

Professional Perspective

Planning and Disclosing Indications of Interest for Participating in IPOs

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Upfront indications of interest to purchase shares in small and micro-cap initial public offerings are key to IPO completion in today's volatile, uncertain markets. An investor's indication of interest, through testing-the-waters communications, provides a strong message to the market, especially for smaller retail-oriented IPOs. At the same time, the issuer and underwriters must carefully review such disclosures to ensure compliance with applicable securities laws.

Indications of interest are conditional, non-binding pre-IPO expressions of interest from potential investors to participate in an IPO that is in registration and awaiting approval by the Securities and Exchange Commission. These originate with an issuer's directors, executive officers, large existing stockholders, or potential new anchor investors. This action communicates increased deal execution certainty by pre-"selling" a portion of the shares to be sold in the IPO. Naturally, this reduces the number of shares required to be sold in the book-building process, and builds market momentum by providing endorsement and backing for the IPO.

When an investor commits to placing a sizable order at the beginning of the book-building process, this gives issuers and underwriters a head start on raising capital during an open IPO window. Disclosure of potential investments by specialists in certain sectors can be highly persuasive in validating an offering. This is true, for example, with smaller early-stage and first-time issuers and companies in industries characterized by a considerable degree of uncertainty, such as biotech.

Typically, if indicated investors are involved in an IPO, the IPO prospectus will prominently include a statement such as:

Certain of our existing stockholders or persons associated with them have indicated an interest in purchasing from us an aggregate of up to and no more than \$X.X million, or X00,000 shares of our common stock in this offering. All shares sold to these stockholders or persons associated with them will be at the initial public offering price and on the same terms as the other investors in this offering.

Communications and Receipt of Interest

Disclosure of indications of interest in an IPO prospectus requires an issuer to carefully consider the regulations surrounding such investments. Most importantly, the indicated investor may not "agree to purchase" shares in a forthcoming offering, but may only "indicate an interest in purchasing" shares in the offering, prior to the effective date of the registration statement. During the "quiet period" (after the decision to proceed with an offering has been made, but before the registration statement is filed), Section 5(c) of the [Securities Act of 1933](#) prohibits all "offers," in either oral or written form, prior to the filing of a registration statement.

During the "waiting period" (between filing and effectiveness of the registration statement), written or oral offers, but not sales, can be made. However, any offer made in writing or other means has to be made exclusively through the preliminary "red herring" prospectus filed as part of the registration statement. After the registration statement is effective (the "post-effective period"), offers and sales may be made. Offers in violation of Section 5 are often referred to as "gun jumping."

In view of these restrictions on premature "offers" and "sales," the SEC has periodically requested issuers, through staff comment letters, to explain how and when they received the indications of interest, especially from new unaffiliated investors, and disclose any written communications or agreements that accept the investments or indications of interest. The SEC has also asked issuers to disclose the number of potential indicated investors the issuer communicated with on the topic.

As a result, issuers should note that any pre-IPO meetings or oral communications with potential new investors—where an investor indicates an interest in purchasing shares—must be conducted in the context of "testing-the-waters" activities pursuant to Section 5(d) of the [Securities Act](#). An underwriter should generally be able to seek non-binding indications of interest from prospective investors (including the number of shares they may seek to purchase at various price ranges) as long as the underwriters do not solicit actual orders and an investor is not otherwise asked to commit to purchase any particular securities.

Similarly, when the issuer or underwriter engages a potential investor in any written communications (as defined in Rule 405 under the Securities Act), they may also need to provide them to SEC staff, who will verify whether the issuer violated Section 5.

To address SEC concerns, issuers often provide additional disclosure in their IPO prospectus to rebuff any suggestion that the issuer reserved shares or guaranteed an allocation for the indicated investors pursuant to a binding agreement, as follows:

Because indications of interest are not binding agreements or commitments to purchase, the underwriters may determine to sell fewer or no shares in this offering to any of these stockholders or persons associated with them, or any of these stockholders or persons associated with them may determine to purchase fewer or no shares in this offering.

With a similar disclaimer, testing-the-waters communications in an exempt offering pursuant to Regulation A to retail investors must formalize this concept by stating that no money is being solicited or will be accepted, if sent in response; no sales will be made or commitment to purchase accepted until delivery of an offering circular that includes complete information about the issuer and the offering; and a prospective purchaser's indication of interest is non-binding.

Key Disclosures

The SEC has issued comments requiring that specific information pertaining to the indicated investors be included in the IPO prospectus, including:

- The specific number of investors who have indicated an interest in purchasing shares in the offering
- The individual number of shares and/or dollar amount of the shares that each investor has indicated an interest in purchasing and, if the number or amount of shares is uncertain, a maximum or ceiling potential purchase, as well as whether the investors are acting independently or in concert
- Whether any investor or "group" of investors has indicated an interest in purchasing over 5% of the shares in the offering or, in some cases, whether such purchase could result in an investor beneficially owning more than 5% of the issuer's outstanding shares following the offering
- Whether the investors are independent third parties or are affiliated with the issuer or its directors or officers

An indications of interest disclosure is frequently included on the outside front cover of the IPO prospectus, where the indicated investors are typically named. Item 501(b) of Regulation S-K limits information that can be included on the prospectus cover page and does not include language reflecting indications of interest to purchase shares in the offering. However, the SEC has generally not objected to such a disclosure on the cover since it informs IPO investors of potential concentration of ownership following the offering. If the indicated investors are affiliates, it also provides prospective investors general information about how many shares will enter the non-affiliate public float through sales to public investors.

Additional disclosure of indications of interest may sometimes also be found in the Summary, The Offering, Risk Factors, Principal Stockholders, Certain Relationships and Related Party Transactions, and Underwriting sections.

For example, risk factor disclosure would note that, if the indicated investors are allocated all or a portion of the shares in which they have indicated an interest and purchased any such shares, the purchases would reduce the available public float for the issuer's shares. This is because such indicated investors may be restricted from selling the shares by a lock-up agreement with the underwriters and/or by restrictions under applicable securities laws.

Thus, any purchase of shares by the indicated investors in the IPO may reduce their liquidity and reduce the number of shares available for sale to the general public. Consequently, the overall trading market for the shares may not be as active relative to what it would have been had these shares been purchased by public investors that may not have been previously associated with the issuer.

If the indicated investors are directors, executive officers, large existing stockholders, or a new anchor investor acquiring more than 5% of the issuer's outstanding shares, the beneficial ownership table in the Principal Stockholders section should note their potential purchase of shares. If the indicated investors are existing stockholders or even third parties (to the

extent of their business relationship with the issuer), Item 404 of Regulation S-K may require information regarding their indications of interest under the Certain Relationships and Related Party Transactions section.

Disclosure in the Underwriting section would be appropriate in the event the underwriters' firm commitment to purchase all of the shares in the offering is contingent upon the indicated investors ultimately purchasing all the shares they have indicated an interest in purchasing, or if the underwriters would receive less cash or equity-based compensation (lower underwriting discount) in connection with the purchase of shares in the offering by the indicated investors than they would on any other shares sold to the public in the offering. Additionally, in a minimum-maximum "best efforts" underwriting, the Plan of Distribution section of the prospectus should clarify that the indicated investors' indicated interest amounts will be counted towards reaching the minimum and maximum offering amounts to close the offering.

Conclusion

Testing-the-waters communications, as expanded by new [Securities Act](#) Rule 163B (effective Dec. 3, 2019), will enable all issuers, not just "emerging growth companies," to gauge market interest by permitting solicitations of interest from institutional investors prior to the filing of their registration statement, so long as no sales are made or commitment to purchase is accepted. The SEC's accommodation should further augment the possibility of issuers lining up influential indicated investors to enhance their chances of a successful IPO.

Allowing such early stage engagement could create advantages for issuers and investors that would normally only be seen in late-stage venture capital and "cross-over" or cornerstone investments. It could also sway issuers back to more inclusive, transparent, and fully registered securities offerings from the less-costly attractiveness of direct listings. The disclosure of indications of interest can be a highly beneficial feature in an IPO, but must be strategically planned and executed to avoid extended SEC review that could delay or even jeopardize the offering.