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NEW RULE ALLOWS ALL COMPANIES TO “TEST-THE-WATERS”

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The Securities and Exchange Commission (the “SEC”) recently adopted a new rule that permits any company to engage in oral or written communications with potential investors that are, or are reasonably believed to be, qualified institutional buyers or institutional accredited investors, before or after the filing of a registration statement to gauge market interest in a contemplated securities offering. The new rule, which becomes effective on December 3, 2019, allows all companies the ability to evaluate market interest for an offering, make any necessary adjustments, and, as a result, improve the likelihood of successfully accessing the public markets.

Background

In 2012, Congress passed the Jumpstart Our Business Startups Act (the “JOBS Act”), which designated a new category of company, an “emerging growth company” (“EGC”), which includes companies with total annual gross revenues of less than \$1.07 billion during its most recently completed fiscal year and which have not sold common equity securities under a registration statement before December 8, 2011.

The JOBS Act previously permitted only EGCs to communicate with potential investors before the filing of a registration statement. These “test-the-waters” communications enable EGCs to gauge market interest without committing to public disclosures or incurring costs associated with filing a registration statement.

New Rule

The new rule extends the ability of all companies, regardless of category and revenue, to “test-the-waters” and is expected to encourage more companies to consider entering the public equity markets. Under the new rule, a company is permitted to engage in “test-the-waters” communications with potential investors that are, or reasonably believed to be, qualified institutional buyers or institutional accredited investors. The SEC did not specify the steps a company could or must take to establish a reasonable belief that the intended recipients of “test-the-waters” communications are qualified institutional buyers or institutional accredited investors. Instead, the SEC noted that companies should continue to rely on methods they currently use to establish such reasonable belief.

In addition, pursuant to the new rule, companies are not required to file “test-the-waters” communications with the SEC or to include any specific legend on such communications. Because written communications are permitted, the SEC clarified that written “test-the-waters” communications are excluded from the definition of free-writing prospectus. The SEC, however, could request that a company furnish any “test-the-waters” communications used in connection with an offering, as has been the practice of the SEC when reviewing offerings conducted by EGCs.

The new rule is a non-exclusive exemption, meaning a company can rely on the new rule concurrently with other communication rules or exemptions under applicable securities laws, provided that the company complies with the conditions of that rule or exemption.

Liability for Fraudulent Statements. “Test-the-waters” communications are still considered “offers” of securities, although such communications are exempt from restrictions on communications to investors before or after the filing of a registration statement. Therefore, companies engaging in “test-the-waters” communications remain subject to civil liability for material misstatements or omissions and other fraudulent statements in the “test-the-waters” communications.

The SEC also clarified that the new rule does not include the condition that “test-the-waters” communications not conflict with the registration statement, recognizing commentators’ concerns that circumstances or messaging may change between when the pre-filing communications are made and when the registration statement is filed. However, generally it is advisable that “test-the-waters” communications be consistent with the registration statement.

Regulation FD Considerations. Regulation FD requires simultaneous public disclosure of any material nonpublic information that has been selectively disclosed to certain securities market professionals or shareholders. The new rule does not exempt “test-the-waters” communications from Regulation FD. As a result, the SEC cautioned that companies subject to Regulation FD would need to consider whether any information in the “test-the-waters” communications would trigger public disclosure obligations under Regulation FD or whether an exemption to Regulation FD applies. Therefore, “test-the-waters” communications that contain material nonpublic information are subject to Regulation FD, absent an exemption or agreement with investors to keep such information confidential.

General Solicitation and Private Placement Considerations. Under the new rule, if a company elects to pursue a private placement rather than a registered offering, the “testing-the-waters” communications the company engaged in prior to placement would not necessarily prevent the company from engaging in the private placement. Therefore, a company could simultaneously rely on both the new rule and any available private placement exemption. The SEC, however, cautioned that, depending on the facts and circumstances, “test-the-waters” communications could be viewed as a general solicitation that could preclude a company from relying on a private placement exemption.

Takeaway

The SEC has leveled the playing field by extending the “test-the-waters” communications accommodation to all companies. The new rule allows companies to gauge market interest, modify the size and terms of an offering, lessen the need for public disclosure, and reduce costs associated with a public offering. The new rule is the result of the SEC’s initiative to provide greater flexibility for companies considering a public offering and to increase the likelihood of successful public offerings.

If you would like more information regarding the SEC's new rule regarding "test-the-waters" communications, which can be found at [this link](#), please contact a member of Harter Secrest & Emery LLP's [Securities and Capital Markets](#) group at 716.853.1616, 585.232.6500, or visit www.hselaw.com.

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