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SEC Proposes Expansion of "Testing the Waters" Accommodation

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Capital Markets and Securities

On February 19, 2019, the Securities and Exchange Commission (the "SEC") proposed a new rule under the Securities Act of 1933 (the "Securities Act") that would expand issuers' ability to gauge potential investor interest in registered securities offerings. The new rule, Rule 163B, would expand "testing the waters" activities that are currently permitted only for emerging growth companies.[1]

Historically, under Section 5 of the Securities Act, no offers of securities, written or oral, in a registered offering were permitted prior to the filing of the registration statement, subject to several limited SEC safe harbors.[2] Violation of these restrictions has been referred to as "gun jumping" and subjected issuers to potential liability under Section 12(a)(1) of the Securities Act. In 2012, as part of the Jumpstart Our Business Startups Act (the "JOBS Act"), however, Congress added a new Section 5(d) to the Securities Act, which permitted emerging growth companies (or persons authorized to act on their behalf) to engage in oral or written communications with potential investors prior to or following the public filing of a registration statement[3] "to determine whether those investors might have an interest in a contemplated securities offering." The only condition to this "test the waters" provision is that the potential investors must be qualified institutional buyers or institutional accredited investors.

The SEC is now proposing to open up this new structure in a modified form to all issuers by adopting Rule 163B under the Securities Act. The new rule would permit all issuers—including

[1] A company will qualify as an "emerging growth company" if it had total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year and did not publicly sell any of its common equity securities pursuant to a registration statement prior to December 8, 2011. Emerging growth company status terminates under specified circumstances

[2] Section 2(a)(3) of the Securities Act defines "offer" broadly to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The SEC excludes certain pre-filing communications from the definition of "offer" (*e.g.*, limited notices of proposed registered offerings (Rule 135); certain third-party research reports (Rules 137, 138 and 139); certain factual business information (Rule 169) and, in the case of reporting companies, limited forward-looking information (Rule 168); and certain communications made more than 30 days before a registration statement is filed (Rule 163A)).

[3] A confidential submission pursuant to the JOBS Act or otherwise does not constitute a public filing for purposes of Section 5 of the Securities Act.

companies that do not qualify as emerging growth companies, as well as investment companies—or any persons authorized on an issuer's behalf, to "test the waters" with potential investors that are, or that the issuer reasonably believes to be, qualified institutional buyers or institutional accredited investors, either prior to or following the public filing of a registration statement. These communications, while exempt from the "gun jumping" provisions of Section 5, could subject an issuer to liability under Section 12(a)(2) of the Securities Act and other applicable anti-fraud laws if misleading in any material respect.

Because "testing the waters" communications under proposed Rule 163B would be limited to certain parties the SEC views as sophisticated institutional investors, these communications would not need to be filed with the SEC or include any specific legend.

Rule 163B as proposed would include a number of protective measures for investors. The information in "testing the waters" materials must not conflict with material information in the issuer's related registration statement. Additionally, issuers subject to Regulation Fair Disclosure ("Regulation FD") would need to assess whether any information included in "testing the waters" materials would trigger any public disclosure obligations under Regulation FD.[4] Finally, Rule 163B would not be available for any communication that is part of a plan or scheme to evade Section 5 requirements, even if the communication is in technical compliance with Rule 163B.

In its proposal, the SEC noted that expanding the universe of issuers eligible to "test the waters" in advance of a public offering could yield a number of benefits, including permitting a greater number of issuers to more accurately assess demand for and valuation of their securities and to conduct successful offerings at a lower cost, which may encourage domestic registered offerings. Investors may also benefit from increased disclosure by issuers, increased transparency in the marketplace, and a wider pool of potential issuers in which to invest.

Rule 163B would be non-exclusive, so a company's reliance on the rule would not preclude that company from also relying on Section 5(d) or other applicable safe harbors. However, since "testing the waters" communications pursuant to Rule 163B would still be subject to potential liability under Section 12(b)(2), we do not expect emerging growth companies would seek to rely on Rule 163B in lieu of Section 5(d). We do note, however, certain nuanced distinctions between the two (for example, Rule 163B applies a knowledge qualification to the issuer's assessment of the sophistication of potential investors, while Section 5(d) uses an objective standard), which will be worth consideration by issuers that could use either construct.

[4] In general, Regulation FD prohibits selective disclosure of material, nonpublic information to certain classes of persons (principally, market professionals) unless that information is disclosed to the public at large simultaneously. Regulation FD applies to all companies with a class of registered securities or that are required to file periodic reports under the Securities Exchange Act of 1934. In its proposing release, the SEC noted that some issuers subject to Regulation FD may choose not to avail themselves of Rule 163B because they may be required to disclose publicly pursuant to Regulation FD certain information they shared with institutional investors during "testing the waters" communications. However, there are limited exceptions to Regulation FD's public disclosure requirements, most notably with regard to disclosure to a person who expressly agrees to maintain the disclosed information in confidence.

If adopted, we believe Rule 163B could also facilitate shelf offerings by well-known seasoned issuers ("WKSIs")[5] that do not have an automatic shelf registration statement on file, because it would allow potential underwriters (as persons authorized on behalf of an issuer) to market confidentially prior to the public announcement of a registered offering. Currently, persons authorized by a WKSI are not permitted to make pre-filing offers.

For more information, see the SEC's proposal here. The proposal is subject to a 60-day comment period that will begin when the proposal is published in the Federal Register.

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[5] A well-known seasoned issuer is an issuer that (i) is required to file periodic reports with the SEC, (ii) meets the registration requirements of Form S-3 or F-3, (iii) within 60 days of filing a shelf registration statement, either has a worldwide public float of at least $700 million or has issued in the last three years at least $1 billion aggregate principal amount of non-convertible securities in registered offerings, and (iv) is not an "ineligible issuer."