Public Companies Practice Alert - Expanded Scope of Testing the Water Communications

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Last week, the SEC proposed a new rule to allow any issuer, not just emerging growth companies, to "test the waters" prior to an initial public offering.

By means of background, the "testing the waters" rule is codified in Section 5(d) of the Securities Act, and was first introduced in 2012 through the JOBS Act. Currently, EGC's (those issuers with less than $1.07 billion in annual revenues that don't qualify as a large accelerated filer) and their agents can gauge market interest in potential IPO's and other proposed registered securities offerings by making oral and written offers to qualified institutional buyers and institutional accredited investors prior to the filing of the registration statement. Prior to the rule's original enactment, those making oral or written offers were deemed to be "gun jumping" under Section 5 of the Securities Act.

Now, the SEC has voted to propose Rule 163B to level the playing field such that now any issuer, not just an EGC, can "test the waters" to certain investors.

Here are some benefits issuers might expect from testing the waters:

- **Protection of Sensitive Information.** *Issuers who decide after testing the waters not to proceed with a registered securities offering forego the risk of public disclosure of its sensitive or proprietary information to competitors (to the extent that the communications are not subject to Regulation FD).*
- **Further Opportunities to Hone the Pitch.** *Increased ability for management to "pitch" prior to the formal road show and incorporate feedback from these meetings.*
- **Correct Calculation of Market Interest.** *Reduced risk of miscalculating market interest in the offering and having to withdraw the offering, thus reducing potential reputational costs.*
- **Gauge Offering Size; Sell Quickly**. *Gauging investor demand for purposes of determining offering size and other terms can potentially result in a more efficient offering process and a higher likelihood of selling the offered amount more quickly.*

Some commentators have pointed out that the proposed rule gives financial institutions an edge over smaller investors as these communications can include a lot of valuable information (e.g. sources of revenue, executive strategy, and corporate strategy). On the other hand, since fewer companies are going public in the first place, the rule may ultimately allow smaller investors to participate in the growth of larger companies they otherwise might not have access to.

What do you think? Does the proposed expansion of permissible test-the-waters communications raise investor protection concerns? If so, how? What concerns might this proposed expansion raise regarding inappropriate marketing, conditioning, or hyping? How might those concerns be alleviated?

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