ALERT MEMORANDUM

SEC Expands Ability to "Test the Waters" to All Issuers

October 1, 2019

Last week, the Securities and Exchange Commission adopted a rule under which any issuer can "test the waters" for a securities offering before or after filing a registration statement. This new rule extends an accommodation previously available only to emerging growth companies (EGCs).

Specifically, new Rule 163B will permit any issuer, or any person authorized to act on its behalf (including an underwriter), to engage in oral or written communications with certain types of potential investors to determine whether they might have an interest in a contemplated registered securities offering. The potential investors are limited to those that are, or are reasonably believed to be, qualified institutional buyers (QIBs) or institutional accredited investors (IAIs). These "testing-the-waters" or "TTW" communications can take place before or after a registration statement is filed. Communications under Rule 163B will be considered "offers" but will not be required to be filed with the SEC.

Rule 163B will take effect 60 days after publication in the Federal Register. Assuming that now occurs promptly, it will be effective in early December 2019.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

New York
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

Andrea M. Basham
+1 212 225 2755
abasham@cgsh.com

Adam E. Fleisher
+1 212 225 2286
afleisher@cgsh.com

Nicolas Grabar
+1 212 225 2414
ngrabar@cgsh.com

Jeffrey D. Karpf
+1 212 225 2864
jkarpf@cgsh.com

David C. Lopez
+1 212 225 2632
dlopez@cgsh.com

Rule 163B exempts communications that comply with the rule from two provisions of the Securities Act:

- Section 5(c) (the prohibition on pre-filing offers, or "gun jumping")
- Section 5(b)(1) (the requirement that a written offer must conform to the requirements for a prospectus)

The 2012 JOBS Act introduced a number of reforms to make IPOs easier for EGCs, and this is the second major example of the SEC extending an EGC reform to all issuers. In 2017, the Division of Corporation Finance changed its policies to allow all issuers to make confidential submissions of initial registration statements for SEC staff review prior to a public filing. As a result of that policy change, all issuers, not just EGCs, have been able to make non-public submissions to the SEC, which has been particularly useful for issuers beginning the process of becoming public companies.

© Cleary Gottlieb Steen & Hamilton LLP, 2019. All rights reserved.
This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

Set forth below are some details about how the new rule will work in practice.

All types of issuers can use it.

Any issuer will be able to rely on the rule – including reporting issuers, EGCs, non-reporting issuers, foreign private issuers, well-known seasoned issuers (WKSIs), and investment companies (including registered investment companies and business development companies (BDCs)).

Underwriters can use it.

The ability to test the waters provided by the new rule is available not only for communications made by the issuer, but also for those made by any authorized representative of the issuer, just like EGC TTW.

In contrast, Rule 163 – the only previously existing exemption that permitted pre-filing offers, which is limited to WKSIs – specifies that it may not be used by "an offering participant that is an underwriter or dealer." This has been a regular source of frustration for market participants, because in practice it limits the ability to explore market opportunities without filing a registration statement, but in the past the SEC staff has declined to pursue revising the rule. Rule 163 will be largely obviated by Rule 163B, except in the relatively uncommon case where a WKSI seeks to communicate directly (without banker involvement) with investors that are not QIBs or IAIs.

A significant benefit of the new rule will be that an issuer contemplating a follow-on or secondary offering before it has filed a shelf registration statement can now wall-cross potential QIB and IAI investors.

We expect that underwriters will use the same level of care to establish and document their authority to act on behalf of the issuer that they have used when engaging in TTW on behalf of EGCs.

Underwriters should keep in mind the SEC FAQ issued by the Division of Trading and Markets in 2012 confirming that seeking non-binding indications of interest from prospective investors in the context of TTW is permitted, but soliciting actual commitments is not.[1]

No legending or filing requirements.

The rule provides that if a written communication is used, there is no requirement to include a legend or to file it with the SEC. This too is unlike Rule 163, where if there is a writing the exemption is conditioned on legending and filing as a "free writing prospectus" (FWP).

The definition of FWP in Rule 405 is amended to make clear that a TTW communication is not an FWP. The SEC also amended the definition to make clear that it excludes TTW communications under Section 5(d). The adopting release confirms that EGCs can rely on Rule 163B in addition to Section 5(d).

As the adopting release specifically says, the staff can always ask to see TTW materials, as they regularly do for EGC IPOs. Outside the IPO context, however, this may be infrequent in practice. For example, for an automatically effective shelf registration statement or a shelf takedown, the SEC would have no particular occasion to request materials.

No specific content limitations.

The adopting release states that the information in TTW communications must not conflict with material information in the related registration statement. Rule 433 has the same requirement for FWPs. The adopting release also clarifies that this is not a condition for the exemption, and it acknowledges that information may change or evolve by the time a subsequent registration statement is filed.

We expect that issuers and underwriters will be cautious about the content of TTW materials, as they have been for EGC TTW, given their liability risk (see below). Accordingly, we expect the content of TTW communications will generally not go beyond the information that is expected to be included in the

[1] *See FAQ* 1 at https://www.sec.gov/divisions/marketreg/tmjobsact-researchanalystsfaq.htm.

registration statement. For example, participants may hesitate to include projections in TTW materials unless they will be included in the registration statement.

Securities law liability.

Communications made in reliance on the rule will still be offers – which means they will be subject to liability under Section 12(a)(2) and Section 17(a) of the Securities Act. Obviously they will also be subject to Exchange Act liability including Rule 10b-5. In TTW for EGC offerings, issuers and underwriters typically do not leave written materials with potential investors, because of the additional liability risk associated with written materials, and we would expect to see a similar approach at least initially under Rule 163B.

Application of Reg FD to TTW.

The release notes that an issuer that is already a reporting company, and thus subject to Regulation FD, will need to consider whether TTW communications would trigger an FD disclosure obligation. Where the fact that an offering is under discussion could be material, we expect to see issuers address the FD concern by entering into a confidentiality agreement in connection with TTW, as they sometimes do today with post-filing wall-crosses.

Verifying QIB/IAI status.

Section 5(d) permits EGCs to engage in TTW with investors that "are" QIBS or IAIs. The new rule will permit TTW with investors the issuer (or person acting on its behalf) "reasonably believes" to be QIBs or IAIs. The adopting release says that issuers (or such persons) can rely on the steps normally taken in connection with Rule 144A and Regulation D (other than Rule 506(c)) offerings under the Securities Act and do not need to take the additional "reasonable verification" steps required by Rule 506(c).

Some commenters highlighted that in the context of offerings by registered investment companies or BDCs, the new rule may not provide much incremental flexibility because investors in some funds do not typically qualify as QIBs or IAIs. While the SEC chose not to permit TTW beyond QIBs or IAIs, it does note in the adopting release that it is conducting an ongoing review of these definitions – perhaps foreshadowing changes to the various sophisticated investor definitions following the SEC's June 2019 concept release on harmonization of security offering exemptions.

Testing a public offering, then doing a private offering.

As the SEC acknowledges in the adopting release, after TTW an issuer could decide not to proceed with a registered offering and instead pursue a private placement. In some cases, the purposes of TTW communications could include evaluating the relative merits of a registered offering and a private placement. Non-U.S. issuers, for example, often compare the advantages of offering equity securities on an SEC-registered basis or under Regulation S with a concurrent private placement to some U.S. investors.

An issuer choosing to test the waters will need to consider whether doing so could constitute general solicitation that would be problematic if the issuer then decides to conduct a private placement. The adopting release states that an issuer in this position should consider whether investors in the private placement were solicited by the TTW or by some other means – an approach similar to the SEC's 2007 guidance on whether a prospective investor became interested in a private placement by means of the registration statement for a public offering. The SEC declined suggestions from commenters that it affirmatively state that TTW communications will not be considered general solicitation.

The SEC does confirm in the adopting release that communications made under Rule 163B generally will not be deemed "directed selling efforts" under 902(c) of Regulation S.

…

CLEARY GOTTLIEB