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"Testing the waters" before a public offering of securities: Navigating the rules, without getting all wet

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** Editor's note: This article was originally published on May 9, 2019, describing the SEC's proposal to adopt a new rule broadening the ability to "test the waters" in the United States by assessing whether potential investors might have an interest in a contemplated registered securities offering. The proposed rule, new Rule 163B under the Securities Act of 1933, as amended, has now been adopted substantially as proposed, and will come into effect on December 3, 2019. This article has been updated to reflect the coming into effect of the new rule as adopted, as well as certain other subsequent developments.*

I test my bath before I sit And am always moved to wonderment That what chills the finger not a bit Is so cold upon the fundament

– Ogden Nash

It is natural to want to put a toe in the water to test the temperature before plunging in, to avoid the shock of an unexpectedly cold reception. For the same reasons, it is natural for a company to want to "test the waters" of the capital markets to see how well its securities would be received by investors before going through the time, expense and scrutiny of a public offering of securities, especially for an initial public offering by a company that is not already subject to public company reporting requirements.

Traditionally, securities laws in the United States and Canada have made it difficult to test the waters before a public offering. Meetings with prospective investors to discuss their possible interest in a securities offering could be viewed as unlawful offers of the security, or as acts in furtherance of the trade in the security, both of which were historically prohibited as "gun jumping" before a registration statement or preliminary prospectus relating to the offering had been filed with the securities regulators.

Since 2012, the traditional rules have been changing. The ability to test the waters before an IPO is now part of the legal landscape in both the United States and Canada, although the rules that apply and the procedures that have to be followed work very differently in the two countries. In the United States, thanks to the Jumpstart Our Business Startups Act (the JOBS Act), the ability to test the waters with institutional investors first became available for an IPO or any subsequent public offering by an emerging growth company (EGC), as that term is defined by the JOBS Act. However, in September 2019, the SEC adopted a new rule to provide a second means of testing the waters with potential institutional investors that is available to all companies (Rule 163B), with an effective date of December 3, 2019. The situation in Canada is different, as the ability to test the waters with all accredited investors, whether or not they are institutions, has been available to all companies since 2013, but only before an IPO.

For IPOs, in particular, the usefulness of being able to test the waters is largely a function of the rules determining when in the public offering process a registration statement or preliminary prospectus is required to be publicly filed and whether a draft document may be submitted confidentially for initial review by the securities regulators. If a public filing has been made, the ability to test the waters for an IPO is of much more limited benefit, as the world will know that a proposed IPO was in the works, and that if it does not actually proceed to completion, it is most likely because the waters, once tested, proved to be too cold.

Again, thanks to the JOBS Act, in 2012 the SEC introduced procedures to allow an EGC to submit a registration statement confidentially for review, an accommodation that had previously only been available to foreign private issuers in certain circumstances. In 2017, the SEC decided to expand the confidential review process for registration statements to all companies, whether or not they are EGCs, so long as they have been public and reporting in the United States for less than one year. In Canada, while there are no formal rules governing the submission of a draft preliminary prospectus for confidential review by the Canadian securities regulatory authorities, the Canadian securities regulators have generally accommodated a confidential review process for cross-border IPOs where confidential treatment is available in the United States, whether through granting a formal exemption order allowing the confidential submission to be made, or through a more informal collaborative process prior to the time of the official public filing in Canada. Certain securities commissions in Canada have indicated a willingness to provide a similar accommodation in IPOs being conducted only in Canada.

A fundamental difference between how the testing the waters rules operate in Canada and how they operate in the United States is that of timing. In Canada, any issuer can test the waters, but only before its IPO, and only if the last of any testing the waters meetings is held at least 15 days before the public filing of a preliminary prospectus in Canada. This 15-day cooling off period is presumably designed to put some distance between testing the waters and the start of marketing once the preliminary prospectus is publicly on file, so as to lessen the risk that testing the waters meetings could be used improperly for premature marketing rather than for the intended purpose of assessing whether the market would be receptive to the offering in advance of permitted actual marketing activities. Confusingly, there is also a 15-day cooling off period with a different purpose in the United States, where an issuer that has confidentially submitted a draft registration statement must make its first public filing with the SEC at least 15 days before it commences “road shows” for the actual marketing of the offering. The purpose of this 15-day cooling off period is, presumably, to let the market absorb the fact that the issuer is contemplating a securities offering that has been under confidential review, and have a chance to catch up on the information about the offering contained in the issuer’s registration statement.[1]

The following is a more detailed description of the rules for testing the waters in the United States following the December 3, 2019 effective date of new Rule 163B, and an overview of the requirements that apply to testing the waters under the Canadian rules.

Regime in the United States

Testing the waters by emerging growth companies – The section 5(d) alternative

In 2012, section 5(d) was added to the U.S. Securities Act of 1933, as amended (the 1933 Act) by the JOBS Act, for the purpose of permitting EGCs, or any person authorized to act on behalf of EGCs, to:

...engage in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors... to determine whether such investors might have an interest in a contemplated securities offering, prior to or following the date of filing of a registration statement with respect to such securities...

An EGC can conduct testing the waters meetings at any time, whether before or after a draft registration statement for an offering has been confidentially submitted or publicly filed. However, road shows for a public offering cannot commence until at least 15 days after the first public filing of a registration statement that was previously confidentially submitted for that offering, together with all previously submitted confidential drafts of the registration statement.

If the testing the waters meetings involve an offer of securities, the information conveyed in those test the waters meetings may be subject to potential liability for any material misstatement or omission made.

Testing the waters by any issuer – The Rule 163B alternative

Under Rule 163B, any company and any person authorized to act on its behalf is permitted to engage in testing the waters. While section 5(d) continues to be available for EGCs, all companies including EGCs may use Rule 163B. The result of the introduction of Rule 163B is that a broader range of issuers can more effectively consult with prospective institutional investors, better identify information that is important to prospective investors prior to embarking on a securities offering and, as a result, increase the likelihood of a successful offering.

Under Rule 163B, testing the waters is permitted with potential investors that are reasonably believed to be: (i) qualified institutional buyers (QIBs) as defined in Rule 144A under the 1933 Act, who are either purchasing for their own account or for the account of other QIBs, and (ii) institutions that are accredited investors (IAIs) as defined in Rule 501(a)(1), (2), (3), (7) or (8) of Regulation D under the 1933 Act. Rule 163B incorporates a reasonable belief standard for determining QIB or IAI status that might make it preferable for some EGCs to test the waters under the new rule rather than section 5(d).

On the other hand, there may be an advantage to using section 5(d), if available. Statements made under Rule 163B will be deemed to be offers, making them subject to potential liability for any material misstatement or omission. For this reason, some EGCs may still prefer to rely on section 5(d) and take the position that no offer of any security was being made in its testing the waters process, in the event of any allegation that the materials used contained a material misstatement or omission. It may, however, be difficult to avoid the conclusion that an offer is being made in a testing the waters meeting under section 5(d), despite the absence of an express provision deeming them to be offers, as applies under Rule 163B.

Amendment to Rule 405 – Definition of free writing prospectus

In connection with the adoption of Rule 163B, the SEC has amended Rule 405 to clarify that a written communication used in reliance on either section 5(d) or Rule 163B is not a free writing prospectus and, accordingly, it is not required to be filed as a free writing prospectus.

The Canadian rules

Canadian securities laws permit testing the waters communications with accredited investors, as that term is defined under Canadian securities laws, prior to the filing of an IPO

prospectus with Canadian securities regulators by any company, so long as the requirements of section 13.4 of National Instrument 41-101 *General Prospectus Requirements* of the Canadian Securities Administrators (the Canadian Rules) are complied with.

The Canadian Rules are generally more restrictive than their U.S. counterparts in section 5(d) or Rule 163B under the 1933 Act. The Canadian testing the waters procedures are not available to any company that is already public in Canada or the United States, or that has securities trading on an over-the-counter market in the United States or listed, quoted or traded anywhere outside Canada, or that is controlled by a public company if the IPO would constitute a material change in the business, capital or operations of the controlling company. Further, in Canada, companies are not permitted to conduct any testing the waters meetings directly by themselves; only a registered investment dealer that has been authorized in writing to act on behalf of the company may do so. In addition, all written testing the waters materials must be approved in writing by the company, marked as confidential and include a legend stating that the material does not provide full disclosure of all material facts relating to the issuer or offering and is not subject to liability for misrepresentation. Dealers must obtain written confirmation from potential investors that they will keep information about the proposed offering confidential, and that they will not use the information for any purpose other than assessing the investor's interest in the offering. As prescribed by the Canadian Rules, the required period during which potential investors must agree to keep this information confidential is until the earlier of the public filing of a preliminary prospectus or the time that the company provides written confirmation that it is not proceeding with an IPO. Issuers and investment dealers must keep detailed records of their testing the waters activities, including the authorization from the company to engage in testing the waters, the written materials approved by the company and the confidentiality agreements obtained from the accredited investors who attend testing the waters meetings.

Summary of the testing the waters rules

	Section 5(d)	**Rule 163B**	**Canadian rules**
Who can test the waters?	EGCs only and persons (including dealers) acting on their behalf.	Every issuer and persons (including dealers) acting on their behalf.	Canadian securities dealers who have been authorized to do so by a company that has not yet become public, is not controlled by a public company and has a reasonable expectation of filing a preliminary prospectus in Canada. Members of management may also be present.
When can they test the waters?	Any time before or after a registration statement has been filed.	Any time before or after a registration statement has been filed.	Any time prior to the 15th day before the initial public filing of a Canadian preliminary prospectus.
How long can a proposed IPO for which the testing is being done be kept confidential?	Registration statement and all prior confidential drafts must be publicly filed at least 15 days before the start of road shows.	Registration statement and all prior confidential drafts must be publicly filed at least 15 days before the start of road shows.	Indefinitely, up to the initial public filing of a Canadian preliminary prospectus.

	Section 5(d)	Rule 163B	Canadian rules
With whom can the waters be tested?	Qualified institutional buyers and institutional accredited investors.	Persons reasonably believed to be qualified institutional buyers or institutional accredited investors as defined in Rule 501(a)(1), (2), (3), (7) or (8) of Regulation D.	Any accredited investor, including individual accredited investors.
What confidentiality requirements apply?	No express requirement for confidentiality, but in practice the parties met with are asked to agree to keep the meetings confidential. Companies that are already public also need to consider implications of disclosing material non-public information about a potential offering and compliance with Regulation FD.	No express requirement for confidentiality, but in practice the parties met with are asked to agree to keep the meetings confidential. Companies that are already public also need to consider implications of disclosing material non-public information about a potential offering and compliance with Regulation FD.	Parties met with must expressly agree in writing to keep the meetings and contents of any written material confidential until the earlier of: (i) the public filing of a Canadian preliminary prospectus; and (ii) receipt of advice from the company that the proposed IPO is not proceeding.
Contents of written materials	No restrictions other than potential liability considerations. Also, the SEC may ask to review the materials as part of its registration statement review.	No restrictions other than potential liability considerations. Also, the SEC may ask to review the materials as part of its registration statement review.	Must be approved in writing by the company. Must be marked confidential and contain a statement that it does not contain full disclosure and is not subject to liability for misrepresentations. Also, the Canadian securities regulators may ask to review the materials as part of their prospectus review.
Liability considerations for oral and written statements	Statements that are offers may be subject to liability for material misstatements or omissions.	Statements made under the rule are deemed to be offers making them subject to liability for material misstatements or omissions.	No statutory liability applies to oral statements or the written contents of testing the waters materials.

Practice points for cross-border initial public offerings

While the testing the waters rules in the United States can be used either before or following an IPO, the rules in Canada are designed exclusively for use in context of a company that is not yet public in either Canada or the United States. For this reason, a proposed cross-border IPO puts the greatest strain on the differences between the U.S. and Canadian testing the waters rules.

A number of practice points are helpful to bear in mind in the context of testing the waters for a proposed U.S./Canada cross-border IPO, where the company is planning to file both a U.S. registration statement and Canadian prospectus:

- All companies proposing to conduct a cross-border IPO will be eligible to test the waters in both countries, but the rules governing the timing and conduct of that process in Canada are quite different from the section 5(d) and Rule 163B procedures in the United States.

- Companies and dealers involved in testing the waters in both countries will, as a practical matter, want to use the same written materials in both countries, so that potential investors in both countries are seeing and hearing the same things. Further, the contents of any written materials should not contain any information that will not ultimately be included in the U.S. registration statement and Canadian prospectus, or be able to be derived from included information, to help ensure that no liability risk is being taken for a statement that has not been subjected to the rigors of the due diligence process applied to the contents of a U.S. registration statement and Canadian prospectus.
- The last testing the waters meeting held in Canada must be at least 15 days before the first public filing of a preliminary prospectus in Canada. The first day of any road show being conducted in the United States must be at least 15 days after the public filing of the registration statement in the United States. These two rules both contain the number 15, but otherwise have nothing in common with each other.
- If the issuer is headquartered in Canada, counsel to the company and the dealers involved should consider whether, or to what extent, it may be necessary to comply with the Canadian testing the waters rules for any testing the waters activities taking place outside of Canada, or whether any express exemption from the application of the Canadian rules is available.
- Written testing the waters materials should not be left behind with investors in either Canada or the United States, despite all caution taken to ensure that the information in the written materials will only be a subset of what is ultimately included in the U.S. registration statement and Canadian prospectus.

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[1] It is important to note that, outside of the context of an IPO, companies may have a "shelf" registration statement or prospectus in place which allows them to offer and sell securities from time to time. Having a shelf available eliminates the need for, and benefit of, the testing the waters rules and the confidential filing procedures since companies with a shelf are not prohibited from making offers and can effectively already test the waters at any time, and do not need to worry about confidentially filing a registration statement or prospectus for a particular offering as they already have one publicly on file that can cover potential future offerings. Nevertheless, not every company is eligible to have a shelf in place, and not every company that is eligible to put up a shelf will necessarily wish to do so.