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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 230

[Release No. 33-10607, File No. S7-01-19]

RIN 3235-AM23

Solicitations of Interest Prior to a Registered Public Offering

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing a new rule under the Securities Act of 1933 that would permit issuers to engage in oral or written communications with potential investors that are, or are reasonably believed to be, qualified institutional buyers or institutional accredited 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. If adopted the rule would extend such accommodation currently available to emerging growth companies to all issuers.

DATES: Comments should be received by April 29, 2019.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment forms (http://www.sec.gov/rules/proposed.shtml); or
- Send an email to rule-comments@sec.gov. Please include File Number S7-01-19 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-01-19. This file number should be included in the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (https://www.sec.gov/rules/proposed.shtml). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Room 1580, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by e-mail.

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 proposing for public comment 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.

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I. Introduction

In 2012, Congress passed the Jumpstart Our Business Startups Act (the "JOBS Act"),[1] which created new Section 5(d) of the Securities Act.[2] Section 5(d) permits an emerging growth company ("EGC")[3] and any person authorized to act on its behalf to engage in oral or written communications with potential investors that are qualified institutional buyers ("QIBs"), as that term is defined in paragraph (a) of 17 CFR 230.144A ("Rule 144A"), and institutional accredited investors ("IAIs")[4] before or after filing a registration statement to gauge such investors' interest in a contemplated securities offering.[5] The Commission's rules have long recognized that QIBs and accredited investors have a level of financial sophistication and ability to sustain investment losses that render the protections of the Securities Act's registration process unnecessary.[6]

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

[2] 15 U.S.C. 77e(d).

[3] 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 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").

[4] 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.

[5] 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.

[6] *See, e.g., Regulation D Revisions; Exemption for Certain Employee Benefit Plans*, Release No. 33-6683 (Jan. 16, 1987) [52 FR 3015 (Feb. 2, 1987)] (describing the concept of "accredited investor" as a keystone of Regulation D "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary"); *Resale of Restricted Securities; Changes to Method of Determining Holding Period of*

Permitting issuers to "test the waters" is intended to provide increased flexibility to issuers with respect to their communications about contemplated registered securities offerings, as well as a cost-effective means for evaluating market interest before incurring the costs associated with such an offering.[7] Although the test-the-waters provisions under Section 5(d) are available only to EGCs, such issuers make up a substantial portion of the IPO market. By one estimate, EGCs "dominate the [IPO] market, accounting for 87% of IPOs that have gone effective since the JOBS Act was enacted in April 2012."[8]

Evidence suggests that a significant percentage of EGC issuers conducting IPOs have availed themselves of the accommodation afforded by Section 5(d),[9] and there have been calls for the Commission to consider expanding the test-the-waters accommodation to issuers that are not EGCs,[10] as well as recent proposed legislation to effect such a change

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Restricted Securities Under Rules 144 and 145, Release No. 33-6862 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)] (noting that "qualified institutional buyers," the definition of which is "focused on assets invested in securities, should target, with more precision than the asset test originally proposed, sophisticated institutions with experience in investing in securities"). *See also* "Report on the Review of the Definition of 'Accredited Investor,'" a report by the staff of the U.S. Securities and Exchange Commission, December 28, 2015 (providing a comprehensive review of the accredited investor definition, including background information on its origin).

[7] *See* H. Rept. 112-406 – Reopening American Capital Markets to Emerging Growth Companies Act of 2011.

[8] Update on emerging growth companies and the JOBS Act, November 2016, Ernst and Young, LLP. *See also infra* note 88.

[9] *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).

[10] *See, e.g., 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-Capital-Markets-FINAL-FINAL.pdf ("Treasury Report") and *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public*, Sec. Industry and Fin. Markets Association & Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, et al., (2018), https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/05/CCMC_IPO-Report_v17.pdf ("SIFMA Report").

statutorily.[11] In our observation, pre-filing solicitations pursuant to Section 5(d) have not been a significant cause for concern with respect to investor protection. We believe that extending the test-the-waters accommodation to a broader range of issuers than provided in Section 5(d) may benefit more issuers seeking capital in our public markets and level the playing field with respect to permissible investor solicitations for EGCs and other issuers contemplating a registered securities offering. We believe that the ability to test the waters may also encourage additional participation in the public markets. Increased participation in our public markets, in turn, promotes more investment opportunities for more investors, including retail investors, as well as transparency and resiliency in the marketplace.

Notwithstanding Section 5(d), the Securities Act generally restricts communications by issuers contemplating a registered securities offering during various phases of the offering process. Under Section 5 of the Securities Act and related Securities Act rules, the communication restrictions depend primarily on the timing of the communication. Generally, written and oral offers prior to filing a registration statement are prohibited, absent an exemption.[12] Any violation of these restrictions—whether before, during or after a public offering—is commonly referred to as "gun-jumping."

Over the years, the Commission has undertaken several initiatives to liberalize communications during the offering process. As part of the Securities Offering Reform rulemaking, the Commission adopted, among other Securities Act communications reforms, 17 CFR 230.163 ("Rule 163") to provide an exemption from Section 5(c) for pre-filing

[11] *See* H.R. 3903 "Encouraging Public Offerings Act of 2017"; and S. 2347 "Encouraging Public Offerings Act of 2018." On July 17, 2018, the U.S. House of Representatives passed a House Amendment to S. 488 "Encouraging Employee Ownership Act," which incorporates H.R. 3903.
[12] *See* Securities Act Section 5(c).

communications by well-known seasoned issuers ("WKSIs"), without limitation as to the type of investors that may be solicited, subject to certain filing and legending requirements.[13] Similarly, in its 2015 amendments to Regulation A, the Commission adopted 17 CFR 230.255 ("Rule 255") that allows eligible issuers conducting an offering under Regulation A to engage in test-the-waters communications with potential investors, without restriction as to the type of investors, subject to compliance with certain disclaimer and filing requirements.[14] Each of these initiatives has contributed to the modernization of the Securities Act communications rules.[15]

As we continue to assess the effectiveness of the Securities Act offering communications framework, and in light of our experience with permissible test-the-waters communications under Section 5(d), we are proposing new Rule 163B to allow all issuers, including non-EGC 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

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[13] *See Securities Offering Reform*, Release No. 33-8591 (Jul. 19, 2005) [70 FR 44721 (Aug. 3, 2005)]. *See also infra* note 53 and accompanying text (discussing legislation directing the Commission to extend the securities offering rules that are available to other issuers required to file reports under Section 13(a) or Section 15(d) of the Exchange Act (which include Rule 163) to business development companies and certain registered closed-end investment companies).

[14] *See Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A)*, Release No. 33-9741 (Mar. 25, 2015) [80 FR 21805 (Apr. 20, 2015)] ("Regulation A Adopting Release").

[15] In addition to these initiatives, in 1995 the Commission proposed to expand permissible pre-IPO solicitations of interest (the "1995 Proposal") for most issuers, subject to certain filing and legending requirements, "to reduce the regulatory impediments and cost of accessing public markets consistent with investor protection interests." *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"). The 1995 Proposal would not have imposed restrictions on investors to whom test-the-waters communications could be directed but did exclude certain specified categories of issuers, such as registered investment companies, asset-backed securities ("ABS") issuers, and blank check and penny stock issuers. *See also infra* notes 122 and 125. The 1995 Proposal, however, was never adopted.

following the date of filing of a registration statement related to such offering.[16] If adopted, the rule would provide an exemption from Section 5(b)(1) and Section 5(c) of the Securities Act for such communications.

We believe that, by allowing more issuers to engage with certain sophisticated institutional investors while in the process of preparing for a contemplated registered securities offering, the proposed rule could help issuers to better assess the demand for and valuation of their securities and to discern which terms and structural components of the offering may be most important to investors. This in turn could enhance the ability of issuers to conduct successful offerings and lower their cost of capital. To the extent this is the case, the proposed rule could encourage additional registered offerings in the U.S. We believe that increasing the number of registered offerings can have long-term benefits for investors and our markets, including improved issuer disclosure, increased transparency in the marketplace, better informed investors, and a broader pool of issuers in which any investor may invest.

We believe that many benefits of the proposed rule if finalized would similarly apply to investment company issuers. Test-the-waters communications may help investment company 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. However, we also recognize that certain features of investment companies discussed below may make their use of the proposed rule more limited than other issuers.[17]

[16] EGCs would be able to rely on the proposed rule and would continue to be able to rely on the statutory accommodation in Section 5(d).
[17] *See infra* Sections II.E. and III.C.5.

II. Proposed Amendments

A. Proposed Exemption

We are proposing an exemption from the gun-jumping provisions of Section 5 of the Securities Act for test-the-waters communications by an issuer contemplating a registered securities offering. Specifically, the proposed exemption would permit any issuer or person authorized to act on behalf of an issuer,[18] 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 the issuer reasonably believes are, QIBs or IAIs, to determine whether such investors might have an interest in the contemplated offering.

Section 5(c) prohibits any written or oral offers prior to the filing of a registration statement. 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.[19] Under the proposed rule, communications soliciting interest in a registered securities offering with potential investors that are, or are reasonably believed to be, QIBs or IAIs would be exempt from Section 5(b)(1) and Section 5(c). The proposed rule would not

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[18] Under the proposed rule, an issuer or a person authorized to act on its behalf would be required to have a reasonable belief that a potential investor is a qualified institutional buyer or institutional accredited investor. *See* proposed Rule 163B(b)(1). In this release, for ease of discussion, we sometimes refer only to the issuer having a reasonable belief, though the reasonable belief requirement of proposed Rule 163B applies equally to any person authorized to act on an issuer's behalf.

[19] 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 does not modify or otherwise exempt these requirements.

be available, however, 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.

Test-the-waters communications that comply with the proposed rule would not need to be filed with the Commission, nor would they be required to include any specified legends. We do not believe it is necessary to impose such requirements because communications under the proposed rule would be limited to investors that are, or are reasonably believed to be, QIBs and IAIs. These types of investors are generally considered to have the ability to assess investment opportunities, thereby reducing the need for the additional safeguards provided by a filing or legending requirement. Consistent with this approach, we are proposing to amend Rule 405 to exclude a written communication used in reliance on the proposed rule from the definition of free writing prospectus. As a result, any such communication that is limited to gauging interest in a contemplated registered securities offering would not be considered a "free writing prospectus" as that term is defined in Securities Act Rule 405. Furthermore, we are proposing that communications made under the proposed rule would not be required to be filed pursuant to 17 CFR 230.424(a) ("Rule 424(a)") or 17 CFR 230.497(a) ("Rule 497(a)") of Regulation C[20] under the Securities Act or Section 24(b) of the Investment Company Act of 1940[21] (the "Investment Company Act") and the rules and regulations thereunder.[22]

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[20] 17 CFR 230.401 through 230.498.

[21] 15 U.S.C. 80a-24.

[22] *See* proposed Rule 163B(b)(3); *see also infra* Section II.E (discussing the exemption from the filing requirements of 17 CFR 230.497 ("Rule 497") and Section 24(b) of the Investment Company Act and the rules and regulations thereunder for communications made by registered investment companies and business development companies under the proposed rule).

We believe that the flexibility afforded in exempting test-the-waters communications from Sections 5(b)(1) and (c) would still maintain investor protections. The proposed rule would only allow test-the-waters communications with certain institutional investors, which, as noted above, do not need the protections of the Securities Act's registration process. Further, these communications, while exempt from the gun-jumping provisions of Section 5, would nonetheless still be considered "offers" as defined in Section 2(a)(3) of the Securities Act[23] and would therefore be subject to Section 12(a)(2) liability in addition to the anti-fraud provisions of the federal securities laws.[24]

Additionally, information provided in a test-the-waters communication under the proposed rule must not conflict with material information in the related registration statement. 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 the staff any test-the-waters communication used in connection with an offering.[25]

Further, issuers subject to Regulation FD would need to consider whether any information in the test-the-waters communication would trigger any obligations under

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[23] 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).

[24] 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 on which they were made, not misleading. Liability under Section 12(a)(2) would attach to test the waters oral and written communications under the proposed rule both before and after a registration statement has been filed. Communications under the proposed rule would 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.

[25] *See* 17 CFR 230.418 of the Securities Act.

Regulation FD, or whether an exception to Regulation FD would apply.[26] Regulation FD requires public disclosure of any material nonpublic information that has been selectively disclosed to certain securities market professionals or shareholders[27] if the issuer has a class of securities registered under Section 12 of the Exchange Act or is required to file reports under Section 15(d) of the Exchange Act.[28] 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. For example, Regulation FD generally does not apply if the selective disclosure was made to a person who owes a duty of trust or confidence to the issuer or to a person who expressly agrees to maintain the disclosed information in confidence.[29] Thus, to avoid the application of Regulation FD, an issuer could consider obtaining confidentiality agreements from any potential investor engaged under the proposed rule.[30]

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[26] *See* 17 CFR 243.100 *et seq.* of the Securities Act.

[27] *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.

[28] *See* 17 CFR 243.101(b) of Regulation FD. Regulation FD applies to closed-end investment 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.

[29] *See* Regulation FD Rule 100(b)(2). Regulation FD also provides a limited exception for communications in connection with certain registered securities offerings if the disclosure is made by: a registration statement filed under the Securities Act; a free writing prospectus used after filing a registration statement for the offering or a communication falling within the exception to the definition of prospectus contained in clause (a) of section 2(a)(10) of the Securities Act; any other Section 10(b) prospectus; a notice permitted by 17 CFR 230.135 under the Securities Act; a communication permitted by 17 CFR 230.134 ("Rule 134") under the Securities Act; or an oral communication made in connection with the registered securities offering after filing of the registration statement for the offering under the Securities Act. *See id.*

[30] *See* Regulation FD Rule 100(b)(2)(ii). If the issuer determines not to proceed with the offering and the filing of a registration statement at that time, the issuer may choose to disclose information regarding the communications publicly in order to release the potential investors from the terms of such confidentiality agreement.

Request for Comment

1. Would the proposed exemption from Section 5(b)(1) and Section 5(c) to allow solicitations of interest from QIBs and IAIs prior to and following the filing of a registration statement provide issuers with appropriate flexibility in determining when to proceed with a registered public offering? Do test-the-waters communications aid issuers in assessing demand for their offerings? Do they aid issuers in structuring their offerings? Does this information potentially lead to a lower cost of capital? Would the additional flexibility provided by the proposed rule result in a greater number of issuers pursuing a registered public offering? Why or why not?
2. In what circumstances and how do EGCs currently take advantage of the accommodations of Securities Act Section 5(d)? What are the reasons why an EGC may choose not to avail itself of the accommodations?
3. Does the proposed expansion of permissible test-the-waters communications raise investor protection concerns? If so, how? Does the proposed expansion of permissible test-the-waters communications raise concerns of inappropriate marketing, conditioning, or hyping? How might such concerns be alleviated?
4. Should test-the-waters communications under the proposed rule be deemed "offers" under Securities Act Section 2(a)(3) that are subject to Section 12(a)(2) liability, as proposed? Why or why not?
5. Should we require written communications under the proposed rule to be filed with the Commission, for example, as an exhibit to a registration statement, and to become

subject to Section 11 liability? Why or why not? If so, at what point should they be required to be filed?

6. Should legends or disclaimers be required on any written materials used in compliance with the proposed rule? Why or why not? If so, should we prescribe the content of those legends or disclaimers?
7. Should we permit written or oral solicitations of interest to be made by an issuer before and after a registration statement is filed, as proposed? Why or why not? Should we treat pre-filing and post-filing test-the-waters communications differently? If so, how should they be treated?
8. In what circumstances does Regulation FD affect the use of the current accommodation for test-the-waters communications under Section 5(d)? Should there be a specific exception to Regulation FD for some or all communications made in compliance with the proposed rule? If so, under what circumstances and how should such an exception apply?

B. Eligibility

Any issuer, or person authorized to act on behalf of the issuer, would be able to rely on the proposed rule to engage in exempt oral or written communications with potential investors that are, or that the issuer or person authorized to act on behalf of the issuer reasonably believes are, QIBs or IAIs. All issuers—including non-reporting issuers, EGCs, non-EGCs, WKSIs, and investment companies (including registered investment companies and business development companies ("BDCs"))[31]—would be eligible to rely on the

[31] *See infra* Section II.E (discussing the proposed rule's application to investment companies).

proposed rule.[32] We believe that, in light of our 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 accommodations to all issuers.[33]

Request for Comment

9. Should the proposed rule be available to all issuers as proposed? Why or why not?
10. Should certain groups of issuers, such as non-reporting issuers, ABS issuers, certain or all types of "ineligible issuers" as defined in Rule 405, such as blank check issuers or penny stock issuers, be excluded from the rule? If so, which issuers should be excluded and why? Should communications related to certain types of securities offerings be excluded from the rule? If so, which types of offerings and why?

C. Investor Status

If adopted, the rule 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 and IAIs.[34] A QIB 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

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[32] Under Section 5(d), test-the-waters communications are only permitted for as long as an issuer qualifies as an EGC, which can be up to five years after the date of the first sale of the issuer's common equity securities pursuant to an effective registration statement. Since the proposed rule would be available to all issuers, there would be no similar limitation on qualification. An EGC would have the option of relying on the proposed rule or on Section 5(d) when it engages in any test-the-waters communications.

[33] This is in contrast with the 1995 Proposal, which would have excluded certain specified categories of issuers but which would have allowed testing the waters with all investors, not just QIBs or IAIs.

[34] Although this discussion refers to the "issuer," under the proposed rule an issuer or a person authorized to act on its behalf would be required to reasonably believe a potential investor is a qualified institutional buyer or institutional accredited investor. *See* proposed Rule 163B(b)(1).

$100 million in securities of unaffiliated issuers.[35] Banks and other specified financial institutions must also have a net worth of at least $25 million.[36] 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.[37] IAIs are any institutional investor that is also an accredited investor, as defined in paragraph (a) of Rule 501 of Regulation D. 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). The proposed limitation to these institutional investors is intended to ensure that test-the-waters communications are directed to investors that are financially sophisticated and therefore do not require the same level of protections of the Securities Act's registration process as other types of investors.

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 believe this standard would avoid imposing an undue burden on issuers compared to requiring issuers to verify investor status, as in 17 CFR 230.506(c) ("Rule 506(c)") of Regulation D. For example, under the proposed rule, an issuer could reasonably believe that a potential investor is a QIB or IAI even though the investor may have provided false information or documentation to the issuer. We do not believe an issuer should be subject to a violation of

[35] 17 CFR 230.144A(a)(1)(i).

[36] 17 CFR 230.144A(a)(1)(vi).

[37] 17 CFR 230.144A(a)(1)(ii).

Section 5 in such circumstances, so long as the issuer established a reasonable belief with respect to the potential investor's status based on the particular facts and circumstances.

We are not proposing 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.[38] Identifying specific steps or providing additional guidance that could be used by an issuer to establish a reasonable belief regarding an investor's status could create a risk that such steps or guidance would become a de facto minimum standard. Instead, we believe issuers should continue to rely on the methods they currently use to establish a reasonable belief regarding an investor's status as a QIB or accredited investor pursuant to Securities Act Rules 144A and 501(a), respectively. 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.

Request for Comment

11. Should issuers be required to establish a reasonable belief that the potential investors involved in proposed Rule 163B communications are QIBs and IAIs, as proposed? If

[38] 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.

not, what would be the appropriate standard? Are existing guidance and practice sufficient for issuers to be able to establish a reasonable belief with respect to QIB and IAI status? Should the proposed rule provide a non-exclusive list of methods that could be used to establish a reasonable belief as to whether an investor is a QIB or IAI? Why or why not?

12. Should the proposed exemption limit communications to QIBs and IAIs, as proposed? Why or why not? If not, what different types of investors should issuers be permitted to communicate with? Alternatively, should there be no restrictions on the types of investors that issuers could communicate with under this rule? Why or why not? If there are no restrictions on the types of investors that issuers could communicate with, should the rules impose any filing or legending requirements for the communications? Why or why not?

D. Non-exclusivity of the Proposed Rule

The proposed rule would be non-exclusive. Attempted compliance with proposed Rule 163B would not act as an exclusive election and an issuer could rely on other Securities Act communications rules or exemptions when determining how, when, and what to communicate related to a contemplated securities offering. An issuer would not be precluded, for instance, from relying on the proposed rule and Securities Act Section 5(d), Securities Act Rules 163, or 17 CFR 230.164 ("Rule 164"), or Rule 255 of Regulation A. The following table summarizes some of the existing provisions that issuers may rely on in addition to, or in lieu of, the proposed rule:

Provision	Summary

Section 5(d)	• Allows EGCs and those acting on their behalf to test the waters with QIBs and IAIs before and after filing a registration statement to gauge their interest in a contemplated registered offering.
Rule 163	• Allows WKSIs to make oral and written offers before a registration statement is filed, subject to certain conditions. • Does not restrict communications to any particular group of potential investors. • The communications may be made by or on behalf of the WKSI, but may not be made on behalf of the WKSI by an offering participant who is an underwriter or dealer.[39] • Not available for communications related to business combination transactions or communications by registered investment companies or BDCs.[40] • Written communications are subject to certain legending requirements and a requirement to file such communications promptly upon the filing of a registration statement.[41]
Rule 164	• Allows certain issuers to use free writing prospectuses ("FWPs") after filing a registration statement, on the condition that such FWPs are accompanied by legends and are publicly filed.[42] • Ineligible issuers, as defined in Rule 405 cannot rely on Rule 164 except where the FWPs of such ineligible issuers, other than penny stock, blank check, and shell companies (other than business combination-related shell companies), solely contain a description of the terms of the securities being offered and the offering. • Registered investment companies and BDCs also currently cannot rely on Rule 164 to use FWPs.[43]
Rule 255	• Permits issuers to engage in solicitations of interest in Regulation A offerings before and after filing a Form 1-A, so

[39] *See* Rule 163(c).

[40] While registered investment companies and BDCs cannot currently rely on Rule 163, Congress has directed the Commission to extend the securities offering rules that are available to other issuers required to file reports under Section 13(a) or Section 15(d) of the Exchange Act (which include Rule 163) to BDCs and certain registered closed-end investment companies. *See infra* note 53 and accompanying text.

[41] *See* Rule 163(b).

[42] *See* Rule 164(b) and Rule 433(d).

[43] *See infra* note 53 and accompanying text.

	long as the solicitation materials meet certain conditions, such as including legends or disclaimers and filing requirements.[44]

While an issuer contemplating a registered securities offering may solicit interest from QIBs and IAIs without legending or filing those materials in compliance with new Rule 163B, if the same issuer decides to claim the availability of another exemption or communication rule with respect to those communications, the conditions of the other exemption or rule relied upon must be satisfied.

For instance, a WKSI may intend to solicit interest from QIBs under the new rule and, in compliance with the rule, omit any legending. If the issuer decides later during the offering process to expand pre-filing solicitations of interest to include potential investors not within the scope of Rule 163B, for example accredited investors that are natural persons, the issuer may instead be able to claim an exemption under Rule 163. To avail itself of that exemption, the issuer must have complied with Rule 163's legending requirements from the start of any communications with non-QIBs or non-IAIs, and would have to file the legended materials if a registration statement is filed. Similarly, if an issuer engaged in test-the-waters communications with institutional investors to determine whether to pursue either a registered securities offering or an offering under Regulation A, the issuer must comply with the legending and filing requirements of Securities Act Rule 255 until such time that it determines not to pursue the Regulation A offering.[45]

[44] *See* 17 CFR 230.255(b).

[45] Test-the-waters communications under Regulation A must state that: (i) no money is being solicited or will be accepted, if sent in response; (ii) no sales will be made or commitment to purchase accepted until delivery of an offering circular that includes complete information about the issuer and the offering; and (iii) a prospective purchaser's indication of interest is non-binding. *See* Securities Act Rule 255.

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13. Should the proposed rule be non-exclusive, as proposed? Why or why not?

14. How would the proposed rule affect reliance on Section 5(d), Rule 163, Rule 164, or Rule 255, if at all? In light of the proposed rule, are there changes that we should consider making to those rules?

15. Are there other rules not addressed above that we should consider that could affect or be affected by the proposed rule? If so, how should we address the interaction between such other rules and the proposed rule?

E. Considerations for Use by Investment Companies

Issuers that are, or are considering becoming, registered investment companies or BDCs (together, "funds") would be eligible to engage in test-the-waters communications under the proposed rule. Funds and their advisers may have an interest in engaging in test-the-waters communications to help assess market demand for a fund—for example, for a particular investment strategy or fee structure—before incurring the full costs of a registered offering. Thus, we believe it would be appropriate to allow funds to rely on the proposed rule. However, as discussed below, funds' use of test-the-waters communications under the proposed rule, and the associated benefits, may be more limited than for other issuers in practice, particularly with respect to pre-filing communications.

Fund communications contemplated by proposed Rule 163B generally would be considered "sales literature" and are currently subject to their own rules under the Securities

Act and Investment Company Act.[46] Under the current framework, compliance with these rules is generally necessary for certain communications not to be deemed an offer that otherwise could be a non-conforming prospectus whose use may violate Section 5 of the Securities Act.[47] For example, after a fund has filed a registration statement, it may engage in communications that are advertisements under Rule 482 under the Securities Act,[48] or that are deemed to be sales literature under Rule 34b-1 under the Investment Company Act.[49] Communications under Rule 482 and Rule 34b-1 are also subject to certain filing,[50] disclosure,[51] and legending requirements.[52] In addition, Congress has directed the Commission to extend the securities offering rules that are available to other issuers required to file reports under Section 13(a) or Section 15(d) of the Exchange Act (which include certain communications rules) to BDCs and certain registered closed-end investment

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

[47] However, BDCs that are EGCs can currently engage in the communications that proposed Rule 163B contemplates pursuant to Securities Act Section 5(d). *See* 15 U.S.C. 77e(d).

[48] Rule 482 establishes requirements for advertisements or other sales materials with respect to the securities of registered investment companies and BDCs. The rule does not apply to certain specified communications, including advertisements excepted from the definition of prospectus under section 2(a)(10) of the Securities Act.

[49] Rule 34b-1 provides that any advertisement, pamphlet, circular, form letter, or other sales literature ("sales literature") addressed to or intended for distribution to prospective investors that is required to be filed with the Commission by Section 24(b) of the Investment Company Act will have omitted to state a fact necessary in order to make the statements made therein not materially misleading unless it includes certain specified information. *See infra* note 59 (discussing the scope of Section 24(b) of the Investment Company Act).

[50] *See* 17 CFR 230.482(h) under the Securities Act; Rule 497(i) under the Securities Act; Section 24(b) of the Investment Company Act [15 U.S.C. 80a-24(b)]; 17 CFR 270.24b-2 under the Investment Company Act; 17 CFR 270.24b-3 under the Investment Company Act.

[51] For example, Rule 482 and Rule 34b-1 restrict, among other things, the manner in which registered open-end funds present performance information. *See* 17 CFR 230.482(b)(3), (d), (e), and (g) under the Securities Act; 17 CFR 270.34b-1(b) under the Investment Company Act.

[52] *See, e.g.,* 17 CFR 230.482(b)(2) under the Securities Act; 17 CFR 230.482(b)(3)(i) under the Securities Act.

companies.[53] Under the proposal, funds could rely on proposed Rule 163B to engage in permissible test-the-waters communications without complying with these other communications rules.

Because funds are primarily investment vehicles (*i.e.*, they are formed to issue securities that provide investors with an interest in the pool of assets held by the fund), a fund typically conducts an exempt or registered offering within a relatively short period of time after it is organized in comparison to most other types of issuers. We understand that, as part of this process, funds typically register as investment companies[54] during a seeding period in which the fund's sponsor tests the fund's investment strategy and establishes a performance track record for marketing purposes.[55] Under the proposed rule, a fund could engage in test-the-waters communications with QIBs and IAIs during the seeding period without filing a Securities Act registration statement. However, if a fund is contemplating a registered offering at the time of its organization, we recognize it is common practice to simultaneously

[53] *See* Section 803(b) of Small Business Credit Availability Act, Pub. L. No. 115-121, title VII; Section 509(a) of Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115–174.

[54] Absent any available exemptions under Section 3 or Section 6 of the Investment Company Act, a fund is generally required to register as an investment company before offering its shares. *See* Section 7 of the Investment Company Act [15 U.S.C. 80a-7].

A fund that qualifies for the business development company exemption in Section 6(f) of the Investment Company Act is not required to register as an investment company and may rely on this exemption for a period of time before electing to be regulated as a BDC. *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 under 17 CFR 274.15 and 274.54 of the Investment Company Act.

[55] A fund may be able to qualify for one of the private fund exemptions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act during the seeding period. We understand, however, that, in practice, funds currently do not typically rely on these exemptions during the seeding period. Moreover, if a fund is planning to conduct a registered public offering, these exemptions generally would become unavailable if it 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").

file a registration statement under both the Investment Company Act and the Securities Act to take advantage of certain efficiencies.[56] If funds collectively continue to prefer to file a single registration statement under both Acts under these circumstances, funds may be less likely to use the proposed rule for pre-filing communications than other issuers.[57] In any event, however, funds that preliminarily engage in exempt offerings—including certain registered closed-end funds and BDCs—could rely on the proposed rule to engage in pre-filing communications if they are considering a subsequent registered offering.[58]

In addition, funds may benefit from test-the-waters communications after filing a Securities Act registration statement. Proposed Rule 163B would allow them to communicate with QIBs and IAIs about a contemplated offering without either being an EGC or 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. To promote consistent treatment of different types of issuers' test-the-waters communications under proposed Rule 163B and for similar policy reasons as explained above with respect to other issuers, we are proposing to exclude funds' test-the-waters communications conducted

[56] Registered investment companies generally are able to use the same Commission form, and provide much of the same information, to register under the Investment Company Act and to register a securities offering under the Securities Act. Simultaneously filing under both Acts allows a fund to make fewer filings with the Commission, which can reduce certain associated burdens.

[57] Since a BDC is not required to register under the Investment Company Act, it may to some extent be more likely to use the proposed rule to engage in pre-filing communication when it is contemplating a registered offering close in time to the fund's inception. *See supra* note 54.

[58] Registered open-end funds may be less likely to use the proposed rule because they typically offer their shares to retail investors in registered offerings.

under proposed Rule 163B from the filing requirements in Rule 497 under the Securities Act and in Section 24(b) of the Investment Company Act and the rules thereunder.[59]

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16. Would funds or persons acting on their behalf rely on the proposed rule in practice? If so, in what contexts would they use the proposed rule, and what would be the associated benefits? For example, would the proposed rule impact communications during the product development stage before a registration statement is filed? Why or why not? Are there ways we should modify the proposed rule with respect to fund issuers in recognition of differences between funds and corporate issuers (*e.g.*, differences in general investor bases)?
17. Would certain types of funds (such as BDCs and registered closed-end funds) be more likely to benefit from the proposed rule than other types of funds (such as open-end funds)? Should certain or all funds be excluded from the scope of the proposed rule? Why or why not?
18. Do BDCs that are EGCs currently engage in test-the-waters communications? If so, under what circumstances have test-the-waters communications been useful? If test-the-waters communications have not been useful to BDCs that are EGCs, why have

[59] Rule 497 requires investment companies to file every form of prospectus given to any person prior to the effective date of the registration statement that varies from the form of prospectus included in its registration statement. Section 24(b) of the Investment Company Act generally requires filing of any sales literature that a registered open-end company, registered unit investment trust, or registered face-amount certificate company, or an underwriter of any such fund, intends to distribute to prospective investors in connection with a public offering of the fund's securities. 15 U.S.C. 80a-24(b). The definition of "sales literature" could include communications under proposed Rule 163B. *See* Investment Company Act Release No. 89 (Mar. 13, 1941) [11 FR 10992 (Sept. 27, 1946)] ("So it may be said that every written communication used by the issuer or an underwriter with the intention of inducing or procuring, or of facilitating the inducement or procurement, of any sale of the securities of any of the companies enumerated in section 24(b) is within the purview of that section.").

they not been useful? Have these communications been limited due to any restrictions in the Investment Company Act or other legal requirements? If so, should we provide any exemptions from these requirements? Why or why not?

19. Are there legal or other restrictions that would impede the ability of fund sponsors, underwriters, or others to engage in test-the-waters communications under the proposed rule in connection with forming a new registered investment company or BDC? If so, how should we address such restrictions? For example, could Section 7 of the Investment Company Act restrict or limit the usefulness of test-the-waters communications in practice?[60] Should we provide an exemption from Section 7 of the Investment Company Act for test-the-waters communications conducted under the proposed rule, for some or all types of fund issuers? Why or why not?
20. Should we restrict the types of information that funds can provide under the proposed rule? For example, should we limit open-end fund performance information in test-the-waters communications, similar to Rule 482? Why or why not? Should we apply other requirements, such as filing, disclosure, or legending requirements, to funds' written test-the-waters communications?
21. Would a private fund that is considering converting to a registered investment company or BDC benefit from engaging in test-the-waters communications with QIBs and IAIs to inform this decision, or would the decision to convert be driven by communications with existing investors? If a private fund would have a use for test-the-waters communications, are there legal or other restrictions that would limit the

[60] *See supra* note 54.

ability of the private fund, or persons authorized to act on its behalf, to rely on the proposed rule? For example, would language in Section 3(c)(1) or 3(c)(7) of the Investment Company Act restricting public offerings have a potential chilling effect on otherwise permissible test-the-waters communications under the proposed rule?[61] If so, how should we address this issue?

22. To the extent that open-end funds would benefit from the ability to engage in pre- or post-filing test-the-waters communications with QIBs and IAIs, are there differences between series funds (*i.e.*, where a single registrant can create new funds by filing post-effective amendments to its registration statement)[62] and non-series funds that the rule should take into account?

III. Economic Analysis

A. Introduction and Broad Economic Considerations

We are mindful of the costs imposed by and the benefits obtained from our rules. Securities Act Section 2(b)[63] and Investment Company Act Section 2(c)[64] 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)

[61] *See supra* note 55.

[62] Many open-end funds are organized as single registrants with several series under Sections 18(f)(1) and (2) of the Investment Company Act and Rule 18f-2 thereunder. *See* 15 U.S.C. 80a-18(f)(1) and (2); 17 CFR 270.18f-2. A registrant may add a series—which is often treated as a separate fund under our rules and which has its own investment objective, policies, and restrictions—by filing a post-effective amendment to its registration statement. *See, e.g.,* 17 CFR 230.485 under the Securities Act.

[63] 15 U.S.C. 77b(b).

[64] 15 U.S.C. 80a-2(c).

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 raising capital through registered offerings, resulting in potential competitive impacts. The lower flexibility in raising capital through registered offerings may contribute to decreased willingness among non-EGCs to rely on registered offerings or impair their ability to raise capital through registered offerings at a lower cost. The proposed rule would expand the permissibility of test-the-waters communications to all issuers and potential issuers in contemplated registered securities offerings, regardless of whether such issuers qualify as EGCs.

Test-the-waters communications would 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[65] in a contemplated registered securities offering, these communications

[65] 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 public offerings, particularly for

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, including non-EGCs, the proposed rule would 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 would remain voluntary, we anticipate that the issuers most likely to engage in these communications would 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 proposed rule would be those that are seeking to better assess the demand for and valuation of their securities, as well as those that are seeking more information from potential investors regarding the attractiveness of various terms or structural elements of the offering.[66] This could in turn enhance the ability of issuers to conduct successful offerings and potentially lower their cost of capital.

By reducing the potential costs and risks associated with conducting a registered securities offering, the proposed rule might make registered securities offerings more attractive to certain issuers, particularly non-EGC issuers, that otherwise would have relied on private placements or not pursued a securities offering.[67] The resulting potential increases

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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.

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

[67] For instance, one study found a significant increase in IPO activity, particularly among pharmaceutical and biotechnology companies, in the two years after the JOBS Act enactment ("[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"). *See* Michael Dambra, Laura Field, & Matthew Gustafson, The JOBS Act and IPO Volume: *Evidence That*

in the number of registered offerings and reporting companies may improve capital formation and efficiency of allocation of investor capital. However, because some of the issuers undertaking registered offerings as a result of proposed Rule 163B might have otherwise raised capital in private markets, the net impact on total capital formation is difficult to assess.

The proposed rule also might provide information to some potential investors about a broader range of potential future offerings at an earlier stage, before a registration statement is publicly filed, which might on the margin enable such investors to formulate a more informed investment strategy. However, the proposed rule might have adverse effects on such investors if the test-the-waters communications contain incomplete or misleading information and if solicited investors improperly rely on such communications rather than on the filed offering materials when making investment decisions. We expect such potential adverse effects on investors to be mitigated by several factors, including the general applicability of anti-fraud provisions of the federal securities laws and liability under Section

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Disclosure Costs Affect the IPO Decision, 116 J. Fin. Econ. 121, 121-143 (2015) ("DFG Study"), at 121. 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 ("[i]n practice, issuers usually combine TTW with a second de-risking provision, allowing EGCs to file their IPO draft registration statement confidentially.") and Congressional Research Service (2018) Capital Markets, Securities Offerings, and Related Policy Issues (July 26, 2018), https://crsreports.congress.gov/product/pdf/R/R45221 ("CRS Report"), at 18.

We also note 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 89-91.

12(a)(2),[68] as well as the limitation of permissible test-the-waters communications under the proposed rule to QIBs and IAIs, which generally have a sophisticated ability to process investment information.

By extending to all issuers the flexibility to test the waters currently available only to EGCs, the proposed rule also would eliminate the competitive disadvantage of those non-EGC issuers that might find test-the-waters communications to be of value to their capital raising efforts. This competitive disadvantage 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 proposed 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 EGCs.

Potential users of the proposed rule include, for example, issuers contemplating an IPO as well as reporting issuers that are interested in conducting follow-on and other registered offerings. Regulation FD may limit use of the proposed rule by some issuers in the second group. As discussed in Section II.A above, issuers subject to Regulation FD that selectively disclose material nonpublic information regarding the issuer to specified parties are required to disclose such information publicly. Accordingly, reporting issuers that selectively disclose material nonpublic information to QIBs and IAIs in reliance on the proposed rule may be required to disclose publicly certain test-the-waters communications notwithstanding the fact that the proposed rule would not require such disclosure. This may

[68] *See supra* note 24.

reduce reliance on proposed Rule 163B. However, some issuers that would be able to rely on proposed Rule 163B are not subject to Regulation FD[69] or may avail themselves of an exception under Regulation FD, such as the exception involving confidentiality agreements.[70]

Where possible, we have attempted to quantify the economic effects of the proposed rule. However, in some cases we are unable to do so. For example, it is difficult to quantify the extent to which issuers would elect to test the waters in connection with a contemplated registered securities offering under the proposed rule; the extent to which the option to engage in test-the-waters communications would affect the willingness of potential issuers newly eligible for testing the waters under the proposed rule to undertake 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 proposed 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 by the differences between EGC and non-EGC issuers (including non-

[69] *See supra* note 28 and accompanying text.

[70] *See supra* notes 29-30 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.

EGC issuers that are investment companies) and the offerings they undertake;[71] the voluntary nature of reliance on Section 5(d) among EGC issuers;[72] the potential confounding effects resulting from reliance on other JOBS Act provisions by EGC issuers simultaneously with reliance on test-the-waters accommodations; and the generally favorable market conditions observed in the post-JOBS Act period.[73] Moreover, while the flexibility not to pursue a registered offering after gauging investor interest can be valuable to issuers, we do not have information on issuers that test the waters under the existing rules but subsequently do not proceed with a registered offering.

Below we discuss the potential effects of the proposed 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 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

[71] *See infra* notes 89–91.

[72] *See infra* note 82.

[73] *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.").

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. Under the current rules, only issuers that qualify for EGC status can rely on a test-the-waters provision in advance of a contemplated registered offering.[74] Registered investment companies are ineligible for EGC status.[75] 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.[76] Some studies have estimated the incidence of test-the-waters communications by IPO issuers based on issuer responses to

[74] *See supra* note 3.

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

[76] 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.

staff comment letters associated with IPO registration statement filings.[77] Using this method, recent industry studies found that in 2015 and 2016, respectively, 38% and 23% of EGC IPOs referenced testing the waters in comment letter responses.[78] Based on the analysis of comment letter responses, staff has estimated that approximately 35% of EGC IPOs during 2012-2017 have used the test-the-waters provision.[79] 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, based on an analysis of underwriting agreements filed as exhibits to registration statements, that approximately 71% of EGC IPOs authorized underwriters to test the waters.[80] Another academic study found that approximately 68% 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.[81] Because underwriting agreement data does not indicate whether the underwriter actually engaged in test-the-waters communications, those estimates are considerably higher than the estimates based solely on staff comment letters.

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[77] Because only some issuers in follow-on offerings receive staff comment letters, this estimate only applies to IPOs. We note that estimates based on staff comment letters will likely not account for oral test-the-waters communications not involving written materials.

[78] *See supra* note 9. The studies covered a subset of EGC IPOs.

[79] 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 are retrieved from Intelligize and manually classified. Missing or ambiguous responses are supplemented with staff analysis of cover letters submitted by issuers in response to staff reviews of registration statements, where available.

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

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

Because estimates based on staff comment letters reference actual use of test-the-waters materials, we believe they are more relevant for the purposes of this baseline analysis.

The practice of testing the waters is voluntary. Today it is used by those EGCs that may be most likely to benefit from it, for example, because of a high level of uncertainty about potential investor demand for their securities offering.[82] 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.[83]

2. Affected Parties

We anticipate that the proposed rule would affect issuers, investors, and intermediaries.

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[82] 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 9.

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 (for example, stating 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.

[83] *Id*.

i. Issuers

The proposed rule would affect current and potential issuers in contemplated registered securities offerings. While the proposed rule would be available to all issuers, including EGCs, it would particularly affect non-EGC issuers that are not allowed to test the waters under Section 5(d). EGC issuers would remain eligible to rely on Section 5(d). To the extent that EGC issuers would rely on the proposed rule, the proposed rule would affect such EGC issuers. The proposed rule also would indirectly affect any issuers that do not rely on the proposed rule to the extent that they compete with issuers that rely on the proposed rule for investor capital or in the product market.

We estimate that there were approximately 2,096 EGCs and 8,942 non-EGCs that filed Securities Act registration statements or periodic reports during 2017,[84] excluding ABS issuers and registered investment companies. We estimate that in 2017 there were approximately 1,672 ABS issuers[85] and approximately 12,620 registered investment companies,[86] which were ineligible for EGC status.[87] While EGCs made up a minority of all

[84] 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 2017, as well as any BDCs included in the SEC's September 2017 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 2017 based on Ives Group's Audit Analytics data. We include filers of periodic reports because the proposed rule is available to seasoned issuers that have already become reporting companies.

[85] The estimate is based on the number of unique CIKs with ABS-related filings during calendar year 2017 (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.

[86] We estimate that there are 9,360 mutual funds, 1,821 exchange-traded funds (1,829 ETFs less 8 UIT ETFs), 711 closed-end funds, 5 variable annuity separate accounts registered as management investment companies on Form N-3 (covering 14 investment options), and 724 UITs (predominantly variable annuity separate accounts registered as UITs on Form N-4 and Form N-6). *See* Release No. 33-10506 (Jun. 5, 2018) [83 FR 29158], at

filers with registration statements declared effective, they accounted for a majority of new issuers in traditional IPOs.[88]

The proposed 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, it is important to recognize that there are considerable differences between an average EGC and an average 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.[89] Further, non-EGC issuers include older companies that first issued common equity pursuant to a Securities Act registration statement before December 8, 2011[90] or that

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29184, fn. 342 and accompanying text and Release No. 33-10569 (Oct. 30, 2018) [83 FR 61730], at 61733, fn. 23. This estimate is not limited to registered investment companies that filed annual reports.

[87] *See* Jumpstart Our Business Startups Act Frequently Asked Questions: Generally Applicable Questions on Title I of the JOBS Act, https://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm ("JOBS Act Title I FAQs").

[88] Based on Ives Group's Audit Analytics data, during calendar year 2017, EGC issuers accounted for approximately 187 out of 212, or approximately 88%, of priced exchange-listed IPOs (excluding deals identified as mergers, spin-offs, or fund offerings). During the period from April 5, 2012 through December 31, 2017, EGC issuers accounted for approximately 1,018 out of 1,183, or approximately 86% of such IPOs.

[89] For example, one study comparing a subset of exchange-listed EGC IPOs to exchange-listed non-EGC IPO controls 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).

[90] 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.

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.[91]

ii. Investors

The proposed rule would affect current and potential 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 investors.

We lack information necessary to estimate the number of QIBs and IAIs that would be solicited in connection with registered offerings under the proposed 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 proposed rule because disclosure of investor status across all such investors is not required and because we lack comprehensive data that would cover all categories of potential QIBs and IAIs.

[91] *See id*.

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 2017, 6,111 unique filers filed Form 13F on behalf of 6,580 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),[92] 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 and because, 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 would allow us to estimate the unique number of investors across all categories of IAIs under Rule 501.[93]

In addition to QIBs and IAIs, other investors may be indirectly affected by the proposed rule, as discussed in Section III.C below. For example, the proposed 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 would benefit

[92] 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.

[93] 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.

existing investors in these issuers. Furthermore, the proposed 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 benefits. 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).[94]

iii. Intermediaries

Similar to Section 5(d), proposed Rule 163B would 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.[95] Thus, the proposed rule would potentially affect such underwriters or other third parties engaged in a similar role.

We estimate that there were approximately 958 registered broker-dealers that reported being underwriters or selling group participants for corporate securities in 2018.[96] 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 280

[94] *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. The proposed test-the-waters provision could be used irrespective of security type, so the overall set of potentially indirectly affected investors is likely to be larger.

[95] *See supra* notes 80-81 and accompanying text.

[96] This estimate is based on Form BD filings as of October 2018.

registered broker-dealers reported being mutual fund underwriters or sponsors in 2018 (of which approximately a quarter also reported being underwriters for corporate securities).[97] 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 1,831 investment advisers to registered investment companies and approximately 109 investment advisers to BDCs.[98] We do not have data to predict how many of these fund intermediaries would 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 proposed rule.

C. Anticipated Economic Effects

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

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 the capital raising strategy for issuers considering a registered securities offering.[99] While EGC issuers would also be permitted to rely on proposed Rule 163B, non-EGC issuers are expected to be most affected by the proposed rule because they cannot rely on Section 5(d).

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[97] *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.

[98] This estimate is based on Form ADV filings as of October 2018.

[99] *See, e.g.,* Treasury Report, 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.

1. Potential Benefits to Issuers

Expanding the availability of test-the-waters communications could improve the likelihood of successfully raising capital in a registered offering and enable a more efficient and potentially lower-cost capital raising process. Specifically, testing the waters could help issuers 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 other terms included in the initial filing more closely to market interest.

We expect the greatest benefit of testing the waters to be realized by issuers that solicit investors before 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 public filing may also benefit some issuers.[100] Specifically, the option to test the waters can benefit the issuers affected by the proposed rule in several ways:

- 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

[100] In the context of Regulation A, the Commission determined that issuers may benefit from broad flexibility to test the waters both before and after 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 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* Regulation A Adopting Release, at 21882.

filing decreases the risk of public disclosure of sensitive or proprietary information about the issuer to competitors (to the extent that the communications are not subject to Regulation FD).[101]

- 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.
- Testing the waters, particularly before the registration statement filing, can help issuers gauge investor demand for purposes of determining offering size and other

[101] Several factors may serve to limit this benefit for some issuers. First, communications under the proposed rule could be subject to Regulation FD. *See supra* note 28.

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.

terms, potentially resulting in a more efficient offering process and a higher likelihood of selling the offered amount more quickly.[102]

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 would especially benefit issuers with high proprietary disclosure costs."[103] 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."[104]

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 would be limited because communications are only permitted with QIBs and IAIs and 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 market a potential future offering. However, as discussed in greater detail in Section III.C.5 below, such benefits may be limited for most funds. To the extent that the proposed rule facilitates the registered offering process and potentially lowers its costs and risks for some

[102] It is difficult to assess the extent to which test-the-waters communications after the initial filing incrementally would 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. We expect that issuers that find test-the-waters communications to be most beneficial would elect to undertake such communications.

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

[104] *See* DFG Study, at 124.

issuers, the availability of testing the waters might facilitate capital formation through registered securities offerings, particularly for non-EGC issuers that are ineligible for test-the-waters provisions of Section 5(d). In evaluating the potential benefits of expanded test-the-waters communications under the proposed rule for capital formation, we acknowledge that the issuers affected by the proposed rule already have the flexibility to solicit the same 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 proposed rule might enable issuers to adopt the most efficient and lowest-cost capital raising strategy.

To the extent that the proposed rule encourages additional issuers to conduct a registered securities offering, issuers may benefit from greater 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 proposed rule also may benefit from the greater ease of raising follow-on financing through future registered offerings.

2. Potential Costs to Issuers

Issuers that elect to test the waters under the proposed rule might incur costs, including the cost of identifying QIBs and IAIs; holding events with QIBs and IAIs 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.[105] Further, communications made pursuant to the proposed rule may be subject to Regulation FD. Because the use of test-the-waters communications would remain voluntary under the proposed rule, we anticipate that issuers would elect to rely on test-the-waters communications only if the benefits anticipated by issuers outweigh the expected costs to issuers.

3. Potential Benefits to Investors

To the extent that the proposed rule encourages additional issuers to conduct a registered securities offering, a broader set of investors might more efficiently allocate capital among issued securities. These efficiency benefits are more likely to accrue to non-accredited investors, which are more limited in their ability to invest in securities issued 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 proposed 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 would not be restricted and such securities are more likely to have a secondary market). Investors also would benefit from the availability of disclosure and market information about registered securities (resulting in more informationally efficient prices and potentially better informed investment decisions). By increasing shareholder value of affected issuers through cost

[105] In addition, 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. *See Revisions of Limited Offering Exemptions in Regulation D,* Release No. 33-8828 (Aug. 3, 2007) [72 FR 45116 (Aug. 10, 2007)].

savings and improved ability to raise external financing, the proposed rule also could benefit existing shareholders of affected issuers.

Test-the-waters communications might offer some prospective investors the potential benefit of additional time to evaluate, understand, and ask questions about potential investment opportunities before the public filing of a registration statement. To the extent that such communications might provide solicited QIBs and IAIs with valuable early information about potential investment opportunities, these communications might enhance the ability of solicited QIBs and IAIs to assess the quality of future investment opportunities, and in some instances, potentially facilitate better informed future investment decisions and efficient allocation of capital. In the context of the proposed rule, such potential informational advantages would be limited by several factors. First, because 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, the incremental value of the information conveyed to solicited investors through test-the-waters communications might be small. Second, to the extent that potential issuers newly eligible for testing the waters under the proposed rule would have otherwise provided similar information to QIBs and IAIs in the course of seeking private financing, such potential informational benefits could be reduced. Third, potential informational benefits to solicited investors likely would be smaller for issuers in follow-on offerings (to the extent that issuers have provided disclosures in an IPO registration statement and subsequent Exchange Act reports). Further, communications made pursuant to the proposed rule may be subject to Regulation FD. Finally, even if solicited investors view the potential offering as an attractive investment opportunity on the basis of

test-the-waters communications, there is no assurance that an issuer will proceed with an offering, and no investors can invest in the offering until a registration statement has been declared effective.

4. Potential Costs to Investors

If issuers with a traded class of securities test the waters in conjunction with a potential follow-on offering, solicited investors might potentially use the resulting information advantage to realize trading profits at a cost to investors that were not solicited. 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 III.A above.

Selective solicitation of QIBs and IAIs may result in some institutional investors having a relatively greater influence on the offering process and terms, which might potentially place investors that are not solicited at a relative competitive disadvantage. This incremental effect of test-the-waters communications may be less likely to the extent that test-the-waters communications do not involve a mechanism for a credible commitment of capital. Thus, any expressions of interest are likely to be preliminary in nature. Further, similar differences in investor influence might emerge in the course of the book building process in the absence of test-the-waters communications, or in the course of a private placement if the issuer chooses to forgo a registered offering.

The proposed expansion of permissible test-the-waters communications also might result in costs to solicited investors, including potentially less-informed decisions or less efficient capital allocation, if test-the-waters communications contain incomplete or misleading information and if solicited investors improperly rely on test-the-waters communications, and not on the filed offering materials, in their investment decisions.

We expect that any such potential adverse effects on solicited investors might be mitigated by the following factors:

- The issuer would 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 QIB or IAI would 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.
- Test-the-waters communications would be permitted only with QIBs and IAIs. Although the level of investor sophistication may vary across such investors (for example, it may be relatively higher for the larger QIBs and IAIs, which are likely to have more investment and due diligence expertise than the relatively smaller QIBs and IAIs), 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.

- Because test-the-waters communications represent an offer of securities, although they would not be subject to liability under Section 11 of the Securities Act, they would 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.[106] In addition, the associated risk of private securities litigation may further reduce incentives to engage in misleading test-the-waters communications.
- If an issuer proceeds with an offering, written test-the-waters materials generally may be subject to staff review.[107]
- Reputational concerns of underwriters and/or issuers that may expect to participate in future offerings with the same institutional investors on future deals may reduce the incentives to engage in misleading test-the-waters communications with these investors.
- 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.

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

[107] Based on a review of staff comment letters issued in connection with IPO registration statements of EGCs during 2012-2017 identified through Intelligize data, comment letters commonly request issuers to submit to the staff for review any written test-the-waters communications in reliance on Section 5(d). *See also supra* Section II.A.

- The proposed rule might be less likely to be relied upon by micro-cap firms, which are linked to a higher risk of such fraud, because institutions tend to have smaller stakes in such issuers.[108]

In evaluating any potential adverse effects of the risk of incomplete or misleading test-the-waters communications under the proposed 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. 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 proposed 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 would be expected to increase.

5. Variation in Economic Impact Due to Issuer Characteristics

The described economic effects of the proposed rule are expected to vary as a function of issuer and offering characteristics and investors' ability to process information.

[108] 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.

The incremental benefits of the proposed rule are expected to be smaller for large[109] 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 follow-on offerings with an established track record of capital raising. Issuers whose communications with investors may be subject to Regulation FD are less likely to benefit from the proposed rule.[110] In addition, issuers with low costs of proprietary disclosure (*e.g.*, low R&D intensity and limited reliance on proprietary technology) may be less likely to benefit from the proposed 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 non-accredited institutional investors, including many registered investment companies,[111] might realize relatively smaller benefits from the proposed rule, which only allow test-the-waters communications with QIBs and IAIs. Further, issuers relying upon other rules that permit offering-related communications may be less likely to benefit from the proposed rule.[112]

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[109] 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 with QIBs and IAIs. *See supra* note 9.

[110] *See supra* note 27.

[111] *See infra* note 116.

[112] *See supra* Section II.D. For example, WKSIs may elect to rely on Rule 163. We estimate that there were approximately 3,786 WKSIs that filed Securities Act registration statements or Exchange Act periodic reports in 2017, based on the analysis of filings of automatic shelf registration statements and XBRL data in periodic reports during calendar year 2017. *See also supra* note 53 and accompanying text.

In contrast, other types of issuers might realize relatively greater benefits from expanded testing the waters under the proposed rule. Because proposed Rule 163B mitigates the risk of competitors learning potentially valuable proprietary information about the issuer's financing needs, business, products, and R&D, it is expected to particularly benefit issuers with high costs of proprietary disclosure (*e.g.*, issuers in R&D-intensive industries, such as life sciences and technology). In addition, issuers not subject to Regulation FD are more likely to benefit from the proposed rule.[113] 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 proposed 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, in particular, IPO issuers, small and development-stage issuers with limited operating history and high information asymmetries, and issuers of securities with high information sensitivity (*e.g.*, equity, convertible debt, speculative-grade straight debt) and 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, 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

[113] *See supra* note 28.

offering might be relatively higher.[114] All else equal, issuers that predominantly market their offerings to institutional investors are expected to realize relatively greater benefits from the expansion of test-the-waters communications with QIBs and IAIs.[115]

The proposed rule would 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 proposed 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 would likely be limited for funds.[116] Further, as discussed in Section II.E above, with respect to registered investment companies, a fund typically would register as an investment company and conduct an exempt or registered

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[114] In the 1995 Proposal, the Commission excluded blank check and penny stock issuers "because of the substantial abuses that have arisen in such offerings." See 1995 Proposing Release. However, the 1995 Proposal did not impose restrictions on investors to whom test-the-waters communications may be directed. In contrast, the proposed rule is limited to QIBs and IAIs, which are expected to have a high level of sophistication in processing investment information.

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

[116] The vast majority (89%) of mutual fund shares are estimated to be held through retail accounts. The mean institutional holding is estimated to be approximately 45% for exchange-traded funds and 21% for registered closed-end funds. *See Covered Investment Fund Research Reports,* Release No. 33-10580 (Nov. 30, 2018) [83 FR 64180, 64199 (Dec. 13, 2018)]. Therefore, among registered investment companies, mutual funds may be least likely to rely on the proposed 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 30%, so the benefits of the proposed rule may be similarly limited for some BDCs. *See id.*

offering within a relatively short period of time after it is organized. 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 efficiencies. To the extent that investment companies required to register under the Investment Company Act continue this practice of simultaneously filing registration statements under the Securities Act and the Investment Company Act, such funds would be less likely to benefit from the option to undertake test-the-waters communications prior to a public registration filing.[117] Since a BDC is not required to register under the Investment Company Act, it may to some extent be more likely to benefit from the proposed rule with respect to pre-filing communications.

Some funds that preliminarily engage in exempt offerings, including certain registered closed-end funds and BDCs, could rely on the proposed rule to engage in pre-filing communications if they are considering a subsequent registered offering. In addition, funds could realize benefits from relying on proposed Rule 163B for post-filing communications. The proposed rule would 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

[117] 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.

greater flexibility for funds seeking to engage in post-filing communications with QIBs and IAIs.

6. Variation in Economic Impact Due to Investor Characteristics

The composition of QIBs and IAIs solicited in conjunction with an issuer's planned offering also might affect the economic impact of the proposed 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 proposed rule, those QIBs and IAIs that mainly invest in the securities of such issuers may be less affected by the proposed rule.

As a general consideration, the provisions of proposed 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.

If adopted, the rule would require that the solicited investor is, or that the issuer reasonably believes the investor to be, a QIB or IAI. The reasonable belief provision is

expected to reduce the risk for issuers of inadvertently violating the conditions of testing the waters while maintaining a low likelihood that less sophisticated investors are solicited. Proposed Rule 163B does not specify steps that an issuer could or must take to establish a reasonable belief regarding investor QIB or IAI status or otherwise require the issuer to verify investor status, as in Rule 506(c) of Regulation D. This is expected to benefit issuers by allowing issuers 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. To the extent that the reasonable belief provision as proposed results in some investors that are not QIBs or IAIs being solicited, less sophisticated investors may be solicited, which may result in less informed investment decisions by some of those investors. These effects are expected to be partly mitigated by the factors discussed in Section III.C.4 above.

D. Reasonable Alternatives

We evaluate reasonable alternatives to the proposed rule and their anticipated economic effects below. The proposed rule would provide the option to engage in test-the-waters communications to all issuers. The conditions of proposed Rule 163B would be generally similar to the requirements presently applicable to EGC issuers under Section 5(d). As an alternative, we could apply different requirements to test-the-waters communications under proposed Rule 163B. Compared to the proposed rule, applying less extensive (more extensive) requirements to test-the-waters communications under the proposed 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 proposed rule. Further, compared

to the proposed rule, applying more extensive requirements to test-the-waters communications under proposed Rule 163B could place non-EGC issuers at a relative competitive disadvantage to EGC issuers, which would remain eligible to test the waters under Section 5(d). The effects specific to individual reasonable alternatives are discussed in greater detail below.

If adopted, the rule would permit all issuers to test the waters. As an alternative, the proposed rule could exclude certain categories of issuers,[118] such as blank check issuers,[119] penny stock issuers,[120] ABS issuers,[121] or all or some registered investment companies.[122] If some solicited investors make less informed decisions as a result of test-the-waters communications by these categories of issuers, the alternative of excluding these categories of issuers might potentially result in more efficient investor decisions compared to the proposed rule. However, because solicited investors can review the registration statement in

[118] In the 1995 Proposal, 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 Proposal would have allowed testing the waters with all investors, not just QIBs or 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.

[119] Approximately 213 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 2017, were estimated to be blank check issuers based on Ives Group's Audit Analytics and OTC Markets data as of the end of 2017 and XBRL data in filings made during calendar year 2017. Based on Ives Group's Audit Analytics data as of the end of 2017, among those, approximately 80% were EGCs. Blank check issuer status was determined based on having SIC code 6770.

[120] Approximately 1,418 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 2017 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 the end of 2017. Based on Ives Group's Audit Analytics data as of the end of 2017, among those, approximately 38% were EGCs.

[121] *See supra* note 85.

[122] *See supra* note 86 and *supra* Section II.E.

addition to any test-the-waters communications prior to investing and because QIBs and IAIs generally have a high level of sophistication in processing information, as well as in light of the other considerations discussed in Section III.C.4 above, this concern is likely to have a minor impact, if any. To the extent that these categories of issuers would have elected to test the waters under the proposed rule, this alternative would not allow such issuers to realize the benefits of the proposed rule (*e.g.*, potentially more efficient and lower cost of capital raising), particularly non-EGC issuers ineligible under Section 5(d). To the extent that some of these issuers may be less likely to rely on proposed Rule 163B as discussed in Section III.C.5 above, the effects of excluding them from proposed Rule 163B would be more limited.

Similar to Section 5(d), the proposed rule would permit solicitation of investor interest both before and after the filing of a registration statement. As an alternative, the proposed rule could permit issuers to test the waters only before or only after the public filing of the registration statement. Compared to the proposed 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).[123]

Similar to Section 5(d), the proposed rule would not require issuers to publicly file test-the-waters communications, nor would it require the use of legends. As an alternative, the proposed rule could require issuers to include certain legends or to file test-the-waters communications with the registration statement. Compared to the proposed rule, the

[123] *See* also *supra* note 100 and accompanying text.

alternative of requiring legends on test-the-waters communications under the proposed 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 proposed rule. Compared to the proposed 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 proposed Rule 163B (including the direct cost of filing additional exhibits and, in instances where test-the-waters materials contain proprietary information, the disclosure of which could cause competitive harm, 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 decrease the benefits for the level, efficiency, and cost of capital raising for affected issuers, particularly non-EGC issuers ineligible under Section 5(d). Compared to the proposed 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 expected to be limited by the factors discussed in Section III.C.4 above, including the ability of investors to review the information in the registration statement before investing; the general 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 proposed rule, filing test-the-waters materials with the registration statement under this alternative

could offer informational benefits to investors that have not been solicited. However, such benefits, compared to the proposed 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, under this alternative. Further, in certain circumstances, communications under the proposed rule may be subject to Regulation FD, as discussed in Section III.A above.

Similar to Section 5(d), if adopted, the rule would permit issuers to test the waters only with QIBs and IAIs. As an alternative, the proposed rule could permit issuers to test the waters with all investors.[124] This alternative might benefit issuers, particularly issuers whose offerings attract investors that are neither QIBs nor 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, by exposing individual and small institutional investors to pre-offering information that is not required to be publicly filed and is not subject to Section 11 liability, this alternative might decrease investor protection to the extent that some of the solicited individual and small institutional investors might be susceptible to misleading test-the-waters communications. This concern is expected to be partly mitigated by the ability of all investors to review the filed registration statement, in addition to any test-the-waters communications, prior to investing, as well as

[124] Rule 164 under the Securities Act permits 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 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.

other factors discussed in Section III.C.4 above. However, to the extent that individual and small institutional investors are less sophisticated than QIBs and IAIs and may fail to review the information in the registration statement, this alternative may result in less informed investment decisions by such investors.

Similar to Section 5(d), the rule, if adopted, would 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). 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 proposed rule from engaging in other communications under the existing rules. Compared to the proposed rule, this alternative would restrict the ability of issuers to tailor their solicitation strategy to 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. 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 proposed rule does not limit the scope of the content 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 proposed rule. For instance, we could limit how open-end funds, or all registered investment companies, present performance information in test-the-waters communications. Limiting the scope of test-the-waters communications may strengthen investor protection compared to the proposed rule, by lowering the potential for incomplete or misleading information to be included in such materials. However, these benefits to investors may be small given the mitigating factors analyzed in Section III.C.4. Such restrictions also may reduce the utility of test-the-waters communications to issuers and the associated benefits for capital formation, compared to the proposed rule.

Proposed Rule 163B contains a reasonable belief provision 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 determine that the investor is a QIB or IAI or specify steps that an issuer could or must take to establish a reasonable belief. Compared to the proposed rule, these alternatives might result in a lower risk of solicitation of investors that are neither QIBs nor IAIs. However, they also might significantly increase costs for issuers electing to rely on the proposed 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 proposed rule.

E. Request for Comment

We request comment on all aspects of our economic analysis, including the potential costs and benefits of the proposed rule and alternatives to it, and whether the proposed rule, if adopted, would promote efficiency, competition, and capital formation or have an impact on investor protection. Commenters are requested to provide empirical data, estimation methodologies, and other factual support for their views, in particular, on the estimates of costs and benefits for the affected parties.

1. Would the ability to undertake test-the-waters communications under proposed Rule 163B facilitate capital formation? If so, how? Would the proposed rule result in additional capital formation, or would issuers switch between registered and exempt offerings?
2. Which categories of issuers would realize the greatest benefits from proposed Rule 163B? Would issuers in follow-on offerings realize benefits from proposed Rule 163B? What factors would affect the ability of issuers to realize benefits from the proposed rule? For instance, what effect would the application of Regulation FD have on the use of the proposed rule?
3. Would registered investment companies realize benefits from being able to engage in test-the-waters communications? If so, which categories of registered investment companies would realize the greatest benefits? What factors would affect the ability of registered investment companies to realize benefits from the proposed rule?
4. Would ABS issuers realize benefits from being able to engage in test-the-waters communications?

5. Would proposed Rule 163B benefit investors?
6. Would proposed Rule 163B have adverse effects on investors? If so, in which circumstances would such adverse effects be most likely?
7. What steps could we take to mitigate potential adverse effects on investors? How would such changes affect the likelihood that issuers would rely on the proposed rule and the costs and benefits of the proposed rule?
8. What are the benefits and costs of the reasonable belief approach in proposed Rule 163B? What are the benefits and costs of an alternative approach requiring an issuer to take specified steps to determine an investor's status?
9. Would proposed Rule 163B have effects on competition among issuers? Would proposed Rule 163B have effects on competition among investors?
10. What other economic effects would proposed Rule 163B have?

IV. Paperwork Reduction Act

We do not believe that the proposed rule would impose any new "collection of information" requirement as defined by the Paperwork Reduction Act of 1995 ("PRA"),[125] nor create any new filing, reporting, recordkeeping, or disclosure requirements. Accordingly, we are not submitting the proposed rule to the Office of Management and Budget for review under the PRA.[126] We request comment on our assertion that the proposed rule would not create any new, or revise any existing, collection of information pursuant to the Paperwork Reduction Act.

[125] 44 U.S.C. 3501 *et seq.*

[126] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

V. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"),[127] we solicit data to determine whether the proposed rule constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

The Commission requests comment on the potential annual effect on the U.S. economy; any potential increase in costs or prices for consumers or individual industries; and any potential effect on competition, investment, or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VI. Initial Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act ("RFA")[128] requires the Commission, in promulgating rules under Section 553 of the Administrative Procedure Act, to consider the impact of those rules on small entities. The Commission has prepared this Initial Regulatory Flexibility Analysis ("IRFA") in accordance with Section 603 of the RFA.[129] This IRFA relates to proposed Rule 163B and proposed amendments to Rule 405 of the Securities Act.

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[127] Pub. L. 104-121, tit. II, 110 Stat. 857 (1996).

[128] 5 U.S.C. 601 *et seq.*

[129] 5 U.S.C. 603.

A. Reasons for, and Objectives of, the Proposed Action

The primary objective of the proposed rule is to enable all issuers to engage in solicitations of interest prior to a registered public offering to determine potential investors' interest in an offering before or after the filing of a registration statement, provided that the potential investors are QIBs or IAIs. Pre-filing communications under our rules are currently limited to specific types of issuers and offerings.[130] By liberalizing pre-filing and post-filing communications for all issuers, we are also providing them with a cost-effective means for gauging market interest prior to incurring the full costs of a registered offering. The reasons for, and objectives of, the proposed rule are discussed in more detail in Sections I and II above.

B. Legal Basis

We are proposing the amendments pursuant to 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.

C. Small Entities Subject to the Proposed Rule

The proposed rule would affect issuers that are small entities. The RFA defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."[131] For 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

[130] *See* Securities Act Section 5(d), which is only available to EGCs, Rule 163, which is available only to WKSIs, and Rule 255, which is available only to issuers conducting exempt offerings pursuant to Regulation A.

[131] 5 U.S.C. 601(6).

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 proposed rule would permit all issuers, including small entities, to engage in test-the-waters communications. We estimate that there are currently 1,163 entities, other than investment companies, that would be eligible to rely on the proposed rule that may be considered small entities.[132] In addition, we estimate that, as of June 2018, there were 116 registered investment companies and BDCs that would be eligible to rely on the proposed rule that may be considered small entities.[133]

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 would be eligible to rely on the proposed rule if it is adopted. Because reliance on the proposed rule would be voluntary, we cannot accurately estimate the number of small entities that would choose to test the waters, though we anticipate that the small entities most likely to engage in these communications would be those that expect the benefits of this strategy to outweigh the costs.

D. Projected Reporting, Recordkeeping and Other Compliance Requirements

[132] This estimate is based on staff analysis of XBRL data submitted by filers, other than co-registrants, with EDGAR filings of Forms 10-K, 20-F, and 40-F and amendments filed during the calendar year 2017.

[133] 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.

The purpose of the proposed 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 proposed rule, the use of test-the-waters communications would be voluntary and any communications that comply with the proposed rule would 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 proposed rule would not impose a filing requirement, we do not expect the proposed rule to significantly impact existing reporting, recordkeeping and other compliance burdens. Small entities choosing to avail themselves of the proposed 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 proposed rule to all issuers, including small entities, in Section III above.

E. Duplicative, Overlapping, or Conflicting Federal Rules

For the reasons discussed above, we believe that the proposed rule would partially overlap with Securities Act Section 5(d) and Rule 163. We do not believe the proposed rule would otherwise duplicate, overlap or conflict with federal rules.

F. Significant Alternatives

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 proposed 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.

We believe that different compliance or reporting requirements for small entities are not necessary because, while the proposed rule would broaden the number of issuers eligible to engage in communications before and after filing a registration statement, including the number of small entity issuers, it would not establish any new reporting, recordkeeping or compliance requirements for small entities. We do not believe that the proposed rule would impose any significant new compliance obligations. Accordingly, we do not believe it is necessary to exempt small entities from all or part of the proposed rule.

Finally, with respect to using performance rather than design standards, the proposed rule generally contains elements similar to performance standards, which we believe is appropriate because issuers would have the flexibility to tailor their communications when assessing market interest in their securities offerings.

G. Request for Comment

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- The number of small entities that may be affected by the proposed rule;

- The existence or nature of the potential impact of the proposed rule on small entity issuers discussed in the analysis; and
- How to quantify the impact of the proposed rule.

Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule is adopted, and will be placed in the same public file as comments on the proposed rule itself.

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 the Proposed 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.

* * * * *

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)(1) 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).

(2) 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.

(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 that are, or that it reasonably believes are, qualified institutional buyers, as defined in § 230.144A, or institutions that are accredited investors, as defined in §§ 230.501(a)(1), (a)(2), (a)(3), (a)(7), or (a)(8), or any successor thereto, 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 shall 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 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.

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.

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Free writing prospectus.

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(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.

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By the Commission.

Dated: February 19, 2019.

Jill M. Peterson,

Assistant Secretary.