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SEC Expands 'Testing-the-Waters' Communications to All Issuers

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Four Times Square
New York, NY 10036
212.735.3000

On September 26, 2019, the Securities and Exchange Commission (SEC) adopted new [Rule 163B](#) and related amendments under the Securities Act to expand the permitted use of “testing-the-waters” communications to all companies regardless of size or reporting status, including business development companies (BDCs) and other registered investment companies. The new rule enables any issuer, including those that are not an emerging growth company (EGC) or any person authorized to act on the issuer’s behalf, to make oral and written offers to qualified institutional buyers (QIBs)¹ and institutional accredited investors (IAIs)² before or after the filing of a registration statement to gauge investors’ interest in an offering.

This new rule is a much-anticipated development that will level the playing field for issuers seeking to evaluate market interest prior to a registered public offering and represents an additional example of the SEC taking concerted action to encourage public capital formation.

The rule will become effective 60 days following its publication in the Federal Register.

Background

In 2012, Congress passed the Jumpstart Our Business Startups Act (JOBS Act) to ease regulatory burdens on smaller companies and encourage public and private capital formation. The JOBS Act created a new class of issuers, EGCs, with less than \$1 billion (subsequently increased to \$1.07 billion) in annual revenues and implemented a number of changes to the initial public offering (IPO) process, including establishing a transitional “on-ramp” that provides for scaled disclosure for EGCs.

As part of these reforms, the JOBS Act significantly eased long-standing restrictions on “gun-jumping” under Section 5 of the Securities Act by permitting EGCs, or persons authorized to act on their behalf, to make testing-the-waters communications before or after the filing of a registration statement. Testing-the-waters communications may solicit nonbinding indications of interest but may not solicit a binding commitment or

¹ In general, a QIB is any entity included within one of the categories of “accredited investor” defined in Rule 501 of Regulation D, 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 (\$10 million for a broker-dealer).

² An IAI refers to any institutional investor that is also an accredited investor, as defined in Rule 501 of Regulation D (generally an entity not formed for the purpose of investing in the securities being offered with total assets in excess of \$5 million).

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customer order. Offerings for which EGCs may test the waters include IPOs, exchange offers, follow-on offerings and stock merger-related offerings.

Testing-the-waters activities vary from deal to deal. Typically, in a capital markets transaction, they resemble a roadshow presentation where management meets with potential investors and gives a presentation describing the issuer and the proposed offering. Representatives of the lead underwriter(s) usually arrange and accompany management at these meetings. Written materials may be used, although investment banks' internal policies vary and some limit or prohibit written materials. Most often, management uses a presentation that resembles a roadshow deck but does not leave behind and carefully limits any other written materials.³

New Rule 163B

The SEC's new rule, Securities Act Rule 163B, expands testing-the-waters accommodations to 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 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.

Under Rule 163B:

- All issuers are entitled to rely on the exemption, including nonreporting issuers, EGCs, non-EGCs, well-known seasoned issuers (WKSIs) and BDCs and other registered investment companies.
- Testing-the-waters communications will not need to be filed with the SEC or required to include any specific legend.
 - The release, however, notes that the SEC staff anticipates requesting, in connection with its review of a registration statement, that any testing-the-waters communication used in connection with the offering be furnished to the staff for review, as has been its practice when reviewing offerings conducted by EGCs.

³ Although there is no prohibition on using or providing copies of the registration statement that was confidentially submitted to the SEC for testing-the-waters communications (often referred to as the "pink herring" prospectus), a number of investment banks prohibit such practice. Similarly, while there is no prohibition on recording testing-the-waters presentations and posting them on a restricted access site such as NetRoadshow, these practices are rare. However, investment banks may permit presentation materials to be made available for a limited time and on a restricted access basis on NetRoadshow in order to facilitate telephonic meetings. Finally, there is no prohibition on conducting testing-the-waters meetings with groups of more than one QIB and/or IAI, but it is uncommon to do so, and investment banks often prefer to conduct meetings with potential investors one-on-one.

- Issuers will not be required to otherwise verify an investor's QIB or IAI status as long as they reasonably believe the potential investor meets the requirements of the rule.
 - The SEC did not adopt specific steps or methods to establish a reasonable belief, or to require issuers to take reasonable steps to verify, that the intended recipients of testing-the-waters communications are QIBs or IAIs.
 - Rather, issuers may continue to rely on methods they currently use to establish a reasonable belief regarding an investor's status as a QIB or IAI pursuant to Rule 144A or Rule 501(a). This approach is intended to provide issuers with the flexibility to use methods that are cost-effective but appropriate in light of the facts and circumstances of each contemplated offering and each potential investor.
- Rule 163B communications, while exempt from Section 5(b)(1) and Section 5(c) of the Securities Act, will be considered "offers" as defined in Section 2(a)(3) of the Securities Act and therefore subject to Section 12(a)(2) liability in addition to the anti-fraud provisions of the federal securities laws.
- Issuers subject to Regulation FD will need to consider whether any information in a testing-the-waters communication might trigger public disclosure obligations under Regulation FD, absent an agreement to keep such information confidential.
 - If a reporting issuer's testing-the-waters communications includes material nonpublic information (MNPI), or the fact that the issuer intends to pursue a registered public offering itself is deemed to constitute MNPI, the issuer must make simultaneous public disclosure of the MNPI or require that the investors expressly agree to maintain the confidentiality of the testing-the-waters communications and the fact of the offering itself. We expect that issuers and underwriters using Rule 163B will require investors to agree to keep such information confidential for a period of time in order to receive any information about the offering, to ensure compliance with Regulation FD. Consistent with current market practices, we generally expect that cleansing disclosures will not be required if the only MNPI shared with investors is the fact that the issuer is contemplating an offering.
- The rule does not contain a condition that testing-the-waters communications not conflict with material information in the related registration statement.
 - The proposing release includes a statement that a testing-the-waters communication should not conflict with the registration statement, which statement was intended to remind issuers of their anti-fraud liability under the federal securities laws. In response to commenters' concerns that circumstances or messaging may change between the time a

prefiling Rule 163B communication is made and the time a registration statement is filed, the SEC clarified that statement in the proposing release is not a condition to new Rule 163B. That said, because of liability concerns, we expect Rule 163B testing-the-waters communications generally to be consistent with the registration statement, as has been market practice with Section 5(d) testing-the-waters materials. As is the case with a typical underwriting agreement for an EGC offering, we expect that issuers that may engage in Rule 163B testing-the-waters activities will need to include a representation in the relevant underwriting agreement that the testing-the-waters materials do not conflict with the registration statement.

- Securities Act Rule 405 has been amended to clarify that testing-the-waters communications used in reliance on Rule 163B will not be considered a free writing prospectus.⁴
- The final rule does not include a proposed clause that would have made the rule unavailable for any communication that, while in technical compliance with the rule, is part of a plan or scheme to evade the requirements of Section 5 of the Securities Act.
 - The proposed clause was not included because the SEC agreed with commenters that such language may raise uncertainty and would risk limiting the utility of the rule.

Key Takeaways

Rule 163B represents the latest entry in the SEC's ongoing effort to ease access to capital markets by providing flexibility to issuers in the offering process. In this regard, the rule has a number of key features.

Supporting Large Issuer IPOs. While the substantial majority of IPOs conducted in recent years have been conducted by EGCs, Rule 163B addresses a disconnect in the current regulatory framework. The SEC recently expanded the confidential draft registration statement process to non-EGC issuers, but these companies have been unable to communicate with potential investors during the critical time between submitting a confidential draft registration statement and the public filing of the registration statement. This has hindered some of the larger IPO issuers from adequately gauging market interest before filing a public registration statement and, as a result, has increased execution risk. Rule 163B significantly addresses this problem.

⁴ Rule 405 was further amended to clarify the SEC's historical position that Section 5(d) testing-the-waters communications are not free writing prospectuses.

Expanding "Wall Crossing" to All Issuers. The practice of confidentially premarketing an offering to a select number of institutional investors activities (*i.e.*, "wall crossing") has become an established part of the capital markets playbook. The practice, however, currently is only available to WKSIs and issuers with a shelf registration statement on file. Rule 163B will level the playing field by permitting all issuers and their underwriters⁵ to engage in wall crossing activities.

Nonexclusivity. Rule 163B is a nonexclusive exemption. An issuer may rely concurrently on any other available Securities Act rules or exemptions when communicating with potential investors prior to an offering (provided it complies with the conditions of any other exemption or rule relied upon).

Offerings Concurrent With or Preceding Private Placements. Rule 163B covers communications in advance of a registered offering, but it does not foreclose bona fide private placements subsequent to a registered offering. The adopting release notes that if an issuer engages in testing-the-waters communications under Rule 163B concurrently with communications related to a private offering, it can conduct such communications in a manner that preserves the availability of both Rule 163B and any valid private placement exemption. But the adopting release cautions that if an issuer seeks to pursue a private placement in lieu of a registered offering immediately after engaging in testing-the-waters communications, it should consider whether the communication was conducted in such a way as to constitute a general solicitation, as this could preclude any private placement exemption.

Investor Use of Information. The SEC also addressed concerns about the implications of a QIB or IAI passing testing-the-waters information on to nonqualified parties in violation of its confidentiality obligations or otherwise in a manner inconsistent with the reasonable steps undertaken by the issuer to prevent such redistribution. The SEC said that where an issuer has taken reasonable steps to prevent testing-the-waters communications from being shared with non-QIBs and non-IAs and such information is nonetheless shared, such circumstances, in themselves, would not give rise to Section 5 liability for the issuer or the need for any cooling-off period.

⁵ Existing Rule 163 provides a limited exemption for WKSIs to test the waters, but the exemption is of limited utility because it is not available to underwriters working on the registered public offering.

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Contacts

New York

Ryan J. Dzierniejko

Partner
212.735.3712
ryan.dzierniejko@skadden.com

Gregory A. Fernicola

Partner
212.735.2918
gregory.fernicola@skadden.com

David J. Goldschmidt

Partner
212.735.3574
david.goldschmidt@skadden.com

Laura A. Kaufmann Belkhaty

Partner
212.735.2439
laura.kaufmann@skadden.com

Andrea L. Nicolas

Partner
212.735.3416
andrea.nicolas@skadden.com

Michael J. Schwartz

Partner
212.735.3694
michael.schwartz@skadden.com

Yossi Vebman

Partner
212.735.3719
yossi.vebman@skadden.com

Dwight S. Yoo

Partner
212.735.2573
dwight.yoo@skadden.com

Michael J. Zeidel

Partner
212.735.3259
michael.zeidel@skadden.com

Los Angeles

Michelle Gasaway

Partner
213.687.5122
michelle.gasaway@skadden.com

Palo Alto

Thomas J. Ivey

Partner
650.470.4522
thomas.ivey@skadden.com

Gregg A. Noel

Partner
650.470.4540
gregg.noel@skadden.com

Washington, D.C.

Brian V. Breheny

Partner
202.371.7180
brian.breheny@skadden.com

Andrew J. Brady

Of Counsel
202.371.7513
andrew.brady@skadden.com

Frankfurt

Stephan Hutter

Partner
49.69.74220.170
stephan.hutter@skadden.com

Hong Kong

Z. Julie Gao

Partner
852.3740.4863
julie.gao@skadden.com

Jonathan B. Stone

Partner
852.3740.4703
jonathan.stone@skadden.com

London

James A. McDonald

Partner
44.20.7519.7183
james.mcdonald@skadden.com

Danny Tricot

Partner
44.20.7519.7071
danny.tricot@skadden.com

Pranav L. Trivedi

Partner
44.20.7519.7026
pranav.trivedi@skadden.com

Singapore

Rajeev P. Duggal

Partner
65.6434.2980
rajeev.duggal@skadden.com

Sydney

Adrian J. S. Deitz

Partner
61.4294.44311
adrian.deitz@skadden.com

Tokyo

Kenji Taneda

Partner
81.3.3568.2640
kenji.taneda@skadden.com

Toronto

Riccardo A. Leofanti

Partner
416.777.4703
riccardo.leofanti@skadden.com

Associate **Ryan J. Adams** and **Blake M. Grady** assisted in the preparation of this alert.