Client Alert | Capital Markets

Hoping to Encourage Increased Participation in the Public Markets, SEC Proposes New Rule Allowing all Issuers to Test the Waters

February 2019

Authors: Era Anagnosti, Stuart Bressman, Rupa Briggs, Jessica Chen, Colin Diamond, Holt Goddard, Michelle Rutta, John Vetterli

The SEC is proposing to extend the testing-the-waters ("TTW") accommodation to all issuers, including investment company issuers.[1] Citing the dominance of the IPO market by emerging growth companies ("EGCs")[2] and evidence that a significant percentage of EGC issuers conducting IPOs have taken advantage of the TTW accommodation afforded by Section 5(d) of the Securities Act of 1933, as amended (the "Securities Act"), the SEC's proposed new Rule 163B would level the playing field with respect to permissible investor solicitations as between EGCs and non-EGCs contemplating a registered securities offering, and thereby encourage public capital formation. The proposal would allow all prospective issuers to gauge market interest in any proposed registered securities offering (although the proposed rule will be especially beneficial for IPOs by non-EGCs) by permitting discussions with certain investors prior to or following the filing of a registration statement. Proposed new Rule 163B would be non-exclusive and, when taken together with exemptions already provided under the Securities Act, should further reduce the risk of "gun-jumping" violations and facilitate pre-offering market checks that are commonplace outside of the United States, but have been denied to the largest issuers in US IPO market.

Proposed New Rule 163B

Proposed new Rule 163B under the Securities Act would allow all issuers to engage in TTW communications with potential investors that are, or that the issuer reasonably believes to be,[3] qualified institutional buyers ("QIBs") (under Rule 144A) or institutional accredited investors ("IAIs") (under Regulation D of the Securities Act) either prior to or following the date of filing of a registration statement with the SEC. The proposed rule would provide an exemption from the "gun jumping"[4] provisions of Section 5(b)(1) and Section 5(c) of the Securities Act for such communications by an issuer, or person authorized to act on behalf of an issuer, including an underwriter, either prior to or following the filing of a registration statement, enabling them to engage in oral or written communications with QIBs or IAIs, to determine whether such investors might have an interest in the contemplated offering. The SEC is also proposing to amend Securities Act Rule 405 to

1 Refer to SEC Release No. 33-10607 available here.

2 An EGC is an issuer with "total annual gross revenues" of less than $1.07 billion during its most recently completed fiscal year.

3 The reasonable belief standard with respect to QIB and IAI status in proposed Rule 163B is different from the standard contained in Section 5(d) of the Securities Act, which applies to EGCs only and which simply requires that the potential investors be QIBs or IAIs. Proposed Rule 163B is therefore marginally more lenient than Section 5(d) of the Securities Act, which may result in EGCs and investment banks choosing to relying on it rather than Section 5(d).

4 "Gun-jumping" is an expression, not defined in the US securities laws, that generally refers to a violation of US securities law restrictions on issuer publicity and communications before, during or after a public offering.

exclude a written communication used in reliance on the proposed rule from the definition of a free writing prospectus.

Proposed Rule 163B is not limited to IPOs, but would also be available to reporting companies under the Exchange Act. Such issuers would need to consider whether any information in their TTW communication would trigger any obligations under Regulation FD. Regulation FD requires public disclosure of any material nonpublic information that has been selectively disclosed to certain securities market professionals or shareholders if the issuer has a class of securities registered under Section 12 of the Exchange Act or is required to file reports under Section 15(d) of the Exchange Act of 1934, as amended.

Potential Impact of the Proposed Rule

The concept of TTW was introduced in 2012 by the JOBS Act, which limited it only to EGCs. At the time[5] we queried why the TTW accommodation was not made available to all issuers, since the size of a company has no direct correlation to the IPO process. This stands in contrast, for example, to the scaled disclosure provisions that logically differentiate between EGCs and non-EGCs based on their size. We therefore welcome the proposal to extend TTW to all issuers.

As a practical matter, non-EGCs have engaged in a form of TTW *after* the public filing of a registration statement on the basis that the Securities Act permits oral offers of securities from that point forward.[6] This practice has been used for many years, particularly in the context of outsized IPOs where "cornerstone" investors require more than a two to three week roadshow to make a decision to invest hundreds of millions of dollars. The SEC clarified that the JOBS Act TTW provisions applicable to EGCS did not change the ability of non-EGCs to engage in such activity.[7]

Proposed Rule 163B therefore addresses two "donut holes" that currently exist for non-EGCs:

- Non-EGCs remain unable to engage in TTW between the time that they are under SEC review during the confidential submission stage and the public filing of a registration statement. This has impacted the ability of some of the largest IPO companies to adequately inform themselves as to investor sentiment before they file their registration statement publicly. For those issuers that have a choice of listing jurisdiction, this fact can be impactful. For others, it increases the risk of an unsuccessful IPO.

- Relying on the informal framework of oral offers after the filing of a registration statement does not constitute a "safe harbor." Most investment banks prefer to rely on the TTW safe harbor in an IPO even after the public filing of a registration statement because it minimizes the risk of an inadvertent "gun jumping" mistake. This is not currently possible for non-EGCs.

In addition, overall the proposed rule would have the effect of aligning the TTW regime between EGCs and non-EGCs in all key areas: timing of communications, investor eligibility, lack of SEC filing requirement and liability.

While the proposed rule would extend TTW to reporting companies under the Exchange Act, we do not expect many of these issuers to take advantage of the new proposed Rule 163B. EGCs can also engage in TTW communications after their IPOs; however, investment banks and issuers have not used this provision and have instead relied on the longstanding ability of an issuer to make oral offers after it has an effective Form S-3 or F-3 shelf registration statement on file. Unlike TTW, these discussions are not limited to determining "whether such investors might have an interest in a contemplated registered securities offering." These discussions with potential investors are made by means of "wall crossing" those investors and restricting them from trading while discussing the possibility of an offering. Companies that are not yet eligible to file a Form S-3 or F-3 (for example, issuers with less than $75 million in public float or a reporting history of less than 12

5 See our alert FAST Act Amends JOBS Act, dated December 2015, available here.

6 Note, however, that with respect to non-reporting issuers, the instruction to paragraph 501(b)(3) of Regulation S-K prohibits the distribution of a preliminary prospectus to a prospective investor *even if the related registration statement has been publicly filed* if the preliminary prospectus does not contain a price range. Therefore, TTW activities by EGCs and non-EGCs do not include distributing to potential investors the publicly filed registration statement before a price range is included.

7 See Question 1, Jumpstart Our Business Startups Act Frequently Asked Questions About Research Analysts and Underwriters, Division of Trading and Markets, available at https://www.sec.gov/divisions/marketreg/tmjobsact-researchanalystsfaq.htm.

calendar months) might find some benefit from being able to engage in TTW before filing a registration statement on Form S-1 or F-1 for an offering, although they might be wary of the risk that an offering may be delayed if the subsequently-filed registration statement becomes subject to an SEC review.

Some Global Context for the Change

The concept of TTW is common outside of the United States. "Pilot fishing" in Europe involves holding meetings with a small number of sophisticated investors to try to gauge interest in a proposed IPO before it is publicly launched. Pilot fishing is a core element of the IPO process in most of Europe, together with the publication of pre-IPO research reports by investment bank analysts. In that context, it is worth remembering that the JOBS Act contained provisions that removed the prohibition on pre-IPO research reports by investment bank analysts.[8] Publication of pre-IPO research is still alien to the US IPO market and is restricted as a matter of practice until 25 days after an IPO,[9] while the publication of pre-IPO research by investment bank analysts plays a critical role in investor education in other key global markets, including most of Europe and Hong Kong. Despite the intent of the JOBS Act, we do not see any pressure for SEC action in this area for either EGCs or non-EGCs given the liability risk that banks would perceive to be associated with publishing such research.

Request for Comments

In its request for comment, the SEC is soliciting input on a number of topics, including but not limited to:

- whether the proposed expansion of permissible TTW communications raises investor protection concerns;
- whether such TTW communications should be deemed offers under Section 2(a)(3) of the Securities Act subject to Section 12(a)(2) liability; and
- whether such communications should be filed as exhibits to the registration statement.

The public comment period will remain open for 60 days following publication in the Federal Register.

Considerations for Investment Companies

The proposal also extends to issuers that are, or are considering becoming, registered investment companies or Business Development Companies (together, "Funds"). Under the proposed rule, Funds would be eligible to engage in TTW communications. Fund communications contemplated by proposed Rule 163B generally would be considered "sales literature" subject to their own rules under the Securities Act and Investment Company Act.[10] Under the proposal, Funds could rely on proposed Rule 163B to engage in permissible TTW communications without complying with these other communications rules. Proposed Rule 163B would allow funds to communicate with QIBs and IAIs about a contemplated offering without either being an EGC or complying with the requirements of Section 24(b) of the Investment Company Act or Rules 482 or 34b-1, including the associated filing, disclosure, and legend requirements. The SEC is also proposing to exclude Funds' TTW communications conducted under proposed Rule 163B from the filing requirements in Securities Act Rule 497 and in Section 24(b) of the Investment Company Act and the rules thereunder.

8 Prior to the JOBS Act, the earliest time that pre-IPO research could be published was 40 days after the IPO pursuant to then-effective rules of the Financial Industry Regulatory Authority (FINRA).

9 There is no restriction on the publication of research reports before or after the IPO of an EGC, but given the 25-day prospectus delivery requirement under Section 4(a)(3) of the Securities Act as modified by Rule 174(d) under the Securities Act, as a matter of practice investment banks have not sanctioned the publication of research until 25 days after the IPO of an EGC. Investment banks working on a non-EGCs IPO are still subject to a formal 10-day restriction on the publication of research following their IPO pursuant to FINRA Rule 2441(b)(I).

10 After a fund has filed a registration statement, it may engage in communications that are advertisements under Rule 482 under the Securities Act or that are deemed to be sales literature under Rule 34b-1 under the Investment Company Act. Communications under Rule 482 and Rule 34b-1 are also subject to certain filing disclosure and legend requirements.

White & Case LLP
1221 Avenue of the Americas
New York, New York 10020-1095
United States

T +1 212 819 8200

White & Case LLP
701 Thirteenth Street, NW
Washington, District of Columbia 20005-3807
United States

T +1 202 626 3600