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"Test-the-Waters" Communications

The SEC Proposes to Expand the Permitted Use of "Test-the-Waters" Communications to All Issuers

SUMMARY

On February 19, 2019, the Securities and Exchange Commission proposed a 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] The proposal, if adopted, would permit all issuers, as well as persons acting 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. The proposal represents a substantial expansion of the TTW provisions, currently available only to emerging growth companies, in support of the SEC's efforts to encourage additional registered offerings in the United States. Combined with the extension to all issuers of the availability of the confidential review process for IPO and other registration statements, the proposal would level the playing field for companies seeking to assess market demand on an entirely confidential basis. In addition, the proposal would permit more companies and their underwriters to engage in confidential pre-marketing activities, commonly referred to as "wall crossings", currently available only to well-known seasoned issuers and issuers with an effective shelf registration statement. Comments on the proposed rule will be due 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 (i) created a new category of issuer, "emerging growth companies" or "EGCs", and (ii) 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 to determine whether those investors might have an interest in a contemplated securities offering, either prior to or following the date of filing a registration statement. With certain exceptions, an EGC is an issuer that had total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year and has not had an initial public offering or is within five years of its initial public offering.[2]

Test-the-waters 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 Securities and Exchange Commission (the "SEC"). Under the JOBS Act, an EGC is permitted to confidentially submit a draft registration statement to the SEC, and the SEC will provide comments on the draft before the registration statement becomes public. In July 2017, the SEC expanded 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. Since then, in a similar vein, there have been calls for the SEC to consider expanding the test-the-waters accommodations to issuers that are not EGCs.

DISCUSSION

A. SUMMARY OF PROPOSED RULE 163B

The proposed Rule provides an exemption from the provisions of Section 5(b)(1) and Section 5(c) of the Securities Act. The Rule would permit 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 or institutional accredited investors, to determine whether those investors might have an interest in a contemplated securities offering. The proposal 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 notes in the proposing release that issuers should continue to rely on the methods they currently use to make such determinations.[3]

Communications that comply with Rule 163B would not need to be filed with the SEC or include any specific legends.[4] Information provided in such communications, however, must not conflict with material information in the related registration statement, and the SEC staff may continue to request that copies of test-the-waters communications be furnished to the Staff as part of the registration statement review process. However, communications under the proposed Rule would still be considered "offers" under the Securities Act and therefore subject to liability under the federal securities laws. In particular, the SEC indicates in the proposing release that these communications would be subject to liability under Section 12(a)(2) under the Securities Act, which imposes a negligence-type standard for liability.

Under the proposal, Rule 163B would be non-exclusive, and issuers could 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, would be eligible to rely on the proposed rule.

B. IMPLICATIONS FOR EXISTING REPORTING COMPANIES

Material Non-Public Information (MNPI)

Reporting issuers seeking to rely on Rule 163B would need to consider whether any information in a TTW communication would trigger obligations under Regulation FD (or corresponding concerns under Rule 10b-5 under the Securities Exchange Act of 1934), or whether an exemption to Regulation FD's prohibition on the selective disclosure of MNPI to securities market professionals or shareholders would apply.[5] If a reporting issuer's TTW communications included MNPI or the proposed offering itself were MNPI, the issuer would generally need to make simultaneous disclosure of the MNPI to the public or require that the institutional investors expressly agree to maintain the confidentiality of the TTW materials and the potential offering itself. 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, we would expect that issuers and underwriters seeking to rely on proposed Rule 163B would require institutional investors to execute confidentiality agreements prior to receiving any information about the proposed offering, to ensure compliance with Regulation FD.

Availability of Wall-Crossings to All Issuers

Wall-crossings have become commonplace in registered offerings, particularly during periods of market volatility, because they allow issuers to gauge interest in a proposed offering on a confidential basis prior to public disclosure of the offering. Existing SEC rules have effectively limited the practice to WKSIs and issuers having effective shelf registration statements on file with the SEC who directly reach out to prospective investors. Wall-crossing is not available to non-WKSIs and their underwriters without an effective registration statement. Proposed Rule 163B would therefore have the effect of allowing all issuers to use wall-crossing procedures and would allow underwriters to engage in wall-crossings on behalf of issuers, even when issuers do not have a registration statement on file.

C. CONSIDERATIONS FOR INVESTMENT COMPANIES

Issuers that are, or are considering becoming, registered investment companies or business development companies ("BDCs" and together, "funds") would be eligible to use TTW communications under the proposed Rule 163B. 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 of 1940 (the "Investment Company Act"). To promote the consistent treatment of different types of issuers' TTW communications under the proposed Rule, the SEC is also proposing

revisions to rules relating to securities offerings by these funds to exclude their TTW communications conducted in accordance with proposed Rule 163B from the filing and other requirements in Rules 482 and 497 under the Securities Act and in Section 24(b) of the Investment Company Act and the rules thereunder.

The proposing release states that funds and their advisers may have an interest in using TTW 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. However, the SEC acknowledged that the proposed Rule 163B may not be as practically important for certain investment companies since, unlike corporate issuers, they typically conduct exempt or registered securities offerings shortly after formation. Under the proposed rule, a fund could engage in test-the-waters communications with qualified institutional buyers and institutional accredited investors during the seeding period without filing a Securities Act registration statement. However, newly formed funds that currently expect to engage in a public offering typically file a registration statement under both the Investment Company Act and the Securities Act to take advantage of certain efficiencies, thereby limiting the pre-filing period. Nonetheless, funds that are targeting qualified institutional buyers and institutional accredited investors—not the typical mutual fund—may benefit from test-the-waters accommodations after filing a Securities Act registration statement, as the proposed Rule 163B and related amendments to the investment company rules would allow them to communicate with institutional investors about a contemplated offering without the filing, disclosure and legending requirements of the Investment Company Act or other Securities Act rules. The proposing release notes that mutual funds may be least likely to rely on the proposed rule because they have the highest share of retail ownership, whereas BDCs were reported to have an estimated mean institutional holding of approximately 30%, so the benefits of the proposed rule may be similarly limited for some BDCs.

CONCLUSION

Proposed Rule 163B and the related amendments build on prior initiatives undertaken by the SEC to facilitate initial public offerings and capital raising. If adopted, Rule 163B would significantly change the communications landscape for many non-EGC issuers and allow them to communicate more freely with institutional investors to gather reliable information about investor interest before registered offerings. Moreover, in the context of initial public offerings, proposed Rule 163B would level the playing field and permit larger companies to ascertain market interest in their proposed offerings on a confidential basis before publicly filing a registration statement and conducting the customary IPO roadshows.

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ENDNOTES

[1] For the full text of the release, *see Solicitations of Interest Prior to a Registered Public Offering*, SEC Release No. 33-10607, *available at* https://www.sec.gov/rules/proposed/2019/33-10607.pdf (Feb. 19, 2019).

[2] An EGC continues to be an EGC 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: (i) its total annual gross revenues are $1.07 billion or more; (ii) it has issued more than $1 billion in non-convertible debt in the past three years; or (iii) it becomes a "large accelerated filer", as defined in 17 CFR 240.12b-2 under the Securities Exchange Act of 1934.

[3] The proposal does not require issuers to satisfy the accredited investor verification requirements of Rule 506(c) of Regulation D under the Securities Act. However, the SEC seeks comment on this issue.

[4] The SEC is also proposing to amend Rule 405 to provide that any written communication that complies with the proposed Rule 163B would not be considered a "free writing prospectus".

[5] As proposed, the exemption to Regulation FD in Rule 100(b)(2)(iii) for certain communications in connection with registered securities offerings would not apply to TTW communications.

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