BETTER MARKETS

April 29, 2019

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Solicitations of Interest Prior to a Registered Public Offering (Release No. 33-10607; File No. S7-01-18)

Dear Mr. Fields:

Better Markets[1] appreciates the opportunity to submit this letter in response to the Securities and Exchange Commission's ("SEC" or "Commission") above-captioned request for comment ("Proposal" or "Release").

The Proposal creates a new rule ("Rule 163B") under the Securities Act of 1933 that would permit **all issuers** to communicate with and solicit interest from certain potential investors **prior** to a contemplated public securities offering. This Proposal would essentially create a broad exemption from current SEC rules that prohibit most issuers from communicating with and soliciting interest from potential investors **prior** to the filing of a registration statement of a public securities offering. While all issuers can take advantage of this new so-called "test-the-waters" ("TTW") exemption, as proposed in the Release, the issuers, or persons acting on their behalf, can only solicit interest from investors that are – or the issuer "reasonably believes" are – sophisticated investors, defined as qualified institutional buyers ("QIBs")[2] and institutional accredited investors

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 17 CFR § 230.144A defines QIBs as – among several entities such as investment companies, insurance companies, investment advisers, certain dealers, business development companies, etc. – "any […] entities, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity." QIBs are generally deemed highly sophisticated in their ability to analyze risk and sustain significant financial losses associated with complex and risky investments.

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("IAIs").[3] The Commission preliminarily believes that by "liberalizing pre-filing and post-filing communications for all issuers, [they] are providing them with a cost-effective means for gauging market interest prior to incurring the full costs of a registered offering."[4]

SUMMARY

1. As a threshold matter, the Release fails to identify or explain the legal authority that would permit the Commission to make such a sweeping amendment to the securities laws, and it does not appear that such authority exists. While Congress chose to exempt certain issuers from the proscriptions against TTW communications, it chose not to extend that exemption broadly or to give the Commission the authority later to modify or expand the exemption in its discretion.

2. The Proposal creates a dangerous loophole by not requiring issuers (and persons authorized to act on their behalf including underwriters) to validate the status of the investor (to assure whether the investor is in fact a QIB or an IAI) before a solicitation is made. This loophole would permit solicitations to **retail** and other investors who either lack financial sophistication or cannot bear the financial risks associated with investing in highly risky investments such as those offered by, for example, penny stock issuers, leveraged business development companies, or asset-backed security issuers. As proposed, Rule 163B would in effect permit anyone to check a box at the bottom of a lengthy fine-print disclaimer that would self-certify that the investor meets the eligibility criteria. This self-certification would in turn permit the issuer or anyone acting on its behalf to claim that the issuer has attained "reasonable belief" that the solicitation is directed at QIBs and IAIs. This dangerous, anti-investor protection loophole must be closed before the Proposal is finalized.

3. The Commission should require issuers that engage in TTW **and** subsequently file a registration statement for a securities offering to also file the TTW communications with the SEC. As proposed, Rule 163B would not require issuers to file these solicitation communications after the offering is registered with the SEC. Requiring the filing of these already-prepared and disseminated communications would add no additional burden on the issuers and would provide the Commission with information to monitor and police the market. Moreover, it would allow current and future investors to compare the TTW communications (and the claims made therein) with the prospectus of the issuer and the performance of the securities themselves.

4. The Commission's primary mission and duty is to protect investors. Therefore, any regulatory changes must be carefully and narrowly tailored to ensure that they will not compromise investor protection. In this case, that means maintaining the strict limitation on the type of investor to whom TTW may be directed—QIBs and IAIs. It is essential that the Proposal maintain this feature in any final rule.

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[3] *See* Release at 6714, fn. 4. An institutional accredited investor refers to any institutional investor that is also an accredited investor. Release available at https://www.regulations.gov/contentStreamer?documentId=SEC-2019-0222-0001&contentType=pdf. Accessed on April 18, 2019.

[4] Release at 6730.

5. Finally, permitting issuers (and persons authorized to act on their behalf, including underwriters) to communicate with QIBs and IAIs of their choosing increases the problem of information asymmetry between a selected subset of investors who are "in the know" and all other similarly qualified investors who learn about the existence and characteristics of a securities offering only once it is made public through the ordinary filing of a registration statement. This creates an unlevel playing field and gives further advantage to selected sophisticated investors, who are able to afford underwriters and other intermediaries who are more connected to existing or prospective issuers, over other similarly qualified investors, such as smaller pension funds or asset managers that do not have similar connections. Consistent with the bedrock principles that govern rulemaking under the Administrative Procedure Act ("APA"), the Commission must consider these factors before finalizing any rule and must articulate a satisfactory explanation for any choices it makes, in light of the factual predicate for the rule, the Commission's core mission of protecting investors, and any impact this feature of the rule may have on efficiency, fair competition, and capital formation.[5]

BACKGROUND

Section 5(c) of the Securities Act of 1933 and SEC rules generally prohibit issuers or persons affiliated with issuers from offering securities prior to the filing of a registration statement on SEC's EDGAR system, which then makes these registration and other disclosures fully available to everyone at the same time and in the same manner. Once a securities offering registration statement is filed, SEC rules generally require issuers to use a prospectus to make any written offers of securities.[6] However, Congress in 2012, through the enactment of the Jumpstart Our Business Startups Act ("JOBS Act"), created a new category of issuers – the emerging growth companies ("EGCs") – and permitted these issuers to solicit from and engage in TTW communications – which are separate and apart from prospectuses – with QIBs and IAIs both before and after filing the registration statement.[7]

The Proposal now dramatically broadens the ability to engage in TTW communications to **all issuers, for all types of issuances**, so long as the investors that are being solicited are, or the issuer reasonably believes that they are, QIBs or IAIs. The Commission explicitly declines to outline an approach or provide any guidance that could or should be used to establish this "reasonable belief" standard.

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5 *See Motor Veh. Manuf. Ass'n v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43-45 (1983).

6 Release at 6722.

7 *See* Release at 6714, fn. 3. These emerging growth companies ("EGCs") are issuers that had total annual gross revenues of less than $1.07 billion during their most recently completed fiscal year and, as of December 8, 2011, had not sold common equity securities under a registration statement. These issuers remain EGCs for the first five fiscal years after the date of the first sale of their common equity securities pursuant to an effective registration statement, unless one of the following occurs: Their total annual gross revenues are $1.07 billion or more; they have issued more than $1 billion in non-convertible debt in the past three years; or they becomes a ''large accelerated filer.''

In the Release, the Commission argues that "permitting issuers to ''test the waters'' is intended to provide increased flexibility to issuers with respect to their communications about contemplated registered securities offerings, as well as a cost-effective means for evaluating market interest before incurring the costs associated with such an offering."[8] The Commission claims permitting investment companies such as mutual funds to engage in TTW communications would have positive implications for the markets as this would allow "investment company issuers to better assess market demand for a particular investment strategy, as well as appropriate fee structures, prior to incurring the full costs of a registered offering."[9] And more broadly, the Commission argues that allowing all issuers to engage with certain sophisticated institutional investors "could help issuers to better assess the demand for and valuation of their securities and to discern which terms and structural components of the offering may be most important to investors," and this could in turn "enhance the ability of issuers to conduct successful offerings and lower their cost of capital."[10]

Finally, the Commission argues that the new Rule 163B "could encourage additional registered offerings in the U.S. …and [these] offerings can have long-term benefits for investors[11] and our markets, including improved issuer disclosure, increased transparency in the marketplace, better informed investors, and a broader pool of issuers in which any investor may invest."[12]

Regrettably, the Commission provides little data and/or persuasive analysis to show connections between the claims reproduced above and how the proposed Rule 163B would concretely address or achieve the public policy needs. As a prime example, it is unclear from the Proposal whether liberalizing TTW would in fact cause more issuers to issue registered offerings. At various points, the Proposal discusses how the results of a TTW engagement may **discourage** issuers from going forward with a public issuance since the issuer will learn that the valuation or other characteristics of the contemplated issuance is not attractive to buyers.[13] The Proposal, in this instance, is intended to function as a cost-avoidance mechanism for the prospective issuer but how it will **increase** public offerings remains unclear to us.

COMMENTS

1. **It does not appear that the Commission has the authority to dramatically expand the limited exception that Congress established in the JOBS Act, and the Release certainly fails to identify such authority.**

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8 Release at 6714.

9 Release at 6715.

10 Release at 6715.

11 The Commission seems to anticipate that making it easier for all issuers to engage in TTW would benefit retail investors. *See* Release at 6714: "We believe that the ability to test the waters may also encourage additional participation in the public markets. Increased participation in our public markets, in turn, promotes more investment opportunities for more investors, including retail investors, as well as transparency and resiliency in the marketplace."

12 Release at 6715.

13 *See* "Potential Benefits to Issuers" in the Release at 6724.

As a threshold matter, it does not appear that the Commission has the requisite authority to finalize the Proposal, and the Release makes little effort to demonstrate the existence of any such authority. As noted in the introduction above, Section 5(c) of the Securities Act has long prohibited issuers or persons affiliated with issuers from making written or oral offers of securities prior to the filing of a registration statement with the SEC. In 2012, Congress created a clearly defined exemption for the benefit of EGCs who seek to engage in TTW communications with QIBs and IAIs.

Now the Commission proposes to permanently expand that exception, by rule, to cover any and all issuers. The Release offers no analysis of the legal authority that would justify this extraordinary exercise of regulatory power. Certainly, the JOBS Act itself provides none. There, Congress created a limited exemption from the normal prohibitions governing the offer and sale of securities, for the benefit of a defined class of issuers, the EGCs. Section 5(d) provides that EGCs may engage in oral or written communications with certain potential investors, notwithstanding the broad prohibition in Section 5(c). However, Congress chose not to extend this exemption beyond EGCs. Moreover, it conspicuously omitted any language in Section 5(d) granting the Commission the authority to later expand upon the exemption through rules that the agency might deem necessary or appropriate in the public interest.

In fact, the Release offers a single, one-line paragraph titled "B. Legal Basis," which simply lists the sections of the Securities Act and the Investment Company Act pursuant to which the Commission is proposing the amendments.[14] However, they are not persuasive grounds on which to base such a sweeping regulatory exemption. For example, Section 19(a) titled "Special Powers of the Commission" confers upon the Commission the authority to make rules necessary to carry out the provisions of the subchapter, "including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms in this subchapter." Clearly, however, this section does not confer an exemptive authority, and is in fact aimed at authorizing rules necessary to carry out—not rewrite—the statute.

Section 28 of the Securities Act, also cited in the "Legal Basis" portion of the Release, is certainly a general grant of exemptive authority, but even it has its limits. It allows for the exemption of "persons" or "classes of persons" from the provisions of the subchapter, but in this case, the Commission is proposing to exempt **all** issuers seeking to engage in TTW communications with certain investors, not just a subset. In fact, according to the Release, this regulatory amendment to the statute covers vastly more companies than the original JOBS Act amendment did: In 2017, the Commission estimates that there were approximately 2,096 EGCs and 8,942 non-EGCs that filed Securities Act registration statements or periodic reports.[15] At a minimum, the Commission has an obligation to more fully identify and explain the legal authority it contends allows it to effect such a broad amendment to the statute.

14 Release at 6730.
15 Release at 6723.

2. Issuers and Affiliated Persons Must Validate the Status of the Investor Before Engaging in TTW Communications to Ensure Only Sophisticated Investors are Solicited.

As discussed above, the Commission explicitly declines "to specify the steps an issuer could or must take to establish a reasonable belief that the intended recipients of test-the-waters communications are QIBs or IAIs."[16] The Commission believes that "by not specifying the steps an issuer could or must take to establish a reasonable belief as to investor status," the Proposal would "provide issuers with the flexibility to use methods that are cost-effective but appropriate in light of the facts and circumstances of each contemplated offering and each potential investor."[17] The Commission argues that "identifying specific steps or providing additional guidance that could be used by an issuer to establish a reasonable belief regarding an investor's status could create a risk that such steps or guidance would become a de facto minimum standard."[18]

This approach is not justified or justifiable. The supposed need to provide issuers with flexibility tailored to specific facts and circumstances is not supported with any specific data or analysis in the Release. And in fact, there is no persuasive reason why circumstances surrounding TTW communications would be so unique as to defy the application of general protocols carefully designed, and based on experience in other areas, to ensure that an issuer's belief regarding the status of an investor is justified. Equally unpersuasive is the inexplicable fear that identifying specific steps or providing guidance runs the risk of establishing "a de facto minimum standard." A minimum standard is precisely what is necessary and appropriate under these circumstances.

The Commission's decision not to require that issuers validate the status of their potential investors, or at a minimum specify how an issuer must satisfy the "reasonable belief" standard, is doubly unacceptable given the fact that the Commission already has at least two workable regulatory solutions that aim to reduce the likelihood that unsophisticated investors would be solicited for unsuitable investments. SEC Rule 506(c) for Regulation D offerings and Rule 144A(d)(1) for private resale of securities require validation of investor status and specify how an issuer must evaluate the profile of an investor, respectively. For example, Rule 144A(d)(1) sets forth "non-exclusive means to determine whether a prospective purchaser is a QIB."[19] Particularly, the rule calls for evaluating purported QIB's through "(i) most recent publicly available financial statements; (ii) the most recent publicly available information appearing in documents filed by the prospective purchaser with the Commission or another U.S. federal, state, or local government agency or self-regulatory organization, or with a foreign governmental agency or self-regulatory organization; (iii) the most recent publicly available information appearing in a recognized securities manual; or (iv) a certification by the chief financial officer." [20]

Given this sensible and workable verification mechanism available to the Commission, and the industry practices that have comfortably adapted to these requirements, it is unacceptable that the Commission would not require that issuers or persons acting on their behalf that choose to

16 Release at 6717.
17 Release at 6717.
18 Release at 6717.
19 Release at 6717, fn. 38.
20 Release at 6717.

engage in TTW communications validate the status of the investor in accordance with minimum guidelines and standards. At a bare minimum, the Commission must establish specific criteria that an issuer and all those acting on an issuer's behalf must use to evaluate the status of the investor to ensure that the investor is indeed a QIB or an IAI.

The Commission has also failed to strike the right balance between the speculated burden on issuers versus the very real threat that the wrong type of investor will be the subject of TTW communications. The Release explains that "under the proposed rule, an issuer could reasonably believe that a potential investor is a QIB or IAI even though the investor may have provided false information or documentation to the issuer. We do not believe an issuer should be subject to a violation of Section 5 in such circumstances, so long as the issuer established a reasonable belief with respect to the potential investor's status based on the particular facts and circumstances."[21] While it may be sensible from a regulatory perspective not to hold an issuer liable when they are being actively lied to by an overzealous investor who is willing to falsify his or her way into an investment offering, it is much easier to see countless other scenarios where an investor is confused into signing a self-certification form that follows an incomprehensible fine-print on a webpage.

Given the intent to maximize participation and returns, it is only reasonable to expect that issuers and persons acting on their behalf (like underwriters, promoters, and unscrupulous or incompetent brokers), especially issuers of risky investments like penny stocks and certain asset-backed securities, will design mechanisms that maximize self-certification. For these reasons as well, the Proposal should include minimum standards or guidelines to enhance the reliability of determinations surrounding the type of investor receiving TTW communications.

In the release, the Commission explicitly states concerns about protecting investors[22] who lack the financial sophistication to understand or otherwise bear the risk of complex and risky investments. Given this, the Commission simply must do more to shield these investors from being solicited with TTW communications. As the Commission is all too familiar, these types of materials too often contain hype, wildly optimistic prognoses about the prospects of the issuer, and in many cases attempt to inappropriately condition the investor so that he or she becomes less critical of the issuer and/or the risks associated with investing in the offered security.

3. <u>The Commission Must Require the Filing of Test-the-Waters Communications with the Registration Statements to Enable Investors to Make More Informed Decisions.</u>

As proposed in the Release, issuers are not required to file with the Commission the TTW communications materials. The Commission states that "it does not believe it is necessary to impose such requirements because communications under the proposed rule would be limited to investors that are, or are reasonably believed to be, QIBs and IAIs;" additionally, "these communications … would [] be considered 'offers' as defined in Section 2(a)(3) of the Securities Act 23 and would therefore be subject to Section 12(a)(2) liability in addition to the anti-fraud

21 Release 6717.

22 The Release claims that "The proposed limitation to these institutional investors is intended to ensure that test-the-waters communications are directed to investors that are financially sophisticated and therefore do not require the same level of protections of the Securities Act's registration process as other types of investors." *See* Release at 6717.

provisions of the federal securities laws;" and finally, "information provided in a test-the-waters communication under the proposed rule must not conflict with material information in the related registration statement."[23]

While these are indeed important mitigating factors, it is nonetheless shortsighted by the Commission to deny itself, the investing public, analysts and entities that serve investors, journalists, and other interested parties from gaining the benefits and insights that come from seeing and evaluating these TTW communication materials. The information gleaned from these communications could aid sophisticated investors who were not privy to the initial TTW engagement to evaluate comparable investment opportunities offered through other TTW engagements. The Release itself recognizes that "filing test-the-waters materials with the registration statement … could offer informational benefits to investors that have not been solicited."[24] We further expect that this information could be useful for all interested parties (and not just those exposed to the TTW engagement) to evaluate the performance of the security (and the underlying issuer) in light of the claims made in the TTW communication materials. Finally, the Commission's requiring of the filing of TTW communication materials will not be unprecedented or unduly burdensome: Regulation A permits issuers to engage in TTW communications for certain issuances but requires that these TTW communication materials be publicly filed with the SEC.[25]

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23 Release at 6715-6.

24 Release at 6729.

25 Release at 6729, fn. 124.

4. **<u>Limiting the Type of Investor to Whom TTW Communications May Be Directed is Essential and Must Be Strengthened in the Final Rule.</u>**

As a general proposition, we agree with the Commission that large, sophisticated investors commanding hundreds of millions of dollars in investable assets have the wherewithal to understand complex financial products and their specific risks and can sustain investment losses should their understanding of and confidence in their investments not materialize. However, we must remind the Commission that the Financial Crisis that cost over $20 trillion to the US economy[26] also featured countless sophisticated investors and intermediaries who simply did not understand[27] the complexity of the financial products they invested in, particularly many types of asset-backed securities, and they lacked the ability to sustain significant financial losses without causing or contributing to widespread systemic instability and chaos.[28]

Notwithstanding these risks, we do not oppose regulatory changes that would facilitate more efficient methods of capital formation, making it less burdensome for issuers to raise needed capital through the public markets to grow their businesses and increase social welfare. But the Commission's primary mission and duty is to protect investors. Therefore, any such changes must be crafted to ensure that they will not compromise investor protection. One of the most important investor protection safeguards in this case is the strict limitation on the type of investor to whom TWW may be directed—QIBs and IAIs. The Proposal must maintain this feature.

Permitting blank check, penny stock issuers, asset-backed securitizers, leveraged business development companies, and certain investment companies to engage in TTW communications with non-sophisticated investors using materials that hype, inappropriately condition (making them less critical in their analysis of the eventual offering), or worse, mislead investors would be a dereliction of SEC's duty of investor protection. The SEC must vigilantly prevent capital raising mechanisms designed for sophisticated investors from being used and abused to attract and dupe retail or other investors who lack the means and sophistication to bear the financial harm that could arise out of such investment "decisions." The SEC must not engage in efforts that would weaken critical investor protection safeguards built through decades of painful lessons and financial calamities that have befallen vulnerable Americans.

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26 Better Markets, The Cost of the Crisis, $20 Trillion and Counting (July, 2015), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

27 Jennifer Taub, *The Sophisticated Investor and the Global Financial Crisis* (April 1, 2011); James P. Hawley, Shyam J. Kamath, and Andrew T. Williams, eds, *Corporate Governance Failures: The Role of Institutional Investors in the Global Financial Crisis* University of Pennsylvania Press (2011), *available at* SSRN: https://ssrn.com/abstract=1784299

28 "The bankruptcy of Lehman Brothers in 2008 sent shock waves through the entire global banking and financial system across numerous and unexpected transmission channels when the price bubble in the US housing market tied to the subprime mortgage market suddenly burst...Global stock markets, individual and corporate investors, and staff of the Firm and its other related businesses bore the brunt of the financial disaster in the form of huge losses, liquidations, job losses, reduction in asset prices and a subsequent global financial crises which could have been prevented." Adu-Gyamfi, Mike, *The Analysis of the Collapse of Lehman Brothers*, at 2 (April 2015), *available at* SSRN: https://ssrn.com/abstract=2771615 or http://dx.doi.org/10.2139/ssrn.2771615

5. <u>The Commission Must More Fully Address the Potential Unfairness and Unequal Market Access Raised by the Proposal.</u>

Permitting issuers (and persons authorized to act on their behalf, including underwriters) to communicate with QIBs and IAIs of their choosing would increase the problem of information asymmetry between investors who are "in the know" and investors who learn about the existence and characteristics of a securities offering only once it is made public through the ordinary filing of a registration statement. This risks de-leveling the playing field and giving further advantage to some sophisticated investors, who are able to afford underwriters and other intermediaries who are more connected to existing or prospective issuers, over other investors, who are otherwise qualified (*e.g.* smaller pension funds or asset managers) that do not have similar connections.

The problem of information asymmetry becomes more pronounced the more beneficial and informative the TTW communications become. Indeed, this could become a serious matter if the benefits contemplated by the Commission are realistic: "Test-the-waters communications might offer some prospective investors the potential benefit of additional time to evaluate, understand, and ask questions about potential investment opportunities before the public filing of a registration statement. To the extent that such communications might provide solicited QIBs and IAIs with valuable early information about potential investment opportunities, these communications might enhance the ability of solicited QIBs and IAIs to assess the quality of future investment opportunities, and in some instances, potentially facilitate better informed future investment decisions and efficient allocation of capital."[29] The Commission's actions should be aimed at leveling the playing field and not supporting regulatory regimes that advantage some qualified investors over other similarly qualified investors lacking connections.[30]

Consistent with the bedrock principles that govern rulemaking under the APA, the Commission must consider these factors before finalizing any rule and must articulate a satisfactory explanation for any choices it makes, in light of the factual predicate for the rule, the Commission's core mission of protecting investors, and any impact this feature of the rule may have on efficiency, fair competition, and capital formation.[31]

<u>CONCLUSION</u>

We hope the Commission finds these comments helpful and that they are fully and properly considered and addressed as the Commission proceeds with this rulemaking.

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29 Release at 6725.

30 To its credit, the Commission does seem to recognize the problematic aspects of information asymmetry. *See* Release at 6726: "Selective solicitation of QIBs and IAIs may result in some institutional investors having a relatively greater influence on the offering process and terms, which might potentially place investors that are not solicited at a relative competitive disadvantage."

31 *See Motor Veh. Manuf. Ass'n v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43-45 (1983).

Sincerely,

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