SEC's Proposed Expansion of Testing-the-Waters Communications: First Analysis

A Lexis Practice Advisor® Practice Note by
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Introduction

This article discusses a recently proposed rule by the Securities and Exchange Commission (SEC) that would expand the permitted use of "testing-the-waters" communications from emerging growth companies (EGCs) only to all issuers, regardless of size or reporting status. Proposed by the SEC on February 19, 2019, Rule 163B under the Securities Act of 1933, as amended (the Securities Act) would permit all issuers, and persons acting on their behalf, to gauge market interest in a prospective registered securities offering by engaging in oral or written communications with potential investors that are, or are reasonably believed by the issuer to be, qualified institutional buyers (QIBs) or institutional accredited investors (IAIs). These communications could occur prior to, or following, the filing of a registration statement with the SEC. For the full text of the proposed rule, see Solicitations of Interest Prior to a Registered Public Offering, SEC Release No. 33-10607 (Feb. 19, 2019).

Rule 163B would represent a significant expansion of the testing-the-waters rules and is a continuation of the SEC's prior actions to extend reforms available for EGCs to all issuers. In 2017, for example, the SEC began to allow all issuers to file initial registration paperwork confidentially with the SEC, an accommodation that was, until then, only available to EGCs. Similarly, Rule 163B's expansion of the availability to test-the-waters would allow non-EGC issuers to engage with certain potential investors to better determine the demand for their securities, and receive feedback regarding the terms of the offering most important to investors. In its proposing release, the SEC commented that the new rule is intended to provide "increased flexibility" for issuers and provide a "cost-effective means for evaluating market interest before incurring the costs" associated with a public offering.

The SEC's public comment period for the proposed Rule 163B closed on April 29, 2019. After a thorough review of submitted comments, it is expected that the SEC will adopt the rule in substantially the form in which it was proposed.

For further information on the federal securities laws applicable to communication and publicity matters involving companies conducting securities offerings, see IPOs, Follow-On Offerings, Road Shows, and Earnings Guidance: FAQs on Publicity, Communications, and Offers. For a general overview of, and links to available resources regarding, these communication and publicity issues, see Publicity and Communications Resource Kit.

Background

Absent an exemption, Section 5(c) of the Securities Act prohibits written or oral offers of securities prior to the filing of a registration statement. Section 5(b)(1) further requires that, once a registration statement has been filed, issuers use a prospectus that meets the requirements of Section 10 of the Securities Act for any written offers of securities. These provisions are collectively known as the "gun-jumping rules."

In 2012, Congress passed the Jumpstart Our Business Startups Act (JOBS Act), which established EGCs as a new

category of issuer and added Section 5(d) to the Securities Act. Section 5(d) permits EGCs and persons authorized to act on their behalf to participate in oral or written communications with potential investors that are QIBs and IAIs to determine if those investors may be interested in a potential securities offering. The JOBS Act utilized the same definition of qualified institutional buyer as Rule 144A under the Securities Act. In general, a QIB is a specified institution that, acting for its own account or for the accounts of other QIBs, owns and invests on a discretionary basis at least $100 million in securities of unaffiliated issuers. In addition, banks and certain other specified financial institutions must also have a net worth of at least $25 million. Finally, a registered broker-dealer is a QIB when it owns and invests on a discretionary basis at least $10 million in securities of issuers that are not affiliated with the broker-dealer. An institutional accredited investor refers to any institutional investor that qualifies as an accredited investor under Rule 501 of Regulation D under the Securities Act.

Communications made pursuant to Section 5(d) are not considered "offers" under Section 5 and, therefore, are excluded from the gun-jumping rules. An EGC is defined under the JOBS Act as a company with annual gross revenues of less than $1.07 billion during its most recent fiscal year. With some exceptions, an EGC retains its status as long as it has total annual gross revenues less than $1.07 billion and either has not completed an initial public offering (IPO) or has not yet reached the fifth anniversary of its IPO.

Initial Guidance

Proposed Rule 163B extends Section 5(d)'s "testing-the waters" provisions to all issuers and would "permit any issuer, or any person authorized to act on its behalf, to engage in oral or written communications with potential investors that are, or are reasonably believed by the issuer to be, QIBs or IAIs, 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." The rule, if adopted, would provide an exemption from Section 5(b)(1) and Section 5(c) of the Securities Act for such communications. The proposal would also amend Rule 405 to exclude such communications from the definition of "free writing prospectus."

The proposed rule contains no legend or filing requirements, but would require that testing-the-waters communications not conflict with information in the registration statement for the related offering. Rule 163B would be non-exclusive, meaning an issuer could also rely on other exclusions or exemptions to the gun-jumping rules when determining how to communicate about a potential securities offering. Although similar to Section 5(d) in many respects, unlike Section 5(d), Rule 163B requires only a reasonable belief that the investors receiving communications are QIBs or IAIs rather than requiring that such investors in fact fall into those categories. This reasonable belief language is a beneficial change from Section 5(d), since a person relying upon that provision could face potential liability should some investors ultimately not qualify as a QIB or IAI.

Importantly, the SEC's proposing release makes clear that while communications benefiting from Rule 163B would not violate the gun-jumping rules, they would still be considered "offers" under the Securities Act and thus would be subject to liability under Section 12(a)(2) under the Securities Act or anti-fraud provisions such as Rule 10b-5 under the Securities Exchange Act of 1934 (Exchange Act).

Benefits of the Rule

Most IPO issuers are EGCs that already may engage in testing-the-waters activities. However, to the extent an IPO issuer is not an EGC it will benefit from Rule 163B's safe harbor, and, as mentioned, all issuers, including EGCs will benefit from reasonable belief standard included in the proposed rule. Although there are other safe harbors that allow an issuer to avoid a gun-jumping violation (including, for example: Rule 163, Rule 163A, Rule 168 and Rule 169), the proposed Rule 163B is a non-exclusive safe harbor and attempted compliance with it will not act as an election to the exclusion of another exemption.

In addition to the clear benefits for all issuers, generally, Rule 163B also carries particular potential benefits for issuers that are, or are considering becoming, registered investment companies. Investment companies would be able to engage in testing-the waters communication to assess market demand and speak to potential investors about strategy or fee structure before incurring the full cost of a registered offering. Indeed, to help facilitate the consistent treatment of Rule 163B communications, the SEC has proposed amendments to existing rules relating to securities offerings by investment companies. These amendments would exclude an investment company's testing-the-waters communications from the requirements of Rule 482 under the Securities Act (establishing requirements for advertisements or other sales materials with respect to securities of registered investment companies and business development companies), Rule 497 under the Securities Act (requiring an investment company to file forms of prospectuses that vary from the form of prospectus included in its registration statement) as well as Section 24(b) of the Investment Company Act of 1940 (Investment Company Act) (requiring filing "sales literature" intended to be used by certain funds in connection with a public offering of a fund's securities). Unfortunately, these

benefits may not be fully realized as investment companies will still be required to comply with the registration requirements of the Investment Company Act when conducting a public offering.

In addition to those issuers considering an IPO, the broad language of Rule 163B allows for its use by reporting issuers that are interested in conducting a follow-on offering. One limitation in this context is Regulation FD, which generally requires public disclosure of any material nonpublic information that has been selectively disclosed to certain securities market professionals or shareholders. QIBs or IAIs often fall under the category of securities market professionals to whom selective disclosure cannot be provided. While a potential problem for issuers, Rule 100(b)(2) of Regulation FD provides an exemption from its requirements 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. If issuers or underwriters sought to rely on Rule 163B, they could ensure compliance with Regulation FD by requiring investors to enter into a confidentiality undertaking prior to disclosing any information about the offering. This technique is currently used for confidentially marketed public offerings and is known as "wall-crossing." Should the issuer not ultimately move forward with the planned offering, it could then publicly disclose information about its communications with potential investors to release those investors from the terms of the confidentiality agreement (commonly referred to as "cleansing").

While some market participants already engage in wall-crossing with investors to assess interest in a potential offering, currently all issuers must have a registration statement on file prior to having underwriters communicate with investors about an offering on their behalf. Although well-known seasoned issuers (WKSIs) currently benefit from rules which permit them to make certain offers during the pre-filing period, those rules do not extend to underwriters acting on the WKSI's behalf. Rule 163B would remove these constraints and allow all issuers as well as underwriters to participate in wall-crossing communications in the pre-filing period. The proposed rule would also provide additional flexibility when an issuer's filed registration statement does not cover the type of security that the underwriters propose to offer.

Looking Ahead

Propoed Rule 163B seeks to level the playing field by expanding to all issuers the ability to engage in pre-filing communications with QIBs and other IAIs. While some issuers may not be able to take full advantage of the rule, it has the potential to improve the efficiency of the capital raising process while encouraging more companies to conduct public offerings.

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In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.