

The Investment Lawyer

Covering Legal and Regulatory Issues of Asset Management

VOL. 26, NO. 12 • DECEMBER 2019

REGULATORY MONITOR

SEC Update

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SEC Extends “Testing the Waters” Exemption

The Securities and Exchange Commission (SEC) recently issued final regulations permitting all operating companies to “test the waters” regarding certain investors’ potential interest in a securities offering.¹ Although the new rule has limited value to most registered investment companies and private funds, the SEC believes that business development companies (BDCs) and some closed-end funds should benefit from the new rule.

New Rule 163B, which extends an exemption under the Securities Act of 1933 (Securities Act) currently available only to emerging growth companies (EGCs), permits issuers to engage in oral or written communications with certain sophisticated institutional investors, either prior to or following the filing of a registration statement, to determine whether such investors might have an interest in a contemplated registered securities offering. The rule is designed to facilitate access to the public markets by allowing issuers to gauge investor interest without incurring the significant costs associated with preparing and filing a registration statement. The regulations become effective on December 3, 2019.

Investor Status

Rule 163B permits an issuer to engage in pre- and post-filing solicitations of interest with

potential investors that are, or that the issuer reasonably believes to be, Qualified Institutional Buyers (QIBs) or Institutional Accredited Investors (IAIs). A QIB generally is a specified institution that, acting for its own account or the accounts of other QIBs, in the aggregate, owns and invests on a discretionary basis at least \$100 million in securities of unaffiliated issuers. An IAI is any institutional investor that also is an accredited investor, as defined in paragraph (a) of Rule 501 of Regulation D.² Under the rule, any potential investor solicited must meet, or the issuer must reasonably believe that the potential investor meets, these requirements.

Availability of Exemption for Underwriters

In extending the availability of the testing the waters exemption to all issuers, Rule 163B also permits underwriters to communicate with potential investors prior to the filing of a registration statement, provided they are authorized to do so by the issuer. Current Rule 163 only applies to “well-known seasoned issuers” (WKSI), and does not extend to the underwriters of a WKSI offering.

Not a Free Writing Prospectus; No Filing Requirement; Regulation FD

The rule exempts qualifying testing the waters communications from the definition of free writing

prospectus provided in Rule 405 under the Securities Act and the prospectus filing requirements of Rule 424(b) under the Securities Act. However, any such communications are considered offers under the Securities Act and as such remain subject to the anti-fraud provisions under the federal securities laws, including Section 12(a)(2) of the Securities Act. The SEC notes that, even though there is no filing requirement, the Staff may request copies of any testing the waters communications in connection with its review of a registration statement, similar to its current practice with respect to EGCs.³ In making Rule 163B communications, issuers would need to make sure they comply with the selective disclosure rules of Regulation FD.

Non-Exclusivity

Under the non-exclusive exemption provided by Rule 163B, an issuer would be able to rely concurrently on other Securities Act communications exemptions when determining how, when and what to communicate in connection with a contemplated securities offering. However, the SEC cautions that an issuer that solicited interest from QIBs and IAs in reliance on Rule 163B would need to make sure it had not engaged in a general solicitation were it to rely on a private placement exemption in lieu of proceeding with a registered offering.⁴

Use by Investment Companies and BDCs

The exemption provided under Rule 163B similarly applies to issuers that are, or that are considering becoming, registered investment companies or BDCs. The SEC notes, however, that legal and other considerations would likely limit the use of Rule 163B to BDCs and certain closed-end funds.

Registered funds typically rely on a single registration statement pursuant to forms that are promulgated under both the Investment Company Act of 1940 (1940 Act) and the Securities Act.⁵ The SEC declined to provide a parallel exemption that would

permit a fund to avoid 1940 Act registration while engaging in communications under Rule 163B, expressing concern that such an exemption would permit funds to avoid the substantive requirements of the 1940 Act when marketing a fund. The SEC also notes that Rule 163B will be of little use to private funds, because private funds offer securities in reliance on the private placement exemptions and do not engage in registered offerings.

Certain other funds would likely benefit from Rule 163B to engage in pre-filing communications to gauge interest in a potential registered offering. Because BDCs are not required to register under the 1940 Act, they could seek to rely on Rule 163B to communicate with potential investors.⁶ Funds that initially conduct exempt offerings, including BDCs and certain closed-end funds, may also use Rule 163B to communicate with potential investors if they are contemplating a subsequent registered offering.

Funds will be able to more broadly rely on Rule 163B to engage in test the waters communications under the Securities Act after filing a registration statement but prior to effectiveness. The SEC notes that many funds already engage in test the waters communications under other SEC and FINRA rules, such as FINRA Rule 2210 (which permits certain communications with institutional investors without FINRA pre-filing requirements); however, to the extent available, Rule 163B imposes no additional conditions on a fund seeking to rely on the Rule unlike such other SEC and FINRA rules that may contain additional filing, legending, or content requirements.⁷

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NOTES

¹ See *Solicitations of Interest Prior to a Registered Public Offering*, SEC Release No. 33-10699, 84 Fed. Reg.

53011 (Oct. 4, 2019), available at <https://www.sec.gov/rules/final/2019/33-10699.pdf> (the Adopting Release).

² An institutional investor that meets the criteria of Rule 501(a)(1), Rule 501(a)(2), Rule 501(a)(3), 501(a)(7) or 501(a)(8) of Regulation D under the Securities Act.

³ See the Adopting Release at 7.

⁴ *Id.* at 20-21.

⁵ *Id.* at 31-32.

⁶ The use of Rule 163B by BDCs may be limited, as the SEC notes, due to BDCs' relatively high levels of retail investor ownership. *Id.* at n.136.

⁷ *Id.* at 34-37.

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