Overview

On February 19, 2019, the Securities and Exchange Commission (SEC) announced a proposal to expand the “testing-the-waters” exemption to all issuers. Currently the exemption is limited to emerging growth companies (EGCs). If implemented, the rule and related amendments under the Securities Act of 1933, as amended (the Securities Act), would allow all issuers to communicate with qualified institutional buyers (QIBs) and institutional accredited investors (IAIs) regarding contemplated registered securities offerings, before or after an issuer files a registration statement.

Background on Testing-the-Waters

In 2012, Congress passed the Jumpstart Our Business Startups Act (JOBS Act), which, among other things, created a new Section 5(d) of the Securities Act and eased the restrictions on so-called “gun jumping” communications by introducing the “testing-the-waters” exemption. Section 5(d) permits an EGC, or any person authorized to act on behalf of an EGC, to engage in oral or written communications with potential investors that are QIBs or IAIs, to determine whether such investors might have an interest in a contemplated securities offering. These communications may occur either before or after the EGC files a registration statement with respect to such securities.

Since the JOBS Act was enacted, EGCs have dominated the IPO market. EGCs account for an estimated 87% of IPOs that have gone effective. A significant portion of these EGC issuers utilized the testing-the-waters exemption when conducting IPOs. Testing-the-waters communications are limited to QIBs and IAIs because these investors generally are considered to be financially sophisticated and have the ability to sustain investment losses.

The rationale behind the exemption is to provide: (1) increased flexibility to issuers regarding their communications about contemplated registered securities offerings; and (2) a cost-effective means for evaluating market interest before incurring the costs associated with such an offering. As SEC Chairman Jay Clayton stated, “Extending the test-the-waters reform to a broader range of issuers is designed to enhance their ability to conduct successful public securities offerings and lower their cost of capital, and ultimately to provide investors with more opportunities to invest in public companies.” This is consistent with other remarks Chairman Clayton has made endorsing the SEC’s efforts to promote capital formation.

Proposed Securities Act Rule 163B

Proposed Securities Act Rule 163B (the Proposed Rule) would provide a non-
exclusive safe harbor that permits any issuer, or any person authorized to act on its behalf, to communicate with potential investors that are, or are reasonably believed to be, QIBs or IAIs before or after filing a registration statement. The scope of the Proposed Rule is similar to the current testing-the-waters exemption for EGCs, except that the Proposed Rule may provide more flexibility in specifically allowing communications with investors that an issuer reasonably believes to be QIBs and IAIs. The Proposed Rule does not establish a specific method by which an issuer must determine that a potential investor is a QIB or an IAI, and would allow issuers to continue to rely on the methods that they currently use to establish a reasonable belief regarding an investor’s status under current Securities Act rules.

Similar to the Section 5(d) exemption for EGCs, the SEC would not require issuers to file or include specific legends on testing-the-waters communications made under the Proposed Rule. Consistent with the SEC’s current practice, any such communications would be subject to the SEC staff’s review, which is intended to ensure that testing-the-waters communications do not conflict with any material information included in the registration statement. Additionally, testing-the-waters communications under the Proposed Rule would continue to be considered “offers” under the Securities Act. As such, such communications also would be subject to potential liability under the Securities Act and other anti-fraud provisions of the federal securities laws.

**Application to Business Development Companies and Registered Investment Companies**

Although registered investment companies and business development companies (together, Funds) would be eligible to make pre- and post-filing communications under the Proposed Rule, the SEC noted that the benefits associated with using testing-the-waters communications could be more limited under the current disclosure framework applicable to certain Funds. Specifically, SEC noted that testing-the-waters communications generally would be considered advertisements or “sales literature,” which are subject to certain filing, disclosure and legend requirements under the Securities Act and the Investment Company Act of 1940, as amended. To allow Funds to benefit from the Proposed Rule to the same extent as other filers, the Proposed Rule would exempt Funds’ testing-the-waters communications from complying with the filing, disclosure and legend requirements that would otherwise apply to such communications.

Although the SEC noted that Funds may be less likely to use testing-the-waters communications during the pre-filing period, due to the fact that Funds often file registration statements under both the Securities Act and the Investment Company Act immediately upon organizing, the SEC recognized that Funds should have the flexibility to engage in pre-filing communications if they wanted to.

In light of the unique regulatory structure and capital-raising process for Funds,
the SEC is requesting comments regarding the application of the Proposed Rule to business development companies and registered investment companies. Such comments will be due 60 days after the SEC publishes the Proposed Rule in the Federal Register.

SEC Press Release: SEC Proposes to Expand “Test-the-Waters” Modernization Reform to All Issuers

Proposed Rule: Solicitations of Interest Prior to a Registered Public Offering

1 An emerging growth company refers to an issuer that had total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year and, as of December 8, 2011, had not sold common equity securities under a registration statement. That issuer continues to be an emerging growth company for the first five fiscal years after the date of the first sale of its common equity securities pursuant to an effective registration statement, unless one of the following occurs: its total annual gross revenues are $1.07 billion or more; it has issued more than $1 billion in non-convertible debt in the past three years; or it becomes a “large accelerated filer.” See Rule 405 and Rule 12b-2 (defining “emerging growth company”).

2 As defined in paragraph (a) of 17 CFR 230.144A (Rule 144A).

3 Any institutional investor that is also an accredited investor, as defined in 17 CFR 230.501 (Rule 501) of Regulation D.


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