Capital Markets Alert

Skadden

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# SEC Proposes New Rule 163B to Expand 'Testing-the-Waters' Communications to All Issuers

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.



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On February 19, 2019, the Securities and Exchange Commission (SEC) voted to propose a new rule and related amendments under the Securities Act that would expand the permissible use of testing-the-waters communications to enable any issuer, or any person authorized to act on their 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 the offering.

In recent years, there have been calls for the SEC to expand the testing-the-waters accommodation to issuers beyond emerging growth companies (EGCs), and recent proposed legislation has sought to statutorily effect such a change. The proposed rules are a welcome development that would level the playing field with respect to permissible investor solicitations and represent an additional example of the SEC taking concerted action to encourage public capital formation.

The proposal will have a 60-day public comment period 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 facilitate public and private capital formation. Most prominently, 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. 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 the EGC's behalf, to make "testing-the-waters" communications before or after the filing of a registration statement to gauge investors' interest in the offering.

Since adoption of the JOBS Act, testing-the-waters communications have been used in a significant portion of EGC IPOs, and recently, certain groups have called for an

[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 institutional accredited investor refers to any institutional investor that is also an accredited investor, as defined in Rule 501 of Regulation D.

expansion of their availability to all issuers.[3] Moreover, in July 2018 the House of Representatives passed the JOBS and Investor Confidence Act (JOBS Act 3.0), a package of reforms consisting of a variety of legislation designed to boost the IPO market that, if signed into law, would expand testing-the-waters communications to all issuers.

## Proposed Securities Act Rule 163B

The SEC's proposed rule, Securities Act Rule 163B, would 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. All issuers — including nonreporting issuers, EGCs, non-EGCs, well-known seasoned issuers and investment companies (including registered investment companies and business development companies) — would be eligible to rely on the proposed rule.

The proposed rule would be nonexclusive, and an issuer could rely on other Securities Act communications rules or exemptions when determining how, when and what to communicate related to a contemplated securities offering. The proposed rule would not be available, however, 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.

Under the proposed rule:

- Testing-the-waters communications would not need to be filed with the SEC or required to include any specific legend.
  - Securities Act Rule 405 would be amended to clarify that testing-the-waters communications would not be considered a free writing prospectus.
- Issuers would not be required to verify investor status as long as they reasonably believe the potential investor meets the requirements of the rule.
  - The ability of an issuer to rely on the rule based on a reasonable belief that an investor is a QIB or IAI is a welcome expansion from Section 5(d), which does not include a "reasonable belief" standard. The proposing release notes that based on the particular facts and circumstances, an issuer could reasonably believe that a potential investor is a QIB or an IAI even though the investor may have provided false information or documentation to the issuer.
- Testing-the-waters communications may not conflict with material information in the related registration statement.
  - This requirement aligns with existing practices, which generally require that any testing-the-waters communications not conflict with or include information materially beyond the information in the registration statement.
  - Consistent with current review practice, the SEC staff could request that an issuer provide it with copies of any testing-the-waters communications used in connection with an offering.
- Issuers subject to Regulation FD would need to consider whether any information in a testing-the-waters communication, or the fact that the issuer is making an investor outreach, would trigger disclosure obligations under that regulation or whether an exemption would apply.
  - Testing-the-waters communications that also include material nonpublic information could be subject to Regulation FD unless an exclusion applies. For example, Regulation FD generally does not apply if the selective disclosure was made to a person who owes a duty of trust or confidence to the issuer or to a person who expressly agrees to maintain the disclosed information in confidence. Thus, the proposing release notes that to avoid the application of Regulation FD, an issuer could consider obtaining confidentiality agreements from any potential investor engaged under the proposed rule.

## Next Steps

We expect the SEC will attempt to move quickly to adopt the proposed rule after the 60-day public comment period closes.

[3] *See, e.g.*, "A Financial System That Creates Economic Opportunities: Capital Markets," U.S. Dep't of the Treasury (2017), and "Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public," Sec. Industry and Fin. Markets Association & Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, *et al.*, (2018).

# Capital Markets Alert
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