Lowenstein Sandler

Client Alert

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SEC Proposes Expansion of "Test-the-Waters" Communications to All Issuers

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What You Need To Know:

- **SEC expands eligibility to use "test-the-waters" materials to all issuers, including investment companies.**
- **All issuers may now solicit interest from Qualified Institutional Buyers and Institutional Accredited Investors prior to the filing of a registration statement in order to gauge interest in securities.**

On February 19, 2019, the Securities and Exchange Commission (the "SEC") proposed a new Rule 163B (the "Proposed Rule") that would allow all issuers to use "test-the-waters" material prior to the filing of a registration statement in the context of a public offering of securities. All issuers—including non-reporting issuers, emerging growth companies ("EGCs")[1], non-emerging growth companies, well-known seasoned issuers, and investment companies (including registered investment companies and business development companies)—would be eligible to take advantage of this exemption from Section 5 of the Securities Act of 1933 (the "Securities Act"). The SEC's proposing release (the "Release") is available here.

Section 5(c) of the Securities Act generally prohibits any written or oral offers to purchase a security prior to the filing of a registration statement with the SEC. Violations of this provision are typically known as "gun jumping." Any marketing or solicitation activity conducted prior to the filing of a registration statement, absent an exemption, would be considered a violation of Section 5. Even after an issuer has filed a registration statement, Section 5(b)(1) restricts written communications with potential investors to "statutory prospectuses," which must conform with specific informational requirements of the Securities Act.

However, since 2012, the Jumpstart Our Business Startups Act (the "JOBS Act"), permitted EGCs to engage in oral or written communications with potential investors that are qualified institutional buyers ("QIBs")[2] and institutional accredited investors ("IAIs")[3] *before or after* filing a registration statement. This exemption from "gun jumping" allows EGCs to gauge the interest of QIBs and IAIs and give EGCs the opportunity to "better assess the demand for and valuation of their securities and to discern which terms and structural components of the offering may be most important to investors" before undertaking the significant costs of a traditional road-show.

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[1] "EGC" refers to an issuer that had total annual gross revenue of less that $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 EGC 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," as defined in Rule 12b-2 under the Exchange Act of 1934.

[2] "QIB" is defined in paragraph (a) of Rule 144A, generally as a specified institution that, acting for its own account or the accounts of other QIBs, in the aggregate, owns and invests on a discretionary basis at least $100 million in securities of unaffiliated issuers.

[3] "IAI" refers to an institutional investor that is also an accredited investor that meets the criteria of SEC Rule 501(a)(1), (a)(2), (a)(3), (a)(7) or (a)(8), and it includes organizations with assets in excess of $5 million not formed for the purpose of acquiring the securities offered.

Under the Proposed Rule, any issuer, not just an EGC, or a party acting on behalf of an issuer (*i.e.*, underwriters), that solicits interest in a registered securities offering from potential investors that are or are reasonably believed to be[4] QIBs or IAIs would be exempt from Section 5(b)(1) and Section 5(c) of the Securities Act. The Proposed Rule would not require that the test-the-waters materials or communication be filed with the SEC, nor would the materials be required to include any special legend language. This approach is consistent with the SEC's belief that QIBs and IAIs are sophisticated enough and able to absorb potential losses to an extent that renders the protections of the Securities Act superfluous.

The SEC reminded issuers that plan to rely on the Proposed Rule that test-the-waters material is still an "offer" under Section 2(a)(3) of the Securities Act, and therefore the liability and anti-fraud provisions of the federal securities laws still apply. The SEC also reminded issuers that the staff of the Division of Corporation Finance will continue its practice of requesting the test-the-waters materials be submitted for review so that the SEC can ensure that materials do not conflict with disclosures made in the related registration statement.[5] Additionally, the SEC reminded public issuers that the test-the-waters material is subject to Regulation FD, meaning material information must be publicly disclosed or shared on a confidential basis. To avoid potential Regulation FD violations, issuers may want to enter into confidentiality agreements with those potential investors who will receive the test-the-waters materials, as Regulation FD exempts selective disclosures to any party who owes a duty of trust or confidence to the issuer.

The SEC will accept comments from the public for 60 days after the Proposed Rule is published in the Federal Register.

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[4] The Release does not require issuers to verify the status of a potential investor as a QIB or IAI; issuers must only establish a reasonable belief with respect to a potential investor's status. The SEC stopped short of prescribing specific steps issuers should take to verify the status of potential investors, instead leaving them to issuers to determine under their specific circumstances.

[5] Issuers should remember to contemporaneously request Rule 418 confidential treatment of the submitted materials and submit the materials in hard copy only; if filed electronically on EDGAR or sent via email to the SEC examiner, the materials will not be returned and will become public. For guidance with Rule 418 confidential treatment requests, please contact one of the Lowenstein Sandler attorneys listed on this client alert.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

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