This article was originally published in *PLI Current: The Journal of PLI Press*, Vol. 2, No. 3 (Summer 2018), www.pli.edu/PLICurrent.

PLI Current
The Journal of PLI Press

Vol. 2, No. 3, Summer 2018

Modernizing Communications Safe Harbors

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Time and technology often conspire to make our existing views and approaches seem dated. It's inevitable, and such is the case with the regulations that address permissible communications by issuers. The securities laws regulating communications by issuers have not undergone many revisions since Securities Offering Reform in 2005[1] despite the fact that the ways in which issuers communicate with investors and in which investors access information have undergone significant change. The Securities and Exchange Commission (SEC, or the Commission) now is required to propose rules relating to the application of the communications safe harbors under Securities Act Rules 138 and 139 in relation to certain funds. The dialogue relating to measures that may promote capital formation, without sacrificing investor protections, has prompted the Commission to consider extending the ability to "test the waters," made available by the Jumpstart

Our Business Startups (JOBS) Act to emerging growth companies (EGCs), to all companies.[2] While the Commission certainly could limit its rulemaking to acting on these specific matters, it would seem an opportune time for the Commission to undertake a more comprehensive review of all of the communications safe harbors contained in the Securities Act. In this article, we consider some of the communications safe harbors that may benefit from amendment.

Background

As noted above, the securities laws provide a framework for offerings that are registered under the Securities Act and offerings that are exempt from registration under the Securities Act. The Securities Act sets forth an expansive definition of the types of communications that may be deemed to constitute an "offer." Communications that are considered "offers" are subject to content limitations (in order to ensure that such communications are fair and balanced and do not condition the market for a securities offering). In addition, the securities rules impose limitations on the types of persons that may make certain communications (*i.e.*, whether a communication is made by the issuer or by an underwriter), and these limitations vary depending on whether the issuer is subject to reporting requirements under the Securities Exchange Act of 1934, as amended, whether the issuer's securities are actively traded, and whether current information about the issuer is readily available. Over time, in order to avoid unnecessary constraints on communications, the Commission has adopted a number of safe harbors that provide assurance that certain communications will not be viewed as "offers" under the Securities Act. For example, under Rule 169, the publication of regularly released factual business information that is intended for use by persons other than in their capacity as investors or potential investors and published by issuers not subject to Exchange Act reporting requirements is not considered an offer. Under Rule 168, Exchange Act–reporting issuers may publish regularly released factual business and forward-looking information (subject to certain conditions) without concern that publication of the information will be viewed as an "offer." Communications by issuers that are made more than thirty days prior to the filing of a registration statement and that do not reference an offering are permitted by Rule 163A. While there are certain safe harbors for communications made in proximity to an offering, these are more limited given the heightened investor protection concerns that arise under such circumstances.

Securities Offering Reform modernized the regulatory framework for communications. The Commission reasoned that there would be more publicly available current information, and more research published, about the largest issuers, or well-known seasoned issuers (WKSIs), and the trading price for the securities of such issuers would reflect this information. As a result, it would be less likely that the market for the securities of a WKSI would be susceptible to manipulation. These issuers therefore should have greater flexibility with respect to their communications. Seasoned issuers, which are Exchange Act–reporting companies that meet the requirements for use of a registration statement on either Form S-3 or Form F-3, would be subject to fewer restrictions on communications compared to unseasoned Exchange Act–reporting companies, which include all reporting companies that are neither WKSIs nor seasoned companies. Ineligible issuers—which include issuers that are not current in their Exchange Act reporting requirements, are or were within the prior three years blank check, shell, or penny stock companies, or are subject to certain proceedings—are subject to significant limitations on their communications.

The JOBS Act created a new category of issuer, emerging growth companies, which are permitted to engage in communications with potential investors that are qualified institutional buyers (QIBs) or institutional accredited investors in order to gauge interest in a securities offering prior to or following the filing of a registration statement. These test-the-waters communications are not deemed "offers" under the Securities Act. The JOBS Act also allows broker-dealers, whether or not participating in an offering, to publish or distribute research reports regarding the securities of an EGC, and such reports are not considered "offers." This effectively eliminates the "quiet period" for EGC offerings. The JOBS Act also required that the Commission amend Rule 506 of Regulation D and Rule 144A under the Securities Act in order to relax the prohibition against general solicitation. As a result, an issuer may conduct an offering in reliance on Rule 506(c) and use general solicitation to attract investors with whom it had no pre-existing substantive relationship. An issuer also may conduct a traditional Rule 144A placement and use general solicitation without impacting the availability of the section 4(a)(2) exemption for its sale of the offered securities to the initial purchaser. Regulation A, which was amended as a result of the JOBS Act, and Regulation Crowdfunding, adopted as required by the JOBS Act, also allow issuers that rely on these exemptions from Securities Act registration requirements to conduct broader offering-related communications, subject to compliance with the conditions set forth in such rules.

Setting aside these JOBS Act–related changes to the offering communications framework, there have been no other changes to the rules for over a decade. In late 2009, the Commission proposed an amendment to Rule 163. Rule 163 permits a WKSI to offer securities prior to filing a related registration statement. The safe harbor provided under the rule applies only to communications made by or on behalf of the issuer itself, so it cannot be relied upon by underwriters. This limits its utility. The proposed amendments would have relaxed the restrictions by allowing an underwriter acting on the issuer's behalf to make issuer-authorized or issuer-approved communications prior to the filing of a registration statement by a WKSI. The underwriter that undertook such communications would have had to be identified in the prospectus related to the offering. The proposed amendments were not adopted.

Required Communications-Related Rulemakings

The Commission is now required by statute to undertake rulemaking related to the availability of the communications safe harbors by business development companies (BDCs) and by certain closed-end funds. In March 2018, a new spending bill was passed that included the Small Business Credit Availability Act. The Small Business Credit Availability Act requires that within a year of its enactment the Commission amend various provisions of the Securities Act in order to allow BDCs to rely on communications safe harbors available to operating companies. Rules 168 and 169, discussed above, would be deemed applicable to BDCs. Rule 163A, which provides for a safe harbor for non-reporting and reporting issuers, as well as voluntary filers, for certain communications not referencing an offering and made more than thirty days prior to the filing of a registration statement, would be made available to BDCs. To the extent that a BDC qualifies as a WKSI, it would be able to rely on the Rule 163 safe harbor referenced above. Rule 163 allows WKSIs to make oral or written communications prior to filing a registration statement. Any written offer made in reliance on the rule is required to contain a prescribed legend, must be filed with the Commission promptly upon the filing of a registration statement for the related offering, and cannot relate to an "ineligible offering," such as a business combination.

The Small Business Credit Availability Act also requires that the Commission amend the research report–related safe harbors contained in Rule 138 and Rule 139 in order to make these available for BDC research reports. Rule 138 of the Securities Act permits a broker-dealer participating in the distribution of an issu-

er's securities to publish and distribute research reports that either: relate solely to the issuer's common stock, debt securities, or preferred stock convertible into common stock, where the offering solely involves the issuer's non-convertible debt securities or non-convertible non-participating preferred stock; or relate solely to the issuer's non-convertible debt securities or non-convertible non-participating preferred stock, where the offering solely involves the issuer's common stock, debt securities, or preferred stock convertible into common stock. Rule 138 is available for research reports about all reporting issuers, other than voluntary filers, that are current in their Exchange Act reporting requirements, as well as foreign private issuers that satisfy the requirements for use of a registration statement on Form F-3 and either have a public float of at least $75 million or are issuing non-convertible investment grade securities, and either have had equity securities listed on a designated offshore securities market for at least twelve months or have a worldwide common equity market value held by non-affiliates of at least $700 million. Rule 139 provides a safe harbor for research reports written by underwriters participating in a securities offering about the offered securities. Pursuant to the rule, a broker-dealer participating in a registered offering can publish research reports about the issuer and its securities or the issuer's industry or sub-industry, provided that the issuer has filed all required Exchange Act reports during the preceding twelve months and meets the registrant requirements for use of Form S-3 or F-3, and either has $75 million or more in public float or is or will be offering securities that qualify as non-convertible investment grade securities, or is a WKSI, or is a foreign private issuer that meets the requirements set forth above with respect to the availability of the Rule 138 safe harbor for foreign private issuers. For an issuer-specific report, Rule 139 requires that the broker-dealer must publish or distribute research reports in the regular course of its business, and the publication of the report cannot represent either the initiation or re-initiation of publication. In the case of an industry-specific report, the publication of the research cannot be initiated prior to the offering; the report must contain similar types of information about the issuer or its securities as were contained in prior reports; similar information about other issuers in the industry or sub-industry must be contained; and the information about the issuer that is engaged in the offering cannot be given greater prominence or space than that given to other issuers referenced in the report.

The Fair Access to Investment Research Act of 2017 directed the Commission to provide a safe harbor for research reports relating to certain registered investment companies, including exchange-traded funds, BDCs, and exchange-traded

commodity- or currency-based trusts or funds. Recently, the Commission proposed Rule 139b in order to address this congressional mandate. As proposed, Rule 139b would provide a safe harbor for the publication or distribution of covered investment fund research reports by unaffiliated broker-dealers participating in a securities offering of a covered investment fund. The safe harbor would be available for covered investment funds that have been subject to reporting requirements under the Exchange Act and/or the Investment Company Act of 1940, as amended, for at least twelve calendar months prior to the broker-dealer's proposed reliance on the safe harbor. Consistent with existing Rule 139, the covered investment fund must have filed its periodic reports in a timely manner during the immediately preceding twelve months. The minimum public market value requirement (or net asset value for a registered open-end investment company) tracks the minimum public float and aggregate market value requirements under Rule 139. The other conditions contained in proposed Rule 139b also track the conditions of Rule 139.

While the proposed amendments to Rule 139b are welcome, and we look forward to the changes to the communications safe harbors required to be made by the Small Business Credit Availability Act, it would seem that these rulemaking mandates provide an opportunity for a broader reexamination of the communications safe harbors. As discussed in the next section, modernizing the communications safe harbors should be an important part of the Commission's initiatives to promote capital formation.

Promoting Capital Formation

Given the decline in recent years in the number of public companies in the United States and the decline compared to prior periods in the number of initial public offerings (IPOs), many commentators have recommended undertaking securities law reforms that would promote capital formation. Much of the dialogue relating to capital formation has focused on the IPO market. Commentators have advocated that certain of the "IPO on-ramp" provisions of the JOBS Act be extended and made available to companies that are not EGCs. Already, the Staff of the Commission's Division of Corporation Finance has extended to all companies the ability to submit for confidential Staff review draft registration statements relating to IPOs and to the registration of a class of securities under the Exchange Act. The confidential submission process also has been extended for all companies for follow-on offerings made within the first twelve months follow-

ing the registration of a class of securities under the Exchange Act or the completion of an IPO. The U.S. Treasury Department's report on reforms to capital markets regulations[3] issued pursuant to Executive Order 13772[4] recommended that Securities Act section 5(d) be amended to permit all issuers to test the waters in connection with their IPOs. There is pending legislation that would amend the Securities Act for this purpose, and representatives of the Commission also have discussed their intention to propose amendments to accomplish this result.

However, setting aside IPO-related communications, there has been relatively little discussion concerning modernizing other communications-related provisions of the Securities Act. In light of all of the technological changes that have transpired since adoption of Securities Offering Reform and the increased reliance on social media, it bears revisiting whether the principles articulated by the Commission at the time it adopted Securities Offering Reform remain relevant. As part of Securities Offering Reform, the largest issuers, WKSIs, were given the greatest flexibility with regard to communications. For example, WKSIs were allowed to make certain oral and written communications prior to filing a registration statement. WKSIs and seasoned issuers meeting the conditions set out in Rule 433(b)(1) and Rule 164 were allowed to use free writing prospectuses following the filing of a statutory prospectus. The enhanced flexibility for WKSIs and seasoned issuers was premised on the notion that if issuers met certain public float requirements and had a reporting history, they would have a market following. Enough information about these issuers would be readily available to investors and the price of the securities of such issuers would reflect current information. Given the proliferation of information about public companies and the speed at which information is disseminated, is it still appropriate to condition communications safe harbors on public float and reporting history? Or do we need a new approach?

Given technological changes and social media, is it still appropriate to condition communications safe harbors on public float and reporting history?

Even if one were to subscribe to the Commission's theory that the availability of communications safe harbors ought to be premised on the accessibility of current information about an issuer and on the issuer's market following, there are a number of reforms that would seem appropriate. For example, many Canadian issuers that rely on the multijurisdictional disclosure system (MJDS) and file annual reports on Form 40-F have a long reporting history, have a very significant public float, and benefit from research analyst coverage. The securities of many of these issuers are actively traded, and many have a broad market following. The WKSI definition should be amended to include these MJDS issuers. Issuers that are "voluntary filers" also should be able to qualify as WKSIs provided that they have been making filings for at least twelve months and are current in their filings. The $700 million public float threshold currently contained in the WKSI definition should be reevaluated, since many reporting companies that meet the Form S-3 or F-3 registrant requirements and have lower public floats still would be considered to have a broad market following and have securities that are actively traded and unlikely to be readily subject to manipulation. Given that the Commission is considering amending the definition of "smaller reporting companies," it could use that opportunity to redefine the various categories of issuers for purposes of the communications safe harbors. If the definition of a WKSI were amended to lower the public float requirement and to include MJDS and voluntary filers, it would promote capital formation. These issuers would be able to share information more easily with the public and would be able to raise capital more efficiently.

The Commission also should revisit its proposed amendments of Rule 163. The current formulation of Rule 163 is of limited utility. Many issuers now rely on wall-crossed or confidentially marketed underwritten public offerings to raise additional capital. In fact, if one considers publicly available information, most follow-on offerings undertaken in the last several years have been structured as "takedowns" pursuant to shelf registration statements, and these takedowns have been conducted using abbreviated marketing. In these transactions, the underwriter will "test the waters" on a confidential basis with institutional investors on the issuer's behalf. Rule 163 should be amended to facilitate these follow-on offerings and allow underwriters authorized by issuers to contact institutional investors on their behalf even prior to the filing of an automatic shelf registration statement.

The U.S. Treasury Department's Capital Markets Report also recommended that a review be undertaken relating to the research rules.[5] Legislation has been proposed that would require that the Commission undertake a study regarding the factors affecting research on EGCs.[6] Given the other amendments that the Commission is required to undertake with respect to Rules 138 and 139, there would be an opportunity to consider more comprehensive changes. Just as Rules 138 and 139 will soon be available for research reports relating to BDCs, the Commission should consider whether these safe harbors should be available to voluntary issuers that are current in their filings. The Commission also should reevaluate the rationale for conditioning the availability of the Rule 139 safe harbor on an issuer's ability to meet the registrant requirements for use of Form S-3 or F-3. Publication of regular research reports should be allowed to continue regardless of the issuer's eligibility for a short-form registration statement. More information should be viewed as helpful to investors.

It is also not clear why eligibility for use of a registration statement on Form F-3 is necessary for foreign private issuers that seek to rely on the Rule 168 safe harbor for regularly released factual business and forward-looking information. Along the same lines, it is not clear why the Rule 168 safe harbor should not be made available to voluntary issuers that are current in their filings.

The ability to use a free writing prospectus is conditioned largely on the issuer's status. As noted above, a WKSI may use a free writing for an offering at any time, and a seasoned issuer may use a free writing prospectus at any time after the registration statement is filed without being subject to a requirement to deliver a section 10 prospectus with or in advance of the free writing prospectus. Unseasoned issuers and non-reporting issuers can use a free writing prospectus at any time after the filing of a section 10 prospectus provided, generally, that the statutory prospectus precedes or accompanies the free writing prospectus. Given the availability of securities filings, it is not clear that this additional requirement remains necessary for unseasoned and non-reporting issuers. Ineligible issuers are limited in their ability to use certain types of free writing prospectuses. Oddly, a master limited partnership that is undertaking a public offering on a best-efforts basis would be considered an "ineligible issuer" and would be limited in its use of free writing prospectuses in connection with such an offering. This requirement would not appear to be reasonably related to the availability of current information and may merit review.

Finally, it would be useful to reexamine the utility of the post-IPO quiet period. While there may be continuing challenges associated with the publication of research coverage relating to newly public companies, the Commission might consider addressing whether observing a twenty-five-day quiet period post-IPO for issuers is sensible. The IPO quiet period does not seem to be observed with the same rigor in the social media age, and it is sensible to consider whether an issuer should continue to be limited in its communications during this period only to regularly released factual business information.

Conclusion

We appreciate that there is rarely a convenient time to undertake comprehensive revision of regulation that has served us well in the past—yet, there may be a right time to do so. The rapid evolution of the ways in which most components of our global society now communicate suggests to us that this is the right time for a comprehensive overhaul of the SEC regulation relating to communications by issuers.

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NOTES

1. Securities Offering Reform, Securities Act Release No. 8591, 2005 WL 1692642 (July 19, 2005) (final rule).
2. Jumpstart Our Business Startups Act, Pub. L. No. 112-06, 126 Stat. 306 (Apr. 5, 2012).
3. U.S. Dep't of Treasury, A Financial System That Creates Economic Opportunities: Capital Markets (Oct. 2017) [hereinafter CAPITAL MARKETS REPORT], www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.
4. Exec. Order No. 13,772, Core Principles for Regulating the United States Financial System, 82 Fed. Reg. 9965 (Feb. 3, 2017).
5. *See* CAPITAL MARKETS REPORT, *supra* note 3, at 37–38.
6. *See, e.g.,* A Bill to direct the Securities and Exchange Commission to conduct a study with respect to research coverage of small issuers before their initial public offerings, and for other purposes, H.R. __, 115th Cong. (2018), https://financialservices.house.gov/uploadedfiles/bills-115-sec_r006.pdf (one of a number of legislative proposals introduced in the House Financial Services Committee).