

## SEC's 'Test The Waters' Expansion Could Spur More Offerings

By Tom Zanki

*Law360 (October 11, 2019, 12:03 PM EDT)* -- The U.S. Securities and Exchange Commission's decision to allow all companies to pursue "testing-the-waters" communications with institutional investors before registering their offerings is welcomed by corporate attorneys, who say the policy could spur more deal-making, though investor groups are skeptical that the public will benefit from the rule change.

How much of an impact the new SEC's policy will have remains unclear, given that law already allows many companies to "test the waters" — meaning they can initiate preliminary discussions with select investors to gauge market interest before or after filing their registration statement.

The Jumpstart Our Business Startups Act of 2012 granted such benefits to a large swath of issuers called emerging growth companies, generally those with \$1.07 billion or less in revenue. The JOBS Act aimed to stimulate initial public offerings, which have declined in recent decades.

The SEC on Sept. 26 approved expanding "testing the waters" benefits to all issuers regardless of size. Capital markets lawyers hope the move will build on the momentum generated by the prior policy, which they say was well received by market participants.

"We think this is a great development and we are looking forward to seeing how well this plays out the market," Latham & Watkins LLP partner Alex Cohen said.

The idea is that by allowing companies to gauge sentiment from institutional investors regarding a potential offering without fear of violating communications restrictions under current securities laws, issuers will gain a better sense of whether the market will support their offerings.

Lawyers say this flexibility could give issuers more confidence to proceed with deals, or save them money and embarrassment if they get chilly responses and decide to put off their offerings.

"Having a successful IPO is challenging regardless of size," Covington & Burling LLP partner Brian Rosenzweig said. "So opening up those tools to the entire universe of potential IPO issuers can only help."

Most of the 20 comment letters the SEC received after proposing this rule change in February supported expanding "testing the waters" to all issuers. Many concurring letters were submitted by corporate law firms, plus business and Wall Street groups and the Nasdaq stock exchange.

Investor group Better Markets dissented, arguing the SEC did not have the authority to expand the JOBS Act provisions beyond what Congress specified in the law and questioned whether the rule change would increase public offerings, among other things. In its final rule, the SEC cited “broad authority” granted to it by Congress to authorize exemptions from securities laws.

Barbara Roper, director of investor protection at the Consumer Federation of America, said in an email to Law360 that she does not expect the new rule to have “meaningful impact” in encouraging more IPOs. She argued that the decline in public offerings largely reflects actions by Congress and the SEC taken in recent decades to expand exemptions from registration, which enable more companies to stay private longer.

“Between them, Congress and the SEC have systematically destroyed the incentives companies had to go public, and tweaks like this aren’t going to change that,” Roper said.

The SEC declined to comment. The agency in its final rule, known as Rule 163B, said it believes the new policy could motivate more companies to go public by mitigating certain market uncertainties, though the SEC added it couldn’t quantify the impact of the rule change.

Data isn’t precise as to how many emerging growth companies have used “testing the waters” benefits since the JOBS Act was enacted, partly because companies can conduct such communications orally or in writing but are not required to file records of these communications with their registration statements. But judging by SEC staff comments in response to IPO filings, the SEC cited a report indicating that 37% of issuers used this benefit from 2012 to 2018.

The SEC notes that other studies show higher percentages of IPO issuers that authorized their underwriters to conduct “testing the waters” communications on their behalf, though it’s not certain whether the underwriters actually engaged in such communications. In any event, capital markets lawyers note that the benefit has gained traction among issuers since it took effect.

“In our experience across a broad variety of IPOs, it’s popular,” Cohen said. “Whether you [test the waters] or not, it’s always a topic of conversation. It’s a very useful tool in the arsenal.”

The SEC reports that “testing the waters” is most popular with the biotechnology, pharmaceutical, technology, media, and telecommunications industries. The agency notes that issuers may be more inclined to “test the waters” if they are uncertain about their valuation and the timing of their IPO depends on regulatory approvals, which is common among biotechnology companies.

Mayer Brown LLP partner Anna Pinedo noted that more issuers are pricing offerings within their stated price ranges in recent years, which she attributed in part to “testing the waters” benefits.

There are “more opportunities to interact with investors and to gauge appropriately the right price range for an offering,” Pinedo said. “That’s very valuable.”

Apart from IPOs, capital markets lawyers say expansion of “testing the waters” could provide a bigger benefit to existing public companies conducting follow-on offerings. Before the new rule, issuers had to be identified either as an “emerging growth company” or a category of large companies known as “well-known seasoned issuers” to qualify for “testing the waters” benefits.

The new rule applies this benefit to all public companies. In addition, prior rules did not allow the underwriters of well-known seasoned issuers to engage in “testing the waters” communications on the issuer’s behalf. But the new Rule 163B extends that benefit to their underwriters as well.

"The real significance of this is not as much on the IPO market, but in the market for follow-ons and secondary offerings," Cohen said.

In terms of IPOs, the SEC rule change comes during a choppy year for such offerings. While the IPO market has been busy from about March until a recent slowdown, several high-profile private companies including Uber and Lyft saw their shares sink in public trading following heavily hyped IPOs. Coworking giant WeWork canceled IPO plans after a frosty reception from investors.

All these companies have more than \$1.07 billion in annual revenue, which would have made them eligible to use “testing the waters” benefits had the new policy been in effect. Whether it would have made a difference in helping the companies gauge market sentiment is not clear.

Healthy Markets Association CEO Tyler Gellasch said he doesn’t believe expanding “testing the waters” will provide much benefit for large private companies, noting that such companies are likely to already have widespread contacts among investment banks and institutional investors.

“It’s hard to see how expanding this to companies with over \$1 billion in revenues will materially, positively impact the offering of securities and lead to more IPOs,” said Gellasch, whose organization advocates for asset managers.

The new rule takes effect by Dec. 3. Capital markets lawyers say they will be watching closely to see how the rule is received, noting that companies were slow to embrace “testing the waters” when it first came out but warmed up to the idea as it became more established.

“It will be interesting to see how quick people are to adopt it," Pinedo said.

--Editing by Katherine Rautenberg.