Proskauer

SEC Proposes Reform of "Test-the-Waters" Communications Rules

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On February 19, 2019, the Securities and Exchange Commission (the "SEC") proposed Rule 163B under the Securities Act of 1933, as amended (the "Securities Act"), which would permit all prospective issuers, including registered investment companies and business development companies ("BDCs"), to engage in communications with certain potential investors prior to, or following, the filing of a registration statement.[1] The proposed rule would expand the current scope of test-the-waters communications rules available to emerging growth companies. As proposed, Rule 163B would allow all prospective issuers to gauge market interest in contemplated registered securities offerings by permitting certain communications, outside of the prospectus, both before and after the filing of a registration statement. The proposed rule will be subject to a 60-day public comment period following its publication in the Federal Register.

Permitted Communications. Sections 5(c) and 5(b)(1) of the Securities Act generally prohibit oral and written offers of securities before the issuer files a registration statement, and written offers of securities after the filing of the registration statement must meet the requirements for a statutory prospectus. The proposed rule would allow issuers to gauge market interest in potential registered securities offerings by providing an exemption from these restrictions for oral or written communications by an issuer (or someone authorized to act on its behalf, including an underwriter) with potential investors who are, or who the issuer reasonably believes are, "qualified institutional buyers" (as defined in Rule 144A under the Securities Act) or institutional "accredited investors" (as defined in Regulation D).

Communications that comply with the proposed rule would not need to be filed with the SEC or include any specific legends, and the SEC proposes to amend the definition of "free writing prospectus" to exclude communications made under the proposed rule. As proposed, the communications would be deemed "offers" and would be subject to liability under the Securities Act, as well as the anti-fraud provisions of the federal securities laws.

Generally, the proposed rule does not limit the type of information that may be included in test-the-waters communications. The information in a test-the-waters communication must not conflict with material information in the related registration statement, and the SEC may request copies of any test-the-waters communication as part of its review of the registration statement pertaining to the offering or otherwise. Additionally, issuers, including closed-end investment companies, with a class of securities registered under Section 12 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), or required to file reports under Section 15(b) of the Exchange Act will need to ensure compliance with the applicable requirements under Regulation FD.

Application to Registered Investment Companies and BDCs. The proposed rule would permit issuers that are, or are considering becoming, registered investment companies or BDCs (collectively, "Funds") to engage in test-the-waters communications. After filing a registration statement under the Securities Act, a Fund would be permitted to communicate with qualifying prospective investors about a contemplated offering without complying with the existing regulations on "sales literature," including certain filing, disclosure and legending requirements in Rules 482 and 497 under the Securities Act and Section 24(b), and the rules and regulations thereunder, of the Investment Company Act of 1940, as amended (the "Investment Company Act").

The benefits of the proposed rule may be more limited to Funds than to other issuers. For example, Funds contemplating a registered offering at the time of their formation often register as investment companies during a seeding period. Typically, these Funds file a single registration statement under both the Securities Act and the Investment Company Act, which limits the length of the pre-filing period for newly formed entities. Further, Funds, other than certain private BDCs or other private funds that subsequently choose to provide liquidity through a registered public offering, typically conduct an offering within a shorter time frame after formation than most other types of issuers. Moreover, the practical utility of test-the-waters communications may be limited for BDCs and closed-end funds due to the absence of significant demand from institutional investors in recent registered public offerings.

Despite the potentially more limited use of the proposed rule by Funds, test-the-waters communications may help Funds better evaluate market demand for particular investment strategies and fee structures prior to filing a registration statement, thereby minimizing disclosure changes (and related costs) associated with disclosures on investment strategy and fee structure. The proposed post-filing communications may also result in lower costs and greater flexibility for Funds desiring to communicate with qualifying investors after filing a registration statement. In addition, a Fund that preliminarily engages in an exempt offering but is considering a subsequent registered offering could rely on the proposed rule to engage in test-the-waters communications before filing a registration statement under either the Securities Act or the Investment Company Act.

Interplay with Pending Securities Offering Reform for Funds. Proposed Rule 163B would be non-exclusive, and issuers could rely on other Securities Act rules when communicating about a contemplated securities offering. For instance, a qualifying issuer could rely on Rule 163 (the well-known seasoned issuer exemption) or Rule 164 (the free writing prospectus exemption). Funds, however, are "ineligible issuers" under both rules and currently cannot rely on those exemptions.

Congress has directed the SEC to extend to BDCs and certain registered closed-end funds the securities offering rules, including Rules 163 and 164, that are available to other issuers required to file reports under Section 13(a) or 15(d) of the Exchange Act.[2] The SBCAA provides that if the SEC does not complete the required rule and form amendments within a year following the date of the enactment of the SBCAA (*i.e.*, March 23, 2019), BDCs may deem those required amendments as having been completed in accordance with the actions required of the SEC under the SBCAA. Under the Growth Act, the SEC has until May 24, 2019 to propose, and until May 24, 2020 to finalize, similar rule and form amendments for certain registered closed-end funds, although the SEC has discretion under the Growth Act to impose additional conditions on closed-end funds that do not apply to other Exchange Act registrants, including BDCs.

Until the SBCAA and Growth Act rule and form amendments are finalized, proposed Rule 163B would offer an exemption similar in some aspects to Rule 163, although the SEC has proposed some significant differences. For example, Rule 163 does not limit communications to any particular group of potential investors, while Rule 163B would limit communications to qualified institutional buyers and institutional accredited investors. In addition, underwriters would be permitted to rely on Rule 163B, whereas they may not rely on the exemption provided by Rule 163.

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[1] SEC Release No. 33-10607 is available at: https://www.sec.gov/news/press-release/2019-14.

[2] *See* Section 803(b) of the Small Business Credit Availability Act, Pub. L. No. 115-121, title VII (the "SBCAA") and Section 509(a) of the Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 (the "Growth Act").