

Impact of “Test-the-Waters” Reform Debated

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by Nicole H. Strydom

As we previously noted, in February, the SEC proposed expanding its “test-the-waters” accommodation from emerging growth companies (EGCs) only to all issuers via a new Rule 163B and related amendments. This accommodation would enable all issuers to engage in “test-the-waters” communications with certain institutional investors regarding a contemplated registered securities offering prior to, or following the filing of a registration statement related to such offering. These communications would be exempt from restrictions under Section 5 of the Securities Act on written and oral offers before or after filing a registration statement. The accommodation would be limited to communications with qualified institutional buyers (QIBs) and institutional accredited investors (IAIs).

The proposal is part of SEC Chairman Jay Clayton’s well-publicized initiative to encourage more issuers to consider entering the public equity markets. The proposal builds on a popular similar provision of the Jumpstart Our Business Startups Act (JOBS Act) that had also previously been limited to EGCs but now allows all issuers to make non-public filings with the SEC during their initial stages of becoming a public company.

The “test-the-waters” reform is intended to provide a broader range of issuers with the “[enhanced] ability to conduct successful public securities offerings and lower their cost of capital, and ultimately to provide investors with more opportunities to invest in public companies,” according to Chairman Clayton. The overwhelming majority of the comment letters received during the 60-day comment period agreed that the new proposal would accomplish this intention, with a common theme being that it provided a good balance of encouraging greater participation in the public markets while still adequately protecting investors.

One comment letter, however, sounded some ominous warning bells. Better Markets argued that this reform would create “a dangerous loophole” through which unsophisticated investors could slip, since the proposed rule would allow self-certification of QIB or IAI status by a simple check of a box. In addition, the rule would allow issuers

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to communicate with QIBs and IAs of their own choosing. Better Markets worries that this would create further information asymmetry between a “selected subset of investors that are *in the know*” and other investors who may be similarly qualified but only learn about the offering once it is made public because they can’t afford the underwriters and other intermediaries of the former group.