"Test-the-Waters" Exemption to be Available to All Issuers

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**Speed Read**

The Securities and Exchange Commission (SEC) has adopted a new rule that will allow all issuers to engage in test-the-waters communications regarding a contemplated registered securities offering with qualified institutional buyers (QIBs) and institutional accredited investors (IAIs) before or after the filing of a registration statement. A similar exemption has been available since 2012 for emerging growth companies (EGCs) only. New Rule 163B will be effective 60 days after publication in the Federal Register and is expected to provide all issuers with greater flexibility in determining whether to proceed with a registered public offering and how to structure the offering terms.

**OVERVIEW**

The SEC has adopted Rule 163B, which will permit all issuers to engage in test-the-waters communications, largely as proposed in February 2019 and summarized in our earlier alert. Rule 163B will permit any issuer, or any person authorized to act on the issuer’s behalf, to engage in written or oral communications with potential investors that are, or are reasonably believed to be, QIBs or IAIs, both before and after the filing of a registration statement, to determine whether these investors might be interested in a contemplated registered securities offering. These communications have become known as “test-the-waters” communications. Rule 163B communications will not be subject to any filing or legending requirements, but will be “offers” that are potentially subject to liability under the federal securities laws. If the issuer files a registration statement related to the offering, the SEC expects that test-the-waters communications will not be inconsistent with material information contained in the registration statement. In addition, issuers that are subject to Regulation FD should be aware that material information contained in a Rule 163B communication that hasn’t previously been publicly disclosed may trigger disclosure obligations under Regulation FD.

**BACKGROUND**

The Jumpstart Our Business Startups Act (JOBS Act), enacted in 2012, amended Section 5 of the Securities Act of 1933 (Securities Act) to permit an EGC and any person acting on its behalf to engage in test-the-waters communications with QIBs and IAIs. This permits EGCs to explore the possibility of a public offering without making the public financial and business disclosures (and incurring the expenses) associated with filing a registration statement.

Before the JOBS Act permitted EGCs to engage in test-the-waters communications, the Securities Act prohibited any “offers” (which are broadly defined) made in writing or orally before the issuer had filed a registration statement unless there was exemption available. Between the filing date and the effective date of
the registration statement, the Securities Act permitted oral offers, but written offers generally were limited to a statutory prospectus that conforms to specified disclosure requirements under the Securities Act or a free writing prospectus subject to filing and other requirements. Permitting EGCs – and all issuers, after Rule 163B becomes effective – to engage in test-the-waters communications is a significant change in the restrictions that apply to public offerings.

**EFFECTIVE DATE**

Rule 163B will be effective 60 days after publication in the *Federal Register*.

**ELIGIBLE ISSUERS**

Rule 163B will apply to test-the-waters communications made by or on behalf of all issuers. This includes non-reporting issuers, well-known seasoned issuers (WKSIIs), EGCs and issuers that are not EGCs, such as:

- Potential initial public offering (IPO) candidates with more than $1 billion in annual revenues;
- Issuers that have ceased to qualify as EGCs due to an increase in annual revenues to more than $1 billion, an equity market capitalization of $700 million or more, the expiration of the five-year period following the issuer’s IPO, or otherwise; and
- All issuers that were already public before the JOBS Act was enacted.

Rule 163B will also be available to investment companies (including registered investment companies and business development corporations), although this alert does not discuss the aspects of Rule 163B that are unique to investment companies.

**INVESTOR STATUS**

Rule 163B applies only to communications with QIBs and IAIs or investors reasonably believed to be a QIB or an IAI. The SEC considered and specifically declined to extend Rule 163B to individual accredited investors and to investors who are not “U.S. persons” in offerings made under Regulation S but do not qualify as QIBs or IAIs.

Rule 163B does not specify any steps that an issuer could or must take to establish a reasonable belief that an investor is a QIB or an IAI. Rule 163B will therefore be consistent with current practices in Rule 144A offerings and Section 4(a)(2) private placements. In the adopting release, the SEC explicitly states that Rule 163B will permit issuers the flexibility to use any methods that are appropriate in light of the circumstances of each potential investor and each contemplated offering.

The SEC also addressed a comment letter expressing concern about the implications of a QIB or an IAI sharing Rule 163B communications with parties that were not eligible to receive the communication in violation of a confidentiality agreement or in a manner that was inconsistent with reasonable steps taken by an issuer to prevent redistribution of test-the-waters communications. In response, the SEC states that “[i]n our view, where an issuer has taken reasonable steps to prevent test-the-waters communications from being shared with non-QIBs and non-IAIs 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.”

**NO FILING OR LEGENDING REQUIREMENTS**

Rule 163B does not require that issuers file test-the-waters communications with the SEC, nor does it require any legends. In connection with adoption of Rule 163B, the SEC amended Securities Act Rule 405 to expressly exclude test-the-waters communications under both Section 5(d) and Rule 163B from the definition of free-writing prospectuses, which is consistent with the practice of the staff of the SEC Division of
Corporation Finance (Staff) with EGC test-the-waters communications. However, it has been the practice of the Staff to request that EGCs furnish any test-the-waters communications used in connection with an offering if and when the Staff reviews registration statements filed by EGCs, and the SEC indicated in the adopting release that it anticipates that the Staff will continue to request that issuers furnish any test-the-waters communications used in connection with an offering to the Staff in connection with its review of the offering.

**LIABILITY FOR TEST-THE-WATERS COMMUNICATIONS**

Rule 163B communications made both before and after an issuer files a registration statement related to an offering will be “offers” subject to potential liability under Section 12(a)(2) of the Securities Act for misstatements and omissions of material facts. Rule 163B communications will also be subject to the anti-fraud provisions of the federal securities laws. In light of this potential liability, issuers should exercise the same care and diligence with test-the-waters communications that they would apply to Securities Act filings and other offering-related disclosures.

In this context, the SEC explicitly addressed treatment of potentially conflicting information. Initially, in the proposing release, the SEC had stated that information provided in a test-the-waters communication under the proposed rule must not conflict with material information in the related registration statement. In the final release, in response to comments, the SEC clarified that its statement was merely intended to provide guidance to issuers on their obligations under Section 12(a)(2) and the anti-fraud provisions of the federal securities laws, and that SEC statements that Rule 163B communications must not conflict with material information in the related registration statement was not an additional condition to the availability of Rule 163B.

The SEC acknowledged that circumstances or messaging could change between the time of a test-the-waters communication and the filing of a registration statement, but the SEC also reiterated that statements made in test-the-waters materials must not contain material misstatements or omissions at the time the statements are made. As a result, issuers should expect the Staff to continue to focus on potential inconsistencies between test-the-waters communications and the registration statement and should not assume that factual errors, if any, contained in test-the-waters communications may be corrected solely through the inclusion of conflicting, corrected information in the prospectus ultimately used in the offering.

**NON-EXCLUSIVITY**

Rule 163B explicitly states that it is non-exclusive. This means that issuers can rely on Rule 163B concurrently with other Securities Act exemptions and communication rules. Although Rule 163B requires no filing or legends, as discussed below, issuers that rely upon other exemptions or rules must comply with the conditions for those other exemptions or rules.

**REGULATION FD IMPLICATIONS**

Regulation FD requires simultaneous public disclosure of any material nonpublic information that is intentionally disclosed to certain securities market professionals, institutional investors or shareholders if the issuer has a class of securities registered under Section 12 of the Securities Exchange Act of 1934 (Exchange Act) or is required to file reports under Section 15(d) of the Exchange Act. Rule 163B does not exempt test-the-waters communications from Regulation FD, and the types of communications for which issuers would seek to rely on Rule 163B generally are not within the categories of public offering disclosures that are exempt from Regulation FD. Furthermore, in many cases, the mere possibility of an imminent future offering by the issuer may constitute material nonpublic information. As a result, non-IPO issuers that engage in test-the-waters communications may need to require recipients to expressly agree to maintain the disclosed information in confidence in order to avoid triggering disclosure obligations under Regulation FD.
PRIVATE PLACEMENT IMPLICATIONS

In response to comment letters expressing concern that test-the-waters communications could be viewed as a general solicitation that could disqualify an issuer from completing a private placement immediately after abandoning efforts to conduct a registered public offering, the SEC states that "whether a test-the-waters communication would constitute a general solicitation depends on the facts and circumstances regarding the manner in which the communication is conducted." The adopting release also indicates that the SEC’s 2007 framework for simultaneous conduct of registered offerings and private placements continues to apply. Importantly, the SEC does recognize that an issuer can conduct test-the-waters communications in a manner that preserves the availability of Rule 163B and any offering exemption upon which it might otherwise rely.

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