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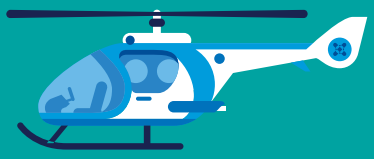

Defining Issues®

SEC proposes to expand its test-the-waters accommodation to all companies

February 22, 2019

KPMG reports on the SEC's proposal[1] to permit companies to communicate with potential investors before an offering.

Applicability

Companies contemplating a registered securities offering, including investment companies.

Background

The SEC proposed new Rule 163B that would allow companies contemplating a securities offering[2] to engage in oral or written 'test-the-waters' communications with potential qualified investors, either before or after they file a registration statement, including initial public offerings.

Companies generally are prohibited from offering securities, either directly or through an agent, before filing a registration statement.[3] However, in 2012 the Jumpstart Our Business Startups Act allowed emerging growth companies (EGCs) to test the waters with potential qualified investors.[4] Rule 163B would extend this accommodation to all companies.

The proposed rule "would allow companies to more effectively consult with investors and better identify information that is important to them in advance of a public offering," said SEC Chairman Jay Clayton.

Comments on the proposed rule are due within 60 days of publication in the Federal Register.

Proposed requirements

Rule 163B would allow companies to communicate with potential investors who are, or who they reasonably believe are, qualified institutional buyers (QIBs) or institutional accredited investors (IAIs). The SEC pointed out that these communications have increased EGCs' access to the capital markets.

The SEC considers QIBs and IAIs to be sophisticated investors that have the ability to evaluate investment opportunities and sustain investment losses, and therefore have a reduced need for additional safeguards provided by filing or legending requirements. Communications that comply with the proposed rule would not need to be filed with the SEC or include any specified legends.

[1] SEC Release No. 33-10607, Solicitations of Interest Prior to a Registered Public Offering, February 19, 2019

[2] The proposed rule to the Securities Act of 1933 is part of the SEC's modernization initiative. Companies that would be affected include non-reporting issuers, EGCs, non-EGCs, well-known seasoned issuers (WKSIs) and investment companies, including registered investment and business development companies.

[3] Securities Act, Section 5(c)

[4] Securities Act, Section 5(d)

KPMG observation

While the proposed rule would require a company to evaluate whether it reasonably believes that the potential investors are QIBs or IAIs, the company does not need absolute assurance about their status.

The SEC does not believe that the company would violate any rules if it appropriately established a reasonable belief that ultimately was based on false information or documentation provided by the potential investors.

While the SEC is not proposing specific steps that a company could or must take to establish reasonable belief, we believe it may need to consider whether its policies and procedures establish an appropriate reasonable belief.

Other investor safeguards

While the proposed rule would exempt companies from 'gun-jumping' violations, these communications would still be considered 'offers' and may violate other laws in addition to federal anti-fraud laws.[5]

Sellers of securities may have liability if their oral or written communication includes either an untrue statement or omission of material fact. These communications must not conflict with registration statements.

Regulation FD requires public disclosure of any material nonpublic information that has been selectively disclosed to certain securities market professionals or shareholders. Companies subject to Regulation FD should consider whether their test-the-waters communications would trigger an obligation or an exception.[6]

The proposed rule would also allow companies that are, or are considering becoming, registered investment companies or business development companies to engage in test-the-waters communications without complying with rules related to 'sales literature' under the Investment Company Act of 1940.[7] However, the SEC requested comments about whether there are legal or other restrictions that would affect test-the-waters communications.

Non-exclusive election

Companies, other than EGCs, that engage in communications may also rely on other Securities Act rules or exemptions including:

- **Rule 163** - exempts WKSIs for pre-filing communications, with some restrictions;
- **Rule 164** - allows certain companies to use free-writing prospectuses after filing a registration statement, subject to certain conditions; and
- **Rule 255** - allows companies to engage in solicitations of interest in Regulation A offerings before and after filing a Form 1-A, subject to certain conditions.

[5] 'Gun-jumping' is a term commonly used to reference any violation of the Securities Act communications rules in Section 5 of the Securities Act. However, these communications may be considered offers under Section 2(a)(3), and sellers may be subject to liability under Section 12(a)(2).

[6] Securities Exchange Act of 1934 (Regulation FD), Rule 100(a) and 100(b)(2), respectively

[7] Section 24(g) of the Investment Company Act [15 U.S.C. 80a-24(g)]; 17 CFR 230.482 (Rule 482) under the Securities Act; and 17 CFR 270.34b-1(Rule 34b-1) under the Investment Company Act of 1940

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