

## **SEC Proposes to Expand “Test-the-Waters” Communications to All Issuers**

On February 19, 2019, the Securities and Exchange Commission (the “SEC”) issued a release (the “Release”)<sup>1</sup> proposing new Rule 163B under the Securities Act of 1933, as amended (the “Securities Act”) to expand the use of “test-the-waters” (“TTW”) communications – currently limited to emerging growth companies (“EGCs”)<sup>2</sup> – to all issuers (or any person authorized to act on their behalf). TTW communications (oral or written communications by issuers, or their authorized representatives, with certain investors made before or after a registration statement (that covers the securities to be offered) is filed with the SEC) are designed to determine whether there is sufficient investor interest in a contemplated registered securities offering. The SEC hopes that proposed Rule 163B, if enacted, will encourage more issuers to access the capital markets through a registered offering.

### **I. Executive Summary**

Key parts of proposed Rule 163B are:

- TTW available to all issuers and their agents: All issuers (including non-EGCs) or any person authorized to act on their behalf (including underwriters or dealers) would be permitted to engage in TTW communications;
- Timing: TTW communications could be made prior to or after the filing of a registration statement with the SEC;
- Only for certain investors: TTW communications could only be made to prospective investors that are, or reasonably believed to be, qualified institutional buyers (“QIBs”)<sup>3</sup> or institutional accredited investors (“IAIs”)<sup>4</sup>;
- No verification requirement: Issuers would not be required to verify an investor’s status so long as they “reasonably believe” the potential investor meets the QIB or IAI requirements;
- No legend or filing requirements: Any TTW communications would not need to be filed with the SEC or include any specific legend;
- Non-exclusive: The rule would be non-exclusive, meaning issuers could rely on other exemptions;
- Liability: Any TTW communication would constitute an “offer” under the SEC rules and thus be subject to liability under the federal securities laws; and

<sup>1</sup> For the full text of the release, see Securities and Exchange Commission, 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> (February 19, 2019).

<sup>2</sup> Pursuant to Section 2(a)(19) of the Securities Act, an EGC is defined as a company with annual gross revenues of less than \$1.07 billion in its most recently completed fiscal year, and has not completed its initial public offering under a registration statement on or before December 8, 2011. An EGC will retain such status until the earlier of: (1) the last day of the fiscal year in which the fifth anniversary of its initial public offering occurred; (2) the last day of the fiscal year in which its annual gross revenues first exceed \$1.07 billion; (3) the date on which it becomes a large accelerated filer (an SEC registered company with a public float of at least \$700 million); or (4) the date on which the company has, during the previous three years, issued \$1 billion of non-convertible debt.

<sup>3</sup> A QIB is an entity meeting the requirements set forth in 17 CFR 230.144A (“Rule 144A”), including, without limitation, any entity included within certain enumerated categories, acting for its own account or the accounts of other QIBs, that in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers not affiliated with the entity (or \$10 million for a broker-dealer).

<sup>4</sup> An IAI is an institution that complies with one of the accredited investor categories as described in 17 CFR 230.501 (“Rule 501”) of Regulation D.

- Other considerations: TTW communications must not conflict with material information in the related registration statement, and issuers will need to consider any applicable obligations under Regulation FD.

## II. Background

Section 5 of the Securities Act and related rules restrict communications by issuers during various phases of the securities offering process. For example, Section 5(c) generally prohibits written and oral offers prior to the filing of a registration statement, absent an exemption,<sup>5</sup> and Section 5(b)(1), which applies once a registration statement is filed, limits written offers to a “statutory prospectus” that includes the information required by Section 10 of the Securities Act.<sup>6</sup> A violation of these provisions is known as “gun-jumping.”<sup>7</sup>

The SEC has gradually taken steps to liberalize these gun-jumping rules, and in 2012, the Jumpstart Our Business Startups Act (the “JOBS Act”) created, among other things, Section 5(d) of the Securities Act and introduced the concept of TTW communications.<sup>8</sup> Under Section 5(d), EGCs (and their authorized agents) are permitted to engage in oral or written communications with QIBs and IAIs to “test-the-waters” before or after the filing of a registration statement to determine investor interest in a contemplated registered offering.<sup>9</sup> The accommodations provided by the JOBS Act have provided EGCs with increased flexibility to communicate with potential investors and, it appears, have encouraged them to access the public markets.<sup>10</sup> For example, since the enactment of the JOBS Act, approximately 87% of IPOs that have been declared effective have been by EGC issuers,<sup>11</sup> and certain studies have shown that 38% and 23% of EGCs engaged in TTW communications in 2015 and 2016, respectively.<sup>12</sup>

Proposed Rule 163B responds to requests that the SEC expand the JOBS Act provisions, including TTW communications, to non-EGCs<sup>13</sup>, and if enacted “would result in greater harmonization of offering process requirements between EGC and non-EGC issuers.”<sup>14</sup>

## III. Proposed Rule 163B

The SEC’s proposed Rule 163B would permit any issuer or its authorized agent to engage in TTW communications with potential investors that are, or that the issuer reasonably believes are, QIBs or IAIs either prior to or following the filing of a registration statement with the SEC in order to determine investor interest in a registered securities offering.

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<sup>5</sup> See 15 U.S.C. 77e(c).

<sup>6</sup> See 15 U.S.C. 77e(b)(1).

<sup>7</sup> SEC Release No. 33-10607, *supra* note 1, at 7.

<sup>8</sup> Public Law 112-106, 126 Stat. 306 (2012).

<sup>9</sup> See 15 U.S.C. 77e(d).

<sup>10</sup> SEC Release No. 33-10607, *supra* note 1, at 6.

<sup>11</sup> *Id.*, at 6 n. 8 (citing *Update on emerging growth companies and the JOBS Act*, November 2016, Ernst and Young, LLP, available at <https://www.ey.com/Publication/vwLUAssets/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016/%24FILE/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016.pdf>).

<sup>12</sup> *Id.*, at 6, n. 9 (citing IPO studies by Proskauer Rose LLP).

<sup>13</sup> *Id.*, at 6-7.

<sup>14</sup> *Id.*, at 30.

## Scope of Proposed Rule 163B

### *Availability to all Issuers and their Authorized Agents*

Proposed Rule 163B would be available to all issuers, including non-reporting companies, EGCs, non-EGCs, well-known seasoned issuers (“WKSIs”)<sup>15</sup> and investment companies (including those issuers that are, or are considering becoming, registered investment companies or business development companies).<sup>16</sup>

In addition, proposed Rule 163B would be available to those authorized to act on behalf of an issuer, including the underwriters or dealers participating in the offering.<sup>17</sup> This is a benefit currently afforded to EGCs under Section 5(d), but is not generally available for non-EGCs. For example, Rule 163 provides a limited exemption for WKSIs to engage in TTW communications made “by or on behalf of the issuer itself,” but does not apply to any offering participants (even if the issuer has authorized the communication).<sup>18</sup> In 2009, the SEC proposed amendments to Rule 163(c) to allow pre-filing communications by the underwriters or dealers acting as the agent to a WSKI issuer,<sup>19</sup> but the SEC never adopted a final rule.

### *Timing of any TTW Communications*

Subject to certain exceptions,<sup>20</sup> non-EGCs are currently not permitted to engage in TTW communications prior to the filing of a registration statement that covers the securities being offered (including during the time between the confidential submission and the initial public filing with the SEC). However, proposed Rule 163B would allow all issuers to have TTW communications prior to or following the filing of a registration statement.

## No Verification Requirement

Under proposed Rule 163B, all issuers and those authorized to act on their behalf would only be able to engage in TTW communications with potential investors that are, or who the issuer reasonably believes are, QIBs or IAs. This is an expansion of the current TTW rules available to EGCs under Section 5(d), which does not include such a “reasonable belief” standard. Furthermore, issuers (or their authorized agents) would not be required to verify an investor’s status as long as they “reasonably believe” the potential investor meets the statutory requirements based on the specific facts and circumstances.<sup>21</sup> The Release does not specify the steps an issuer must take in order

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<sup>15</sup> As defined in Securities Act Rule 405, a WSKI, is an issuer that meets all the registrant requirements of Form S-3 or Form F-3; has at least \$700 million in worldwide market value of outstanding voting and non-voting publicly-held common equity or has issued, for cash, within the last three years at least \$1 billion aggregate principal amount of non-convertible securities through registered offerings; and is not an “ineligible issuer,” as defined in Rule 405.

<sup>16</sup> SEC Release No. 33-10607, *supra* note 1, at 15.

<sup>17</sup> *Id.*, at 42.

<sup>18</sup> See 17 CFR 230.163.

<sup>19</sup> See Securities and Exchange Commission, Proposed Rules, SEC Release No. 33-9098, available at <https://www.sec.gov/rules/proposed/2009/33-9098fr.pdf> (December 28, 2009).

<sup>20</sup> For example, Rule 163 provides a limited exemption for WKSIs to engage in TTW communications before a registration statement is filed, but such exemption is only available for communications made by WKSIs that include a certain legend and are promptly filed with the SEC upon the filing of a registration statement. See 17 CFR 230.163.

<sup>21</sup> SEC Release No. 33-10607, *supra* note 1, at 17.

to establish a reasonable belief, but notes that issuers should continue to rely on the methods they currently use to make such determinations.<sup>22</sup>

## No Legend or Filing Requirements

Any TTW communications made under proposed Rule 163B would not be required to be filed with the SEC or to include any specific legend (consistent with TTW communications made under Section 5(d)).<sup>23</sup> The SEC believes that QIBs and IAIs are sufficiently sophisticated to assess investment opportunities without the protection of additional safeguards (such as a legend or an SEC filing).<sup>24</sup> However, as is currently the practice for TTW communications made under Section 5(d), the SEC staff may request that an issuer provide the SEC with copies of any TTW communications made under proposed Rule 163B.<sup>25</sup>

## Non-exclusivity of the Proposed Rule

The proposed Rule 163B would be non-exclusive such that any attempted compliance with the rule would not prohibit reliance on any other available Securities Act exemptions (such as Rule 255, Rule 163, Rule 164, and Section 5(d) of the Securities Act).<sup>26</sup> However, the Release clarifies that if an issuer is relying on the availability of another exemption with respect to TTW communications, then the conditions of such other exemption must be satisfied irrespective of proposed Rule 163B.<sup>27</sup>

## Securities Law Liability and Material Non-Public Information

As is currently the case for TTW communications made under Section 5(d) of the Securities Act, any TTW communications made under proposed Rule 163B, while exempt from the gun-jumping provisions of Section 5 of the Securities Act, would still be considered an “offer” (as defined in Section 2(a)(3) of the Securities Act), and therefore be subject to the securities law liability provisions, including Section 12(a)(2) of the Securities Act, the anti-fraud provisions of the Securities Act and the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.<sup>28</sup>

Any TTW communications made under proposed Rule 163B may not conflict with material information contained in the registration statement covering the securities to be offered.<sup>29</sup> In addition, any issuers subject to Regulation FD will need to determine whether any information in a TTW communication would trigger any disclosure obligations under Regulation FD or whether an exemption

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<sup>22</sup> As currently proposed, Rule 163B does not require issuers to satisfy the accredited investor verification requirements set forth in Rule 506(c) of Regulation D, but the SEC seeks comment on this issue in the Release. *Id.*, at 18.

<sup>23</sup> *Id.*, at 11.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*, at 12.

<sup>26</sup> *Id.*, at 19.

<sup>27</sup> *Id.*, at 21. For example, the SEC notes if a WKSI intends to communicate with QIBs under proposed Rule 163B, and thus does not include any legends or file such communications, but then later decides to expand pre-filing communications as permitted under existing Rule 163 to include potential investors not within the scope of proposed Rule 163B (such as accredited investors that are natural persons), then the issuer must have complied with proposed Rule 163’s legending and filing requirements from the start of such communications in order to avail itself of that exemption.

<sup>28</sup> *Id.*, at 12.

<sup>29</sup> *Id.*

would apply.<sup>30</sup> Absent another exemption, issuers may want to consider entering into confidentiality agreements with recipients of their TTW communications.

#### IV. Conclusion & Next Steps

With Rule 163B, the SEC is proposing to expand certain benefits previously afforded to EGCs under the JOBS Act to all issuers and their authorized agents. The SEC hopes that, by allowing all issuers to “test-the-waters,” the proposed rule will provide all companies with a cost-effective method for preliminarily assessing valuation, market interest and the attractiveness of offering terms before incurring the costs associated with pursuing a registered offering,<sup>31</sup> and will therefore help make registered securities offerings more attractive to certain issuers that otherwise would have relied on private placements or not pursued an offering.<sup>32</sup>

The SEC is seeking comments on the Release until April 19, 2019.<sup>33</sup>

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Meghan McDermott at 212.701.3619 or [mmcdermott@cahill.com](mailto:mmcdermott@cahill.com); Douglas S. Horowitz at 212.701.3036 or [dhorowitz@cahill.com](mailto:dhorowitz@cahill.com); Helene R. Banks at 212.701.3439 or [hbanks@cahill.com](mailto:hbanks@cahill.com); Geoffrey E. Liebmann at 212.701.3313 or [gliebmann@cahill.com](mailto:gliebmann@cahill.com); Ross Sturman at 212.701.3831 or [rsturman@cahill.com](mailto:rsturman@cahill.com); David A. Rand at 212.701.3189 or [drand@cahill.com](mailto:drand@cahill.com); Bradley J. Bondi at 202.862.8910 or [bbondi@cahill.com](mailto:bbondi@cahill.com); Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); or Elai Katz at 212.701.3039 or [ekatz@Cahill.com](mailto:ekatz@Cahill.com).

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<sup>30</sup> *Id.*, at 12-13.

<sup>31</sup> *Id.*, at 6.

<sup>32</sup> *Id.*, at 30-31.

<sup>33</sup> *Id.*, at 1.