

September 27, 2019

“Test-the-Waters” Communications

SEC Adopts Rule Permitting All Issuers to Use “Test-the-Waters” Communications

SUMMARY

On September 26, 2019, the SEC adopted its previously proposed new rule and related amendments to expand the permitted use of “test-the-waters” or “TTW” communications to all companies regardless of size or reporting status, including registered investment companies and business development companies.¹ New Rule 163B permits all issuers, as well as persons authorized to act on their behalf, such as underwriters, to assess market interest for a proposed registered offering by engaging in oral and written communications with qualified institutional buyers or institutional accredited investors prior to, or following, the filing of a registration statement. TTW communications will not need to be filed with the SEC but will be treated as “offers” for purposes of the liability and anti-fraud provisions of the federal securities laws.

The new Rule represents a substantial expansion of the TTW provisions previously available only to emerging growth companies and permits all issuers to assess market demand for a registered offering on an entirely confidential basis. The Rule will become effective 60 days after publication in the Federal Register.

BACKGROUND

In 2012, Congress passed the Jumpstart Our Business Startups Act (the “JOBS Act”), a law intended to improve access to the public capital markets for emerging growth companies. Among other changes, the JOBS Act created a new category of issuer, “emerging growth companies” or “EGCs”, and amended Section 5 of the Securities Act of 1933 (the “Securities Act”) to add a “test-the-waters” provision, permitting an EGC, and any person authorized to act on its behalf, to engage in oral or written communications with potential investors that are qualified institutional buyers or institutional accredited investors, either prior to or following the date of filing a registration statement, to determine whether those investors might have an

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interest in a contemplated securities offering. TTW communications have been commonly used by EGCs to confidentially gauge market interest in their initial public offerings prior to the confidential submission or public filing of a registration statement with the SEC.

On February 19, 2019, the SEC proposed a new Rule 163B and amendments to Rule 405 designed to expand the permitted use of TTW communications to all companies regardless of size or reporting status, including registered investment companies and business development companies.² In adopting the new Rule and amendments, the SEC emphasized that both investors and companies will benefit from the expansion of TTW provisions and that the new Rule will increase the likelihood of successful public securities offerings.

FINAL RULE

The Rule provides an exemption from the provisions of Section 5(b)(1) and Section 5(c) of the Securities Act, which prohibit written or oral offers prior to the filing of a registration statement and written offers (other than a prospectus meeting the requirements of Section 10 of the Securities Act) after such filing. The Rule permits any issuer (or person authorized to act on its behalf, including an underwriter), before or after filing a registration statement, to engage in oral or written communications with potential investors that are, or are reasonably believed to be, qualified institutional buyers (as defined in Rule 144A) or institutional accredited investors,³ to determine whether those investors might have an interest in a contemplated securities offering. Consistent with the proposal, the Rule does not specify the steps an issuer must take to establish a reasonable belief regarding an investor's status as a qualified institutional buyer or institutional accredited investor, and the SEC noted in the adopting release that issuers should continue to rely on methods they currently use to make such determinations.

Communications that comply with the Rule do not need to be filed with the SEC or include any specific legends. However, the SEC staff may continue to request that copies of TTW communications be furnished to the Staff as part of its registration statement review process, consistent with its approach for EGCs.

In the proposing release, the SEC had noted that information provided in TTW communications must not conflict with material information in the related registration statement. In the adopting release, the SEC clarified that this statement was intended to provide guidance to issuers of their obligations under the federal securities laws, but was not intended to be a condition to the availability of the Rule. The SEC explained that TTW communications must "not contain material misstatements or omissions at the time the statements are made."

Communications made in reliance on the Rule will be deemed "offers" under the Securities Act and therefore subject to liability under the federal securities laws, including, according to the SEC, under Section 12(a)(2) of the Securities Act, which imposes a negligence-type standard for liability. Despite the SEC's belief that TTW communications will be subject to Section 12(a)(2), the SEC also adopted amendments to

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Rule 405 to provide that any written communication that complies with either Section 5(d) of the Securities Act or the Rule would not be considered a “free writing prospectus”. This amendment makes clear that TTW communications will not need to be filed with the SEC or subject to legending requirements.

The SEC did not, however, adopt proposed Rule 163B(a)(2), which stated that the Rule would not be available for any communication that is part of a plan or scheme to evade the requirements of Section 5 of the Securities Act. In doing so, the SEC noted that the language in proposed Rule 163B(a)(2) could raise uncertainty and risk limiting the utility of the Rule.

Importantly, the adopting release noted the continued need for issuers to comply with Regulation FD. Thus, issuers subject to Regulation FD will need to consider whether any information in a TTW communication would trigger disclosure under Regulation FD or whether an exemption under Regulation FD would apply.

The Rule is non-exclusive, and issuers may continue to rely on other Securities Act communications rules or exemptions when communicating with investors about a contemplated securities offering. All issuers, including non-reporting issuers, EGCs, non-EGCs, well-known seasoned issuers, and investment companies, are eligible to rely on the Rule.

IMPLICATIONS

Under the new Rule, all issuers will have the ability to gauge investor interest and identify any areas of concern, in order to better assess whether to proceed with a registered securities offering, before publicly filing a registration statement. Given the intended parity of the Rule with Section 5(d) of the Securities Act, it is likely that the standard practices currently followed with respect to EGC TTW communications will be implemented across all contemplated registered securities offerings. While communications under Section 5(d) and the new Rule can occur at any time, with the expansion of the use of the confidential submission process to all initial public offering filers and to filers of follow-on Securities Act registration statements who are within a year of going public, communications under the new Rule will likely be done after receiving comments on a first confidential submission, similar to the EGC process.

As a result of Regulation FD applying to TTW communications made by reporting issuers, we would expect that issuers and underwriters seeking to rely on the Rule would require institutional investors to execute confidentiality agreements prior to receiving any information about a proposed offering to ensure compliance with Regulation FD, similar to the confidential pre-offering marketing, or “wall-crossing”, activities that are commonly used as a marketing tool to gauge market interest among a select group of investors.

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ENDNOTES

- ¹ For the full text of the adopting release, see Solicitations of Interest Prior to a Registered Public Offering, SEC Release No. 33-10699, *available at* <https://www.sec.gov/rules/final/2019/33-10699.pdf> (Sept. 26, 2019).
- ² For further information about the proposal, please see our Memorandum to Clients, “Test-the-Waters” Communications: The SEC Proposes to Expand the Permitted Use of “Test-the-Waters” Communications to All Issuers (Feb. 27, 2019), *available at* <https://www.sullcrom.com/the-sec-proposes-to-expand-the-permitted-use-of-test-the-waters-communications-to-all-issuers>.
- ³ An institutional accredited investor refers to any institutional investor that is also an accredited investor, as defined in Regulation D under the Securities Act.

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