The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC Adopts Rule Expanding Pre-Filing Communications with Certain Prospective Investors

[31986]

September 30, 2019 TO: ICI Members
Closed-End Investment Company Committee
SEC Rules Committee SUBJECTS: Closed-End Funds
Compliance RE: SEC Adopts Rule Expanding Pre-Filing Communications with Certain Prospective Investors

The Securities and Exchange Commission recently adopted a new rule that will expand the ability of issuers, including investment company issuers, to "test the waters" and gauge market interest in a contemplated securities offering with certain sophisticated investors.[1] We describe the rule, Rule 163B under the Securities Act, below and its potential application to investment companies.

Rule

The new rule will enable issuers to engage in oral or written communications with certain potential investors prior to registering an offering and without delivering a "statutory" prospectus with required disclosures.[2] To rely on the rule, the potential investors must be or must be reasonably believed to be qualified institutional buyers ("QIBs")[3] or institutional accredited investors ("IAIs").[4] Issuers will not need to file any communications with the Commission or include legends or disclaimers on any communications. In addition, there are no content restrictions on the communications, though the communications must not contain material misstatements or omissions at the time the statements are made. Further, the exemption in the rule is not exclusive, and issuers relying on the rule could continue to rely on other offering exemptions to communicate.

Application to Investment Companies

The new rule, adopted substantially as proposed, could benefit funds as both investors and issuers. As investors, it could enable funds to assess the nature and quality of potential future investment opportunities and provide funds with more lead time to evaluate an offering before investing. As issuers, the rule could give certain funds more flexibility to gauge market interest in their proposed offerings, particularly during the periods before a registration statement is filed with the Commission.[5]

Many funds, such as open-end funds, however, will see little or no benefit from the rule. This is because, generally before engaging in activity, an investment company must first register as an investment company under the Investment Company Act. New funds typically file one registration statement to register both the offering and as investment companies. Thus, the benefit of not having to file a registration statement to register the offering will be offset by the need to file a registration statement to register as an investment company. Certain funds, however, may benefit from the rule. These include business development companies, which do not register as investment companies, and closed-end funds that are contemplating follow-on offerings, which already have registered as investment companies.

Contrary to ICI's recommendation, the Commission did not permit funds to rely on the rule prior to registering as investment companies.[6] Permitting funds to rely on the rule prior to registration could have enabled all funds to rely on the rule without incurring the time and expense of preparing and filing a registration statement. The Commission determined not to permit funds to use the rule without registering as investment companies, despite acknowledging that funds would be less likely to use the rule with its decision. It reasoned that doing so could enable funds to engage in activities that are contrary to the substantive requirements of the Investment Company Act (*e.g.*, affiliated transactions) during the period of actively considering and soliciting interest in the offering.[7]

The Commission also proceeded with limiting the communications to only QIBs and IAIs, as proposed and contrary to ICI's recommendation to include registered investment advisers.[8] The Commission stated that it is taking a more holistic view of the issue to ensure regulatory consistency and is considering expanding the definition of IAIs in other contexts, including whether a broader range of registered investment advisers should qualify as IAIs.[9]

Finally, the Commission determined not to require standardized performance for funds using test-the-waters communications. In making this determination, the Commission reasoned 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 antifraud provisions; and (3) these communications are limited to QIBs and IAIs, which would have the bargaining power to request the information needed to assess fund performance.

The new rule takes effect 60 days after publication in the Federal Register.

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endnotes

[1] *See* Solicitations of Interest Prior to a Registered Public Offering, Securities Act Release No. 10699 (Sept. 26, 2019), *available at* https://www.sec.gov/rules/final/2019/33-10699.pdf.

[2] A “statutory” prospectus conforms to the information requirements of Section 10 of the Securities Act.

[3] 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 in a discretionary basis at least $100 million in securities of unaffiliated issuers.

[4] An IAI is any institutional investor that also is an accredited investor, as defined in paragraph (a) of Rule 501 of Regulation D.

[5] Many funds already rely on Rule 482 under the Securities Act to engage in communications after filing their registration statement with the Commission.

[6] *See* Letter from Susan Olson, General Counsel, ICI, to Vanessa Countryman, Acting Secretary, SEC, dated Apr. 29, 2019 (“ICI Comment Letter”), *available at* https://www.sec.gov/comments/s7-01-19/s70119-5423834-184598.pdf. For a summary of the ICI Comment Letter, *see* ICI Memorandum No. 31738, *available at* https://www.ici.org/my_ici/memorandum/memo31738.

[7] We note, however, that our comment letter recommended only allowing funds to *rely on the rule* without registration as an investment company, not *engage in other activities*. *See* ICI Comment Letter.

[8] Our comment letter suggested that registered investment advisers be treated similarly to registered broker-dealers, which qualify as IAIs. It also stated that the recommended approach would be consistent with FINRA Rule 2210, which classifies all SEC-registered investment advisers as institutional investors. *Id*.

[9] *See* Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 10649 (June 18, 2019), *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf.