Conformed to Federal Register version

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 230

[Release No. 33-10699, File No. S7-01-19]

RIN 3235-AM23

Solicitations of Interest Prior to a Registered Public Offering

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting a new communications rule under the Securities Act of 1933 that permits issuers to engage in oral or written communications with certain potential 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.

EFFECTIVE DATE: December 3, 2019.

FOR FURTHER INFORMATION CONTACT: Maryse Mills-Apenteng, Special Counsel, at (202) 551-3430, Office of Rulemaking, Division of Corporation Finance; Angela Mokodean, Senior Counsel, or Amanda Hollander Wagner, Branch Chief, at (202) 551-6921, Investment Company Regulation Office, Division of Investment Management; U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is adopting 17 CFR 230.163B (new "Rule 163B") under the Securities Act of 1933 [15 U.S.C. 77a *et seq*.] ("Securities Act") and amendments to 17 CFR 230.405 ("Rule 405") under the Securities Act.

Table of Contents

I. Introduction

The Commission proposed Rule 163B[1] under the Securities Act to permit issuers to engage in oral or written communications with potential investors that are, or are reasonably believed to be, qualified institutional buyers ("QIBs"), as that term is defined in paragraph (a) of 17 CFR 230.144A ("Rule 144A"), or institutional accredited investors ("IAIs").[2] The proposed rule would allow these communications, either prior to or following the filing of a registration statement, to determine whether such potential investors might have an interest in a contemplated registered securities offering.[3] The proposed rule would extend the accommodations currently available to emerging growth companies ("EGCs")[4] under Securities Act Section 5(d)[5] to all issuers, including fund issuers.

We received approximately 20 comment letters in response to the Proposing Release.[6] We have reviewed and considered the comments that we received on the Proposing Release.

---

[1] *See Solicitations of Interest Prior to a Registered Public Offering*, Release No. 33-10607 (Feb. 19, 2019) [84 FR 6713 (Feb. 28, 2019)] ("Proposing Release").

[2] An institutional accredited investor refers to any institutional investor that is also an accredited investor, as defined in 17 CFR 230.501 ("Rule 501") of Regulation D.

[3] Communications between an issuer and potential investors for the purpose of assessing investor interest before having to commit the time and expense necessary to carry out a contemplated securities offering are often referred to as "testing the waters," and we use this term and its derivations throughout this release to refer to such communications.

[4] The Section 5(d) exemption is available to "emerging growth companies." An emerging growth company refers to an issuer that had total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year and, as of December 8, 2011, had not sold common equity securities under a registration statement. That issuer continues to be an emerging growth company for the first five fiscal years after the date of the first sale of its common equity securities pursuant to an effective registration statement, unless one of the following occurs: its total annual gross revenues are $1.07 billion or more; it has issued more than $1 billion in non-convertible debt in the past three years; or it becomes a "large accelerated filer," as defined in 17 CFR 240.12b-2 ("Rule 12b-2") under the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq.*] (the "Exchange Act"). *See* Rule 405 and Rule 12b-2 (defining "emerging growth company").

[5] 15 U.S.C. 77e(d).

[6] See letters from: S. Lara Ameri ("S. Ameri"); Clint Anderson ("C. Anderson"); American Securities Association ("ASA"); Better Markets ("Better Markets"); Center for Capital Markets Competitiveness ("CCMC"); Bayley

Commenters broadly supported the proposal to allow all issuers to test the waters with QIBs and IAIs before and after filing a registration statement to gauge interest in a contemplated registered offering. After taking into consideration the public comments, we are adopting the amendments largely as proposed. For the reasons set forth below, in certain cases we are adopting modifications to the proposal. The changes we are adopting are designed to address aspects of the proposal, such as the proposed anti-evasion provision, that could raise uncertainty for issuers seeking to rely on the rule. Below we discuss, in turn, the general exemption for test-the-waters communications; the scope of issuers eligible to rely on the rule; the types of investors issuers may communicate with under the rule; non-exclusivity of the rule; and considerations for investment companies' use of the rule.

II. Discussion of the Amendments

A. Exemption Allowing Test-the-Waters Communications

1. Proposed Amendments

Proposed Rule 163B would permit any issuer or person authorized to act on behalf of an issuer,[7] including an underwriter, either prior to or following the filing of a registration statement, to engage in oral or written communications with potential investors that are, or that

---

Clark ("B. Clark"); Cleary Gottlieb Steen & Hamilton LLP ("Cleary"); Cravath, Swaine & Moore LLP ("Cravath"); The Credit Roundtable ("CRT"); Davis Polk & Wardwell LLP ("Davis Polk"); Dechert LLP ("Dechert"); Federated Investors, Inc. ("Federated"); Hamilton & Associates Law Group, P.A. ("Hamilton"); Investment Company Institute ("ICI"); Nasdaq, Inc. ("Nasdaq"); Raymond Kenneth Petry ("R. Petry"); Austin J. Rahskopf ("A. Rahskopf"); Securities Industry and Financial Markets Association ("SIFMA"); Monica Stuchlik ("M. Stuchlik"); and Sullivan & Cromwell LLP ("Sullivan"). Comment letters related to the Proposing Release are available at https://www.sec.gov/comments/s7-01-19/s70119.htm.

[7] Under the proposed rule, an issuer or a person authorized to act on its behalf may rely on the rule. In this release, for ease of discussion, we sometimes refer only to an issuer's reliance on the rule, though these statements apply equally to an issuer or any person authorized and acting on its behalf.

the issuer reasonably believes are, QIBs or IAIs, to determine whether such investors might have an interest in the contemplated offering.

As discussed in the Proposing Release, Section 5(c) prohibits any written or oral offers prior to the filing of a registration statement.[8] Once an issuer has filed a registration statement, Section 5(b)(1) limits written offers to a "statutory prospectus" that conforms to the information requirements of Securities Act Section 10.[9] As proposed, Rule 163B communications would be exempt from Section 5(b)(1) and Section 5(c)[10] but, as described below, would be subject to Section 12(a)(2) liability in addition to the anti-fraud provisions of the federal securities laws.[11]

Further, as proposed, Rule 163B communications would not need to be filed with the Commission, including pursuant to 17 CFR 230.424(a) ("Rule 424(a)") or 17 CFR 230.497(a) ("Rule 497(a)") of Regulation C[12] under the Securities Act, or pursuant to Section 24(b) of the Investment Company Act of 1940[13] (the "Investment Company Act") and the rules and regulations thereunder.[14] Nor would such communications be required to include any specified

---

[8] *See* Section II.A of the Proposing Release.

[9] After effectiveness of a registration statement, a written offer, other than a statutory prospectus, may be made only if a final prospectus meeting the requirements of Securities Act Section 10(a) is sent or given prior to or at the same time as the written offer. *See* Securities Act Section 2(a)(10) [15 U.S.C. 77b(a)(10)]. A free writing prospectus, as defined in Securities Act Rule 405, which is a Section 10(b) prospectus, may also be used after effectiveness of a registration statement subject to the conditions of Securities Act Rules 164 and 433. The proposed rule would not affect these requirements.

[10] Section 5(b)(1) does not include a limitation on oral offers after the filing of a registration statement, and therefore, Rule 163B does not concern such offers.

[11] Section 12(a)(2) of the Securities Act provides purchasers of an issuer's securities in a registered offering private rights of action for materially deficient disclosure in oral communications and prospectuses and imposes liability on sellers for offers or sales by means of an oral communication or prospectus that includes an untrue statement of material fact or omits to state a material fact that makes the statements made, in light of the circumstances under which they were made, not misleading.

[12] 17 CFR 230.401 through 230.498.

[13] 15 U.S.C. 80a-24.

[14] *See* proposed Rule 163B(b)(3).

legends. Additionally, the Commission proposed to amend Rule 405 to clarify that a written communication used in reliance on Rule 163B would not constitute a free writing prospectus.

The Commission also clarified in the Proposing Release[15] that Rule 163B communications, while exempt from Section 5(b)(1) and Section 5(c) as described above, would be considered "offers" as defined in Section 2(a)(3) of the Securities Act[16] and would therefore be subject to Section 12(a)(2) liability in addition to the anti-fraud provisions of the federal securities laws. Additionally, the Commission stated that information provided in a test-the-waters communication under the proposed rule must not conflict with material information in the related registration statement. It also noted that, as is currently the practice of Commission staff when reviewing offerings conducted by EGCs, the Commission or its staff could request that an issuer furnish any test-the-waters communication used in connection with an offering.[17]

Finally, the Commission cautioned that issuers subject to Regulation FD[18] would need to consider whether any information in the test-the-waters communication would trigger any obligations under Regulation FD, or whether an exception to Regulation FD would apply.[19] Regulation FD requires public disclosure of any material nonpublic information that has been selectively disclosed to certain securities market professionals or shareholders[20] if the issuer has a class of securities registered under Section 12 of the Exchange Act or is required to file reports

[15] *See* Section II.A of the Proposing Release.

[16] Securities Act Section 2(a)(3) [15 U.S.C. 77b(a)(3)] defines "offer" as any attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The term "offer" has been interpreted broadly and goes beyond the common law concept of an offer. *See Diskin v. Lomasney & Co.*, 452 F.2d 871 (2d. Cir. 1971); *SEC v. Cavanagh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998).

[17] *See* 17 CFR 230.418 under the Securities Act.

[18] *See* 17 CFR 243.100 *et seq.* under the Securities Act.

[19] *See* Section II.A of the Proposing Release.

[20] *See* 17 CFR 243.100(b)(1) of Regulation FD. Many QIBs and IAIs are the types of securities market professionals or shareholders covered by Regulation FD.

under Section 15(d) of the Exchange Act.[21] Thus, communications made under the proposed rule that also include material nonpublic information could be subject to 17 CFR 243.100(a) of Regulation FD unless an exclusion under 17 CFR 243.100(b)(2) of Regulation FD applies.

2. Comments on the Proposed Amendments Generally

Commenters broadly supported the proposed exemption for test-the-waters communications.[22] Commenters generally concurred that the proposed exemption would allow issuers adequate flexibility to gauge market interest,[23] tailor the size and other terms of the offering,[24] reduce the costs of going public[25] as well as the risk of disclosing sensitive financial and competitive information when choosing not to proceed with an IPO,[26] and "level the playing field" among issuers.[27] Some commenters asserted that proposed Rule 163B may motivate more

[21] *See* 17 CFR 243.101(b) of Regulation FD. Regulation FD applies to closed-end companies as defined in Section 5(a)(2) of the Investment Company Act [15 U.S.C. 80a-5(a)(2)] but not other investment companies. Regulation FD also does not apply to any foreign government or foreign private issuer, as those terms are defined in Securities Act Rule 405.

[22] *See* letters from S. Ameri, C. Anderson, ASA, CCMC, B. Clark, Cleary, Cravath, CRT, Davis Polk, Dechert, Federated, Hamilton, ICI, Nasdaq, R. Petry, A. Rahskopf, SIFMA, M. Stuchlik, and Sullivan. Comments on the scope of eligible issuers that could rely on the proposed rule, the types of investors that issuers could communicate with under the proposed rule, the proposed non-exclusivity provision, and investment company-specific considerations are discussed in separate sections below.

[23] *See* letters from CCMC, Cravath, Davis Polk, Hamilton, ICI, Nasdaq, and Sullivan.

[24] *See* letters from CCMC, Cravath, ICI, and Nasdaq.

[25] *See* letters from CCMC, Cleary, Cravath, Davis Polk, ICI, Nasdaq, M. Stuchlik, and Sullivan.

[26] *See* letters from CCMC, Cravath, and Nasdaq.

[27] *See* letters from CCMC, Cravath, CRT, Davis Polk, ICI, Nasdaq, M. Stuchlik, and Sullivan. *But see* letters from ICI and Federated (stating that the proposed rule was unlikely to benefit certain fund issuers); *infra* Section II.E.

companies to conduct registered offerings.[28] One commenter, however, questioned whether and how the proposed exemption would increase the number of public offerings.[29]

Commenters also broadly supported the view that the proposal does not raise significant investor protection concerns.[30] Several commenters noted that investor protection concerns are mitigated by: (1) the limitation on offerees to QIBs and IAIs;[31] (2) the application of the anti-fraud provisions of the federal securities laws, as well as potential liability under Section 12(a)(2) of the Securities Act, to proposed Rule 163B communications;[32] (3) the need for test-the-waters communications generally to be consistent with the disclosure in any filed registration statement;[33] (4) the application of Regulation FD to communications made by issuers subject to those rules;[34] and (5) the fact that, where an issuer proceeds with a registered offering, offerees will be able to compare the information in the test-the-waters materials against the information in the registration statement and purchasers will ultimately receive a prospectus subject to Section 11 and Section 12(a)(2) liability.[35] One commenter expressed concerns that the proposed reasonable belief standard regarding investor status would create the risk of solicitations to retail and other investors lacking sophistication by permitting issuers to rely on a

[28] *See* letters from S. Ameri, CCMC, Cleary, Cravath, Hamilton, and Sullivan.

[29] *See* letter from Better Markets. This commenter also questioned whether the Commission has the requisite authority to expand by rule the exemption available to EGCs under Section 5(d) to all issuers. *See infra* Section II.A.3.

[30] *See* letters from ASA, CCMC, Cravath, Hamilton, and Nasdaq.

[31] *See* letters from CCMC, Cravath, Davis Polk, Hamilton, ICI, Nasdaq, A. Rahskopf, SIFMA, and Sullivan.

[32] *See* letters from CCMC, Cravath, Davis Polk, and ICI.

[33] *See* letters from ASA, CCMC, Cravath, ICI, SIFMA, and Sullivan.

[34] *See* letters from ASA and Davis Polk.

[35] *See, e.g.*, letters from Cravath, Davis Polk, and SIFMA.

"check-the-box" or other self-certification method of determining investor status, as discussed in more detail in Section II.C below.[36]

Most commenters indicated that Rule 163B should not require issuers to file test-the-waters communications or include legends or disclaimers.[37] Commenters noted, among other reasons, that: (1) such a requirement would be inconsistent with test-the-waters communications under Section 5(d)[38] and other rules;[39] (2) Section 12(a)(2) and Section 10(b) liability would provide adequate safeguards for QIBs and IAIs;[40] and (3) the staff could continue its practice of reviewing written test-the-waters materials used in connection with a registered offering.[41] On the other hand, one commenter asserted that the Commission should require issuers to file test-the-waters materials in those instances when an issuer files a related registration statement since filing of these already-prepared and disseminated communications would add no additional burden on the issuers, would provide the Commission with information to monitor the market, and would allow investors to compare the claims in those communications with the prospectus and with the performance of the securities themselves.[42]

One commenter recommended that the Commission also exclude Section 5(d) written communications from the definition of "free writing prospectus" in Rule 405 and from the

---

[36] *See* letter from Better Markets.

[37] *See* letters from CCMC, Cleary, Cravath, Davis Polk, Federated, ICI, SIFMA, and Sullivan. *See also infra* Section II.E (discussing comments on investment company-specific considerations regarding filing, legending, and content requirements in test-the-waters communications).

[38] *See, e.g.*, letter from Davis Polk.

[39] *See* letter from Sullivan (suggesting this approach is consistent with Rule 144A and Regulation D, which do not require filing of offering materials).

[40] *See* letter from Cravath.

[41] *See* letters from CCMC, SIFMA, and Sullivan.

[42] *See* letter from Better Markets.

prospectus filing requirement in Rule 424(b) to avoid implying that communications under Section 5(d) and proposed Rule 163B would be treated differently.[43] Another commenter recommended that a clear, brief disclaimer should accompany any forward-looking information in the context of an offering of corporate credit securities, but noted that written material provided during market soundings that is broadly available should not be subject to additional filing requirements.[44]

Of the commenters that expressed a view on whether the communications under the rule would be "offers" as defined in Securities Act Section 2(a)(3) subject to Section 12(a)(2) liability,[45] only one commenter argued that test-the-waters communications should not be treated as "offers" subject to Section 12(a)(2) liability based on the preliminary nature of test-the-waters communications, the sophistication of their recipients, the applicability of the general anti-fraud provisions, and the availability of a final disclosure document.[46]

Commenters generally agreed that Regulation FD should continue to apply to material statements made in a Rule 163B communication, unless an existing exception from that rule applies, and that a separate exception to Regulation FD for proposed Rule 163B communications is not necessary.[47] One commenter stated that Regulation FD currently provides sufficient flexibility to allow issuers to engage in meaningful communications with investors, while still

[43] *See* letter from Cleary (noting that an amendment to Rule 405 "is arguably unnecessary, since an issuer relying on new Rule 163B would not rely on Rule 164 and consequently would not be subject to Rule 433, but it is a helpful clarification").

[44] *See* letter from CRT.

[45] *See* letters from Cravath, Davis Polk, and SIFMA.

[46] *See* letter from SIFMA.

[47] *See, e.g.*, letters from Cravath, Davis Polk, and SIFMA.

providing the appropriate protections against selective disclosures.[48] Another commenter expressed the view that "test-the-waters flexibility or specifically market soundings prior to a new credit issue should have reasonable exceptions to Regulation FD for some communications such as open ended dialogues on investor and issuer needs and wants."[49]

Three commenters[50] took exception to the statement in the Proposing Release that "information provided in a test-the-waters communication under the proposed rule must not conflict with material information in the related registration statement."[51] One commenter recommended that the Commission specify that the statement is guidance and not a condition for the availability of the exemption.[52] Another commenter asserted that, because test-the-waters communications may be used before a registration statement is filed, requiring consistency between those communications and a yet-to-be-filed registration statement could be problematic.[53] Failure to comply, this commenter noted, would trigger a violation of Section 5 with its attendant consequences, which could have a chilling effect on the use of these communications. The commenter also noted that Section 5(d) has no such proviso.[54] Yet another commenter noted that, while it generally agreed that communications made after a registration statement has been filed should be consistent with material information in the registration statement, the expectation that communications made before the filing of a

[48] *See* letter from SIFMA.

[49] *See* letter from CRT.

[50] *See* letters from CCMC, Cleary, and SIFMA.

[51] *See* Section II.A of the Proposing Release.

[52] *See* letter from Cleary.

[53] *See* letter from SIFMA.

[54] *Id.*

registration statement should also be consistent could create compliance difficulties.[55] This commenter observed that an issuer could change its messaging in response to investor feedback, which could result in a situation where the information provided while testing the waters conflicts with material information in the related registration statement.[56]

Three commenters recommended eliminating the "anti-evasion" language from paragraph (a)(2) of the proposed rule.[57] Two of these commenters asserted that it is unclear how anti-evasion language could apply to test-the-waters communications since it is unclear how permissible communications could be part of a scheme to evade Section 5 of the Securities Act, and that including such language could give rise to confusion or uncertainty, and thereby limit the utility of the proposed rule.[58] One of these commenters asserted that such language is not necessary since it is "typically included in exemptions that are intended to serve as safe harbors from the registration or gun-jumping provisions of Section 5."[59]

Two commenters expressed concern regarding the effect of the proposed rule on private placements following test-the-waters communications.[60] One commenter disagreed that the integration guidance referenced in the Proposing Release[61] should continue to apply in the

---

[55] *See* letter from CCMC.

[56] *Id.*

[57] *See* letters from Cravath, SIFMA, and Sullivan. Proposed Rule 163B(a)(2) read: "This rule is not available for any communication that, although in technical compliance with this rule, is part of a plan or scheme to evade the requirements of section 5 of the Act."

[58] *See* letters from Cravath and Sullivan.

[59] *See* letter from SIFMA. The SIFMA letter provides examples of the types of rules with anti-evasion language, which include the private placement provision of Regulation D, the resale provisions of Rules 144, 144A and 145(d), the communication provisions in Rules 168 and 169, and the offshore offering provisions in Regulation S.

[60] *See* letters from CCMC and Cleary.

[61] *See* Proposing Release at note 105 (stating that "similar to Section 5(d), the proposed rule would not modify existing rules on solicitation in conjunction with private placements. The Commission's 2007 framework for analyzing how an issuer can conduct simultaneous registered and private offerings would continue to apply.").

context of testing the waters under either Section 5(d) or proposed Rule 163B.[62] Another commenter stated that the Commission should clarify through interpretive guidance or amendment to Rule 155 that issuers may immediately conduct a private placement or Regulation A offering after abandoning the proposed public offering to which the Rule 163B communications relate because, in the commenter's view, the act of testing the waters could be viewed as a general solicitation that disqualifies the issuer from immediately completing a subsequent private placement.[63]

3. Final Amendments

We are adopting the exemption and related amendments as proposed, except as noted below with respect to removing the anti-evasion language in proposed Rule 163B(a)(2) and revising the definition of "free writing prospectus" in Rule 405.

As a preliminary matter, the Commission has the requisite authority to extend the accommodations currently available under Section 5(d) to all issuers.[64] Section 28 of the Securities Act gives the Commission broad authority to "conditionally or unconditionally exempt any person … or any class or classes of persons … from any provision or provisions of" the Securities Act and rules or regulations issued thereunder "to the extent that such exemption is

---

See also Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828 (Aug. 3, 2007) [72 FR 45116 (Aug. 10, 2007)] (the "2007 Integration Guidance").

[62] *See* letter from Cleary (asserting that "[just] as [sophisticated] institutional investors have been judged to be able to fend for themselves in handling the potential for market conditioning otherwise prohibited by Section 5, so too should they be able to evaluate a possible private placement even if that is the first time the prospective investor was solicited by this issuer or its agents" and suggesting that the Commission take the position that "conducting test-the-waters communications in reliance on Rule 163B or Section 5(d) would not itself constitute general solicitation, whether or not there is a substantive, pre-existing relationship with the prospective investor").

[63] *See* letter from CCMC.

[64] *See* letter from Better Markets (expressing concern that the Commission lacks the authority to extend the accommodations currently available under Section 5(d) to all issuers).

necessary or appropriate in the public interest, and is consistent with the protection of investors."[65] Rule 163B will exempt from certain requirements the class of persons who are issuers contemplating a registered securities offering and who meet the conditions set forth in the rule. As explained here and in the Proposing Release, we believe that the final rule furthers the public interest and includes appropriate investor protections.

Nothing in the Jumpstart Our Business Startups Act (the "JOBS Act")[66] indicates that Congress sought to limit the Commission's ability to extend the accommodations currently available to EGCs to other issuers, nor does Section 28 include any such limitation. The final rule's use of exemptive authority is thus consistent with the plain language of Section 28.

We agree with commenters that the final rule generally will allow issuers to consult effectively with investors as they evaluate market interest in a contemplated registered securities offering before incurring the costs associated with such an offering, while maintaining adequate investor protections.[67] As commenters noted, several aspects of the rule will mitigate investor protection concerns, notably:

- The limitation of Rule 163B communications to investors that are financially sophisticated, and, as one commenter said, "are unlikely to ignore the statutory prospectus and rely exclusively on information provided to them during the [test-the-waters] process";[68]

[65] 15 U.S.C. 77z-3.

[66] Public Law 112-106, 126 Stat. 306 (2012).

[67] We recognize that Rule 163B may be less beneficial to certain fund issuers. *See infra* Section II.E.

[68] *See* letter from Davis Polk.

- The application of the anti-fraud provisions of the federal securities laws and exposure to Section 12(a)(2) liability;[69]
- The continued application of Regulation FD to certain issuers; and
- The fact that, should the issuer move forward with the offering, all investors would ultimately receive a Section 10(a) prospectus subject to Section 11 and Section 12(a)(2) liability.[70]

However, we are not adopting proposed Rule 163B(a)(2), which stated that the rule would be 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 Act. We are persuaded by the commenters who expressed concerns that such language may raise uncertainty and would risk limiting the utility of the rule.[71] Communications made under the rule will be deemed offers under Section 2(a)(10) and will still be subject to the anti-fraud and other applicable provisions of the federal securities laws, and an issuer that proceeds with the contemplated public offering after testing-the-waters will be required to file a registration statement. We therefore believe eliminating the anti-evasion language will avoid any confusion or chilling effect such language may introduce without introducing significant risk to investors.

As noted above, one commenter recommended that we exclude both Section 5(d) and Rule 163B written communications from the definition of "free writing prospectus" in Rule 405

[69] Liability under Section 12(a)(2) will attach to test-the-waters oral and written communications under the rule both before and after a registration statement has been filed. Communications under the final rule will also be subject to the anti-fraud provisions of Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 thereunder.

[70] For the reasons set forth in this paragraph and as discussed in more detail throughout this release, we find that the final rule is necessary or appropriate in the public interest and is consistent with the protection of investors. *See* 15 U.S.C. 77z-3.

[71] *See, e.g.*, letters from Cravath and SIFMA.

and from the prospectus filing requirement in Rule 424(b) to avoid any confusion that the communications should be treated differently.[72] The Commission historically has not treated Section 5(d) communications as free writing prospectuses that are required to be filed. To the extent the proposed amendment creates any implication that they would be treated differently than Rule 163B communications for this purpose, we are amending Rule 405 to clarify this point, consistent with existing practice.

We are not requiring, as suggested by one commenter, that test-the-waters communications be filed.[73] While "the investing public, analysts and entities that serve investors, journalists, and other interested parties" may gain some "benefits and insights . . . from seeing and evaluating these [test-the-waters] communication materials,"[74] as this commenter asserted, we believe those benefits are likely to be limited[75] and are concerned that imposing a filing requirement, which would be inconsistent with the requirement under Section 5(d) for EGCs, may have a chilling effect on the usefulness of the rule. In addition, as noted by one commenter, "much of the interaction in [test-the-waters] meetings is oral in nature … so a filing requirement would not cover what is often the most substantive component of the meeting."[76] Accordingly, consistent with the proposal, we are not adopting a filing requirement.[77] We note that Commission staff in the Division of Corporation Finance anticipates requesting, in connection with its review of a registration statement, that any test-the-waters communication

[72] *See* letter from Cleary.

[73] *See* letter from Better Markets.

[74] *Id.*

[75] *See* Section IV.D below for further discussion of the limited benefits of filing test-the-waters materials.

[76] *See* letter from Davis Polk. *See also* Section IV.D below for further discussion of the potential costs that a filing requirement could have on issuers that elect to test the waters under Rule 163B.

[77] *See* Rule 163B(b)(3).

used in connection with the offering be furnished to the staff for review, as is currently its practice when reviewing offerings conducted by EGCs.[78]

In the Proposing Release, the Commission observed that information in a Rule 163B communication must not conflict with material information in the related registration statement.[79] This statement was intended to remind issuers that, although such communications would be exempt from Section 5 of the Securities Act, issuers nevertheless must take care to ensure that they are made in compliance with other provisions of the federal securities laws.[80] We acknowledge the concerns expressed by certain commenters regarding the possibility that circumstances or messaging may change between the time the pre-filing Rule 163B communications are made and the time of filing, causing the information in the test-the-waters materials to differ from information in the related registration statement.[81] At the same time, it is important to keep in mind that statements made in the test-the-waters materials and in the related registration statement, if filed, must not contain material misstatements or omissions at the time the statements are made.

Based on Commission staff's experience in reviewing test-the-waters materials used by EGCs and provided at the Commission staff's request in connection with a registered offering, material information regarding financial condition and performance, business operations and strategy, information about management, and other operational information is generally

[78] *See* 17 CFR 230.418 under the Securities Act.

[79] *See* Section II.A of the Proposing Release.

[80] Because Rule 163B communications are subject to Section 12(a)(2) and the anti-fraud provisions of the federal securities laws, there may be liability concerns if a Rule 163B communication materially conflicts with the information in a registration statement.

[81] *See* letters from SIFMA and CCMC.

consistent with information presented in the filed registration statement.[82] Even if an issuer changes its capital raising strategy or modifies offering terms based on investor input during the pre-filing test-the-waters phase, or where an issuer changes its "messaging due to investor demand,"[83] material information about the issuer itself usually remains consistent, other than updates to reflect continuing operations and material changes that may develop during the time between the communication and filing. As noted above, information in the Rule 163B communication should not contain material misstatements or omissions at the time the communication is made and we note that it is especially important to be mindful of this obligation when discussing material information about the issuer itself. Nevertheless, we recognize that between the time of the Rule 163B communication and the time a registration statement is filed, disclosures may be changed in order to reflect a change in circumstances or offering terms. We also clarify, as one commenter suggested, that this statement is intended to provide guidance to issuers on their obligations under the federal securities laws and is not a condition to the availability of Rule 163B.

As noted above, one commenter asserted that the preliminary nature of Rule 163B communications, the liability that can attach to such communications, and the nature of the potential investors to whom the communications would be directed do not support the communications being deemed "offers" under Securities Act Section 2(a)(3).[84] As stated in the

[82] As one commenter noted, "We have also seen market participants developing robust policies and procedures for test-the-waters communications in order to ensure that information communicated in test-the-waters materials does not conflict with the information ultimately presented in the registration statement." *See* letter from Sullivan. *See also supra* note 17 and accompanying text (discussing the ability of the Commission or its staff to request that an issuer furnish the staff any test-the-waters communication used in connection with an offering).

[83] *See* letter from CCMC.

[84] *See* letter from SIFMA.

Proposing Release, the term "offer" has been interpreted broadly,[85] and would encompass communications that are intended to gauge interest in a contemplated registered offering.[86] In general, the factors described by the commenter are not germane in determining whether a particular communication would be deemed an "offer" as defined in Section 2(a)(3). As noted by another commenter, "since one of the primary goals of using test-the-waters communications is to provide prospective investors additional time to evaluate, understand, and ask questions about potential investment opportunities, the conclusion that they should be deemed 'offers' is, in our view, inescapable."[87] We agree, and are adopting Rule 163B(b)(2) as proposed, which states that communications under the rule constitute offers as defined in Section 2(a)(3), and are thereby subject to Section 12(a)(2) liability.

As noted above, one commenter expressed concern that a test-the-waters communication could be viewed as a general solicitation that could disqualify an issuer from immediately completing a private placement in lieu of a registered offering,[88] and another commenter suggested that the Commission should take the position that a test-the-waters communication made in reliance on Rule 163B would not itself constitute a general solicitation.[89]

In our view, whether a test-the-waters communication would constitute a general solicitation depends on the facts and circumstances regarding the manner in which the

---

[85] *See* Proposing Release at note 23.

[86] The Commission has explained that "the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer . . . ." *Guidelines for the Release of Information by Issuers Whose Securities are in Registration*, Release No. 33-5180 (Aug. 16, 1971) [36 FR 16506 (Aug. 21, 1971)].

[87] *See* letter from Cravath.

[88] *See* letter from CCMC.

[89] *See* letter from Cleary.

communication is conducted.[90] If an issuer chooses to engage in test-the-waters communications under Rule 163B concurrently with communications related to a private offering, it can conduct such communications in a manner that preserves the availability of both Rule 163B and any offering exemption upon which it might otherwise rely.

Where an issuer wishes to pursue a private placement in lieu of a registered offering immediately after engaging in test-the-waters communications, the issuer should consider whether the test-the-waters communication was conducted in such a way as to constitute a general solicitation. If the communication constitutes a general solicitation, the issuer should consider whether the private offering exemption upon which the issuer is relying allows for general solicitation and, if it does not, whether the investors in the private placement were solicited by means of such a test-the-waters communication, or through some other means that would otherwise not foreclose the availability of the exemption.

Another commenter raised a concern about the implications of a QIB or IAI passing test-the-waters information on to nonqualified parties in violation of a confidentiality agreement or otherwise in a manner inconsistent with the reasonable steps undertaken by the issuer to prevent such redistribution.[91] In our view, where an issuer has taken reasonable steps to prevent test-the-waters communications from being shared with non-QIBs and non-IAIs and such information is nonetheless shared, such circumstances, in themselves, would not give rise to Section 5 liability for the issuer or the need for any cooling-off period.

B. Scope of Eligible Issuers

[90] As stated in the Proposing Release, the Commission's 2007 framework for analyzing how an issuer can conduct simultaneous registered and private offerings continues to apply. *See* Proposing Release at note 105. This guidance can be applied to address circumstances that may arise with respect to pre-filing test-the-waters communications and concurrent or immediately subsequent private offerings.

[91] *See* letter from CCMC.

Under the proposed rule, any issuer, or person authorized to act on behalf of the issuer, would be able to engage in exempt oral or written communications with potential investors that are, or that the issuer or persons authorized to act on behalf of the issuer reasonably believes are, QIBs or IAIs. All issuers—including non-reporting issuers, EGCs, non-EGCs, well-known seasoned issuers ("WKSIs"), and investment companies (including registered investment companies and business development companies ("BDCs"))—would be eligible to rely on the rule.[92] In the Proposing Release, the Commission expressed its belief that, in light of its experience with test-the-waters communications for EGCs under Section 5(d), and given the sophisticated nature of the institutional investors to which communications under the proposed rule could be directed, it is appropriate to expand the accommodation to all issuers.[93]

All but one of the commenters that expressed a view on eligibility supported extending the test-the-waters accommodation currently available to EGCs to all issuers, as proposed.[94] Commenters observed that the size or reporting status of an issuer is not generally correlated with its desire to gauge investor interest prior to a registered public offering[95] and that QIBs and IAIs have the sophistication to evaluate investment opportunities regardless of the type of issuer.[96] One commenter stated that permitting all issuers to test the waters would harmonize

---

[92] *See infra* Section II.E (discussing considerations for investment companies' use of Rule 163B).

[93] *See* Section I of the Proposing Release.

[94] *See* letters from CCMC, B. Clark, Cravath, ICI, Nasdaq, and Sullivan. As discussed above, Better Markets questioned the Commission's authority to extend the accommodation to all issuers. Such authority exists in our view, *see supra* Section II.A.3, and we agree with the other commenters that the accommodation should be extended to all issuers.

[95] *See* letter from Sullivan.

[96] *See* letter from Cravath.

U.S. practice with that of other jurisdictions that permit similar kinds of communications.[97] Another commenter stated that the proposed rule would facilitate initial public offerings as well as secondary offerings by companies that have already gone public, particularly those companies that do not qualify as either EGCs or WKSIs.[98] This commenter also observed that, unlike the current accommodation for WKSIs under Rule 163, which does not extend to WKSIs' underwriters, the proposed rule would enable underwriters to participate in test-the-waters communications.[99] Some commenters expressly supported allowing fund issuers to rely on the proposed rule (and no commenters stated that the rule's scope should not include fund issuers), but some stated that fund issuers may be less likely to benefit from the rule, as proposed.[100]

Accordingly, and for the reasons set forth in this release and in the Proposing Release, we are adopting Rule 163B as proposed with respect to eligibility.

C. Investor Status

As proposed, Rule 163B would permit 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, QIBs or 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.[101] An IAI is any institutional investor that is

---

[97] *See* letter from CCMC.

[98] *See* letter from Nasdaq.

[99] *See id*.

[100] *See infra* Section II.E.

[101] 17 CFR 230.144A(a)(1)(i). Banks and other specified financial institutions must also have a net worth of at least $25 million. 17 CFR 230.144A(a)(1)(vi). Unlike other institutions, a registered broker-dealer qualifies as a QIB if, in the aggregate, it owns and invests on a discretionary basis at least $10 million in securities of issuers that are not affiliated with the broker-dealer. 17 CFR 230.144A(a)(1)(ii).

also an accredited investor, as defined in paragraph (a) of Rule 501 of Regulation D.[102] Under the proposed rule, any potential investor solicited must meet, or issuers must reasonably believe that the potential investor meets, the requirements of the rule. We did not propose 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.[103] As noted in the Proposing Release, the limitation of the exemption to these institutional investors, consistent with Section 5(d), 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 provided by the Securities Act's registration process as other types of investors.[104]

We received several comments on two issues raised in the Proposing Release with respect to investor status: (1) whether the proposed exemption should limit communications to QIBs and IAIs; and (2) whether issuers should be required to establish a reasonable belief that the potential investors involved in a Rule 163B communication are QIBs and IAIs and, if so, whether existing guidance and practice is sufficient to enable issuers to establish such reasonable

[102] Specifically, for the purposes of the proposed rule, an IAI would be an institution that meets the criteria of Rule 501(a)(1), (a)(2), (a)(3), (a)(7), or (a)(8).

[103] Although Securities Act Rule 501(a) does not provide specific details as to the actions an issuer can take to form a reasonable belief that an entity meets the definition of an institutional accredited investor, Rule 144A(d)(1) sets forth non-exclusive means to determine whether a prospective purchaser is a QIB. The rule provides that a seller and any person acting on its behalf are entitled to rely upon the following non-exclusive methods of establishing the prospective purchaser's ownership and discretionary investment of securities: (i) the prospective purchaser's 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, a person fulfilling an equivalent function, or other executive officer of the purchaser, specifying the amount of securities owned and invested on a discretionary basis by the purchaser as of a specific date on or since the close of the purchaser's most recent fiscal year.

[104] *See* Section II.C of the Proposing Release.

belief or whether the rule should include a non-exclusive list of methods that could be used to establish such reasonable belief.

1. Limiting Communications to QIBs and IAIs

Commenters generally agreed with the proposed rule's requirement that solicitations of interest be limited to QIBs and IAIs.[105] Several commenters recommended, however, that the Commission consider expanding the class of eligible investors.[106]

One commenter suggested that the Commission consider expanding the applicability of test-the-waters communications to individual accredited investors.[107] Another commenter recommended, as a way to facilitate global offerings made on a registered basis, expanding the class of eligible investors to include parties that are not "U.S. Persons" (as defined in Rule 902(k)) who may purchase outside of the U.S. in a non-U.S. tranche of a registered offering.[108] This commenter also recommended, in the case of an offshore tranche offered and sold under Regulation S in tandem with a domestic registered offering, that the Commission confirm that communications made under Rule 163B would not be deemed "Directed Selling Efforts" under 17 CFR 230.902(c) ("Rule 902(c)") for purposes of Regulation S.[109]

Two commenters suggested that the Commission expand Rule 163B to permit fund issuers to test the waters with any SEC-registered investment adviser, which could help issuers gauge the potential viability of a fund offering. These commenters suggested that all SEC-

---

[105] *See, e.g.*, letters from Better Markets, CCMC, Cravath, Nasdaq, SIFMA, and Sullivan.

[106] *See* letters from L. Ameri, C. Anderson, Federated, and ICI.

[107] *See* letter from SIFMA (suggesting that the Commission address this possible expansion in a separate rulemaking given that the definition of accredited investors is presently under Commission review).

[108] *See* letter from CCMC.

[109] *Id.*

registered investment advisers should be considered sophisticated enough to receive these communications.[110]

One commenter disagreed with limiting investors eligible to receive test-the-waters communications, arguing instead that the rule should be expanded to include all accredited investors and, eventually, all investors.[111]

In our view, because the exemption will be available to all issuers, we think it is appropriate, as an initial matter, to limit the communications, consistent with Section 5(d), to those institutional investors that the Commission has long recognized as having the ability to fend for themselves. Also, the intent of the exemption is to help issuers gauge market interest in a potential offering, and limiting the communications to institutional investors will allow issuers to accomplish this goal while mitigating any potential adverse effects on investors.

We recognize that, as two commenters noted, some but not all SEC-registered investment advisers would currently qualify as QIBs or IAIs.[112] We are not, however, expanding the class of eligible investors under Rule 163B to include all SEC-registered investment advisers at this time. In connection with our ongoing review of the definition of "accredited investor" under Rule 501(a) of Regulation D, we are considering whether a broader range of SEC-registered

---

[110] *See* letters from Federated and ICI (stating that "only registered investment advisers that in the aggregate own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the adviser [under the QIB definition] would be eligible to receive test-the-waters communications"). One commenter suggested that, for purposes of proposed Rule 163B, SEC-registered investment advisers should be treated similarly to registered broker-dealers, which qualify as IAIs. This commenter also stated that its recommended approach would be consistent with FINRA Rule 2210, which classifies all SEC-registered investment advisers as institutional investors. *See* letter from ICI.

[111] *See* letter from L. Ameri.

[112] An SEC-registered investment adviser would generally qualify as an IAI if it has total assets in excess of $5 million. *See* Rule 501(a)(3) of Regulation D. An SEC-registered investment adviser would generally qualify as a QIB if it owns and invests on a discretionary basis at least $100 million in securities of unaffiliated issuers. *See* Rule 144A(a)(1)(i)(I).

investment advisers should qualify as IAIs, beyond those that currently qualify as IAIs under Rule 501(a)(3).[113] We believe a more holistic review of the treatment of SEC-registered investment advisers under Rule 501 of Regulation D will help ensure appropriate consistency throughout our regulations.

At this time we believe it is appropriate to limit Rule 163B communications to QIBs and IAIs, consistent with communications made under Section 5(d), for the reasons set forth in this release and in the Proposing Release.[114]

2. Reasonable Belief Standard

Commenters broadly supported a "reasonable belief" standard for proposed Rule 163B, but objected to creating a non-exclusive list of methods to establish a reasonable belief.[115] In expressing this view, several commenters noted that, unlike in the context of offerings made in reliance on 17 CFR 230.506(c) of Regulation D, all investors who would receive "Rule 163B communications and who in turn proceed to make an investment in the issuer will ultimately have the benefit of a registration statement."[116] One commenter stated that the standard for proposed Rule 163B should "be no more burdensome for issuers and their underwriters than current practice in Rule 144A and Section 4(a)(2) private placements."[117]

One commenter opposed the proposed reasonable belief standard, arguing that by not requiring issuers—and persons authorized to act on their behalf, including underwriters—to

[113] *See* Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-10649 (June 18, 2019) [84 FR 30460 (June 26, 2019)].

[114] We do, however, confirm that communications made under Rule 163B generally would not be deemed "Directed Selling Efforts" under Rule 902(c) for purposes of Regulation S. Further, we confirm that issuers may engage in communications under Rule 163B to non-U.S persons who are also QIBs or IAIs.

[115] *See* letters from CCMC, Cleary, Cravath, Davis Polk, Hamilton, and SIFMA.

[116] *See* letter from Cravath. *See also* letters from Hamilton and Davis Polk.

[117] *See* letter from Davis Polk.

validate the status of the investor as a QIB or IAI before a solicitation is made, the proposed rule would permit solicitations to retail and other unsophisticated investors.[118] This commenter urged that, at a minimum, the Commission should establish specific criteria that must be used to evaluate the status of the investor and ensure the investor is in fact a QIB or IAI.[119]

We are adopting the reasonable belief standard as proposed. Accordingly, Rule 163B does not specify the steps that an issuer could or must take to establish a reasonable belief regarding investor status or require the issuer to verify investor status. As the Commission noted in the Proposing Release, by not specifying the steps an issuer could or must take to establish a reasonable belief as to investor status, this approach is intended to 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.[120]

In addition, we disagree with the commenter's assertion that, absent a requirement that issuers take reasonable steps to verify investor status, the rule would permit solicitations to non-qualifying investors, and that the Commission should therefore "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."[121] While issuers will not be required to take specific steps to verify investor status, the rule limits solicitations to potential investors that are, or that the issuer reasonably believes to be, QIBs or IAIs. The issuer could not, for example, form such reasonable belief if it has knowledge that the investor is not a QIB or IAI. As noted in

[118] *See* letter from Better Markets.

[119] *Id.*

[120] *See* Section II.C of the Proposing Release. *See also Interpretive Release on Regulation D*, Release No. 33-6455 (Mar. 3, 1983) [48 FR 10045 (Mar. 10, 1983)] (explaining, in the context of the definition of "accredited investor," "[w]hat constitutes 'reasonable' belief will depend on the facts of each particular case").

[121] *See* letter from Better Markets.

the Proposing Release, we believe that issuers should continue to rely on the methods that they currently use to establish a reasonable belief with respect to an investor's status as a QIB or IAI pursuant to Rule 144A and Rule 501(a).[122] Furthermore, in response to this commenter's concern regarding issuers relying on a "check-the-box" or other self-certification method of determining investor status, we reiterate that the steps necessary to establish a reasonable belief as to investor status will be dependent on the facts and circumstances of the contemplated offering and each potential issuer.

For these reasons, we are not adopting specific steps or methods to establish a reasonable belief, or requiring issuers to take reasonable steps to verify, that the intended recipients of test-the-waters communications are QIBs or IAIs. Instead, issuers may continue to rely on methods they currently use to establish a reasonable belief regarding an investor's status in other contexts.[123]

D. Non-Exclusivity

As proposed, Rule 163B explicitly stated that it would be non-exclusive. In other words, an issuer would be able to rely concurrently on other Securities Act communications rules or exemptions when determining how, when, and what to communicate related to a contemplated securities offering. The Commission cautioned in the Proposing Release,[124] however, that while an issuer contemplating a registered securities offering may solicit interest from QIBs and IAIs without legending or filing those materials in compliance with Rule 163B, should it decide to

[122] *See* note 103, *supra*.

[123] One commenter recommended that the Commission consider specifying that this reasonable belief approach is also sufficient under Section 5(d). *See* letter from Cleary. Given that Rule 163B is available to all issuers, an EGC may rely on Rule 163B in addition to Section 5(d).

[124] *See* Section II.D of the Proposing Release.

claim the availability of another exemption or communication rule with respect to those communications, the issuer must also comply with the conditions of any other exemption or rule relied upon.

All commenters that discussed non-exclusivity of the rule supported the rule as proposed, and none opposed the non-exclusivity provision.[125] Accordingly, and for the reasons discussed in the Proposing Release, we are adopting the non-exclusivity provision of Rule 163B as proposed.

E. Considerations for Use by Investment Companies

Consistent with the proposal, issuers that are, or that are considering becoming, registered investment companies or BDCs (collectively, "funds") would be eligible to engage in test-the-waters communications under Rule 163B. Commenters generally supported allowing all issuers, including fund issuers, to rely on Rule 163B, and we continue to believe it is appropriate for funds to have the option to engage in these communications to help assess market demand for a fund offering.[126]

1. Use of Rule 163B in the Fund Context

We received three comment letters that discussed fund-specific issues.[127] Commenters generally agreed with the Commission's assessment in the Proposing Release that funds are less likely to use Rule 163B than other issuers, due in part to certain considerations under the

[125] *See, e.g.*, letters from CCMC, Dechert, Federated, and ICI.

[126] *See supra* note 94 and accompanying text. *See also* Proposing Release at Section II.E (stating that funds and their advisers may have an interest in using the proposed rule to, for example, assess demand for a particular investment strategy or fee structure, and discussing the existing communications framework for funds that would otherwise only permit post-filing communications, subject to certain filing, legending, and content requirements).

[127] *See* letters from Dechert, Federated, and ICI.

Investment Company Act and associated market practices.[128] One commenter discussed private funds' potential use of proposed Rule 163B.[129] This commenter expressed the view that private funds relying on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act generally offer their securities pursuant to Section 4(a)(2) of the Securities Act (which separately provides for an exemption from Section 5), and therefore these funds would not have a direct use for proposed Rule 163B.[130] We recognize that an issuer that solely conducts offerings that qualify for an exemption from Section 5 of the Securities Act would not specifically benefit from Rule 163B, since the rule only relates to communications about contemplated registered securities offerings that Sections 5(c) or 5(b)(1) of the Securities Act would otherwise restrict.

Two commenters requested that we allow funds to rely on Rule 163B prior to registering under the Investment Company Act so funds can more effectively use the rule to engage in pre-filing communications.[131] These comments were in response to the industry practice discussed in the Proposing Release, whereby funds commonly file a single registration statement under both the Investment Company Act and the Securities Act to take advantage of certain

---

[128] *See* letters from Federated and ICI. *See also* Proposing Release at notes 54-57 and accompanying text.

[129] *See* letter from Dechert.

[130] This commenter also represented that funds often rely on Sections 3(c)(1) or 3(c)(7) during their seeding periods before conducting a registered offering. *See* letter from Dechert. As discussed in the Proposing Release, and based on staff experience and information we have received in other contexts, we continue to believe this is not the typical practice. *See* Proposing Release at note 55. Among other considerations that may contribute to the common practice of funds registering during their seeding periods, a fund generally may only include performance information in its prospectus and sales materials for periods subsequent to the effective date of its registration statement. *See, e.g., infra* note 150. Moreover, if a fund is planning to conduct a registered public offering, the Sections 3(c)(1) and 3(c)(7) exemptions generally would become unavailable if the fund makes, or proposes to make, a public offering. *See* Section 3(c)(1) of the Investment Company Act [15 U.S.C. 80a-3(c)(1)] (requiring that an issuer "is not making and does not presently propose to make a public offering of its securities"); Section 3(c)(7) of the Investment Company Act [15 U.S.C. 80a-3(c)(7)] (requiring that an issuer "is not making and does not at [the time of acquisition of its securities by qualified purchasers] propose to make a public offering of its securities").

[131] *See* letters from Federated and ICI. *See also supra* Section II.C.1 (discussing these commenters' request that fund issuers be permitted to test the waters with any SEC-registered investment adviser to help them better gauge interest in a potential registered offering).

efficiencies.[132] One of these commenters stated that, absent an exemption from Investment Company Act registration requirements, most funds would likely continue to file a single registration statement under both Acts, and therefore would not take advantage of the pre-filing benefits of proposed Rule 163B.[133] We recognize that this consideration will likely limit many funds' use of Rule 163B.[134] At this time, however, we decline to provide a new exemption under the Investment Company Act to allow a fund that would otherwise be required to register under Section 8 of the Investment Company Act to avoid this registration requirement while it engages in communications under Rule 163B. We are concerned that an exemption from registration and from the substantive requirements of the Investment Company Act could allow funds potentially to engage in activities that are contrary to the substantive requirements of the Investment Company Act that protect investors and apply outside of a registered fund's offering. For example, such a new exemption could allow a fund to engage in certain self-dealing transactions—which the Act prohibits for registered funds—that benefit its investment adviser or other affiliated persons while the fund is actively considering and soliciting interest in a public offering.[135] Commenters who suggested that funds should be permitted to rely on Rule 163B prior to registering under the Investment Company Act did not address how such an Investment Company Act registration exemption could address concerns unique to funds that the Act is meant to address. For instance, commenters did not discuss the contours of any conditions

[132] *See* Proposing Release at notes 56-57 and accompanying text.

[133] *See* letter from ICI. To register as an investment company, a fund files a relatively brief notification of registration on Form N-8A and generally must file a more detailed registration statement under the Investment Company Act within three months after filing the notification of registration. *See* Sections 8(a) and 8(b) of the Investment Company Act [15 U.S.C. 80a-8(a), 8(b)]; Investment Company Act Rule 8b-5 [17 CFR 270.8b-5].

[134] *See supra* note 132.

[135] *See, e.g.*, Section 17 and Section 10(f) of the Investment Company Act [15 U.S.C. 80a-17 and 15 U.S.C. 80a-10(f)].

associated with any such exemption or how they would address these concerns. Given the need to consider these matters further, we are not adopting an exemption under the Investment Company Act at this time.

We continue to believe that certain funds may be able to rely on Rule 163B to engage in pre-filing communications to gauge interest in a potential registered offering. For example, because BDCs are not required to register under the Investment Company Act, they may be more likely to engage in pre-filing communications under Rule 163B when contemplating a registered offering close-in-time to the fund's inception.[136] Further, funds that initially conduct exempt offerings—including certain registered closed-end funds and BDCs—may use Rule 163B to communicate with QIBs and IAIs before filing a Securities Act registration statement if they are contemplating a subsequent registered offering.[137] One commenter agreed that the rule would provide these funds with greater flexibility in their communications.[138] This commenter also suggested that Rule 163B may provide registered closed-end funds and BDCs with more comfort regarding discussions about underwriting and offering terms with entities involved in the offering process.

In addition to pre-filing communications, Rule 163B will allow a fund to engage in test-the-waters communications with QIBs and IAIs after filing a Securities Act registration statement while it continues to contemplate a registered offering before the registration statement

---

[136] *See* Sections 6(f) and 54 of the Investment Company Act [15 U.S.C. 80a-6(f) and 80a-53]; Form N-6F and Form N-54A [17 CFR 274.15 and 274.54]. However, like registered investment companies, many BDCs have relatively high levels of retail investor ownership, which may reduce the likelihood that these BDCs will rely on Rule 163B to test the waters with QIBs and IAIs. *See infra* note 227.

[137] *See* Proposing Release at note 58 and accompanying text (recognizing that registered open-end funds may be less likely to use Rule 163B in this way because they typically offer their shares to retail investors in registered offerings).

[138] *See* letter from ICI.

becomes effective. As discussed in more detail below, while funds may already engage in these types of communications under other Commission rules and associated FINRA rules, these communications currently may be subject to certain filing, legending, or content requirements that Rule 163B would not entail.[139]

2. Rule 163B Filing, Legending, and Content Requirements in the Fund Context

The Commission did not propose to require any different filing, legending, or content requirements for funds' test-the-waters communications under proposed Rule 163B, and we are not adopting any such requirements for funds.[140] While commenters supported the ability for funds to rely on proposed Rule 163B without the need to file test-the-waters communications, one commenter expressed doubt that this would result in significant cost savings for funds.[141] This commenter noted that, for example, post-filing communications under proposed Rule 163B are very similar to institutional communications under FINRA Rule 2210 and stated that these existing communications are not required to be filed with FINRA. The commenter expressed doubt that funds would rely on Rule 163B for these communications when they already use, and are familiar with, institutional communications under FINRA rules.[142] While there may be some minor differences between the scope of institutional investors under FINRA Rule 2210 and the QIB and IAI entities that funds may communicate with under Rule 163B,[143] we recognize that

[139] *See* 17 CFR 230.482 ("Rule 482" under the Securities Act); 15 U.S.C. 80a-24(g) (Section 24(g) of the Investment Company Act); 17 CFR 270.34b-1 (Investment Company Act Rule 34b-1); FINRA Rule 2210.

[140] *See* Rule 163B(b)(3); Proposing Release at note 59 and accompanying text.

[141] *See* letter from ICI. *See also infra* Section IV.C.5.

[142] In addition to FINRA rules, funds must comply with relevant Commission rules with respect to these institutional communications. *See, e.g., supra* note 139.

[143] For example, certain investors that qualify as IAIs under Rule 501(a) of Regulation D may not necessarily be treated as institutional investors under FINRA Rule 2210.

funds may choose to rely on other available communications rules to test the waters instead of Rule 163B.[144]

One commenter suggested that the Commission require funds to include performance information in a standardized manner in their test-the-waters communications.[145] This commenter represented that this requirement would facilitate comparisons of fund performance and level the playing field among funds. This commenter also stated that it would not be burdensome for funds to provide standardized performance information because they already present their performance in this manner. As an alternative, this commenter suggested that we require clear and prominent disclosure when a fund's test-the-waters communication includes nonstandardized fund performance.

We do not believe a standardized performance requirement, or a specific requirement to identify nonstandardized performance, is necessary for funds' test-the-waters communications given that: (1) current standardized performance requirements generally would not be relevant at the time a fund tests the waters; (2) any performance presentation in a test-the-waters communication will be subject to anti-fraud provisions; and (3) these communications are limited to QIBs and IAIs, which are financially sophisticated investors that we believe, in the context of receiving test-the-waters communications, would have the bargaining power to request the information they need to assess fund performance.[146] We do not believe the current standardized performance requirements for registered funds would generally be meaningful for purposes of Rule 163B. These current provisions require performance information for certain

[144] *See, e.g., supra* note 139. *See also* Rule 163B(a).

[145] *See* letter from ICI. This commenter pointed to performance presentation requirements under Rule 482 for registered open-end funds and requirements in Form N-2 for registered closed-end funds.

[146] *See infra* note 151 and accompanying text.

periods *after* a registered fund has an effective Securities Act registration statement, while test-the-waters communications would generally occur *before* a fund has an effective Securities Act registration statement.[147] Further, any performance information included in test-the-waters communications will be subject to the anti-fraud provisions and cannot be materially misleading.[148] For example, if a fund provides performance information in a Rule 163B communication, additional statements regarding its performance—such as explanations, qualifications, or limitations—may be necessary or appropriate to make the performance information not misleading.[149] A fund also may need to consider whether these types of statements would be necessary for any performance information in a test-the-waters communication not to conflict with material information in the fund's registration statement.[150] The fact that funds would be able to rely on Rule 163B only for test-the-waters communications

[147] *See, e.g.*, Advertising by Investment Companies, Release No. IC-16245 (Feb. 2, 1988) [53 FR 3868, 3876 (Feb. 10, 1988)] (excluding pre-effective performance from Rule 482 advertisements because funds are likely to be managed differently before they are offered to the public). The Commission has not promulgated standardized performance requirements for private funds. *See, e.g.*, Amendments to Regulation D, Form D and Rule 156, Release No. IC-30595 (July 10, 2013) [78 FR 44806, 44827 (July 24, 2013)] (declining to propose standardized calculation methodologies for private fund performance in connection with general solicitations under rule 506(c) of Regulation D and noting that methodologies for calculating private fund performance can vary for a number of reasons, such as the type of fund, assumptions underlying the calculations, and investor preferences).

[148] *See* Securities Act Section 17(a); Exchange Act Section 10(b); Exchange Act Rule 10b-5; 17 CFR 230.156 ("Rule 156" under the Securities Act) (applying to investment company sales literature, which includes any communication (whether in writing, by radio, or by television) used by any person to offer to sell or induce the sale of securities of any investment company).

[149] *See, e.g.,* Rule 156(b)(2).

[150] *See supra* Section II.A.3. Applicable registration forms generally identify the types of performance information registered funds must include, as relevant. This performance information covers periods subsequent to the fund having an effective registration statement. *See, e.g.*, Item 4(b)(2) of Form N-1A; Instruction 3 to Item 4.1 of Form N-2. In certain limited circumstances, the staff has stated that it would not recommend enforcement action if a registered fund included certain performance information in its registration statement relating to other funds or accounts that are either materially equivalent, or substantially similar, to the registered fund. *See, e.g.*, MassMutual Institutional Funds, SEC Staff No-Action Letter (Sept. 28, 1995); Nicholas-Applegate Mutual Funds, SEC Staff No-Action Letter (Aug. 6, 1996); Bramwell Growth Fund, SEC Staff No-Action Letter (Aug. 7, 1996).

Funds also may want to consider positions of FINRA and its staff regarding performance information that may be included in fund sales materials under FINRA Rule 2210. *See, e.g.*, FINRA Rule 2210(d); FINRA Interpretive Letter to Edward P. Macdonald, Hartford Funds Distributors, LLC (May 12, 2015).

to QIBs and IAIs is also important to our consideration of whether to require standardized performance in these communications. We believe that, in the context of test-the-waters communications, these financially sophisticated institutional investors will have sufficient bargaining power to ask questions about any performance information the fund presents and to request the types of performance information they would find most meaningful when considering their interest in a fund's potential registered offering.[151] Thus, we believe it is appropriate—within the confines of the anti-fraud provisions—to provide flexibility with respect to whether and, if so, how funds provide performance information when testing the waters with QIBs and IAIs.

III. Other Matters

If any of the provisions of these rules, or the application of these provisions to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

Pursuant to the Congressional Review Act,[152] the Office of Information and Regulatory Affairs has designated these rules a "major rule," as defined by 5 U.S.C. § 804(2).

IV. Economic Analysis

A. Introduction and Broad Economic Considerations

[151] For example, as the Commission discussed in the Proposing Release, we anticipate that test-the-waters communications may help fund issuers 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. *See* Proposing Release at Section II.E. To the extent that a fund relies on Rule 163B for these purposes (taking into account certain features of investment companies that may make their use of the rule more limited than other issuers, *see infra* Section IV.C.5), we believe that QIB and IAI recipients of test-the-waters communications (for example, broker-dealers and certain registered investment advisers) as well as fund issuers would each have respective incentives to request and provide relevant fund performance information.

[152] 5 U.S.C. § 801 *et seq*.

We are mindful of the costs imposed by and the benefits obtained from our rules. Securities Act Section 2(b)[153] and Investment Company Act Section 2(c)[154] require us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in (or, with respect to the Investment Company Act, consistent with) the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

As noted above, Securities Act Section 5(d) was enacted under the JOBS Act and permits EGCs to engage in communications with QIBs or IAIs to determine their interest in an offering before or after the filing of a registration statement. However, companies that do not presently qualify as EGCs (including companies that previously qualified as EGCs but that have lost EGC status, larger companies, companies that first issued common equity pursuant to a Securities Act registration statement before December 8, 2011, asset-backed issuers, and registered investment companies) cannot avail themselves of Section 5(d) when considering raising capital through registered offerings, resulting in potential competitive impacts. The inability to test the waters may contribute to reduced willingness of non-EGCs to conduct registered offerings, compared to EGCs. The Commission proposed Rule 163B to expand the permissibility of test-the-waters communications to all issuers that are contemplating registered securities offerings, regardless of whether such issuers qualify as EGCs. As discussed above, after considering public comment, the Commission is adopting the final rule generally as proposed.

---

[153] 15 U.S.C. 77b(b).

[154] 15 U.S.C. 80a-2(c).

Under the final rule, test-the-waters communications will provide issuers, particularly non-EGC issuers that are unable to rely on Section 5(d), with additional tools to gather valuable information about investor interest before a potential registered offering. By allowing issuers to gauge market interest[155] in a contemplated registered securities offering, these communications could result in a more efficient and potentially lower-cost and lower-risk capital raising process for issuers. By extending the flexibility presently afforded to EGCs to all issuers, the final rule will result in greater harmonization of offering process requirements between EGC and non-EGC issuers (including issuers that previously had EGC status but no longer qualify as EGCs).

As the use of test-the-waters communications will remain voluntary, we anticipate that the issuers most likely to engage in these communications will be those issuers that expect the benefits of this strategy to outweigh the costs. Specifically, we expect that the issuers that are most likely to use the final rule will be those that seek to better assess the demand for, and valuation of, their securities, as well as those that seek more information from prospective large institutional investors regarding the attractiveness of various terms or structural elements of the offering.[156] Commenters generally concurred that the proposed rule would allow issuers adequate flexibility to gauge market interest prior to filing a registration statement and tailor the size and other terms of the offering accordingly, reduce the costs of going public as well as the risk of disclosing sensitive financial and competitive information when choosing not to proceed

[155] Test-the-waters communications with institutional investors can help issuers gauge market interest in an offering because institutions account for a key part of the pool of investors in many public offerings, particularly for larger companies. *See*, *e.g.*, Lowry, M., R. Michaely, and E. Volkova, 2017. Initial public offerings: a synthesis of the literature and directions for future research. Foundations and Trends in Finance 11(3-4), 154–320.

[156] We also recognize that the benefits of the final rule may be more limited for certain issuers in practice, which may make them less likely to use the final rule regardless of these factors. *See supra* Section II.E and *infra* Section IV.C.5.

with a public offering, and "level the playing field" among EGC and non-EGC issuers.[157] We continue to believe, after considering these comments, that the benefits of Rule 163B should enhance the ability of issuers to conduct successful registered offerings and potentially lower their cost of capital.

In addition to the benefits discussed above, by reducing the potential costs and risks associated with a registered securities offering, the final rule might make registered securities offerings more attractive to certain issuers, particularly non-EGC issuers, that otherwise might have relied on private placements or not undertaken a securities offering.[158] Because a public

[157] *See, e.g.*, letters from CCMC, Cravath, Davis Polk, Nasdaq, M. Stuchlik, and Sullivan.

[158] *See, e.g.*, letters from ASA (stating its belief that "[the proposed rule] will ultimately help more companies complete a successful IPO . . . . When fewer companies go public, long-term economic growth is inhibited and Main Street investors have fewer opportunities to invest their hard-earned money in growing businesses"); CCMC (stating that "we believe all issuers contemplating an IPO, regardless of size, would benefit from the ability to test the waters, and expect that it would likewise motivate more companies to consider the public offering route"); Cravath (stating that "[b]y gathering information from investors before publicly filing a registration statement, issuers should increase their likelihood of conducting successful public offerings, which in turn we believe should result in a greater number of registered offerings in the United States"); Davis Polk (stating its belief that the rule "will greatly ease access to capital"); and Sullivan (stating its belief that the rule would "potentially result[] in additional registered offerings in the United States and more investment opportunities for U.S. investors, including retail investors"). However, one commenter questioned whether and how the proposed exemption would increase the number of public offerings. *See* letter from Better Markets (stating that "[t]he 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").

One study found a significant increase in IPO activity, particularly among pharmaceutical and biotechnology companies, in the two years after the JOBS Act enactment. *See* Michael Dambra, Laura Field, & Matthew Gustafson, The JOBS Act and IPO Volume: *Evidence That Disclosure Costs Affect the IPO Decision*, 116 J. Fin. Econ. 121, 121-143 (2015) ("DFG Study"), at 121 ("[c]ontrolling for market conditions, we estimate that the JOBS Act has led to 21 additional IPOs annually, a 25% increase over pre-JOBS levels"). The study notes several caveats related to the interpretation of the finding, including that "the recent sustained bull market makes it impossible to investigate the interaction between the JOBS Act provisions and market conditions" and that the estimated increase in the annual IPO volume outside biotechnology and pharmaceutical industries is "small relative to the intertemporal volatility of IPO volume." As a result, the authors caution that "our results should be viewed as preliminary, warranting future research on the topic." *See* DFG Study, at 123.

In addition, we note that the confounding effects of other provisions commonly used by EGCs along with testing the waters, such as the ability to confidentially submit a draft registration statement for nonpublic review by the staff of the Commission prior to public filing, makes it difficult to isolate the incremental effect of the availability of testing the waters on IPO activity among issuers eligible for EGC status. *See* DFG Study, at 124 ("In practice, issuers usually combine [testing the waters] with a second de-risking provision, allowing EGCs to file their IPO draft registration statement confidentially."); and Congressional Research Service (2018) Capital Markets, Securities

offering can be costly and time consuming, particularly for first-time issuers, potential issuers may be reluctant to proceed along that path if the outcome is uncertain.[159] By mitigating some of the uncertainty, the rule could motivate more companies to consider the public offering route.[160] To the extent that this channel results in an increased number of registered offerings and reporting companies, the rule may improve capital formation and efficiency of allocation of investor capital. However, because some of the issuers undertaking registered offerings as a result of Rule 163B might have otherwise sought to raise capital in the private market or in a registered offering outside the U.S., we are unable to quantify the net impact of the final rule on aggregate capital formation and efficiency of capital allocation.

By providing certain preliminary information about contemplated registered offerings at an earlier stage, the final rule also might provide solicited investors with marginal informational benefits that may help some of those investors to formulate a more informed investment strategy. On the other hand, the final rule also might have marginal adverse effects on some solicited investors if the test-the-waters communications contain incomplete or misleading information and if solicited investors rely on such communications when making an investment decision,

---

Offerings, and Related Policy Issues (July 26, 2018), https://crsreports.congress.gov/product/pdf/R/R45221 ("CRS Report"), at 18. Further, as a general caveat, we recognize that inferences from studies of EGC issuers may not be directly applicable to non-EGC issuers because non-EGC issuers are different from EGC issuers. *See infra* notes 182 - 184.

[159] *See* letter from CCMC.

[160] *Id*. Further, some other issuers that would have attempted a public offering without testing the waters might see somewhat increased odds of successful completion of the offering as a result of testing the waters under the final rule (because they can more effectively tailor offering terms to market demand based on the information gathered during testing the waters), resulting in an incrementally greater number of completed public offerings.

While it is indeed possible that some issuers may abandon plans for a registered offering after inferring in the course of testing the waters under the final rule that there is insufficient market interest in the offering, in the absence of testing the waters, those same issuers might have publicly filed and subsequently withdrawn the offering. This could result in the same number of completed public offerings but at a higher cost for those issuers (due to filing and legal fees, as well as reputational costs and potential costs due to the disclosure of proprietary information through a public filing).

rather than on the filed offering materials against which they may compare the information in the test-the-waters materials. We expect such potential adverse effects on solicited investors to be mitigated by several factors. These factors include the general applicability of anti-fraud provisions of the federal securities laws and liability under Section 12(a)(2)[161] and the limitation of permissible test-the-waters communications under the final rule to QIBs and IAIs, which, relative to retail investors, have more experience processing investment information, and a more sophisticated ability to do so. Commenters generally agreed that the proposal did not raise significant investor protection concerns, particularly in consideration of the fact that the proposed rule was limited to certain institutional investors.[162]

By extending to all issuers the flexibility to test the waters currently available only to EGCs, we expect the final rule will benefit non-EGC issuers by making them comparable to EGC issuers in this respect. This difference in the ability to use test-the-waters communications in gauging investor demand for a public offering is particularly pronounced today for non-EGCs that are close to meeting—but marginally fail to meet—EGC eligibility criteria. In turn, to the extent that EGCs compete with non-EGCs for investor capital and in the product market, the incremental benefits that accrue to non-EGCs under the final rule (the ability to pursue a more efficient capital raising strategy while limiting the risk of early disclosure of proprietary information) might have an adverse competitive effect on comparable EGCs.

[161] *See supra* note 69.

[162] *See* letters from ASA, CCMC, Cravath, Hamilton, and Nasdaq. *But see* letter from Better Markets (expressing concern that the proposed reasonable belief standard regarding investor status would create an "anti-investor protection loophole").

On a market-wide basis, providing the option to test the waters to all issuers is expected to improve the efficiency and lower the cost of implementing capital raising strategies for issuers contemplating a registered securities offering.[163]

While EGC issuers will also be permitted to rely on Rule 163B, non-EGC issuers are expected to be most affected by the final rule because they cannot rely on Section 5(d). Potential users of the final rule include, for example, issuers contemplating an IPO as well as reporting issuers that are interested in conducting follow-on and other registered offerings. We recognize that Regulation FD may limit the attractiveness of relying on the final rule for some issuers in the second group. In particular, reporting issuers that selectively disclose material nonpublic information while testing-the-waters with QIBs and IAIs may be required under Regulation FD to disclose such information publicly, which may reduce those issuers' willingness to rely on Rule 163B. However, some issuers are not subject to Regulation FD and those that are may avail themselves of one of the exceptions under Regulation FD, such as the exception involving confidentiality agreements, thereby mitigating the limiting effect that the application of Regulation FD may have on users of Rule 163B.[164]

---

[163] *See A Financial System That Creates Economic Opportunities: Capital Markets*, U.S. Dep't of the Treasury (2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-CapitalMarkets-FINAL-FINAL.pdf, at 30 (stating that "[w]hen combined with the ability to file a registration statement confidentially with the SEC, testing the waters reduces the company's risk associated with an IPO. The company has a better gauge of investor interest prior to undertaking significant expense and, in the event the company elects not to proceed with an IPO, information has been disclosed only to potential investors and not to the company's competitors."). *See also* SIFMA Report, at 10–11.

[164] *See supra* note 21 and accompanying text. For instance, some capital raising methods involve sharing material nonpublic information about a contemplated registered securities offering with outsiders who expressly agree to maintain the information in confidence until the deal is publicly disclosed. However, there is an inherent risk that a deal may not be consummated. If the deal fails to go forward, the outside investors will typically remain bound by the confidentiality agreements until the material nonpublic information is either no longer material or publicly disclosed by the issuer.

Where possible, we have attempted to quantify the economic effects of the final rule. However, in some cases we are unable to do so. For example, confounding factors (other than testing the waters) that affect the decision to go public and the cost of capital in registered offerings, economic differences between non-EGCs (which are more likely to rely on the final rule) and EGCs (which have been eligible to test the waters under Section 5(d)), and limitations of historical data on test-the-waters communications under Section 5(d) make it difficult to quantitatively predict the extent to which issuers will elect to test the waters in connection with a contemplated registered securities offering under the final rule; the extent to which the option to engage in test-the-waters communications will affect the willingness of potential issuers newly eligible for testing the waters under the final rule to conduct registered securities offerings; the effects of test-the-waters communications on the amount and cost of capital raised; and the effect of expanding permissible test-the waters communications on the ability of QIBs and IAIs to form informed assessments of issuer quality and the securities offered for the purposes of determining interest in a contemplated offering.

We have been able to gain some insight into the potential economic effects of the final rule based on the experience of EGC issuers that have been permitted to test the waters pursuant to Securities Act Section 5(d) since April 2012. However, these insights are potentially limited because of the differences between EGC and non-EGC issuers (including non-EGC issuers that are investment companies) and the offerings they undertake;[165] the voluntary nature of reliance on Section 5(d) among EGC issuers;[166] the potential confounding effects resulting from reliance on other JOBS Act provisions by EGC issuers simultaneously with reliance on test-the-waters

[165] *See infra* notes 182–184 and accompanying text.

[166] *See infra* note 176.

accommodations; and the generally favorable market conditions observed in the post-JOBS Act period.[167] Moreover, while the flexibility to not pursue a registered offering after gauging investor interest can be valuable to issuers, we do not have data on EGC issuers that tested the waters under Section 5(d) but subsequently chose not to proceed with a registered offering.

Below we discuss the potential effects of the final rule relative to the economic baseline, which includes existing requirements regarding solicitation of investor interest in connection with registered securities offerings; current practices of EGC issuers related to testing the waters; and information about filers and other parties that are likely to be affected by solicitation requirements.

B. Baseline and Affected Parties

1. Baseline

Section 5(c) of the Securities Act generally prohibits issuers or other persons from offering securities prior to the filing of a registration statement. Once a registration statement has been filed, Section 5(b)(1) generally requires issuers to use a prospectus that complies with Securities Act Section 10 for any written offers of securities. As noted above, Securities Act Section 5(d) nonetheless allows EGCs to engage in test-the-waters communications with QIBs and IAIs both before and after filing the registration statement. Currently, only issuers that qualify for EGC status can rely on the Section 5(d) test-the-waters provision in advance of a contemplated registered offering. Certain issuers, such as registered investment companies and

[167] *See, e.g.,* Susan Chaplinsky, Kathleen W. Hanley, & S. Katie Moon, *The JOBS Act and the Costs of Going Public*, 55 J. Acct. Res. 795, 795-836 (2017) ("CHM Study"), at 828 (using a three-year period post-JOBS Act and finding that "with few exceptions, the equity-market conditions of our post-Act sample period have been generally favorable to IPO issuance. We leave to future work how issuers' disclosure decisions and investors' reaction to them may change under less favorable equity market conditions.") and DFG Study, at 123 (using a two-year period post-JOBS Act and finding that "the recent sustained bull market makes it impossible to investigate the interaction between the JOBS Act provisions and market conditions. Thus, the effects of the JOBS Act we find could differ in a bear market.").

issuers of asset-based securities ("ABS issuers"), are ineligible for EGC status.[168] Permissible test-the-waters solicitations, in oral or written form, may be used before or after the filing of a Securities Act registration statement for an initial or follow-on registered offering.

There is some evidence related to the use of test-the-waters communications by EGC issuers in IPOs. Because disclosure of whether the issuer has tested the waters is not required in the registration statement, studies have used various alternative sources of information to estimate the incidence of test-the-waters communications. Thus, estimates have varied depending on the sources used, the interpretation of references to testing the waters in those sources, and sample construction.[169] Some studies have estimated the incidence of test-the-waters communications by IPO issuers based on issuer responses to staff comment letters associated with IPO registration statement filings.[170] Using this method, recent industry studies found that in 2015 and 2016, respectively, 38 percent and 23 percent of EGC IPOs referenced testing the waters in comment letter responses.[171] Based on the analysis of comment letter responses, staff has estimated that approximately 37 percent of EGC IPOs during 2012-2018

[168] However, BDCs, which are closed-end funds exempt from registration under the Investment Company Act, are eligible for EGC status.

[169] The estimates in the reviewed studies have focused on priced exchange-listed IPOs. As a caveat, information about the use of the test-the-waters provision by issuers that decide not to file a registration statement is not available.

[170] Because not all issuers in follow-on offerings receive staff comment letters, this estimate applies only to IPOs. We note that estimates based on the analysis of issuer responses to staff comment letters on IPO registration statements will likely be incomplete for purposes of capturing oral test-the-waters communications not involving written materials.

[171] *See, e.g.,* Tom Zanki, Testing The Waters' Expansion Could Make IPOs Easier, Law360 (April 30, 2018), https://www.law360.com/articles/1038641 (citing IPO studies by Proskauer Rose LLP, which showed that 38% and 23% of EGCs used the test-the-waters accommodation in 2015 and 2016, respectively, with heavy concentration in the health care and technology-telecommunications-media sectors). The studies covered a subset of EGC IPOs.

used the test-the-waters provision.[172] Other studies have estimated the use of the test-the-waters provision based on whether the underwriting agreement mentions allowing the underwriter to test the waters. One academic study found that, based on an analysis of underwriting agreements filed as exhibits to registration statements, approximately 71 percent of EGC IPOs authorized underwriters to test the waters.[173] Another academic study found that approximately 68 percent of EGC IPOs authorized underwriters to test the waters or, where information was not available in the underwriting agreement, mentioned testing the waters in comment letter responses.[174] Because underwriting agreement data does not indicate whether the underwriter actually engaged in test-the-waters communications, these estimates are considerably higher than the estimates based solely on staff comment letters. Conversely, estimates based on staff comment letters referencing the actual use of test-the-waters materials may not be capturing all instances where testing the waters was conducted. Nevertheless, we believe estimates based on staff comment letters referencing actual use of test-the-waters materials are more relevant for the purposes of this baseline analysis.

The practice of testing the waters is voluntary. Various commenters stated that testing the waters has proven to be a valuable tool for EGCs.[175] Evidence suggests that the provision

[172] EGC IPOs are identified based on Ives Group's Audit Analytics data on priced offerings. Staff comment letters and responses containing "Section 5(d)" and "testing the waters" keywords were retrieved from Intelligize and manually classified. Missing or ambiguous responses were supplemented with staff analysis of cover letters submitted by issuers in response to staff reviews of registration statements, where available.

[173] *See* CHM Study, at 820 (Table 6). The statistic is based on 313 EGC IPOs conducted between April 2012 and April 2015.

[174] *See* DFG Study, at 136 (Table 8). The statistic is based on 155 EGC IPOs conducted between April 2012 and March 2014.

[175] *See, e.g.,* letter from CCMC (stating that "[t]he ability to test the waters is frequently relied upon by EGCs, and that the practice has served to encourage many companies considering an IPO to continue along that that [*sic*] course"); Cleary (stating that "[e]xperience with EGC issuers has proven the Section 5(d) accommodation to be a valuable tool in securities offerings, particularly in the IPO context"); letter from Davis Polk (stating that "[p]re-

has been used more often by EGCs facing uncertainty about potential investor demand for their securities offering, which may find testing the waters to be more valuable.[176] The estimated rate of use of the test-the-waters provision has varied by sector, with heavy concentration of EGC IPOs that engaged in testing the waters in the biotechnology, pharmaceutical, technology, media, and telecommunications industries.[177]

We are not aware of significant investor protection concerns that have arisen to date based on test-the-waters communications by EGCs. We lack data to perform a comprehensive retrospective analysis of the content of EGC test-the-waters communications for three reasons: (i) such communications are frequently in oral format and thus data on their content is not

---

marketing an offering on a confidential basis to a handful of investors prior to making a final decision to launch has become a common and useful marketing tool for registered offerings for EGCs, and we believe the clear ability to engage in these sorts of investor communications is one of the most beneficial innovations of the JOBS Act of 2012"); and letter from Nasdaq (stating that "Nasdaq frequently hears from our listed companies on issues relating to the capital markets, and based on this feedback, we believe the current 'test the waters' accommodation for EGCs has been a resounding success").

[176] Issuers may elect to test the waters if they have high costs of proprietary information disclosure or significant uncertainty about the interest of potential investors in the offering.

According to one law firm study, companies using test-the-waters communications were heavily concentrated in the health care and technology-telecommunications-media sectors. *See supra* note 171.

Another report similarly concluded, based on the experience during the first two years after the JOBS Act was enacted, that the test-the-waters provision may be especially valuable for companies in industries where valuation is uncertain and the timing of the IPO depends on regulatory or other approval (*e.g.*, the biotech and pharmaceutical industries). *See* CRS Report, at 6.

According to one academic study, "smaller firms, biotech[nology]/pharma[ceutical] firms, and research-intensive firms are more likely to elect the testing-the-waters provision, which is consistent with the JOBS Act lowering the cost of proprietary disclosure." *See* DFG Study, at 122. *See also* CHM Study, at 823 for a more general discussion of how the characteristics of EGCs affect their choice to avail themselves of the accommodations available under Title I of the JOBS Act (stating, for example, that "issuers that disclose less information are those that are more likely to have higher proprietary information costs and characteristics that may make them difficult for investors to value"). As a caveat, the cited academic studies generally exclude self-underwritten IPOs, penny stocks, and IPOs that are not listed on an exchange. Therefore, it is unclear if the conclusions would apply to these types of issuers.

[177] *See* studies discussed in note 176 *supra*. *See also* letter from CCMC (stating that "[a]mong EGCs, use of test-the-waters communications during the IPO is not uniform, and varies considerably by industry. Industries that most frequently use the accommodation are those that desire to explain complex issues about their business models to investors. These include life sciences and biotechnology, telecommunications, and other technology-intensive businesses.").

available; (ii) where written test-the-waters materials are submitted by the filer in response to a comment from staff reviewing the registration statement, upon filer request those materials generally are returned to the filer or destroyed after the registration statement review is completed; and (iii) we do not have data on issuers that engaged in test-the-waters communications but have elected not to proceed with a contemplated registered offering after testing the waters.

2. Affected Parties

We anticipate that the final rule will affect issuers, investors, and intermediaries.

i. Issuers

The final rule will affect issuers that are contemplating registered securities offerings. While the final rule will be available to all issuers, including EGCs, it will particularly affect non-EGC issuers that are not allowed to test the waters under Section 5(d). EGC issuers will remain eligible to rely on Section 5(d). The final rule will directly affect EGC issuers to the extent that such issuers rely on the final rule. Issuers that do not rely on the final rule may also be indirectly affected to the extent that they compete with issuers that rely on the final rule for investor capital or in the product market.

We estimate that there were approximately 1,931 EGCs and 7,551 non-EGCs that filed Securities Act registration statements or periodic reports during 2018,[178] excluding ABS issuers and registered investment companies. We estimate that in 2018 there were approximately 1,852

[178] The estimate is based on the number of unique filers of registration statements on Form S-1, S-3, S-4, S-11, F-1, F-3, F-4, or F-10, or periodic reports on Form 10-K, 10-Q, 20-F, or 40-F, or amendments to them, during calendar year 2018, as well as any BDCs included in the SEC's July 2018 BDC report at https://www.sec.gov/open/datasets-bdc.html. The BDC report does not exclude filers that have not yet begun selling shares to the public or filers that have ceased operations but have not yet withdrawn their registration statement or election to be regulated as a BDC. EGCs are identified as of the end of 2018 based on Ives Group's Audit Analytics data. We include filers of periodic reports because the final rule is available to seasoned issuers that have already become reporting companies.

ABS issuers[179] and approximately 12,990 registered investment companies,[180] which were ineligible for EGC status. While EGCs made up a minority of all filers with registration statements declared effective, they accounted for a majority of new issuers in traditional IPOs.[181]

The final rule also could affect issuers that are not yet reporting companies but that elect to test the waters as part of exploring the possibility of a future registered securities offering. In addition, because there is no requirement to disclose the use of testing the waters under Section 5(d), we do not have data on EGCs that have tested the waters but have elected not to file a registration statement for the contemplated offering.

In drawing inferences from the experience of EGCs with the use of test-the-waters communications, we recognize that there are differences between a typical EGC and non-EGC issuer. For example, non-EGC IPO issuers tend to have significantly higher revenues than EGCs due to the size-based eligibility criteria for EGC status.[182] Further, non-EGC issuers include older companies that first issued common equity pursuant to a Securities Act registration

[179] The estimate is based on the number of unique CIKs with ABS-related filings during calendar year 2018 (ABS-15G, ABS-EE, SF-1, SF-3, 10-D, or amendments to them). The estimate is not limited to ABS issuers that filed annual reports.

[180] We estimate that there were 9,599 mutual fund series (including funds of funds); 1,978 exchange-traded funds ("ETFs"); 692 registered closed-end funds; five variable annuity separate accounts registered as management investment companies on Form N-3; 670 variable annuity separate accounts registered as UITs on Form N-4 and Form N-6; and 46 non-insurance UITs registered on Form S-6. Taking into account the 4,917 non-insurance UIT series registered on Form S-6 yields an estimate of approximately 17,861 registered investment company issuers. These estimates are based on data from 2019 ICI Factbook, Bloomberg, and staff analysis of EDGAR filings. These estimates include funds of funds and are not limited to registered investment companies that filed annual reports.

[181] Based on Ives Group's Audit Analytics data, during the period from April 5, 2012 through December 31, 2018, EGC issuers accounted for approximately 1,267 out of 1,440, or approximately 88%, of priced exchange-listed IPOs (excluding deals identified as mergers, spin-offs, or fund offerings).

[182] For example, one study comparing a subset of exchange-listed EGC IPOs to exchange-listed non-EGC IPOs noted that "[a] high percentage of EGCs are unprofitable and substantially younger than the control sample and the majority of these IPOs occur in only two industries—biotech[nology] and pharmaceuticals—that have limited near-term prospects and little revenue to recognize." *See* CHM Study, at 828. *See also* DFG Study, at 127 and 129 (Table 3).

statement before December 8, 2011,[183] or that lost their EGC status because more than five fiscal years have elapsed since their first registered common equity sale. Non-EGC issuers also include ABS issuers and registered investment companies, which have unique operational and regulatory characteristics.[184]

ii. Investors

The final rule will affect QIBs and IAIs that might be solicited in conjunction with contemplated registered securities offerings. Due to their portfolio size and/or investment expertise, we expect that such investors have considerable ability to assess investment opportunities and acquire and analyze information about securities and their issuers. Such investors are generally viewed as sophisticated for purposes of private placements, which are often associated with considerably higher information asymmetry than registered offerings. Under Title I of the JOBS Act, EGCs were provided the flexibility to test the waters with these relatively sophisticated QIB and IAI investors.

We lack information necessary to estimate the aggregate number of QIBs and IAIs that will be solicited in connection with registered offerings under the final rule. Because it is not an item of disclosure required of issuers, we do not have information on the number of QIBs and IAIs that were solicited through test-the-waters communications in connection with EGC offerings in reliance on Section 5(d). We also lack data to generate a comprehensive estimate of the overall number of QIBs and IAIs that may be potentially solicited under the final rule

[183] An "issuer shall not be an emerging growth company for purposes of [the Securities Act and the Exchange Act]…if the first sale of common equity securities of such issuer pursuant to an effective registration statement under the Securities Act of 1933 occurred on or before December 8, 2011." *See* JOBS Act Title I FAQs.

[184] *See id*.

because disclosure of investor status across all such investors is not required, and we lack comprehensive data that, in particular, covers all categories of potential QIBs and IAIs.

For instance, we can gather limited information about certain investors that may be QIBs from EDGAR filings. Based on staff analysis of these filings, we estimate that for calendar year 2018, 6,501 unique filers filed Form 13F on behalf of 6,739 institutional investment managers. However, a number of QIBs, including large institutions that primarily invest in securities other than Section 13(f) securities (*e.g.*, unregistered equity securities; nontraded registered equity securities; or registered non-equity securities),[185] as well as certain types of dealers as specified in Rule 144A will not be captured by this estimate. We similarly lack information for a comprehensive estimate of the overall number of IAIs because disclosure of accredited investor status across all institutional investors is not required. In addition, while we have information to estimate the number of some categories of IAIs (some of which may also be included in the Form 13F estimate), we lack comprehensive data that will allow us to estimate the unique number of investors across all categories of IAIs under Rule 501.[186]

In addition to QIBs and IAIs, other investors may be indirectly affected by the final rule, as discussed in Section IV.C below. For example, the final rule could increase the shareholder value of affected issuers by lowering the cost of raising capital or enabling issuers to pursue a more efficient capital raising strategy, which will benefit existing investors in these issuers.

[185] Form 13-F must be filed only by institutional investment managers that exercised investment discretion over $100 million in Section 13(f) securities. "Section 13(f) securities" are equity securities of a class described in Section 13(d)(1) of the Exchange Act that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association. *See* Form 13F and Rule 13f-1(c) under the Exchange Act.

[186] In addition, Form ADV filers report information about the number of clients of different types, such as pooled investment vehicles, banking institutions, corporations, charities, pension plans, *etc*., some of which are potential IAIs. However, the data available to us does not allow identification of unique clients (to account for cases where a client has multiple advisers) or IAIs that do not retain services of a Form ADV filer.

Furthermore, the final rule could encourage additional registered securities offerings. Due to data availability, we cannot estimate the number of investors that might be affected by such indirect economic effects. According to a recent study based on the 2016 Survey of Consumer Finances, approximately 65 million households owned stocks directly or indirectly (through other investment instruments).[187]

iii. Intermediaries

Similar to Section 5(d), Rule 163B will permit the issuer, or any person authorized to act on behalf of an issuer, to engage in test-the-waters communications. EGC issuers commonly authorize underwriters to engage in test-the-waters communications on their behalf with prospective investors.[188] Thus, the final rule will potentially affect such underwriters or other third parties engaged in a similar role.

We estimate that there were approximately 975 registered broker-dealers that reported being underwriters or selling group participants for corporate securities in 2018.[189] We do not have data on how many underwriters actually engaged in test-the-waters communications in connection with offerings on behalf of EGCs. Further, we lack data on other persons that have engaged in test-the-waters communications on behalf of EGCs. With respect to persons who could be authorized to act on behalf of fund issuers, we estimate that approximately 283 registered broker-dealers reported being mutual fund underwriters or sponsors in 2018 (of which

[187] *See* Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore, Sarah Pack, John Sabelhaus, Jeffrey Thompson, & Richard A. Windle, *Changes in U.S. Family Finances from 2013 to 2016: Evidence From the Survey of Consumer Finances*, 103 Fed. Res. Bull. 1, 1-42 (2017), at 20, https://www.federalreserve.gov/publications/files/scf17.pdf. This is a triennial survey, and the latest data available as of this time is from the 2016 survey. The test-the-waters provision of the final rule could be used irrespective of security type, so the overall set of potentially indirectly affected investors is likely to be larger.

[188] *See supra* notes 173–174 and accompanying text.

[189] This estimate is based on Form BD filings as of December 2018.

approximately a quarter also reported being underwriters for corporate securities).[190] We anticipate that fund advisers also might engage in test-the-waters communications on behalf of the funds they advise. We estimate that there are approximately 1,850 investment advisers to registered investment companies and approximately 119 investment advisers to BDCs.[191] For the reasons noted above, we do not have data to predict how many of these fund intermediaries will actually engage in test-the-waters communications, or how many additional persons authorized to act on behalf of a fund issuer might participate in test-the-waters communications related to fund offerings under the final rule.

C. Anticipated Economic Effects

Below we evaluate the anticipated costs and benefits of the final rule and the anticipated effects of the final rule on efficiency, competition, and capital formation.

1. Potential Benefits to Issuers and Intermediaries

Expanding the availability of test-the-waters communications could facilitate a more efficient and effective process for raising capital in a registered offering (involving, potentially, a lower risk of withdrawal, a lower cost of capital raising, and/or a higher amount of capital raised). Specifically, testing the waters could help issuers to gauge market interest in a potential offering, determine the categories of investors with the most favorable assessment of the issuer, as well as identify the potential concerns and questions that prospective investors may have regarding the offering and its terms. By gathering this information, issuers may reduce the risk of having to withdraw a publicly filed registration statement and can also tailor offering size and

[190] *See id*. Form BD does not separately elicit underwriting activity for other types of funds, so more detailed information about the number of broker-dealers that underwrite those funds' offerings is not available to us.

[191] These estimates are based on Form ADV data as of December 2018, for filings received through March 31, 2019.

other terms included in the initial filing more closely to market interest.[192] Because the use of the final rule is voluntary, issuers that expect to derive the greatest benefits are the most likely to rely on it.

We expect the greatest benefit of testing the waters to be realized by issuers that solicit investors before a public filing. As discussed below, testing the waters before public filing enables issuers to lower the risk of proprietary information disclosure and possibly to avoid incurring the cost of preparing a registration statement. However, testing the waters after a public filing may also benefit some issuers.[193] Specifically, the option to test the waters can benefit the issuers affected by the final rule in several ways:

---

[192] *See, e.g.,* letter from L. Ameri (stating that testing the waters "allowed EGCs to assess market demand and valuation and determine what elements of their business were important to investors"); ASA (stating "this will ultimately help more companies complete a successful IPO"); letter from CCMC (stating that "[t]his approach is also endorsed by the Treasury Department, which in its own recent report on improving the U.S. financial system noted that testing the waters gives companies 'a better gauge of investor interest prior to undertaking significant expense and, in the event the company elects not to proceed with an IPO, information has been disclosed only to potential investors and not to the company's competitors.'"); letter from Cleary (stating that "[e]xperience with EGC issuers has proven the Section 5(d) accommodation to be a valuable tool in securities offerings, particularly in the IPO context, and that experience does not suggest any reason to hesitate in extending the same accommodation to other issuers"); letter from Cravath (stating that testing the waters will give issuers "the same cost-effective means currently enjoyed by EGCs for evaluating market interest before incurring the costs associated with a potential public offering" and identifying the following reasons for companies to engage in testing-the-waters communications: "(1) to better gauge the demand for and valuation of their securities; (2) to settle on offering terms and size to align with market interest; (3) to reduce the risk of having to withdraw a publicly filed registration statement, thus mitigating potential reputational damage; (4) to decrease the risk of public disclosure of sensitive or proprietary information to competitors if the issuer decides not to proceed with a public filing of a registration statement due to insufficient investor interest or adverse market conditions; and (5) to save some or all of the cost of preparing and publicly filing a registration statement in the event of disappointing investor feedback."); letter from Davis Polk (stating that the proposed rule "would allow companies to gauge investor interest in a registered offering prior to committing significant resources to prepare for one"); letter from Hamilton (stating that "[t]he issuer will be able to form an idea about the level of the potential investors' interest, which will help it avoid a failed offering"); letter from Nasdaq (stating that "the proposal would benefit issuers by enabling more of them to discuss IPO plans privately with potential investors in advance of announcing an IPO"); letter from M. Stuchlik (stating that testing the waters will "refine the valuation process for businesses"); letter from Sullivan (stating that "the Proposed Rule would significantly improve the capital-raising process for non-EGC issuers, allowing them to gauge institutional investor interest before a potential registered offering, saving time and costs as issuers would be able to focus on offerings that are more likely to attract investor demand").

[193] In the context of Regulation A, the Commission determined that issuers may benefit from broad flexibility to test the waters both before and after a public filing. For example, in the 2015 adopting release amending Regulation A, the Commission stated: "Allowing test-the-waters communications at any time prior to qualification of the offering

- In the case of issuers that decide after testing the waters not to proceed with a registered securities offering, testing the waters before a public registration statement filing decreases the risk of premature public disclosure of sensitive or proprietary information about the issuer to competitors (to the extent that the communications are not subject to Regulation FD).[194]
- In the case of issuers that decide after testing the waters not to proceed with a registered securities offering, testing the waters before the registration statement filing can save such issuers some or all of the cost of preparing and publicly filing a registration statement.
- Testing the waters, particularly before the registration statement filing, can reduce the risk of miscalculating market interest in the offering and having to withdraw the offering, thus reducing potential reputational costs associated with a failed offering.

---

statement, rather than only prior to filing of the offering statement with the Commission, may increase the likelihood that the issuer will raise the desired amount of capital. This option may be useful for smaller issuers, especially early-stage issuers, first-time issuers, issuers in lines of business characterized by a considerable degree of uncertainty, and other issuers with a high degree of information asymmetry." *See Amendments to Regulation A*, Release No. 33-9741 (Mar. 25, 2015) [80 FR 21805 (Apr. 20, 2015)], at 21882.

[194] Several factors may serve to limit this benefit for some issuers. First, communications under the final rule could be subject to Regulation FD. *See supra* note 20 and accompanying text.

Second, issuers may already request confidential treatment for proprietary information they file with registration statements, subject to the provisions of 17 CFR 230.406 ("Rule 406").

Third, the extension of the option to confidentially submit a draft registration statement to non-EGC issuers has reduced the risk of proprietary information disclosure to competitors prior to an issuer deciding to proceed with the public filing of a registration statement for an IPO or a registered Securities Act offering, or registration of a class of securities pursuant to Exchange Act Section 12(b), within one year after an IPO. Beginning July 10, 2017, staff extended the option of confidential submission of a draft registration statement to most non-EGC issuers. *See* Draft Registration Statement Processing Procedures Expanded, June 29, 2017, https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded, and Voluntary Submission of Draft Registration Statements – FAQs, https://www.sec.gov/corpfin/voluntary-submission-draft-registration-statements-faqs. Separately, draft registration statement procedures were expanded to non-EGC BDCs in 2018. *See* Expanded Use of Draft Registration Statement Review Procedures for Business Development Companies, ADI 2018-01, https://www.sec.gov/investment/adi-2018-01-expanded-use-draft-registration-statement-review-procedures-business.

- Testing the waters, particularly before the registration statement filing, can help issuers gauge investor demand for purposes of determining offering size and other terms, potentially resulting in a more efficient offering process and a higher likelihood of selling the offered amount more quickly.[195]

According to one academic study of EGC IPOs, the option to test the waters "reduces the cost of IPO withdrawal because it allows issuers to disclose information exclusively to investors, but not competitors, until the IPO becomes likely to succeed. This will especially benefit issuers with high proprietary disclosure costs."[196] The study also notes that testing the waters "provides issuers with more certainty regarding the prospects of the IPO before publicly filing with the SEC."[197]

In addition, for issuers that elect to proceed with a registered offering, testing the waters may serve as an element of their marketing strategy by allowing them to inform solicited investors about a potential future offering. However, the marketing benefit to such issuers will be limited because communications are only permitted with QIBs and IAIs and because investors are not permitted to commit capital at the test-the-waters stage.

Similarly, some fund issuers could use test-the-waters communications to gather information about investors' interest in a particular investment strategy or fee structure or to

[195] By enabling issuers to better gauge investor demand before setting initial offer prices, testing the waters may allow issuers to better determine the lowest offer price at which they can raise the required amount of capital, thus potentially enabling issuers to decrease the risk of a failed offering, raise more capital, and/or lower the cost of capital. It is difficult to assess the extent to which test-the-waters communications after the initial filing would incrementally help issuers gauge the demand of QIBs and IAIs as some of these issuers might have obtained similar information about investor demand through the bookbuilding process.

[196] *See* DFG Study, at 122.

[197] *See id.,* at 124.

market a potential future offering. However, as discussed in greater detail in Section IV.C.5 below, such benefits may be limited for most funds.

To the extent that the final rule facilitates the registered offering process and potentially lowers its costs and risks for some issuers, the availability of testing the waters might facilitate capital formation as a result of additional issuers conducting registered securities offerings,[198] particularly for non-EGC issuers that are ineligible for the test-the-waters provision of Section 5(d). In evaluating the potential benefits of expanded test-the-waters communications under the final rule for capital formation, we acknowledge that the issuers affected by the final rule already have the flexibility to solicit the same general categories of investors in connection with private placements. Nevertheless, even if the net level of capital formation is unchanged, due to affected issuers switching from private placements to registered offerings, the added flexibility under the final rule might enable issuers to adopt the most efficient and lowest-cost capital raising strategy. Further, if the final rule encourages additional issuers to conduct a registered securities offering, issuers may benefit from greater secondary market liquidity associated with registered securities, compared to exempt securities, to the extent that greater liquidity makes the issuers' securities potentially more attractive to prospective investors. Any additional issuers that elect to conduct a registered offering in part as a result of the final rule also may benefit from the greater ease of raising follow-on financing through future registered offerings.

The final rule requires that the solicited investor is, or that the issuer reasonably believes the investor to be, a QIB or IAI. The reasonable belief standard is expected to provide issuers with the flexibility to use methods that are cost-effective to identify eligible investors but

[198] *See also supra* notes 158-160 and accompanying text.

appropriate in light of the facts and circumstances of each contemplated offering and each potential investor. This approach also helps issuers to reduce the risk of a violation of Section 5 due to inadvertent solicitation of an investor that is not a QIB or IAI. Therefore, we believe this approach will encourage more issuers to rely on the final rule, thereby enhancing the aggregate economic benefits of the rule. Various commenters expressed support for the reasonable belief standard.[199]

Underwriters in offerings involving test-the-waters communications under Rule 163B may indirectly benefit as a result of the decreased risk of conducting a public offering. A track record of successful offerings strengthens an underwriter's reputation in the marketplace. Conversely, an offering that is initiated but subsequently withdrawn due to a lack of market interest may adversely affect an underwriter's reputation. To the extent that test-the-waters communications reduce the risk of such offerings, underwriters may benefit from a decrease in the reputational costs and risks associated with failed offerings.

2. Potential Costs to Issuers and Intermediaries

Because the use of test-the-waters communications will remain voluntary under the final rule, we anticipate that issuers will elect to rely on test-the-waters communications only if the benefits anticipated by issuers outweigh the expected costs to issuers. Issuers that elect to test the waters under the final rule might incur costs, including costs of identifying QIBs and IAIs (and, for issuers soliciting investors they reasonably believe to be QIBs or IAIs, the costs of establishing such reasonable belief[200]); costs associated with holding events with QIBs and IAIs

[199] *See infra* note 217. *But see* letter from Better Markets (opposing the reasonable belief standard).

[200] As discussed above, with respect to QIBs and IAIs, we expect that it would be efficient for issuers, depending on the facts and circumstances of an offering, to continue to rely on the existing methods of establishing such a

to engage in testing the waters; developing test-the waters solicitation materials; indirect costs of potential disclosure of proprietary information to solicited investors (albeit to a limited number of prospective investors); and in some instances, potential legal costs associated with liability arising from test-the-waters communications with prospective investors.[201] Further, issuers subject to Regulation FD, may incur costs associated with ensuring communications made pursuant to the final rule comply with such requirements or an exemption thereof.[202] We note that issuers that proceed with a registered offering without testing the waters similarly incur costs of searching and soliciting investors (frequently, institutions), either on their own or through an intermediary, as well as direct and indirect costs of disclosure of information once they publicly file the registration statement.

As discussed above, the final rule will benefit those non-EGC issuers that are comparable to EGC issuers or that face similar challenges in gauging investor demand for a public offering and that might find test-the-waters communications to be of value.[203] In turn, to the extent that

---

reasonable belief that have emerged in prevailing market practices associated with Rule 144A and Rule 506 offerings, which might mitigate such costs.

[201] In addition, similar to Section 5(d), the final rule does not modify existing rules on solicitation in conjunction with private placements. The Commission's 2007 framework for analyzing how an issuer can conduct simultaneous registered and private offerings will continue to apply. *See Revisions of Limited Offering Exemptions in Regulation D,* Release No. 33-8828 (Aug. 3, 2007) [72 FR 45116 (Aug. 10, 2007)].

[202] The application of Regulation FD to Rule 163B communications was generally supported by commenters. *See, e.g.*, letters from Cravath, Davis Polk, and SIFMA. *But see* letter from CRT (stating that it "believes test-the-waters flexibility or specifically market soundings prior to a new credit issue should have reasonable exceptions to Regulation FD for some communications such as open ended dialogues on investor and issuer needs and wants").

[203] *See, e.g.,* letters from Cravath (describing "proposed Rule 163B as a commendable effort to level the playing field for EGCs and other issuers contemplating a registered securities offering"); Davis Polk (stating that "[c]urrently, non-EGCs cannot take advantage of this expanded [testing-the-waters] process unless they have publicly filed a registration statement or already have a shelf registration statement on file. We do not see any reason to treat non-EGCs differently.… Proposed rule 163B will simply level the capital-raising playing field for all companies."); Nasdaq (stating that "[i]n addition to facilitating IPOs, the proposal also will facilitate secondary offerings by companies that have already gone public. The SEC rules currently allow 'well-known seasoned issuers' (WKSIs) to engage in 'test the waters' communications for secondary offerings, subject to certain legending and filing requirements. In addition, EGCs retain their ability to engage in 'test the waters' communications following

EGCs compete with non-EGCs for investor capital, as well as in the product market, the incremental benefits that accrue to non-EGCs under the final rule might lead to an adverse competitive effect on comparable EGCs.

In cases where issuers authorize intermediaries to engage in test-the-waters communications on their behalf under Rule 163B in connection with a contemplated registered securities offering, to the extent that intermediaries incur costs associated with testing the waters and meeting the requirements of Rule 163B, we anticipate that intermediaries generally will pass through such costs to issuers, along with other offering expenses.

3. Potential Benefits to Investors

To the extent that the final rule encourages additional issuers to conduct a registered securities offering, a broader set of investors might allocate capital more efficiently among issued securities. These efficiency benefits are more likely to accrue to non-accredited investors, whose investments are more reliant on public markets due to their limited ability to invest in exempt offerings. Further, to the extent that additional issuers consider a registered securities offering instead of a private placement as a result of the final rule, investors that would otherwise have invested in unregistered securities of the same issuer might benefit from greater liquidity of registered securities (because resales of such securities will not be restricted and such securities are more likely to have a secondary market). If additional issuers consider registered offerings, investors also will benefit from the availability of disclosure and market information about

---

their IPO, provided they continue to qualify as an EGC. However, public companies that fall in between these two categories cannot do so and are put at an unnecessary disadvantage. Leveling the playing field for these companies will enhance their ability to access the public markets for secondary offerings and therefore to continue to grow."); Sullivan (stating that "[a]dopting the Proposed Rule would level the playing field by allowing every issuer, whether or not it is an EGC or WKSI, to engage in wall-crossing activities even when it does not have a registration statement on file"). *See also*, *generally*, *supra* note 157.

registered securities (resulting in more informationally efficient prices and potentially better informed investment decisions). By increasing shareholder value of affected issuers through cost savings and improved ability to raise external financing, the final rule also could benefit existing shareholders of affected issuers.

Test-the-waters communications might in some circumstances offer some solicited investors the potential benefit of additional time to evaluate, understand, and ask questions about potential future investment opportunities before a registration statement is publicly filed. In some cases, the additional lead time before a potential offering might provide some solicited investors with small incremental informational benefits in the form of better informed decisions about future investments in the related offering and allocation of capital across issuers and sectors.

However, the incremental value, if any, of the early arrival of such information about any individual contemplated offering at the test-the-waters stage is likely small, for several reasons: (i) it is difficult for solicited investors to take advantage of the early arrival of test-the-waters information because no investor commitments can be made at that stage; (ii) even if solicited investors view the potential offering as an attractive investment opportunity on the basis of test-the-waters communications, the information is highly preliminary in nature and offering terms may change after testing the waters; (iii) extensive information about the issuer and the offering must be disclosed in a publicly filed registration statement should an issuer decide to proceed with an offering, which further attenuates the incremental value of the information conveyed to solicited investors through test-the-waters communications; (iv) to the extent that under the baseline potential issuers newly eligible for testing the waters under the final rule would have otherwise provided similar information to the same institutional investors in the course of

seeking private financing, such potential informational benefits could be reduced; (v) potential informational benefits to solicited investors likely would be even smaller for issuers in follow-on offerings, as such issuers will have provided disclosures in an IPO registration statement and subsequent Exchange Act reports; and (vi) communications made pursuant to the final rule may be subject to Regulation FD (to the extent that an issuer is not exempt from Regulation FD and is not eligible for an exception) and thus may be required to be publicly filed, which would make the information available to all investors.

4. Potential Costs to Investors

Selective solicitation of QIBs and IAIs may result in the solicited institutional investors potentially having a competitive advantage relative to investors that are not solicited. This competitive advantage may stem from early access to preliminary information about contemplated registered offerings, which might potentially place some investors that are not solicited at a relative competitive disadvantage.[204] This potential effect is likely to be mitigated by several factors, including:

- The inability of solicited investors to invest in the contemplated offering at the test-the-waters stage;
- The likely preliminary nature of the information conveyed during testing the waters;

[204] *See also* letter from Better Markets (stating that "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 [testing-the-waters] communications become.").

- The access of all investors to registration statement disclosures if the issuer proceeds with an offering; and
- Regulation FD, which would require the public disclosure of material nonpublic information, making it available to all investors, in certain circumstances (to the extent applicable to the issuer conducting test-the-waters communications).

Furthermore, to the extent that offering terms for issuers that proceed with an offering are informed by testing the waters, investors who were not solicited may benefit from being able to invest at a price that reflects information gathered during testing the waters, which should further mitigate any disadvantage to investors who were not solicited.

Solicited investors may also potentially derive competitive advantages from the ability to provide feedback to the issuer at the early stages of the offering process and thereby potentially exert some influence over future offering terms, should the issuer proceed with an offering. However, in assessing this potential effect of the final rule relative to the baseline, we recognize that, aside from test-the-waters communications (whether under Section 5(d) or under the final rule), disparities in investor access to the issuer and the ability to exert influence over the offering process routinely emerge under the baseline. For instance, issuers (and intermediaries, if applicable) also commonly solicit a select subset of eligible investors in the course of the bookbuilding process for IPOs, in confidentially marketed follow-on offerings, and in private placements.

Further, in assessing the potential costs of the final rule to investors due to disparate access to issuers contemplating registered securities offerings and information about such offerings, relative to the baseline, we recognize that, in the absence of the final rule, disparities in

investor access to issuers and information about contemplated registered offerings already exist for EGC issuers, which account for a considerable share of issuers in IPOs.[205]

Some solicited investors might potentially use the information from test-the-waters communications to realize trading profits at a cost to investors that were not solicited. Such trading may, for instance, involve issuers with a traded class of securities that test the waters in conjunction with a follow-on offering; peers or competitors (with a traded class of securities) of issuers engaging in test-the-waters communications; or, in some limited instances of issuers contemplating an IPO whose unregistered securities have a secondary trading market, private securities of those issuers.[206] However, this possibility may be partly mitigated by (1) the requirement that Exchange Act reporting companies disclose specified information in periodic and current reports and (2) the general applicability of Exchange Act Section 10(b) and Rule 10b-5. Further, communications made pursuant to the proposed rule may in some circumstances be subject to Regulation FD, as discussed in Section IV.A above.

In light of the factors discussed above, we do not anticipate the final rule to have a significant adverse competitive impact on investors that are not solicited under the final rule.

The expansion of permissible test-the-waters communications also might result in costs to solicited investors, including potentially less informed decisions or less efficient capital

[205] *See supra* note 181.

[206] In recent years, markets have developed that facilitate the resale of securities of non-reporting companies. *See Concept Release on Harmonization of Securities Offering Exemptions*, Release No. 33-10649 (Jun. 18, 2019) [84 FR 30460 (Jun. 26, 2019)] ("Harmonization Concept Release"), at n. 34. *See also* David F. Larcker, Brian Tayan, and Edward Watts, *Cashing it in: Private-Company Exchanges and Employee Stock Sales Prior to IPO, Stanford Closer Look Series* (Sep. 12, 2018) ("The pre-IPO marketplace has traditionally been dominated by networks of venture-capital firms, private placement agents, brokers, and banks. These markets have historically been fragmented and opaque, severely limiting access and transparency for potential investors. In the response to the trend of companies staying private longer, a number of secondary private-company marketplaces have evolved to facilitate transactions between employees or early stage investors wishing to liquidate a portion of their holdings and qualified buyers. Buyers generally include wealthy individuals, venture-capital firms, hedge funds, private equity firms, and institutional investors.").

allocation, if test-the-waters communications contain incomplete or misleading information and if solicited investors rely on test-the-waters communications rather than the filed offering materials in their investment decisions. We expect that any such potential adverse effects on solicited investors would be alleviated by the following factors:

- Because test-the-waters communications represent an offer of securities, although they will not be subject to liability under Section 11 of the Securities Act, they will remain subject to general anti-fraud provisions under the Securities Act and the Exchange Act and to liability under Section 12(a)(2) of the Securities Act.[207] In addition, the associated risk of private securities litigation may further reduce incentives to engage in misleading test-the-waters communications.
- Reputational concerns of underwriters and/or issuers that may expect to participate in future offerings with the same institutional investors may reduce the incentives to engage in misleading test-the-waters communications with these investors.
- The issuer will be required to publicly file a registration statement once it determines to proceed with a public offering, enabling solicited investors to review the filed offering materials and to obtain full information about the issuer and the offering before investing. This should serve as a crucial deterrent against the potential for misleading test-the-waters communications at the pre-filing stage because we expect that a solicited QIB or IAI will verify the claims made as part of test-the-waters communications against the complete set of disclosures in the registration statement, which is subject to liability under Section 11 of the Securities Act. Moreover, the Commission has reiterated that

[207] Some states also may impose blue-sky restrictions on pre-offering communications related to non-exchange-listed securities offerings.

information provided in test-the-waters communications must not contain material misstatements or omissions at the time the communication is made.[208]

- To the extent that test-the-waters communications are used by issuers in follow-on registered offerings, solicited investors can access the issuers' past filings of registration statements and Exchange Act reports to aid in the interpretation and verification of information in test-the-waters communications.
- Test-the-waters communications will be permitted only with QIBs and IAIs. Although the level of investor sophistication may vary somewhat across such investors,[209] QIBs and IAIs generally are expected to have a sophisticated ability to process investment information and to review the offering materials, once those materials are filed, before making an investment decision.
- The final rule might be less likely to be relied upon by micro-cap firms,[210] because institutions tend to have smaller stakes in such issuers.[211]
- If an issuer proceeds with an offering, written test-the-waters materials generally may be subject to staff review.[212]

---

[208] *See* Section II.A.3.

[209] For example, the level of sophistication may be relatively higher for the larger institutions, which are likely to have more investment and due diligence expertise than relatively smaller QIBs and IAIs.

[210] One commenter suggested that, some microcap firms may be associated with a higher risk to investors. *See infra* note 238 (letter from Better Markets). *See also, e.g.,* Joshua White (2016) Outcomes of Investing in OTC Stocks, white paper, https://www.sec.gov/dera/staff-papers/white-papers/16dec16_white_outcomes-of-investing-in-otc-stocks.html; *infra* note 239 (discussing academic studies).

[211] For example, institutional ownership is negatively related to firm size among listed stocks. *See, e.g.,* Stefan Nagel, *Short Sales, Institutional Investors and the Cross-Section of Stock Returns*, 78 J. Fin. Econ. 277, 277-309 (2005), Table 1 (correlation between institutional ownership and logarithm of market capitalization is 0.53). Another study finds, among other results, lower post-IPO institutional ownership for IPO issuers with lower filing prices. *See* Chitru S. Fernando, Srinivasan Krishnamurthy, & Paul A. Spindt, *Are Share Price Levels Informative? Evidence from the Ownership, Pricing, Turnover, and Performance of IPO Firms*, 7 J. Fin. Markets 377, 377-403 (2004), Table 2 (filing price has a positive effect on institutional ownership). As a caveat, these studies focus on listed stocks and do not capture smaller institutional owners.

In evaluating any potential adverse effects of the risk of incomplete or misleading test-the-waters communications under the final rule on solicited QIBs and IAIs, it is important to recognize that issuers already have the ability to solicit accredited investors in connection with private placements, which are associated with substantially less disclosure and less extensive investor protections and regulatory oversight than registered offerings. Issuers unable to meet their external financing needs through registered offerings commonly sell securities to IAIs and other accredited investors through private placements. To the extent that the expansion of permissible test-the-waters communications under the final rule induces some issuers to elect a registered offering instead of a private placement, the amount of disclosure and the level of investor protection afforded to the investors in the issuer's securities will be expected to increase relative to the baseline.

The final rule requires that the solicited investor be a QIB or IAI, or that the issuer or person acting on behalf of the issuer reasonably believe the investor to be a QIB or IAI. Following the regulatory framework for private placements under Rule 506(b) and Rule 144A, and as proposed, Rule 163B does not require issuers to verify the status of solicited investors or prescribe specific steps that issuers must take to establish a reasonable belief.[213] While issuers will not be required to verify investor status, the rule limits solicitations to QIBs or IAIs, and

---

[212] Based on a review of staff comment letters issued in connection with IPO registration statements of EGCs during 2012-2018 identified through Intelligize data, comment letters commonly request issuers to submit to the staff for review any written test-the-waters communications made in reliance on Section 5(d). *See also supra* Section II.A.

[213] Rule 144A(d) specifies nonexclusive means to establish a reasonable belief as to whether a prospective purchaser is a QIB. *See supra* note 103.

Rule 506(c) contains a requirement to verify investor status before sales are made and provides nonexclusive means on which issuers may rely to verify accredited investor status (although those means pertain to natural persons). As distinct from Rule 506(c), which conditions sales on verification of investor status, the final rule concerns offers. Crucially, nothing in the final rule changes the requirement that sales be made only pursuant to an effective registration statement, which affords purchasers the benefit of registration statement disclosures and the robust set of protections of the registration process.

requires issuers to have a reasonable belief that the intended recipients of the test-the-waters communications are QIBs or IAIs. As discussed above, the issuer could not, for example, form such reasonable belief if it has knowledge that the investor is not a QIB or IAI. Further, as discussed above, the Commission has provided guidance that issuers may continue to rely on existing means of establishing reasonable belief that are used in Rule 506 or Rule 144A offerings. We believe that issuers and underwriters might draw on some of the existing market practices developed for determining QIB status in Rule 144A offerings and IAI status in Rule 506 offerings for purposes of forming a reasonable belief about the status of investors they solicit under the final rule.[214] We recognize, as stated in the Proposing Release, that if the reasonable belief provision results in the solicitation of some investors that are not QIBs or IAIs, this may in some instances contribute to less informed investment decisions by some of those investors, to the extent that (i) such non-QIB/non-IAI investors, which may be less sophisticated in their ability to process information than QIBs or IAIs, rely on test-the-waters communications and not on the registration statement, and (ii) the information in test-the-waters communications substantially differs from the information in the registration statement.[215] Although we acknowledge that the reasonable belief provision could impact the risk of soliciting investors that are not QIBs or IAIs, we lack data that would allow a quantification of the incremental impact of

[214] *See, e.g.,* letter from Cravath (stating that "[i]ssuers currently rely on various indicia (publicly available financial statements of prospective investors, documents filed by them with the Commission or other government agencies, or a certification by the chief financial officer of such prospective purchaser, among others) to establish a reasonable belief regarding an investor's status as a QIB or accredited investor, and we think such system works reasonably well to ensure appropriate status. Issuers and their advisors should be allowed to follow reasonable steps based on the particular facts and circumstances of a prospective investor without having to abide by inflexible prescribed methods that may be unduly costly or time consuming.") and letter from SIFMA (stating that "[b]roker-dealers participating in Rule 144A offerings have experience applying the standard, which is applied in such offerings using largely consistent practices").

[215] *See also* letter from Better Markets.

this provision, if any, on such investors. Based on the qualitative analysis of the risks and benefits of the reasonable belief standard, however, we are persuaded that the final rule strikes the appropriate balance between realizing the intended economic benefits of the rule for issuers and providing appropriate investor protections.

While one commenter objected to the reasonable belief provision on investor protection grounds,[216] various other commenters expressed support for the reasonable belief provision and stated that it is consistent with investor protection.[217] Overall, after evaluating commenter input, we continue to believe that the potential costs to investor protection from inadvertent solicitation of investors that are not QIBs or IAIs but that issuers (or persons authorized to act on their behalf) reasonably believe to be QIBs or IAIs will be substantially alleviated by the mitigating factors discussed above, in particular:

- The requirement to publicly file a registration statement for issuers that determine to proceed with a public offering, enabling solicited investors to review the filed offering materials and to obtain full information about the issuer and the offering before investing;

[216] *See id*.

[217] *See* letters from CCMC; Cleary (stating that "we agree with the view expressed in the Release that a facts-and-circumstances approach is sufficient and that an issuer should continue to rely on its current methods for developing a reasonable belief regarding investor status under Rule 144A and Rule 501(a)"); Cravath (stating that "[u]nlike in the context of Rule 506(d), all investors who are targeted with Rule 163B communications and who in turn proceed to make an investment in the issuer will ultimately have the benefit of a registration statement that has been declared effective and would presumably be in compliance with the Securities Act and the rules and regulations thereunder"); Davis Polk (stating that "the reasonable-belief standard is sufficient, and that the standard for rule 163B needs to be no more burdensome for companies and their underwriters than current practice in rule 144A and Section 4(a)(2) private placements, in which companies and their underwriters refer to their own documentation as well as to industry-known reliable sources to check investor qualification...after all, unlike with Regulation D offerings, no investors will purchase securities in an offering subject to proposed rule 163B until they have been furnished with a statutory prospectus."); Hamilton (stating that "[g]iven that the investors will not actually invest until a registration statement has been filed, we believe the 'reasonable belief' requirement is adequate"); and SIFMA (stating that "[w]e believe the reasonable belief standard should be retained as proposed. Market participants are familiar with the reasonable belief standard. Existing guidance and practice is sufficient for issuers and broker-dealers. We do not believe there is widespread misapplication of the standard.").

- The applicability of general anti-fraud provisions and liability under Section 12(a)(2) of the Securities Act, as well as the risk of private securities litigation;
- The ability of the staff to review test-the-waters materials for issuers that proceed with a public offering;
- The reputational incentives of underwriters and issuers; and
- For issuers in follow-on offerings, the availability of past registration statements and Exchange Act filings that provide additional disclosures about the issuer and can aid solicited investors in the interpretation and verification of information in test-the-waters communications.

After considering the available market and academic evidence, as well as commenter feedback, we do not see a basis to conclude that the final rule will result in significantly increased risk of investor harm, relative to the baseline, as a result of inadvertent solicitation of investors that are not QIBs or IAIs.

5. Variation in Economic Impact Due to Issuer Characteristics

The described economic effects of the final rule are expected to vary as a function of issuer and offering characteristics and investors' ability to process information.[218] The incremental benefits of the final rule are expected to be generally smaller for large[219] and well-established issuers with low information asymmetries and a history of public disclosures, issuers of securities with low information sensitivity (*e.g.*, straight investment-grade debt), and issuers in

[218] However, one commenter stated that the size or reporting status of an issuer is not generally correlated with its desire to gauge investor interest prior to a registered public offering. *See* letter from Sullivan.

[219] At the same time, it is possible that large private issuers have a more complex business structure and may realize a greater benefit from test-the-waters communications. *See* letter from CCMC (stating that "[b]ecause larger, more-diversified companies often have more complicated business models that require additional explanation relative to smaller ones, we believe non-EGCs would find testing the waters attractive"). *See also supra* note 171.

follow-on offerings[220] with an established track record of capital raising. Issuers whose communications with investors may be subject to Regulation FD might also be less likely to utilize, and benefit from, the final rule.[221] In addition, issuers with low costs of proprietary disclosure (*e.g.*, low research and development intensity and limited reliance on proprietary technology) may be less likely to utilize, and benefit from, the final rule. In turn, due to greater market scrutiny and lower information asymmetries associated with such issuers, the potential of such issuers' test-the-waters communications to bias investor ability to assess the offering is also expected to be small. All else equal, issuers that predominantly market their offerings to individual investors or other investors that are not QIBs or IAIs, including many registered investment companies,[222] might realize relatively smaller benefits from the final rule. Further, issuers relying upon other rules that permit offering-related communications may be less likely to benefit from the final rule.[223]

In contrast, other types of issuers might realize relatively greater benefits from expanded testing the waters under the final rule. Because Rule 163B mitigates the risk of competitors

---

[220] *But see* letter from Nasdaq (stating that "[i]n addition to facilitating IPOs, the proposal also will facilitate secondary offerings by companies that have already gone public").

[221] *See supra* note 20. *But see* letter from Davis Polk (stating that "[i]f the proposed offering or its abandonment were itself material to investors of an already-public company, the company could easily comply with Regulation FD the same way companies do today, benefitting all investors equally. The company would have to obtain confidentiality undertakings and restrict the contacted investors from trading in the company's securities for a day or two, until the contemplated offering is publicly launched or abandoned. This process ensures that investors are protected and the timing of material information disclosure remains fair for all investors."), and letter from SIFMA (stating that "Regulation FD currently provides sufficient flexibility to allow issuers to engage in meaningful communications with investors").

[222] *See infra* note 227.

[223] *See supra* Section II.D. For example, WKSIs may elect to rely on Rule 163. We estimate that there were approximately 3,621 WKSIs that filed Securities Act registration statements or Exchange Act periodic reports in 2018, based on the analysis of filings of automatic shelf registration statements and XBRL data in periodic reports during calendar year 2018. *See also Securities Offering Reform for Closed-End Investment Companies*, Release No. 33-10619 (Mar. 20, 2019) [84 FR 14448 (Apr. 10, 2019)] (proposing to expand the availability of Rule 163 to BDCs and registered closed-end funds).

learning potentially valuable proprietary information about the issuer's financing needs, business, products, and research and development, it is expected to particularly benefit issuers with high costs of proprietary disclosure (*e.g.*, issuers in research and development-intensive industries, such as life sciences and technology). In addition, issuers not subject to Regulation FD are more likely to utilize, and benefit from, the final rule.[224] As described above, test-the-waters communications offer a low-risk, low-cost way of obtaining information about investor interest in a potential registered offering and evaluating whether such an offering could be successful. Thus, the flexibility to test the waters under the final rule is expected to be most valuable for issuers that have greater uncertainty about: the interest of prospective investors in the offering; investor valuation of the issuer's securities; and investor concerns and questions about the issuer's business or the planned offering. These uncertainties are particularly present for: IPO issuers; issuers with high information asymmetries or a lesser degree of investor recognition (*e.g.*, small issuers, issuers with limited operating history, foreign issuers); and issuers of securities with high information sensitivity (*e.g.*, equity, convertible debt, speculative-grade straight debt) or securities with difficult to value, complex payoffs (*e.g.*, structured finance products and other innovative financial instruments). At the same time, due to lower market scrutiny applied to such issuers with higher information asymmetries or greater complexity of valuing such securities, the potential of test-the-waters communications to bias investor ability to assess information about the offering might be relatively higher.[225] All else equal, issuers that

[224] *See supra* note 21.

[225] In 1995 the Commission proposed to expand permissible pre-IPO solicitations of interest for most issuers, subject to certain conditions. *See Solicitations of Interest Prior to an Initial Public Offering*, Release No. 33-7188 (Jun. 27, 1995) [60 FR 35648 (Jul. 10, 1995)] ("1995 Proposing Release"). While this proposal was never adopted, it would have excluded certain specified categories of issuers, particularly blank check and penny stock issuers "because of the substantial abuses that have arisen in such offerings." However, the proposal did not impose restrictions on

predominantly market their offerings to institutional investors are expected to realize relatively greater benefits from the expansion of test-the-waters communications under the final rule.[226]

The final rule will be available to a number of issuers that are not currently eligible to engage in test-the-waters communications under Section 5(d) of the Securities Act, including registered investment companies, non-EGC BDCs, and ABS issuers. The extent of reliance of such issuers on test-the-waters communications under the final rule is difficult to predict. Generally, as discussed above, testing the waters might be relatively more valuable for issuers with a largely institutional investor base, issuers with high information asymmetries, and issuers of information-sensitive securities and securities with complex payoffs. To the extent that funds on average have a high share of retail rather than institutional ownership, those benefits will likely be limited for funds.[227] Further, as discussed in Section II.E above, with respect to registered investment companies, if a fund is contemplating a registered offering at the time of its organization, we recognize it is common practice to simultaneously file a registration statement under both the Investment Company Act and the Securities Act to take advantage of certain

---

investors to whom test-the-waters communications may be directed. In contrast, the final rule discussed in this release is limited to QIBs and IAIs, which are expected to have a high level of sophistication in processing investment information.

[226] However, certain characteristics of such issuers (*e.g.,* size, exchange listing approval, more established track record, and low information asymmetry) that attract institutional investors may reduce the value of testing the waters.

[227] The vast majority (89%) of mutual fund shares are estimated to be held through retail accounts. *See* 2019 ICI Factbook. Based on staff analysis of Form 13F data, the mean institutional holding is estimated to be approximately 48% for exchange-traded funds and 23% for registered closed-end funds. Therefore, among registered investment companies, mutual funds may be least likely to rely on the final rule because they have the highest share of retail ownership. BDCs, which are closed-end funds exempt from registration under the Investment Company Act, have an estimated mean institutional holding of approximately 29%, so the benefits of the final rule may be similarly limited for some BDCs. We calculated "institutional holding" as the sum of shares held by institutions (as reported on Form 13F filings) divided by shares outstanding (as reported in CRSP). Year-end 2018 Form 13F filings were used to estimate institutional ownership. Closed-end funds were matched to reported holdings based on CUSIP. As a caveat, we note that there are long-standing questions around the reliability of data obtained from Form 13F filings. *See Covered Investment Fund Research Reports,* Release No. 33-10580 (Nov. 30, 2018) [83 FR 64180, 64199 (Dec. 13, 2018), n. 223].

efficiencies. If these funds continue to file a single registration statement under both Acts, as one commenter suggested they would, they will be less likely to benefit from the option to conduct test-the-waters communications prior to a public registration filing.[228] Since a BDC is not required to register under the Investment Company Act, it may be more likely to benefit from the final rule with respect to pre-filing communications. However, like registered investment companies, many BDCs have relatively high levels of retail investor ownership, which may reduce the likelihood that these BDCs will engage in and benefit from these pre-filing communications under Rule 163B.[229]

Some funds that preliminarily engage in exempt offerings, including certain registered closed-end funds and BDCs, could rely on the final rule to engage in pre-filing communications if they are considering a subsequent registered offering. In addition, funds could realize benefits from relying on Rule 163B for post-filing communications. The final rule will allow funds to communicate with QIBs and IAIs about a contemplated offering without complying with the requirements of Section 24(b) of the Investment Company Act or Rules 482 or 34b-1, including the associated filing, disclosure, and legending requirements, which could result in potentially lower costs and greater flexibility for funds seeking to engage in post-filing communications with QIBs and IAIs. We recognize, however, that funds may choose to rely on other available communications rules to engage in post-filing communications instead of Rule 163B. If funds

[228] *See* letter from ICI. While a registered investment company could engage in test-the-waters communications for a limited period of time after making a notice filing to become a registered investment company and before filing an Investment Company Act registration statement (generally three months), the benefits of such communications may be diminished since the registered investment company is obligated to file an Investment Company Act registration statement regardless of whether it conducts an exempt or registered offering. *See* 17 CFR 270.8b-5.

[229] *See supra* note 227.

continue to rely on these other rules, funds' cost savings associated with Rule 163B for post-filing communications likely will not be significant.[230]

6. Variation in Economic Impact Due to Investor Characteristics

The composition of QIBs and IAIs solicited in conjunction with an issuer's contemplated registered offering also might affect the economic impact of the final rule. Testing the waters with QIBs and IAIs that have more investment and due diligence expertise might yield more valuable information to issuers, and such investors might be less susceptible to biased information if any is presented while testing the waters. In turn, the presence of QIBs and IAIs with relatively less investment and due diligence expertise might decrease the value of information obtained from investors through test-the-waters communications and might increase the risk of test-the waters communications biasing the ability of solicited investors to adequately assess the offering.

To the extent that certain categories of issuers, including funds, may be less likely to rely on the final rule, those QIBs and IAIs that mainly invest in the securities of such issuers may be less affected by the final rule.

As a general consideration, the provisions of Rule 163B mostly follow the provisions of the existing Section 5(d) accommodation. Such harmonization of permissible test-the-waters communications across all issuers is expected to minimize confusion among potential investors regarding permissible solicitation of investor interest before registered offerings, irrespective of the issuer's EGC status.

---

[230] *See* letter from ICI (expressing doubt that funds would rely on proposed Rule 163B for post-filing communications since they are already familiar with other communications rules and stating that the proposed rule would likely provide only minimal cost savings for funds over existing rules).

D. Reasonable Alternatives

We evaluate reasonable alternatives to the final rule and their anticipated economic effects below. The final rule will provide the option to engage in test-the-waters communications to all issuers. The conditions of Rule 163B will be generally similar to the requirements presently applicable to EGC issuers under Section 5(d). As an alternative, we could apply substantially different requirements to test-the-waters communications under Rule 163B. Compared to the final rule, applying less extensive (more extensive) requirements to test-the-waters communications under the final rule would increase (decrease) the benefits related to the level, efficiency, and cost of capital raising for issuers that would have sought to test the waters under the final rule. Further, compared to the final rule, applying more extensive requirements to test-the-waters communications under Rule 163B could reduce the benefit of the final rule for non-EGC issuers that are comparable to EGC issuers or that face similar challenges in gauging investor demand for a public offering but that remain ineligible to test the waters under Section 5(d). The effects specific to individual reasonable alternatives are discussed in greater detail below.

The final rule will permit all issuers to test the waters, which was generally supported by commenters.[231] As an alternative, the final rule could exclude certain categories of issuers,[232]

[231] *See, e.g.*, letters from CCMC, B. Clark, Cravath, ICI, Nasdaq, and Sullivan.

[232] In the 1995 Proposing Release, the Commission excluded registered investment companies, ABS issuers, partnerships, limited liability companies and other direct participation investment programs because they might be "unsuited to a 'test the waters' concept, given the complex and contractual nature of the issuer." Further, blank check and penny stock issuers were excluded "because of the substantial abuses that have arisen in such offerings." However, the 1995 Proposing Release would have allowed testing the waters with all investors, not just QIBs and IAIs. *See* 1995 Proposing Release. Title I of the JOBS Act, enacted in 2012, did not limit the availability of Section 5(d) to EGCs on the basis of blank check or penny stock issuer status.

such as blank check issuers,[233] penny stock issuers,[234] ABS issuers,[235] foreign issuers,[236] or all or some registered investment companies.[237] If, as one commenter suggested,[238] some solicited investors make less informed decisions as a result of test-the-waters communications by these categories of issuers,[239] the alternative of excluding these categories of issuers might potentially result in more efficient investor decisions compared to the final rule. However, we expect

[233] We estimate that 228 issuers, other than ABS issuers or registered investment companies, that had filed a report on Form 10-K, 10-Q, 20-F, or 40-F, or a registration statement on Form S-1, S-3, S-4, S-11, F-1, F-3, F-4, or F-10, or amendment to it, during calendar year 2018, were blank check issuers based on Ives Group's Audit Analytics and OTC Markets data as of December 2018 and XBRL data in filings made during calendar year 2018. Based on Ives Group's Audit Analytics data as of December 2018, among those, approximately 79% were EGCs. Blank check issuer status was determined based on having SIC code 6770.

[234] We estimate that 1,314 issuers, other than ABS issuers or registered investment companies, that had filed a report on Form 10-K, 10-Q, 20-F, or 40-F, or a registration statement on Form S-1, S-3, S-4, S-11, F-1, F-3, F-4, or F-10, or amendment to it, during calendar year 2018 had at least one class of shares trading on the OTC Market at a closing price below $5 based on OTC Markets data as of December 2018. Including both OTC-quoted and exchange-listed securities, we estimate that 2,187 issuers that had filed a report on Form 10-K, 10-Q, 20-F, or 40-F, or a registration statement on Form S-1, S-3, S-4, S-11, F-1, F-3, F-4, or F-10, or amendment to it, during calendar year 2018 had at least one class of shares (on the OTC Market or a national securities exchange) with a closing price below $5 based on OTC Markets or Ives Group's Audit Analytics data as of December 2018. Based on Ives Group's Audit Analytics data as of December 2018, among those, approximately 30% were EGCs.

[235] *See supra* note 179.

[236] We estimate that 1,115 issuers, other than ABS issuers or registered investment companies, filed annual reports on Form 20-F or 40-F or registration statements on Form F-1, F-3, F-4, or F-10, or amendment to it, during calendar year 2018. Based on Ives Group's Audit Analytics data as of December 2018, among those, approximately 24% were EGCs.

[237] *See supra* note 180 and *supra* Section II.E.

[238] *See* letter from Better Markets (expressing concern regarding the reasonable belief standard and stating that there might be particular risks with permitting "blank check, penny stock issuers, asset-backed securitizers, leveraged business development companies, and certain investment companies" to engage in Rule 163B communications).

[239] *See also supra* note 225. We note, however, that concerns raised in some studies about risks involving some microcap firms significantly predate the availability of testing the waters or are not focused on solicitations targeted at QIBs and IAIs. *See, e.g.,* Kevin C. Bartels, *Click Here to Buy the Next Microsoft: The Penny Stock Rules, Online Microcap Fraud, and the Unwary Investor*, 75 Ind. L. J. 353, 353-377 (2000); Reajesh Aggarwal & Guojun Wu, *Stock Market Manipulations*, 79 J. Bus. 1915, 1915-1953 (2006); Daniel J. Bradley, John W., Cooney, Jr., Steven D. Dolvin, & Bradford D. Jordan, *Penny Stock IPOs*, 35 Fin. Mgmt. 5, 5-29 (2006) (examining the 1990-1998 period); Randolph Beatty & Padma Kadiyala, *Impact of the Penny Stock Reform Act of 1990 on the Initial Public Offering Market*, 46 J. L. & Econ. 517, 517-541 (2003);; Michael Hanke, M. & Florian Hauser, *On the Effects of Stock Spam E-Mails*, 11 J. Fin. Markets 57, 57-83 (2008); Rainer Böhme & Thorsten Holz, *The Effect of Stock Spam on Financial Markets* (Working Paper, 2006); Shimon Kogan, Tobias Moskowitz, & Marina Niessner, 2018, *Fake News: Evidence from Financial Markets* (Working Paper, 2018); Jonathan Clarke, Hailiang Chen, Ding Du, & Yu Jeffrey Hu, *Fake News, Investor Attention, and Market Reaction* (Working Paper, 2018); Thomas Renault, *Market Manipulation and Suspicious Stock Recommendations on Social Media* (Working Paper, 2017). (Working papers and reports cited here and elsewhere have not undergone peer review and may be revised at a future date.)

several factors to mitigate this concern: the availability prior to investing of the registration statement to the solicited investors in addition to any test-the-waters communications, should the issuer proceed with an offering; the generally high level of sophistication of QIBs and IAIs in processing information; and the other mitigating factors discussed in Section IV.C.4 above.[240] To the extent that these categories of issuers would have elected to test the waters under the final rule, this alternative would not allow such issuers to realize the benefits of the final rule (*e.g.*, potentially more efficient and lower cost of capital raising), particularly non-EGC issuers ineligible under Section 5(d).[241] To the extent that some of these issuers may be less likely to rely on Rule 163B as discussed in Section IV.C.5 above, the effects of excluding them from Rule 163B would be more limited.

Similar to Section 5(d), the final rule will permit solicitation of investor interest both before and after the filing of a registration statement. As an alternative, the final rule could permit issuers to test the waters only before or only after the public filing of the registration statement. Compared to the final rule, this alternative would afford less flexibility to affected issuers, and fewer potential benefits for the level, efficiency, and cost of capital raising for affected issuers, particularly non-EGC issuers ineligible under Section 5(d).[242]

Similar to Section 5(d), the final rule will not require issuers to use legends with test-the-waters communications. As an alternative, the final rule could require issuers to include certain legends with test-the-waters communications. Compared to the final rule, the alternative of

---

[240] *See, e.g.*, letter from Cravath (stating that QIBs and IAIs have the sophistication to evaluate investment opportunities regardless of the type of issuer).

[241] *See also* letter from Nasdaq (stating that the proposal will level the playing field in secondary offerings by companies that have already gone public).

[242] *See also supra* note 193 and accompanying text.

requiring legends on test-the-waters communications under the final rule could impose small incremental costs on issuers. However, given the investment and due diligence expertise of QIBs and IAIs, such an alternative likely would not result in significant additional benefits compared to the final rule.[243]

Similar to Section 5(d), the final rule will not require issuers to publicly file test-the-waters communications. As an alternative, we could require the filing of test-the-waters communications. Compared to the final rule, the alternative of requiring the filing of test-the-waters materials could impose additional costs on issuers that elect to test the waters under Rule 163B. These potential costs include the direct cost of filing additional exhibits and costs associated with requesting confidential treatment or disclosing proprietary information. For example, in instances where test-the-waters materials contain proprietary information, the disclosure of which could cause competitive harm, this alternative could impose potential costs of requesting confidential treatment for that information pursuant to Securities Act Rule 406, or alternatively, the risk of disclosure of proprietary information to competitors in instances where confidential treatment of test-the-waters communications is not requested, or requested but not granted. This alternative also could deter issuers from relying on the final rule and thereby decrease the benefits of the final rule for the level, efficiency, and cost of capital raising for affected issuers, particularly non-EGC issuers.

Compared to the final rule, by subjecting test-the-waters communications to Section 11 liability applicable to registration statements, this alternative could improve the accuracy of information provided as part of test-the-waters communications. However, this benefit is

[243] *See, e.g.*, letters from CCMC, Cleary, Cravath, Davis Polk, Federated, ICI, SIFMA, and Sullivan.

expected to be limited by the factors associated with the final rule discussed in Section IV.C.4 above, including the ability of investors to review the information in the registration statement before investing; the generally high sophistication of QIBs and IAIs in processing investment information; and the applicability of Section 12(a)(2) liability and general anti-fraud provisions to test-the-waters communications. Compared to the final rule, the alternative of filing test-the-waters materials with the registration statement could offer informational benefits to investors that have not been solicited.[244] However, the benefits of this alternative, compared to the final rule, are likely minimal because issuers already are required to disclose extensive information in a registration statement and because issuers would retain the option to request confidential treatment for proprietary information in such exhibits, subject to the provisions of Rule 406. Further, in certain circumstances, communications under the final rule may be subject to Regulation FD, as discussed in Section IV.A above. In addition, test-the-waters communications are frequently made in oral format,[245] which attenuates the economic effects of a filing requirement for written test-the-waters materials.

Building on the existing provisions of Section 5(d), as proposed the final rule will permit issuers to test the waters with QIBs and IAIs. As an alternative, the final rule could permit issuers to test the waters with all investors,[246] or with a broader subset of investors.[247] This

[244] One commenter stated that "[r]equiring 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, this requirement would allow current and future investors to compare the [testing-the-waters] communications (and the claims made therein) with the prospectus of the issuer and the performance of the securities themselves." *See* letter from Better Markets.

[245] *See* letter from Davis Polk. Issuers that find the filing requirement to be costly may elect to engage only in oral test-the-waters communications under this alternative, further mitigating the effects of a filing requirement.

[246] For example, Rules 163 and 164 under the Securities Act permit eligible issuers to engage in communications with any investor, including an investor that is not a QIB or IAI, subject to a requirement to file such materials. Regulation A permits issuers to test the waters with all investors. However, Regulation A requires test-the-waters

alternative might benefit issuers, particularly issuers whose offerings attract investors that are not QIBs or IAIs by providing additional flexibility and enabling issuers to reduce the costs of a registered offering. This alternative could therefore facilitate capital formation efforts of such issuers. At the same time, the Commission has not previously recognized non-accredited investors as having the ability to fend for themselves for purposes of securities offerings under the Securities Act, and non-accredited investors have not been included among the investors eligible for solicitation under Section 5(d).

Similar to Section 5(d), the final rule will not restrict issuers from relying on other communications provisions, such as Rules 163 or 255 under the Securities Act (depending on the nature and timing of the communication and the issuer's ability to meet the eligibility and other rule requirements), which was supported by all commenters that expressed a view on this provision.[248] Those rules contain investor safeguards specific to the circumstances in which such communications are permitted. As an alternative, we could have restricted issuers relying on the final rule from engaging in other communications under the existing rules. Compared to the final rule, this alternative would restrict the ability of issuers to tailor their solicitation strategy to

---

communications to be publicly filed and to include certain required legends and disclaimers. Regulation A also imposes offering limits; imposes investment limits for non-accredited investors; and does not preempt state review of offering materials for Tier 1 offerings.

[247] *See* letters from Federated and ICI (recommending that funds be permitted to solicit registered investment advisers); L. Ameri (recommending expanding the rule to include individual accredited investors); C. Anderson (generally recommending that the rule be "expanded beyond this small group of accredited investors"); CCMC (recommending expanding the rule to non-U.S. parties who may purchase outside of the U.S. in a non-U.S. tranche of a registered offering); and SIFMA (recommending expanding the rule to include individual accredited investors). The scope of investors that may be solicited under the final rule is unchanged from the proposal. The solicitation of QIBs and IAIs under the final rule is in line with testing the waters under Section 5(d).

Separately, the Commission is continuing to consider the broader question of which categories of investors (including natural persons and entities) should be treated as sophisticated and able to fend for themselves as part of the ongoing review of the accredited investor definition under Rule 501. *See* Harmonization Concept Release.

[248] *See* letters from CCMC, Dechert, Federated, and ICI.

their needs, which might result in decreased capital formation and a less efficient or costlier capital raising process for some issuers, without a corresponding benefit to investors. For example, issuers might have to choose between incurring costs of early public disclosure of a contemplated offering and forgoing the option of subsequent offering-related communications with a broader range of investors. One commenter further suggested that non-exclusivity is particularly important to preserve the viability of various market practices that have developed in the absence of a comprehensive rule such as proposed Rule 163B.[249] The extent to which such an alternative reduces the flexibility afforded to issuers would depend on whether in practice affected issuers would have elected to combine multiple types of communications.

The final rule does not limit the scope of the content or types of information that may be a part of test-the-waters communications. As an alternative, we could limit the scope of permissible test-the-waters communications to certain types of information about the issuer or offering. For instance, we could limit the scope of communications in a manner similar to Securities Act Rules 17 CFR 230.134 or Rule 482 with respect to advertising and sales literature, for all or some of the issuers eligible to rely on the final rule.[250] Limiting the scope of test-the-waters communications could lower the potential for incomplete or misleading information or improve comparability in such materials, which could benefit investors. However, we believe that these benefits to investors would be relatively insignificant given the sophisticated nature of investors that may receive the test-the-waters communications and the other mitigating factors

[249] *See* letter from CCMC.

[250] *See* letter from ICI (recommending that the Commission require funds to include performance information in a standardized manner in their test-the-waters communications similar to Rule 482). *See also supra* Section II.E (explaining why we are not requiring fund issuers to include standardized performance information in their test-the-waters communications).

analyzed in Section IV.C.4.[251] Such restrictions also may reduce the utility of test-the-waters communications to issuers and the associated benefits for capital formation, compared to the final rule.

As discussed above, Rule 163B contains a reasonable belief provision, which was supported by most commenters,[252] but does not require issuers to take specified steps to determine that the solicited investor is a QIB or IAI or specify steps that an issuer could or must take to establish a reasonable belief. As an alternative, we could require issuers to take specified steps to determine that the investor is a QIB or IAI or specify steps that an issuer could or must take to establish a reasonable belief.[253] Compared to the final rule, these alternatives might result in a lower risk of solicitation of investors that are not QIBs or IAIs.[254] However, they also might significantly increase costs for issuers electing to rely on the final rule and as a result decrease the use of test-the-waters communications and the benefits for the level, efficiency, and cost of capital raising, compared to the final rule.[255] The incremental investor protection benefits of this alternative, compared to the final rule, may be limited by factors that already mitigate the potential harm to an investor that could be solicited based on an incorrect, though reasonable belief, that the investor is a QIB or an IAI. As discussed in greater detail in Section IV.C.4

---

[251] *See also* letter from Hamilton (stating that this alternative "seems to offer little real benefit to investors, especially given that there would be no restriction on the use made of testing the waters communications by EGCs").

[252] *See* letters from CCMC, Cleary, Cravath, Davis Polk, Hamilton, and SIFMA.

[253] *See* letter from Better Markets (stating that "at a minimum, the Commission must establish specific criteria that issuers must use to evaluate the status of the investor and ensure the investor is in fact a QIB or an IAI").

[254] *See id*. (stating that the proposed rule would permit solicitations to retail and other investors lacking sophistication by issuers relying on a check-the-box or other self-certification method).

[255] *See, e.g.,* letter from Davis Polk (stating that the standard for proposed Rule163B should be no more burdensome for issuers and their underwriters than current practice in Rule 144A and Section 4(a)(2) private placements, which permit issuers and their underwriters to refer to their own documentation as well as to industry-known reliable sources to check investor qualification).

above, these include the requirement to publicly file a registration statement for issuers that determine to proceed with a public offering, enabling solicited investors to review the filed offering materials and to obtain full information about the issuer and the offering before investing; the applicability of general anti-fraud provisions and liability under Section 12(a)(2) of the Securities Act, as well as the risk of private securities litigation; the ability of the staff to review test-the-waters materials for issuers that proceed with a public offering; the reputational incentives of underwriters and issuers; and, for issuers in follow-on offerings, the availability of past registration statements and Exchange Act filings that provide additional disclosures about the issuer and can aid solicited investors in the interpretation and verification of information in test-the-waters communications.[256]

As discussed in Section II.E. above, although funds are eligible to rely on the final rule, the final rule does not affect Investment Company Act registration requirements. As an alternative, following the suggestion of two commenters,[257] we could provide an exemption from Investment Company Act registration to funds while they engage in test-the-waters communications under Rule 163B. In light of the existing industry practice discussed in the Proposing Release, whereby funds commonly file a single registration statement under both the Investment Company Act and the Securities Act to take advantage of certain efficiencies, such an alternative would allow funds to more effectively use the rule to engage in pre-filing communications. However, the benefits of such an alternative may be limited since communications under the rule are limited to QIBs and IAIs and most funds have a large retail

[256] *See also supra* note 217.

[257] *See supra* note 131.

investor base.[258] Further, such an exemption could impose significant costs on investors in a resulting public offering if funds relying on it engage in activities that are contrary to the substantive requirements of the Investment Company Act that protect investors in a registered fund's offering (*e.g.*, certain self-dealing transactions—which the Act prohibits for registered funds—that benefit a fund's investment adviser or other affiliated persons while the fund is actively considering and soliciting interest in a public offering).

V. Paperwork Reduction Act

As discussed in the Proposing Release, the final rule does not impose any recordkeeping requirement or otherwise constitute a "collection of information" as defined in the regulations implementing the Paperwork Reduction Act of 1995 ("PRA").[259] The Commission did not receive public comments in response to its request for comments in the Proposing Release regarding the assertion that the proposed rules would not create any new, or revise any existing, collection of information pursuant to the Paperwork Reduction Act. Accordingly, we are not submitting the final rule to the Office of Management and Budget for review in accordance with the PRA.[260]

VI. Final Regulatory Flexibility Act Analysis

This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the Regulatory Flexibility Act ("RFA").[261] It relates to final Rule 163B and final amendments to Rule 405 of the Securities Act. An Initial Regulatory Flexibility Act Analysis

[258] *See supra* Section IV.C.5.

[259] *See* 5 CFR 1320.3(c); 44 U.S.C. 3506

[260] 5 CFR 1320.11; 44 U.S.C. 3507(d).

[261] 5 U.S.C. 601 *et seq*.

("IRFA") was prepared in accordance with the Regulatory Flexibility Act and included in the Proposing Release.

A. Reasons for, and Objectives of, the Amendments

In 2012, Congress passed the JOBS Act, which created new Section 5(d) of the Securities Act permitting EGCs to engage in test-the-waters communications. The purpose of the final rule is to permit all issuers to engage in test-the-waters communications with potential investors that are, or that the issuer reasonably believes to be, QIBs or IAIs, either prior to or following the date of filing of a registration statement related to such offering. These amendments 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. The need for, and objectives of, the final rule are discussed in more detail in Section II above.

B. Significant Issues Raised by Public Comments

In the Proposing Release, the Commission requested comment on any aspect of the IRFA, including the number of small entities that would be affected by the proposed rules, the nature of the impact, how to quantify the number of small entities that would be affected, and how to quantify the impact of the proposed amendments. We did not receive comments specifically addressing the IRFA.

C. Small Entities Subject to the Amendments

The final rule will affect issuers that are small entities. The RFA defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."[262] For

[262] 5 U.S.C. 601(6).

purposes of the RFA, under 17 CFR 230.157, an issuer, other than an investment company, is a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year and is engaged or proposing to engage in an offering of securities not exceeding $5 million. Under 17 CFR 240.0-10(a), an investment company, including a business development company, is considered to be a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.

The rule will permit all issuers, including small entities, to engage in test-the-waters communications. We estimate that there are currently 1,171 issuers that file with the Commission, other than investment companies, that would be eligible to rely on the final rule that may be considered small entities.[263] In addition, we estimate that, as of December 2018, there were 114 registered investment companies and BDCs that would be eligible to rely on the final rule that may be considered small entities.[264]

Small entities meeting the definition of EGC are currently eligible to engage in test-the-waters communications pursuant to Section 5(d) of the Securities Act. These small entities and other small entities that do not meet the definition of EGC may rely on Rule 163B. Because reliance on the rule is voluntary, we cannot accurately estimate the number of small entities that will choose to test the waters, though we anticipate that the small entities most likely to engage in these communications will be those that expect the benefits of this strategy to outweigh the costs.

[263] This estimate is based on staff analysis of issuers, excluding co-registrants, with EDGAR filings of Form 10-K, 20-F and 40-F, or amendments thereto, filed during the calendar year of January 1, 2018 to December 31, 2018. Analysis is based on data from XBRL filings, Compustat, and Ives Group Audit Analytics.

[264] This estimate is derived from an analysis of data obtained from Morningstar Direct as well as data filed with the Commission (Forms N-Q and N-CSR) for the second quarter of 2018.

D. Reporting, Recordkeeping and Compliance Requirements

The purpose of the rule is to allow all issuers, not solely EGCs, to engage in communications with certain potential investors to determine their interest in an offering before or after the filing of a Securities Act registration statement. Under the rule, the use of test-the-waters communications is voluntary and any communications that comply with the rule do not need to include a legend or be filed with the Commission, provided that the communications do not trigger a disclosure obligation pursuant to any other rules.

Given the voluntary nature of the test-the-waters communications and that the rule does not impose a filing requirement, the rule is not expected to significantly impact existing reporting, recordkeeping, and other compliance burdens. Small entities choosing to avail themselves of the rule may seek the advice of legal or accounting professionals in connection with making test-the-waters communications. We discuss the economic impact, including the estimated costs and benefits, of the rule to all issuers, including small entities, in Section IV above.

E. Agency Action to Minimize Effect on Small Entities

The RFA directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the final rule, we considered the following alternatives:

- Establishing different compliance or reporting requirements that take into account the resources available to small entities;
- Clarifying, consolidating, or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and

- Exempting small entities from all or part of the requirements.

For the reasons given above, we believe the rule will limit the compliance burden on issuers, including small entities that choose to rely on the rule.[265] We do not believe that the rule will impose any significant new compliance obligations. Accordingly, we generally do not believe it is necessary to establish different compliance requirements or to exempt small entities from all or part of the rule.

VII. Statutory Authority

We are adopting the rule amendments contained in this document under the authority set forth in Sections 7, 10, 19(a), and 28 of the Securities Act of 1933, as amended, and Sections 6, 24, and 38 of the Investment Company Act of 1940, as amended.

List of Subjects in 17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

Text of Final Amendments

In accordance with the foregoing, we are proposing to amend title 17, chapter II of the Code of Federal Regulations as follows:

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78*l*, 78m, 78n, 78*o*, 78*o*-7 note, 78t, 78w, 78*ll*(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, and Pub. L. 112-106, sec. 201(a), sec. 401, 126 Stat. 313 (2012), unless otherwise noted.

* * * * *

[265] *See* Section VI.C above.

2. Add § 230.163B to read as follows:

§ 230.163B Exemption from section 5(b)(1) and section 5(c) of the Act for certain communications to qualified institutional buyers or institutional accredited investors

(a) Attempted compliance with this rule does not act as an exclusive election, and the issuer also may claim the availability of any other applicable exemption or exclusion. Reliance on this rule does not affect the availability of any other exemption or exclusion from the requirements of section 5 of the Act (15 U.S.C. 77e).

(b)(1) An issuer, or any person authorized to act on behalf of an issuer, may engage in oral or written communications with potential investors described in paragraph (c) of this section to determine whether such investors might have an interest in a contemplated registered securities offering, either prior to or following the date of filing of a registration statement with respect to such securities with the Commission. Communications under this rule will be exempt from section 5(b)(1) (15 U.S.C. 77e(b)(1)) and section 5(c) of the Act (15 U.S.C. 77e(c)).

(2) Any oral or written communication by an issuer, or any person authorized to act on behalf of an issuer, made in reliance on this rule will be deemed an "offer" as defined in section 2(a)(3) of the Act (15 U.S.C.77b(a)(3)).

(3) Any oral or written communication by an issuer, or any person authorized to act on behalf of an issuer, made in reliance on this rule is not required to be filed with the Commission, including pursuant to § 230.424(a) or § 230.497(a) of Regulation C under the Act or section 24(b) of the Investment Company Act of 1940 (15 U.S.C. 80a-24(b)) and the rules and regulations thereunder.

(c) Communications under this rule may be made with potential investors that are, or that an issuer or person authorized to act on its behalf reasonably believes are:

(1) Qualified institutional buyers, as defined in § 230.144A; or

(2) Institutions that are accredited investors, as defined in §§ 230.501(a)(1), (a)(2), (a)(3), (a)(7), or (a)(8).

* * * * *

3. In § 230.405 amend the definition of "Free writing prospectus" by revising paragraphs (2) and (3) and adding paragraph (4) to read as follows:

§ 230.405 - Definitions of terms.

* * * * *

Free writing prospectus.

* * * * *

(2) A written communication used in reliance on Rule 167 and Rule 426 (§230.167 and §230.426);

(3) A written communication that constitutes an offer to sell or solicitation of an offer to buy such securities that falls within the exception from the definition of prospectus in clause (a) of section 2(a)(10) of the Act; or

(4) A written communication used in reliance on Rule 163B (§230.163B) or on section 5(d) of the Act.

* * * * *

By the Commission.

Dated: September 25, 2019

Vanessa Countryman,

Secretary.