SEC ADOPTS RULE EXPANDING "TEST-THE-WATERS" MODERNIZATION REFORM

Date: 17 October 2019

U.S. Investment Management Alert

By: Pablo J. Man

EXECUTIVE SUMMARY

On September 26, 2019, the Securities and Exchange Commission (the "SEC") adopted Rule 163B (the "Rule") under the Securities Act of 1933, as amended (the "1933 Act"), which enables *all* issuers to engage in "test-the-waters" communications with certain institutional investors to gauge interest in a registered securities offering either prior to or following the filing of a registration statement. With respect to registered investment companies, this includes exchange-traded funds ("ETFs"), mutual funds, closed-end funds, and business development companies ("BDCs"). Such investment companies are often excluded from similar exemptions. [1] Under the Rule, such written or oral "test-the-waters" communications are exempt from the restrictions imposed by Sections 5(c) and 5(b)(1) of the 1933 Act.

However, the Rule as adopted, just like the proposed rule, [2] is expected to have limited use for registered funds. This alert summarizes the application of the Rule to registered funds and describes certain challenges that will limit its practical usefulness for such funds. The Rule will become effective on December 3, 2019.

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"). [3] 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."

Section 5(d) of the 1933 Act, adopted in 2012 as part of the Jumpstart Our Business Startups Act, permits an emerging growth company ("EGC"), and any person acting on behalf of the EGC, to engage in written or oral communications with qualified institutional buyers ("QIBs") and institutional accredited investors ("IAIs," and together with QIBs, "Permitted Investors") before or after filing a registration statement to determine whether such investors would be interested in a contemplated securities offering.

On February 19, 2019, the SEC proposed the Rule to expand such "test-the-waters" communications by allowing *all* issuers, and those authorized to act on behalf of the issuer, to engage in "test-the-waters" communications with potential investors who are, or are reasonably believed by the issuer to be, Permitted Investors prior to or following the filing of a registration statement. Such "test-the-waters" communications, which include oral and

©2005-2026 K&L Gates LLP. All Rights Reserved.

written offers to purchase securities, are "offers" of securities under the 1933 Act and thus remain subject to liability under federal securities laws.

The SEC received approximately 20 comments, which were largely supportive of the proposed rule. Accordingly, the Rule was adopted almost entirely as proposed, with the exception of two changes. Specifically, the Rule does not include any anti-evasion language, which would have made the Rule unavailable for any communication that, while in technical compliance with the Rule, is part of a plan or scheme to evade the requirements of Section 5 of the 1933 Act. Additionally, while the proposal sought to amend Rule 405 to exclude Rule communications from the definition of "free writing prospectuses," both Rule 405 and Rule 424(b) are amended to clarify that *neither* Rule communications nor Section 5(d) communications constitute free writing prospectuses requiring filing, thus confirming both types of "test-the-waters" communications will be treated equally. These changes from the proposal were designed to remove certain regulatory uncertainty that would have limited the utility of the Rule.

INVESTMENT COMPANIES

a) Limited Use for Registered Funds

No Exemption From Registration Under the 1940 Act. The SEC received three comments about the application of the proposed rule on registered funds. Commenters noted that registered funds will be less likely to use "test-the-waters" communications than other issuers because, although "test-the-waters" communications are exempt from registration under the 1933 Act, there is no analogous exemption from the requirement to file a registration statement under the Investment Company Act of 1940, as amended (the "1940 Act").

In the adopting release, the SEC recognized that funds that registered as investment companies would not specifically benefit from the Rule, since the Rule only relates to communications about contemplated registered securities offerings that Sections 5(c) or 5(b)(1) of the 1933 Act would otherwise restrict. [4] Filing a single registration statement under both the 1933 Act and the 1940 Act offers certain efficiencies. Absent an exemption under the 1940 Act, funds must register as investment companies *before* offering shares. [5]

In the adopting release, the SEC expressly declined to provide a new exemption under the 1940 Act to allow a fund to avoid the registration requirement under Section 8 of the 1940 Act while it engages in communications under the Rule. The SEC acknowledged the comments received, but expressed concerns that an exemption from registration (and thus from the substantive requirements of the 1940 Act) could allow funds to engage in certain self-dealing transactions and other activities that are prohibited by the 1940 Act.

b) Considerations for Closed-End Funds, BDCs, and ETFs

The SEC noted that BDCs may be more likely to engage in "test-the-waters" communications under the Rule when contemplating a registered offering close in time to the BDC's inception. Additionally, funds that initially conduct private offerings, including certain registered closed-end funds, may use the Rule to communicate with Permitted Investors before filing a 1933 Act registration statement if they are contemplating a subsequent registered offering. [6] Additionally, the Rule may provide a greater safe harbor around the closed-end fund syndicate building stage of an initial public offering and may assist ETFs in gauging seeding interest.

Closed-end funds, however, should consider whether information in any "test-the-waters" communications triggers disclosure obligations under Regulation FD or, alternatively, avoids the application of Regulation FD through a confidentiality agreement. Regulation FD requires public disclosure of any nonpublic information that

©2005-2026 K&L Gates LLP. All Rights Reserved.

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. Closed-end funds subject to Regulation FD must ensure any "test-the-waters" communications containing material nonpublic information comply with Regulation FD, unless the closed-end fund obtains a confidentiality agreement from the potential investor to avoid the application of Regulation FD.

SCOPE AND TERMS OF THE ADOPTED RULE

a) Scope of the Rule

The Rule allows all issuers, including investment companies, and persons authorized to act on behalf of the issuer, to engage in "test-the-waters" communications before or after filing a registration statement by communicating with prospective investors that the issuer reasonably believes are Permitted Investors.

Communications with investment advisers, broker-dealers, and banks, among other types of Permitted Investors, are allowed under the Rule. The Rule defines QIBs in the same manner as Rule 144A under the 1933 Act, 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 Rule defines IAIs as any institutional investor that is also an accredited investor pursuant to Rule 501(a) of Regulation D promulgated under the 1933 Act.

The Rule is nonexclusive, and an issuer can 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.

b) Requirements of the Rule

No Content Restrictions. The Rule does not limit or impose additional restrictions on the content that may be used in "test-the-waters" communications, including performance presentations, so long as such communications do not conflict with material information in the related registration statement. [7] "Test-the-waters" communications must not contain any material misstatements or omissions at the time such communications are made, even though a registration statement may not be available at that time and offering terms and disclosures may evolve in accordance with feedback from potential investors.

Additionally, as proposed, the Rule will not impose any filing or legending requirements as those otherwise required by rules governing similar communications. Under the current framework and without the benefit of the Rule, "test-the-waters" communications would generally be considered "sales literature" and would be subject to rules governing "sales literature" under the 1933 Act and the 1940 Act.

Investor Status Does Not Require Verification. As proposed, the Rule includes a reasonable belief standard and does not require verification of or otherwise specify the steps an issuer could or must take to establish a reasonable belief of an investor's status. Unlike the burdensome verification requirements of Rule 506(c) under the 1933 Act, the reasonable belief standard is intended to provide flexibility to use methods that are cost-effective but appropriate in light of the facts and circumstances of each contemplated offering and each potential

©2005-2026 K&L Gates LLP. All Rights Reserved.

investor. Issuers may continue to rely on the methods they currently use to establish a reasonable belief of investor status as a QIB or IAI pursuant to Rule 144A and Rule 501(a) under the 1933 Act, respectively.

NOTES

[1] 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: (i) Rule 163, which exempts well-known seasoned issuers but is not available to registered investment companies or BDCs; and (ii) Regulation A, which exempts small offerings but is also not available to registered investment companies or BDCs.

[2] Our alert discussing the proposed rule can be found at http://www.klgates.com/sec-proposes-new-rule-to-expand-test-the-waters-modernization-reform-03-18-2019/.

[3] 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)).

[4] Funds sometimes register as investment companies during a seeding period in which the fund's sponsor tests the fund's investment strategy and establishes a performance track record for marketing purposes. Funds could engage in "test-the-waters" communications with Permitted Investors during the seeding period without filing a 1933 Act registration statement.

[5] In theory, a fund could rely on Sections 3(c)(1) and 3(c)(7) of the 1940 Act during the seeding period; however. funds typically do not rely on such exclusions. Furthermore, these exclusions are not available to funds that make, or propose to make, a registered offering. Under the Rule, an issuer choosing to engage in "test-the-waters" communications under the Rule concurrently with communications related to a private offering must conduct such communications in a manner that preserves the availability of both the Rule and the private offering exemption.

[6] Open-end funds are less likely to use the Rule in this manner because they typically offer shares to retail investors. However, mutual funds may find the Rule helpful in conducting "test-the-waters" discussions regarding potential fund distribution with various intermediary platform providers that are Permitted Investors.

[7] Additionally, "test-the-waters" communications are also subject to the anti-fraud provisions of federal securities laws.

©2005-2026 K&L Gates LLP. All Rights Reserved.

KEY CONTACTS



PABLO J. MAN
PARTNER

BOSTON
+1.617.951.9209
PABLO.MAN@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.