WINSTON & STRAWN LLP

CLIENT ALERT

New SEC Rule Allows All Companies to "Test the Waters" Before Securities Offerings

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On September 26, 2019, the Securities and Exchange Commission (SEC) approved new Rule 163B under the Securities Act of 1933 to provide all issuers with the ability to gauge investor interest in a potential registered public offering of securities by engaging in "test-the-waters" communications with qualified institutional buyers (QIBs) and institutional accredited investors (IAIs), either before or after filing an SEC registration statement. Since the passage of the Jumpstart Our Business Startups Act (JOBS Act) in 2012, "emerging growth companies" (EGCs), which are companies with less than $1.07 billion in annual revenues, have been permitted to engage in test-the-waters communications, and this has become an important means for EGCs to determine whether or not to proceed with their IPOs or other securities offerings. This new rule, which is part of the SEC's ongoing initiatives to encourage companies to access the U.S. public markets, will be effective 60 days after publication in the *Federal Register*. A copy of the final rule is available here.

New Rule 163B

New Rule 163B permits all issuers, including non-reporting companies, EGCs, non-EGCs, well-known seasoned issuers (WKSIs), and investment companies (including registered investment companies and business development companies (BDCs)) and any person authorized to act on an issuer's behalf to engage in oral or written communications with potential investors that are, or are reasonably believed to be, QIBs (institutions that own and invest at least $100 million in securities on a discretionary basis) or IAIs (institutions meeting the "accredited investor" definition set forth in Rule 501(d) of Regulation D under the Securities Act), to determine whether the investors might have an interest in a potential registered securities offering. These permitted test-the waters communications may be made either before or after filing a registration statement and would not violate the "gun jumping" prohibitions of Section 5(c) of the Securities Act.

As these new rules mirror the current "test-the-waters" accommodation that has been available to EGCs since 2012 under the JOBS Act, current SEC interpretations of the rules regarding test-the-waters communications for EGCs are expected to apply as well to communications under new Rule 163B. For example, the SEC confirmed that information contained in a Rule 163B communication must not conflict with material information in the registration statement that is filed and that issuers should use methods currently used in connection with Rule 144A or Regulation D offerings to determine whether an investor is a QIB or an IAI. The SEC noted that certain test-the-

waters communications would not necessarily constitute a "general solicitation" that would preclude a simultaneous private offering of securities, but that such communications, in combination with other facts, could be viewed as part of a general solicitation.

Under new Rule 163B:

- There are no filing or legending requirements;
- The communications are deemed "offers" subject to liability under Section 12(a)(2) of the Securities Act and the anti-fraud provisions of the federal securities laws;
- Written communications will not be deemed "free writing prospectuses" under Rule 433 and will not be subject to prospectus filing requirements;
- There is no investor verification requirement, only a "reasonable belief" as to the investor's QIB or IAI status (consistent with the standards under Rule 144A and Rule 501(a));
- Public companies will need to consider whether information contained in their test-the-waters communications would trigger public disclosure obligations under Regulation FD or whether an exemption would be available, such as through the execution of a confidentiality agreement with the prospective investors; and
- The accommodation is non-exclusive and issuers can rely on other SEC rules or exemptions that may be available with respect to test-the-waters communications, such as the existing rules that give WKSIs broad latitude in making offers before filing a registration statement with the SEC.

Expected Benefits of Rule 163B

As noted above, EGCs have had the flexibility to engage in test-the-waters communications since 2012. The SEC staff estimates that approximately 37% of EGC IPOs from 2012 to 2018 used the test-the-waters provision, and based on our experience, this percentage is significantly higher in the most recent few years. While WKSIs have had their own test-the-waters accommodation under Rule 163, which permits test-the-waters communications by a WKSI to any potential investor (not just QIBs and IAIs), Rule 163 does not extend to underwriters, and treats any written communication as a free writing prospectus, which has legending and filing requirements. Accordingly, new Rule 163B would benefit large pre-IPO companies that do not qualify as EGCs (*e.g.*, "unicorns"), former EGCs that have outgrown or aged out of EGC status, and other existing public companies that have not previously had the ability to engage in test-the-waters communications in connection with potential registered offerings and, in the case of WKSIs, allow underwriters to engage in such communications as well. Large and well-established issuers with sufficient information already available to investors and a history of public disclosures, issuers of well-understood and readily marketable types of securities (such as investment-grade straight debt), and issuers in follow-on offerings with an established record of capital-raising are expected to see fewer benefits. In addition, the SEC acknowledged that the new rules may not be as attractive for issuers that are subject to Regulation FD because any material non-public information included in the test-the-waters communication would need to be disclosed publicly, unless an exemption (such as through the use of a confidentiality agreement with the prospective investor) is available.

The expansion of the test-the-waters accommodation to all issuers represents a significant shift from the long-standing prohibition on gun jumping under Section 5(c) prior to the filing of a registration statement and will enable all issuers to acquire insight and learn from the perspectives of institutional investors as to valuation and likely market reaction to their strategic plans. In particular, new Rule 163B will provide more flexibility to issuers that might otherwise have undertaken a private placement or been deterred from offering securities at all.

Investment Companies

Rule 163B also permits registered investment companies to engage in test-the-waters activities. The SEC recognizes that the accommodation may be less useful to funds that must also register under the Investment Company Act because these funds frequently file a single registration statement under both the Securities Act and

the Investment Company Act. However, there may be other investment companies not subject to registration under the Investment Company Act, such as BDCs, that may be able to take advantage of the new test-the-waters accommodation.

Conclusion

New Rule 163B places all issuers on an equal footing with respect to the ability to use test-the-waters communications prior to making a public offering and is a welcome part of the SEC's ongoing efforts to build on the provisions of the JOBS Act to encourage more companies to access the U.S. public capital markets. In announcing the new rule, SEC Chair Jay Clayton stated, "This benefits all investors — as a result of these communications, issuers can better identify information that is important to investors and enhance the ability to conduct a successful registered offering, ultimately providing both Main Street and institutional investors with more opportunities to invest in public companies that, in turn provide ongoing disclosures to their investors."

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