SEC PROPOSES NEW RULE TO EXPAND "TEST-THE-WATERS" MODERNIZATION REFORM TO REGISTERED INVESTMENT COMPANIES

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U.S. Investment Management Alert

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I. EXECUTIVE SUMMARY

On February 19, 2019, the SEC proposed Rule 163B (the "Proposed Rule") and amendments to certain related rules [1] under the Securities Act of 1933, as amended (the "1933 Act"), that would enable *all* issuers, including investment companies registered under the Investment Company Act of 1940, as amended (the "1940 Act"), to engage in "test-the-waters" communications with certain institutional investors regarding a contemplated registered securities offering prior to, or following, the filing of a related registration statement. These communications would be exempt from restrictions imposed by Section 5 of the 1933 Act on written and oral offers prior to or after filing a registration statement, and would be limited to communications with qualified institutional buyers ("QIBs") and institutional accredited investors ("IAIs" and collectively with QIBs, the "Permitted Investors"). This alert summarizes the application of the Proposed Rule to investment companies and describes certain potential challenges that may limit its practical usefulness.

Adopted in 2012 as part of the Jumpstart Our Business Startups Act, Section 5(d) of the 1933 Act permits an emerging growth company and any person acting on its behalf to engage in oral or written communications with potential investors that are Permitted Investors, before or after filing a registration statement, to gauge such investors' interest in a contemplated securities offering. The Proposed Rule would extend this test-the-waters exemption and permit any issuer, or any person authorized to act on its behalf, to engage in oral or written communications with potential investors that are, or are reasonably believed to be, Permitted Investors. The Proposed Rule would be non-exclusive, and an issuer could continue to rely on other 1933 Act communications rules or exemptions when determining how, when, and what to communicate with respect to a contemplated securities offering.

The Proposed Rule may provide a greater safe harbor around the closed-end fund syndicate building stage of an initial public offering. Similarly, the Proposed Rule may be useful for exchange-traded funds ("ETFs") in gauging seeding interest. However, mutual funds, which traditionally target retail investors, may find the Proposed Rule's limitation of communications to Permitted Investors constraining. In addition, private funds that rely on the exceptions from registration under Section 3(c)(1) and 3(c)(7) are unlikely to make use of the Proposed Rule. The Proposed Rule allows certain communications prior to, or after, filing a registration statement to make a public offering, but the exceptions in Section 3(c)(1) and 3(c)(7) are not available for issuers proposing to make a public offering.

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As discussed below, registered funds should be aware that, although the Proposed Rule would allow funds to engage in test-the-waters communications with Permitted Investors without filing a 1933 Act registration statement, the Proposed Rule does not relieve an issuer of an obligation to file a registration statement under the 1940 Act. As a result, as currently drafted, the Proposed Rule would constrain pre-filing communications for registered funds more than for other issuers. Registered funds should consider writing a comment letter to address the 1940 Act registration concern. Comments on the Proposed Rule are due April 29, 2019.

II. BACKGROUND

The 1933 Act imposes strict limitations on an issuer's communications with the public, which includes investors, brokers, and the press, regarding a securities offering prior to the effective date of the registration statement. Section 5(c) prohibits any written or oral offers prior to the filing of a registration statement (the "Restricted Period"). [2] Section 5(b)(1) limits written offers to a "statutory prospectus" that complies with the information requirements of Section 10 of the 1933 Act. Any violation of these prohibitions is commonly referred to as "gun-jumping."

Under the Proposed Rule, an issuer would be exempt from the gun-jumping restrictions and would be able to engage in written or oral communications with potential investors that the issuer reasonably believes are Permitted Investors, either before or after filing a registration statement, to determine whether such investors might have an interest in the offering. Such test-the-waters communications, which include oral and written offers to purchase securities, would still be considered "offers" of securities under the Proposed Rule and thus remain subject to liability under the federal securities laws. The Proposed Rule would not be available for any communication that, while in technical compliance with the Proposed Rule, is part of a plan or scheme to evade the requirements of Section 5 of the 1933 Act.

III. THE PROPOSED RULE

a. Scope of the Proposed Rule

The Proposed Rule would allow all issuers, and persons authorized to act on behalf of the issuer, such as principal underwriters, advisers, market makers and other intermediaries, to engage in test-the-waters communications with prospective investors that the issuer reasonably believes are Permitted Investors before or after filing a registration statement. Investment companies able to rely on the Proposed Rule would include mutual funds, ETFs, closed-end funds, and business development companies ("BDCs"). Notably, such investment companies have historically been excluded from similar exemptions. [3]

The Proposed Rule would cover communications with, among others, investment advisers, broker-dealers, and banks that are Permitted Investors. The Proposed Rule defines QIBs in the same manner as Rule 144A under the 1933 Act, [4] which generally include (1) certain institutions that own or invest, either for their own accounts or the accounts of other QIBs, in the aggregate, at least $100 million in securities of unaffiliated issuers (or $10 million with respect to broker-dealers); and (2) banks that have a net worth of at least $25 million. The Proposed Rule defines IAIs as any institutional investor that is also an accredited investor pursuant to Rule 501(a) of Regulation D. [5]

b. Requirements of the Proposed Rule

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No Content Restrictions. The Proposed Rule does not limit the scope of the content that would be permitted to be included in test-the-waters communications so long as the test-the-waters communications do not conflict with material information in the associated registration statement.

Under the current framework, fund communications contemplated by the Proposed Rule generally would be considered "sales literature" and would be subject to rules governing "sales literature" under the 1933 Act and the 1940 Act. For example, after a fund has filed a registration statement, it may engage in communications that are advertisements under Rule 482 under the 1933 Act, or that are deemed to be sales literature under Rule 34b-1 under the 1940 Act. Communications under Rule 482 and Rule 34b-1 are also subject to certain filing, disclosure, and legending requirements. By contrast, under the proposal, funds could rely on the Proposed Rule to engage in permissible test-the-waters communications without complying with these rules.

Investor Status Does Not Require Verification. In contrast to the verification requirements of Rule 506(c) under the 1933 Act, which some issuers have found to be burdensome, issuers would *not* need to verify an investor's status as a Permitted Investor. The standard under the Proposed Rule is for the issuer to *reasonably believe*, based on the particular facts and circumstances, that an investor is a Permitted Investor, which is a helpful modification from Section 5(d), which lacks a reasonable belief standard. The SEC did not propose to specify the steps that an issuer could or must take to establish a reasonable belief that the intended recipients of test-the-waters communications are Permitted Investors. Issuers, however, may rely on methods used to establish a reasonable belief of a QIB or accredited investor's status pursuant to Rules 144A and 501(a) under the 1933 Act, respectively.

c. Potential Challenges for Registered Investment Companies

No Exception From Filing Registration Statement Under 1940 Act. Funds typically will conduct an offering within a relatively short period of time after they are organized in comparison to other types of issuers. Under the Proposed Rule, funds could engage in test-the-waters communications with Permitted Investors during the seeding period without filing a 1933 Act registration statement. However, the Proposed Rule does not relieve an issuer of an obligation to file a registration statement under the 1940 Act. Specifically, absent an available exemption under the 1940 Act, a fund is generally required to register as an investment company before offering its shares. As discussed above, the exceptions from registration that most funds would rely on (i.e., Sections 3(c)(1) and 3(c)(7)) are not available for issuers proposing to make a public offering. As a result, funds seeking to take advantage of the Proposed Rule may be required to register as investment company and file a registration statement under the 1940 Act. As a result, most registered funds, which would prefer to file a single registration statement under both the 1933 Act and the 1940 Act due to certain efficiencies, may be less likely to use the Proposed Rule for pre-filing communications than other issuers. Registered funds should consider commenting on the Proposed Rule so that test-the-waters communications do not trigger a requirement to file a registration statement under the 1940 Act.

Regulation FD. [6] Closed-end funds (and other issuers subject to Regulation FD), would need to consider whether any information in the test-the-waters communications would trigger disclosure obligations under Regulation FD. Regulation FD requires public disclosure of any nonpublic information that has been selectively disclosed to certain securities market professionals or shareholders if the issuer has a class of securities registered under Section 12 of the Securities Exchange Act of 1934, as amended (the "1934 Act") or is required to file reports under Section 15(d) of the 1934 Act. Accordingly, test-the-waters communications containing material

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nonpublic information would need to comply with Regulation FD or be subject to a confidentiality agreement from the Permitted Investor receiving the communication.

Limited Use for Mutual Funds. Mutual funds typically offer their shares to retail investors in registered offerings, and as such, would likely not take advantage of the Proposed Rule's authorization to engage in communications with Permitted Investors. However, mutual funds may find the Proposed Rule helpful in conducting test-the-waters discussions regarding potential fund distribution with various intermediary platform providers that are Permitted Investors.

IV. CONCLUSION

The Proposed Rule is a helpful expansion of the test-the-waters exemption, which may allow issuers, including investment companies, to gauge investor interest in a registered offering prior to incurring the significant costs associated with a registered offering. Investment companies could use test-the-waters communications to assess interest in investment strategies and fee structures leading to new and more efficient product development.

NOTES

[1] For example, the SEC proposed to amend Rule 405 to exclude a written communication used in reliance on the Proposed Rule from the definition of "free writing prospectus" as that term is defined in Rule 405.

[2] Under the current framework applicable to investment companies, the Restricted Period has three distinct stages governing the types of communications an issuer may have with the public while in the process of making a registered offering: (1) the pre-filing period; (2) the waiting period; and (3) the post-effective period. During the pre-filing period — from deciding to make a securities offering to filing a registration statement — an issuer may not make any offers to sell or buy securities (see Section 5(c)). The SEC interprets an "offer" broadly; it includes a solicitation to purchase securities or a statement designed to condition the market with respect to the registered offering. During the waiting period — from filing a registration statement to the registration effective date — written offers must be a statutory prospectus that conforms to the requirements of Section 10 (see Section 5(b)(1)). A written offer, other than a statutory prospectus, may be made only if a final prospectus meeting the requirements of Section 10(a) is sent or given prior to or at the same time as the written offer (see Section 2(a)(1)). During the post-effective period — from the registration effective date to the date the offering's securities begin trading — an issuer can offer and sell securities, but any communications generally must be accompanied or preceded by a prospectus (see Section 5(b)(2)).

[3] Similar exemptions that allow issuers to engage in test-the-waters communications with potential investors, without restriction as to the type of investors, subject to certain requirements, include Rule 163, which exempts well-known seasoned issuers but is not available to BDCs or registered investment companies, and the 2015 Regulation A amendments, which exempt small offerings but is also not available to registered investment companies or BDCs.

[4] Rule 144A under the 1933 Act.

[5] Rule 501(a) of Regulation D promulgated under the 1933 Act.

[6] Regulation Fair Disclosure (Reg FD), 17 CFR 243.100 et seq. of the 1933 Act.

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