that we have not considered? What is the magnitude of these costs and benefits?

IV. PAPERWORK REDUCTION ACT

We do not believe that the proposed rules would impose any new "collections of information" as defined by the Paperwork Reduction Act of 1995 ("PRA"), 44 U.S.C. 3501 *et seq.*; nor would they create any new filing, reporting, recordkeeping, or disclosure reporting requirements.[376] Accordingly, we are not submitting the proposed rules to the Office of Management and Budget for review under the PRA.[377] We request comment on whether our conclusion that there are no collections of information is correct.

V. REGULATORY FLEXIBILITY ACT ANALYSIS

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with

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[376] As discussed above, certain communications that previously would have been treated as rule 482 advertising prospectuses or rule 34b-1 supplemental sales literature could be considered covered investment fund research reports subject to the proposed rule 139b safe harbor, which could result in a reduction in the information collection burdens for rules 482 and 34b-1. In connection with an extension of a currently approved collection for rules 482 and 34b-1, the Commission will adjust the burdens associated with these collections of information, as appropriate.

[377] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

section 3 of the Regulatory Flexibility Act ("RFA").[378] It relates to proposed rule 139b, proposed rule 24b-4, and proposed revisions to the rules under the Securities Act and the Exchange Act to implement the FAIR Act.

A. Reasons for, and Objectives of, the Proposed Action

Proposed rule 139b provides that, if certain conditions are satisfied, a broker-dealer's publication or distribution of a covered investment fund research report would be deemed for purposes of sections 2(a)(10) and 5(c) of the Securities Act not to constitute an offer for sale or offer to sell a security that is the subject of an offering of the covered investment fund, even if the broker-dealer is participating or may participate in a registered offering of the covered investment fund's securities. Proposed rule 24b-4 provides that a covered investment fund research report about a registered investment company will not be subject to section 24(b) of the Investment Company Act (or the rules and regulations thereunder), except to the extent the research report is otherwise not subject to the content standards in SRO rules related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards. The proposed revision to paragraph (a) of rule 139 would clarify that rule 139 does not affect the availability of any other exemption or exclusion from sections 2(a)(10) or 5(c) of the Securities Act that may be available to a broker-dealer (as provided, for example, by the provisions of rule 139a or proposed 139b). The proposed revision to rule 101 under Regulation M would be a conforming amendment intended to harmonize treatment of research under the Securities Act and Exchange Act rules by

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[378] *See* 5 U.S.C. 603.

permitting distribution participants under Regulation M, such as brokers-dealers, to publish or disseminate any information, opinion, or recommendation relating to a covered security if the conditions of rule 138, rule 139, or proposed rule 139b under the Securities Act are met. The proposed rules and proposed rule revisions would implement the directives under the FAIR Act to extend the current safe harbor available under rule 139 to broker-dealers' publication or distribution of covered investment fund research reports. The reasons for, and objectives of, the proposed rules and proposed rule revisions are discussed in more detail in section II above.

B. Legal Basis

We are proposing the rules contained in this document under the authority set forth in the Securities Act, particularly sections 6, 7, 8, 10, 17(a), 19(a), and 28 thereof [15 U.S.C. *77a et seq*.]; the Exchange Act, particularly, sections 2, 3, 9(a), 10, 11A(c), 12, 13, 14, 15, 17(a), 23(a), 30, and 36 thereof [15 U.S.C. 78a *et seq*.]; the Investment Company Act, particularly, sections 6, 23, 24, 30, and 38 thereof [15 U.S.C. 80a *et seq*.]; and the FAIR Act, particularly, section 2 thereof.

C. Small Entities Subject to the Proposed Rules

The proposed rules would affect broker-dealers that publish or distribute covered investment fund research reports. As such, broker-dealers that are small entities would be affected by the proposed rules. A broker-dealer is a small entity if it has total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which

its audited financial statements were prepared pursuant to §240.17a-5(d),[379] and it is not affiliated with any person (other than a natural person) that is not a small business or small organization.[380] As of December 31, 2017, the Commission estimates that there were approximately 1,042 broker-dealers that would be considered small entities as defined above.[381] To the extent a small broker-dealer would participate in the activity of publishing or distributing covered investment fund research reports and would seek to rely on the proposed rule 139b safe harbor, it may be affected by our proposal. Generally, we believe larger broker-dealers engage in these activities, but we request comment on whether and how the rules we are proposing today would affect small broker-dealers. We also request comment on the number of small entities that would be impacted by our proposal, including any available empirical data.

D. Reporting, Recordkeeping and Other Compliance Requirements

We believe that there are no reporting, recordkeeping and other compliance requirements with respect to proposed rule 139b and the proposed revision to Regulation M. As such, we believe that there are no attendant costs and administrative burdens for small entities associated with these activities, as they relate to proposed rule 139b and the proposed revision to Regulation M.

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379 *See* rule 0-10(c)(1) under the Exchange Act [17 CFR 240.0-10(c)(1)]. Alternatively, if a broker-dealer is "not required to file such statements, a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter)." *See id.*

380 *See* rule 0-10(c)(2) under the Exchange Act [17 CFR 240.0-10(c)(2)].

381 This estimate is derived from an analysis of data for the period ending Dec. 31, 2017 obtained from FOCUS Reports ("Financial and Operational Combined Uniform Single" Reports) that broker-dealers generally are required to file with the Commission and/or SROs pursuant to rule 17a-5 under the Exchange Act [17 CFR 240.17a-5].

Proposed rule 139b would extend the safe harbor under current rule 139 to broker-dealers' publication or distribution of covered investment fund research reports. As discussed above, rule 139 currently is not available for a broker-dealer's publication or distribution of research reports about registered investment companies and business development companies.[382] Instead, we understand that a research report or other communication about a covered investment fund that is a registered investment company would ordinarily have to comply with the requirements of Securities Act rule 482.[383] As a result of the FAIR Act, however, communications that historically have been treated as covered investment fund advertisements under rule 482 now could fall under the proposed rule 139b definition of "research report."

As discussed above, section 24(b) of the Investment Company Act requires registered open-end investment companies to file sales literature addressed to or intended for distribution to prospective investors with the Commission.[384] Section 2(b)(4) of the FAIR Act directs the Commission to provide that a covered investment fund research report shall not be subject to section 24(b) of the Investment Company Act or the rules and regulations thereunder, except that such report may still be subject to 24(b) and the rules and regulations thereunder if it is otherwise not subject to the content standards in the rules of any SRO related to research reports, including those contained in the rules governing communications with the public regarding investment

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382 *See supra* note 100 and accompanying text.

383 *See supra* note 101 and accompanying text.

384 *See* 15 U.S.C. 80a-24(b); 17 CFR 270.24b-3; *supra* section II.D.1.

companies or substantially similar standards.[385] Today, registered investment company sales literature, including rule 482 advertisements, are required to be filed with the Commission under section 24(b) of the Investment Company Act.[386] These filings are typically done by broker-dealers' compliance staff. The Commission proposes to implement section 2(b)(4) of the FAIR Act via proposed rule 24b-4, which provides that a covered investment fund research report about a registered investment company shall not be subject to section 24(b) of the Investment Company Act (or the rules and regulations thereunder), unless the research report is not otherwise subject to the content standards in SRO rules related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards.[387] We interpret section 2(b)(4) of the FAIR Act as excluding covered investment fund research reports from section 24(b) of the Investment Company Act so long as they continue to be subject to the general content standards in FINRA rule 2210(d)(1), described above (or substantially similar SRO rules).[388] Thus, covered investment fund research reports, by operation of proposed rule 24b-4, would no longer be subject to filing requirements under section 24(b) because they would be subject to the general content standards of FINRA rule 2210(d)(1).[389] Proposed rule 24b-4 would affect broker-dealers that, in lieu of a safe harbor such as that proposed to be provided by rule 139b, would have

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385 *See supra* note 167 and accompanying text.

386 *See supra* note 29. Rule 24b-3 under the Investment Company Act deems these materials to have been filed with the Commission if filed with FINRA. *See id.*

387 *See* proposed rule 24b-4; *see also* discussion accompanying *supra* notes 170–174.

388 *See supra* paragraph accompanying notes 174–176.

389 *See supra* section II.D.1.

published or distributed communications styled as "research reports" in compliance with rule 482, which communications would be required to be filed with the Commission subject to section 24(b) of the Investment Company Act. As such, we believe that the administrative costs of broker-dealers that previously filed these communications pursuant to section 24(b) of the Investment Company Act would be reduced. However, large and small broker-dealers would not be affected differently by proposed rule 24b-4.

We encourage written comments regarding this analysis. We solicit comments as to whether the proposed regulation could have an effect that we have not considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

E. Duplicative, Overlapping, or Conflicting Federal Rules

Although broker-dealers would be unable to rely on the rule 139 safe harbor in publishing or distributing certain communications that could be considered covered investment fund research reports,[390] the existing rule 139 safe harbor may be available for their publication or distribution of research reports for certain covered investment funds, such as commodity- or currency-based trusts or funds that have a class of securities registered under the Exchange Act.[391] As discussed above, the FAIR Act directs us to propose and adopt rule amendments that would extend the current safe harbor available under rule 139 to "covered investment fund

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[390] *See supra* notes 11–15 and accompanying text.

[391] *See supra* section II.A.4.

research reports."[392] Proposed rule 139b, which is intended to implement the FAIR Act's directives, includes all of the entities in the definition of "covered investment fund" that are specified in the FAIR Act's parallel definition (including some types of entities where, if a broker-dealer were to publish or distribute a research report about that entity, the rule 139 safe harbor could already be available).[393] As a result, in certain circumstances, a broker-dealer publishing or distributing a covered investment fund research report could rely either on rule 139 or proposed rule 139b. In light of this, we have clarified in proposed rule 139b that it provides a non-exclusive safe harbor, and we propose to amend rule 139 to include similar language regarding the non-exclusivity of the safe harbor available under rule 139.[394] Thus, a broker-dealer would be able to rely on proposed rule 139b to publish or distribute a covered investment fund research report, or could choose to rely instead on any other available exemption or exclusion from sections 2(a)(10) or 5(c) of the Securities Act, including those provided by rules 137, 138, and 139, so long as the applicable conditions are satisfied.

F. Significant Alternatives

The RFA directs us to consider significant alternatives that would accomplish the Commission's stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposals, we considered the following alternatives: (i) establishing different compliance or reporting requirements that take into account the resources available to small entities; (ii) exempting broker-dealers that are small entities from

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[392] *See supra* section I.B.

[393] *See supra* section II.A.3.

[394] *See supra* section II.A.4.

certain proposed conditions that must be satisfied in order for the proposed rule 139b safe harbor to be available (*e.g.*, the extent to which the proposed regular-course-of-business requirements would apply to small broker-dealers); (iii) clarifying, consolidating, or simplifying the conditions that must be satisfied for the proposed rule 139b safe harbor to be available for broker-dealers that are small entities; and (iv) using performance rather than design standards.

We do not believe that establishing different compliance and reporting requirements or timetables for broker-dealers that are small entities, or exempting broker-dealers that are small entities from certain proposed conditions, would permit us to achieve our stated objectives. We have considered a variety of approaches to achieve our regulatory objectives and the directives of the FAIR Act. We do not believe that the proposed rules would impose any significant new compliance obligations, because the proposed rules generally reduce the restrictions regarding communications that would be considered covered investment fund research reports.

As discussed above, the FAIR Act directs us to extend the current safe harbor available under rule 139 to broker-dealers' publication or distribution of covered investment fund research reports, and thus proposed rule 139b's framework, including its scope and conditions, is modeled after and generally tracks rule 139.[395] Rule 139 does not incorporate conditions that would affect the availability of the rule's safe harbor differently for broker-dealers that are small (versus large) entities. We likewise do not believe it is necessary or appropriate that proposed rule 139b incorporate conditions that would affect the availability of the proposed rule's safe harbor differently based on whether a broker-dealer is a small entity. We have considered whether a

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[395] *See supra* paragraph accompanying notes 32–34.

different regular-course-of-business requirement would help mitigate investor confusion in the case of covered investment fund research reports about registered investment companies, as discussed in more detail above.[396] This could have had the effect of limiting the availability of the proposed rule 139b safe harbor to certain broker-dealers, which in turn could have direct or indirect effects on the availability of the safe harbor to smaller broker-dealers. However, for the reasons discussed above,[397] we are not proposing a regular-course-of-business requirement, in either the proposed rule 139b provisions on issuer-specific research reports or the proposed provisions on industry reports, other than a requirement that tracks the provisions of rule 139 (modified as directed by the FAIR Act).

Nor do we believe that clarifying, consolidating, or simplifying the proposed amendments for small entities would satisfy those objectives. Because proposed rule 139b's framework (including its scope and conditions) is modeled after and generally tracks rule 139, proposed rule 139b like rule 139 does not treat small broker-dealers differently than large broker-dealers, including by clarifying, consolidating, or simplifying any conditions. Our proposal includes specific requests for comment on whether clarifications to certain proposed rule provisions are necessary or appropriate, and the comments we receive in response could, in certain circumstances, indirectly affect our approach to small entities.[398] For example, we request comment about whether the proposed regular-course-of-business requirement should be

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396 *See supra* section III.C.6.c.

397 *See id.*

398 *See generally supra* section II.

modified to address newly-established broker-dealers (which are likely to be small entities).[399] We also recognize that the guidance that we provide in this release—which is meant to clarify certain of the provisions of the proposed rule—could indirectly affect small entities, and we request comment on the effects of this guidance on small entities. For example, we request comment about whether smaller broker-dealers, or broker-dealers without significant research departments, be most impacted by our guidance on the proposed affiliate exclusion.[400]

Further, with respect to using performance rather than design standards, the proposed rule generally uses performance standards for all broker-dealers relying on the proposed rule, regardless of size. We believe that providing broker-dealers with the flexibility with respect to the design of covered investment fund research reports that they may publish or distribute in reliance on the proposed safe harbor is appropriate in light of the diversity of entities included in the universe of covered investment funds. We also believe that this approach is appropriate in light of the diverse methodologies that might be taken with respect to research about these entities (particularly because the term "research report" in the FAIR Act and the proposed rule is defined broadly, as discussed above[401]). However, we note that the proposed rule also uses design standards with respect to certain of its conditions (*e.g.*, the conditions relating to reporting history and minimum public market value that apply to issuers that could appear in an issuer-specific research report). These are substantially similar to design standards used in rule 139, and they would apply with respect to the research reports published or distributed by all

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399 *See supra* section II.B.1.c; *see also supra* section II.B.2.b.

400 *See* requests for comment at *supra* section III.C.2.a.

401 *See supra* note 11.

broker-dealers relying on the proposed rule, regardless of their size.[402] For the reasons discussed above, we believe that this use of design standards is appropriate for the furtherance of investor protection, and to help ensure that the proposed rule is not used to circumvent the prospectus requirements of the Securities Act.[403]

As we consider the comments we receive on our proposal, we will consider the available information to determine whether greater flexibility is warranted, consistent with investor protections.

G. General Request for Comment

The Commission requests comments regarding this analysis. We request comment on the number of small entities that would be subject to the proposed rules and whether the proposed rules would have any effects that have not been discussed. We request that commenters describe the nature of any effects on small entities subject to the proposed rules and provide empirical data to support the nature and extent of such effects.

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[402] *See, e.g.*, *supra* sections II.B.1.a (Reporting History and Timeliness Requirements) and II.B.1.b (Minimum Public Market Value Requirement).

[403] *See supra* notes 57–58 and accompanying text.

VI. SMALL BUSINESS REGULATORY ENFORCEMENT FAIRNESS ACT

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"),[404] the Commission must advise OMB whether a proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results in or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposal would be a "major rule" for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment, or innovation.

Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VII. STATUTORY AUTHORITY

We are proposing the rules contained in this document under the authority set forth in the Securities Act, particularly sections 6, 7, 8, 10, 17(a), 19(a), and 28 thereof [15 U.S.C. *77a et*

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[404] Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C., and as a note to 5 U.S.C. 601).

seq.]; the Exchange Act, particularly, sections 2, 3, 9(a), 10, 11A(c), 12, 13, 14, 15, 17(a), 23(a), 30, and 36 thereof [15 U.S.C. 78a *et seq*.]; the Investment Company Act, particularly, sections 6, 23, 24, 30, and 38 thereof [15 U.S.C. 80a *et seq*.]; and the FAIR Act, particularly, section 2 thereof.

List of Subjects

17 CFR Part 230

General Rules and Regulations, Securities Act of 1933

17 CFR Part 242

Regulations M, SHO, ATS, AC, NMS, and SBSR and Customer Margin Requirements for Security Futures

17 CFR Part 270

Rule and Regulations, Investment Company Act of 1940

TEXT OF PROPOSED RULES AND AMENDMENTS

For the reasons set out in the preamble, title 17, chapter II of the Code of the Federal Regulations is proposed to be amended as follows.

PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for part 230 continues to read, in part, as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78*l*, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78*ll*(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, and Pub. L. 112-106, sec. 201(a), sec. 401, 126 Stat. 313 (2012), unless otherwise noted.

* * * * *

2. Amend §230.139 to revise the introductory text of paragraph (a) to read as follows:

§ 230.139 Publications or distributions of research reports by brokers or dealers distributing securities.

(a) *Registered offerings*. Under the conditions of paragraph (a)(1) or (a)(2) of this section, a broker's or dealer's publication or distribution of a research report about an issuer or any of its securities shall be deemed for purposes of sections 2(a)(10) and 5(c) of the Act not to constitute an offer for sale or offer to sell a security that is the subject of an offering pursuant to a registration statement that the issuer proposes to file, or has filed, or that is effective, even if the broker or dealer is participating or will participate in the registered offering of the issuer's securities. For purposes of the Fair Access to Investment Research Act of 2017 [115 P.L. 66, 131 Stat. 1196 (2017)], a safe harbor has been established for covered investment fund research reports, and the specific terms of that safe harbor are set forth in Rule 139b (§230.139b).

* * * * *

3. Add §230.139b to read as follows:

§230.139b Publications or distributions of covered investment fund research reports by brokers or dealers distributing securities.

(a) *Registered offerings.* Under the conditions of paragraph (a)(1) or (a)(2) of this section, the publication or distribution of a covered investment fund research report by a broker or dealer that is not an investment adviser to the covered investment fund and is not an affiliated person of the investment adviser to the covered investment fund shall be deemed for purposes of sections 2(a)(10) and 5(c) of the Act not to constitute an offer for sale or offer to sell a security

that is the subject of an offering pursuant to a registration statement of the covered investment fund that is effective, even if the broker or dealer is participating or may participate in the registered offering of the covered investment fund's securities. This section does not affect the availability of any other exemption or exclusion from sections 2(a)(10) or 5(c) of the Act available to the broker or dealer.

(1) *Issuer-specific research reports.*

(i) At the date of reliance on this section:

(A) The covered investment fund:

(1) Has been subject to the reporting requirements of section 30 of the Investment Company Act of 1940 (the "Investment Company Act") (15 U.S.C. 80a-29) for a period of at least 12 calendar months and has filed in a timely manner all of the reports required, as applicable, to be filed for the immediately preceding 12 calendar months on Forms N-CSR (§§249.331 and 274.128 of this chapter), N-SAR (§§249.330 and 274.101 of this chapter), N-Q (§§249.332 and 274.130 of this chapter), N-PORT (§274.150 of this chapter), N-MFP (§274.201 of this chapter), and N-CEN (§§249.330 and 274.101 of this chapter) pursuant to section 30 of the Investment Company Act; or

(2) If the covered investment fund is not a registered investment company under the Investment Company Act, has been subject to the reporting requirements of section 13 or section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78m or 78o(d)) for a period of at least 12 calendar months and has filed in a timely manner all of the reports required to be filed for the immediately preceding 12 calendar months on Forms 10-K (§249.310

of this chapter) and 10-Q (§249.308a of this chapter), or 20-F (§249.220f of this chapter) pursuant to section 13 or section 15(d) of the Exchange Act; and

(B) The aggregate market value of voting and non-voting common equity held by non-affiliates of the covered investment fund, or, in the case of a registered open-end investment company (other than an exchange-traded fund) its net asset value (subtracting the value of shares held by affiliates), equals or exceeds the aggregate market value specified in General Instruction I.B.1 of Form S-3; and

(ii) The broker or dealer publishes or distributes research reports in the regular course of its business and, in the case of a research report regarding a covered investment fund that does not have a class of securities in substantially continuous distribution, such publication or distribution does not represent the initiation of publication of research reports about such covered investment fund or its securities or reinitiation of such publication following discontinuation of publication of such research reports.

(2) *Industry reports.*

(i) The covered investment fund is subject to the reporting requirements of section 30 of the Investment Company Act (15 U.S.C. 80a-29) or, if the covered investment fund is not a registered investment company under the Investment Company Act, is subject to the reporting requirements of section 13 or section 15(d) of the Exchange Act (15 U.S.C. 78m or 78o(d));

(ii) The research report:

(A) Includes similar information with respect to a substantial number of covered investment fund issuers of the issuer's type (*e.g.*, money market fund, bond fund, balanced fund,

etc.), or investment focus (*e.g.*, primarily invested in the same industry or sub-industry, or the same country or geographic region); or

(B) Contains a comprehensive list of covered investment fund securities currently recommended by the broker or dealer (other than securities of a covered investment fund that is an affiliate of the broker or dealer, or for which the broker or dealer serves as investment adviser (or for which the broker or dealer is an affiliated person of the investment adviser));

(iii) The analysis regarding the covered investment fund issuer or its securities is given no materially greater space or prominence in the publication than that given to other covered investment fund issuers or securities; and

(iv) The broker or dealer publishes or distributes research reports in the regular course of its business and, at the time of the publication or distribution of the research report (in the case of a research report regarding a covered investment fund that does not have a class of securities in substantially continuous distribution), is including similar information about the issuer or its securities in similar reports.

(b) *Self-regulatory organization rules.* A self-regulatory organization shall not maintain or enforce any rule that would prohibit the ability of a member to publish or distribute a covered investment fund research report solely because the member is also participating in a registered offering or other distribution of any securities of such covered investment fund; or to participate in a registered offering or other distribution of securities of a covered investment fund solely because the member has published or distributed a covered investment fund research report about such covered investment fund or its securities. For purposes of section 19(b) of the

Exchange Act (15 U.S.C. 78s(b)), this paragraph (b) of this section shall be deemed a rule under that Act.

(c) *Definitions*. For purposes of this section:

(1) "Affiliated person" has the meaning given the term in section 2(a) of the Investment Company Act.

(2) "Covered investment fund" means:

(i) An investment company (or a series or class thereof) registered under, or that has filed an election to be treated as a business development company under, the Investment Company Act and that has filed a registration statement under the Act for the public offering of a class of its securities, which registration statement has been declared effective by the Commission; or

(ii) A trust or other person:

(A) Issuing securities in an offering registered under the Act and which class of securities is listed for trading on a national securities exchange;

(B) The assets of which consist primarily of commodities, currencies, or derivative instruments that reference commodities or currencies, or interests in the foregoing; and

(C) That provides in its registration statement under the Act that a class of its securities are purchased or redeemed, subject to conditions or limitations, for a ratable share of its assets.

(3) "Covered investment fund research report" means a research report published or distributed by a broker or dealer about a covered investment fund or any securities issued by the covered investment fund, but does not include a research report to the extent that the research report is published or distributed by the covered investment fund or any affiliate of the covered investment fund, or any research report published or distributed by any broker or dealer that is an

investment adviser (or any affiliated person of an investment adviser) for the covered investment fund.

(4) "Exchange-traded fund" has the meaning given the term in General Instruction A to Form N-1A (§§ 239.15A and 274.11A of this chapter).

(5) "Investment adviser" has the meaning given the term in section 2(a) of the Investment Company Act.

(6) "Research report" means a written communication, as defined in Rule 405 (§230.405) that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.

4. Effective May 1, 2020, amend §230.139b by removing "N-Q (§§249.332 and 274.130 of this chapter)," in paragraph (a)(1)(i)(A)*(1)*.

PART 242—REGULATIONS M, SHO, ATS, AC, NMS, AND SBSR AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

5. The authority citation for Part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

* * * * *

6. Section 242.101 is amended by revising paragraph (b)(1) to read as follows:

§ 242.101. Activities by distribution participants.

* * * * *

(b) * * *

(1) *Research.* The publication or dissemination of any information, opinion, or recommendation, if the conditions of §§ 230.138, 230.139, or 230.139b of this chapter are met; or

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PART 270 - RULE AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

7. The authority citation for part 270 continues to read in part as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, 80a-39, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

8. Add §270.24b-4 to read as follows:

§270.24b-4 Filing copies of covered investment fund research reports.

A covered investment fund research report, as defined in paragraph (c)(3) of rule 139b (§230.139b of this chapter) under the Securities Act of 1933 (15 U.S.C. 77a et seq.), of a covered investment fund registered as an investment company under the Investment Company Act, shall not be subject to section 24(b) of the Act or the rules and regulations thereunder, except that such report shall be subject to such section and the rules and regulations thereunder to the extent that it is otherwise not subject to the content standards in the rules of any self-regulatory organization

related to research reports, including those contained in the rules governing communications with the public regarding investment companies or substantially similar standards.

By the Commission.

Dated: May 23, 2018

Brent J. Fields

Secretary