



Investor Accreditation and Qualification

SEC and SIFMA Offer Additional Guidance on Rule 506(c) Accredited Investor Status

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Hedge fund managers and other issuers who wish to offer securities in reliance on the exemption from registration set forth in Rule 506(c) of Regulation D under the Securities Act of 1933 (Securities Act), must take “reasonable steps” to verify that each of the investors is an “accredited investor.” The main attraction of a Rule 506(c) offering is that it is not subject to the traditional ban on general solicitation and advertising in private offerings. Rule 506(c) contains a number of safe harbors covering verification of accredited investor status. In that regard, the SEC recently amended its Securities Act Rules [Compliance and Disclosure Interpretations](#) (CDIs) to clarify the calculation of income and net worth in determining accredited investor status and the applicability of the safe harbors relating to income and net worth. In addition, the Securities Industry and Financial Markets Association (SIFMA) recently offered guidance to registered broker-dealers and investment advisers on the determination of accredited investor status.

Regulatory Background

Securities offered in a private placement that complies with one of the exemptions set forth in Rule 506 of Regulation D under the Securities Act are exempt from registration under the Securities Act. In July 2013, pursuant to the JOBS Act, the SEC amended Rule 506 to add new Rule 506(c), under which offerings to accredited investors are not subject to the ban on general solicitation and general advertising set forth in Rule 502(c). A key requirement of this exemption is that the issuer must take “reasonable steps” to verify that all purchasers of the offered securities are accredited investors. Verification is “an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction,” which the SEC refers to as a “principles-based” approach. See [Adopting Release for Rule 506\(c\)](#). In addition, the exemption is not available if the issuer’s principals or other “covered persons” are deemed to be “bad actors.” See [“SEC Provides Guidance on When the Bad Actor Rule Disqualifies Hedge Fund Managers from Generally Soliciting or Advertising,”](#) Hedge Fund Law Report, Vol. 7, No. 9 (Mar. 7, 2014).

Under Rule 501(a) of Regulation D, the term “accredited investor” includes:

- Corporations and other legal entities with total assets in excess of \$5 million;
- Certain entities, such as banks and broker-dealers, regardless of total assets;
- Certain principals of the issuer;

- “Any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000”; and
- “Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. . . .”

The Rule 506(c) adopting release contains general guidance on verifying accredited investor status. See “[A Compilation of Important Insights from Leading Law Firm Memoranda on the Implications of the JOBS Act Rulemaking for Hedge Fund Managers](#),” Hedge Fund Law Report, Vol. 6, No. 30 (Aug. 1, 2013); and “[SEC JOBS Act Rulemaking Creates Opportunities and Potential Burdens for Hedge Funds Contemplating General Solicitation and Advertising](#),” Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013).

Rule 506(c)(2)(ii) also contains four safe harbors, pursuant to which an issuer will be deemed to have taken reasonable steps to verify accredited investor status, unless the issuer has “knowledge that such person is not an accredited investor.” The safe harbors provide “non-exclusive and non-mandatory” methods to verify accredited investor status:

- *Income Verification.* An issuer may review “any Internal Revenue Service form that reports the purchaser’s income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and [obtain] a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year. . . .” Rule 506(c)(2)(ii)(A).
- *Net Worth Verification.* An issuer may “review one or more of the following types of documentation dated within the prior three months and [obtain] a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed: (1) With respect to assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and (2) With respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies. . . .” Rule 506(c)(2)(ii)(B).
- *Third Party Verification.* An issuer may rely on a statement by a licensed attorney or CPA or a registered broker-dealer or investment adviser that such professional has determined, after reasonable verification, that the purchaser is an accredited investor. Rule 506(c)(2)(ii)(C).
- *Prior Purchaser.* An issuer may rely on a certification from an existing investor who had previously purchased securities in the issuer’s Rule 506(b) offering as an accredited investor that the investor remains an accredited investor. Rule 506(c)(2)(ii)(D).

For more on accredited investor due diligence, see “[Katten Seminar Provides Hedge Fund Managers with a Roadmap for JOBS Act Compliance](#),” Hedge Fund Law Report, Vol. 6, No. 43 (Nov. 8, 2013).

Calculating Income and Net Worth

When an investor's income is not reported in U.S. Dollars, the issuer may calculate the investor's income using "either the exchange rate that is in effect on the last day of the year for which income is being determined or the average exchange rate for that year." (CDI 255.48).

Assets held jointly with a person other than the investor's spouse can be included in calculating net worth under Rule 501(a)(5), "but only to the extent of [the investor's] percentage ownership of the account or property." (CDI 255.49).

Clarification of Income and Net Worth Verification Safe Harbors

The recently-added CDIs make clear that the Income Verification and Net Worth Verification safe harbors are only available upon strict compliance with their requirements. Even so, the new CDIs contain alternatives to satisfy the reasonable verification requirement in the event a safe harbor is not available. In each instance, the SEC cautions that, when an issuer has "reason to question" either the information provided by an investor or the investor's claim to be an accredited investor, the issuer "must take additional verification measures in order to establish that it has taken reasonable steps to verify that the purchaser is an accredited investor."

Income Verification

As used in the Income Verification safe harbor (Rule 506(c)(2)(ii)(A)), the phrase "two most recent years" means the two years *immediately preceding* the current year. Consequently, in 2014, an investor must provide IRS forms for 2013 and 2012. The safe harbor is not available if the investor does not have IRS forms for 2013 and, instead, offers forms for 2012 and 2011. In such an event, the SEC indicated that the issuer could still satisfy the Rule 506(c) verification requirement by (1) reviewing the IRS documents for the two available years and (2) obtaining written representations from the investor: that IRS documents for the immediately preceding year are not available; specifying the investor's income for that year; and that the investor has a "reasonable expectation" that his or her income for the current year will also be sufficient to satisfy the accredited investor income test. (CDI 260.35).

"Comparable tax returns from a foreign jurisdiction" do not satisfy the Income Verification safe harbor. Even so, tax returns from foreign jurisdictions that impose penalties for falsely-reported information that are comparable to those imposed in the U.S. may be reviewed as part of a principles-based verification of income under Rule 506(c). (CDI 260.36).

Net Worth Verification

As used in the Net Worth Verification safe harbor (Rule 506(c)(2)(ii)(B)), the phrase "dated within the prior three months" means just that: An issuer may not satisfy the safe harbor by using the investor's most recent annual tax assessment as evidence of assets if such assessment is more than three months old. Even so, the SEC said that such a statement may still be used as part of a principles-based verification of the investor's net worth. In that regard, the SEC indicated that such a statement that shows (after deducting liabilities) that the investor has "a net worth *substantially* in excess of \$1 million . . . may be sufficient verification. . ." (Emphasis supplied.) (CDI 260.37).

In determining liabilities under the Net Worth Verification safe harbor, the phrase "nationwide consumer reporting agencies" is limited to U.S. agencies. As an alternative to the safe harbor,

the SEC indicated that use of a foreign agency report combined with “any other steps necessary to determine the purchaser’s liabilities (such as a written representation from the purchaser that all liabilities have been disclosed)” could satisfy the verification requirement. (CDI 260.38).

SIFMA Guidance

SIFMA recently issued its own guidance for registered broker-dealers and investment advisers on Rule 506(c) verification. SIFMA believes that a broker/adviser may verify a client’s accredited investor status, or confirm a client’s accredited investor status to an issuer (to satisfy the Third Party Verification safe harbor set forth in Rule 506(c)(2)(ii)(C)), if the client has at least a specified minimum account balance with the broker/adviser or is investing a specified minimum amount in the Rule 506(c) offering. In each case: (1) the client must have maintained an account with the broker/adviser for at least six months; (2) the broker/adviser must not be aware of “facts indicating that the client is not an accredited investor”; and (3) the client must provide a completed questionnaire (Purchaser Representations) covering the following:

- Whether the client is an accredited investor;
- Whether the client is borrowing money to purchase the offered securities;
- Whether the investment is individual or joint;
- The client’s current net worth;
- The amount of any outstanding loans to, or guarantees made by, the client (but only to the extent they exceed the value of any collateral posted); and
- Whether the value of securities to be purchased in the offering exceeds 25% of the client’s net worth.

Account Balance

SIFMA “believes that a review of the firm’s records showing that the purchaser has at least a certain amount of cash and marketable securities, net of any amounts borrowed to purchase securities on margin, may in and of itself constitute reasonable steps to verify a purchaser’s accredited investor status on the basis of net worth, and that no other steps to verify need to be taken other than confirming that the firm is unaware of facts indicating that the client is not an accredited investor and obtaining the Purchaser Representations.” In that regard, SIFMA believes that \$2 million in net cash and marketable securities prior to the proposed investment should be sufficient. In arriving at that figure, SIFMA posits that, based on publicly-available information about U.S. household debt, \$1 million of unsecured liabilities is a “worst case” assumption in the absence of a purchaser’s detailed liability schedule.” The \$2 million in net cash/securities, less the assumed liabilities, would satisfy the Rule 501(a) \$1 million net worth test. Any business debt revealed in the Purchaser Representations should be added to the \$1 million assumed debt figure and the requisite total net cash/securities should be increased accordingly.

Investment Amount

The Rule 506(c) adopting release indicated that the minimum investment amount of an offering is one factor that issuers may consider in a principles-based verification of accredited investor status. SIFMA takes the position that an investment of at least \$250,000, and that does not

exceed 25% of the investor's net worth, should enable a broker/adviser to satisfy the reasonable verification requirement.

Legal Entities

SIFMA believes that brokers and advisers should only have to verify an entity's status as a bank or other entity that is deemed to be an accredited investor under Rule 501(a) "at least annually." It also believes that, for entities required to have at least \$5 million in total assets to have accredited investor status, confirming that a client is designated on the broker's/adviser's client list as an "institutional account" under FINRA rules (at least \$50 million of total assets) or a Qualified Institutional Buyer (at least \$100 million of total assets) should suffice. It also believes that an investment of at least \$5 million in a Rule 506(c) offering should suffice so long as "the entity provides a written representation that it was not formed for the purpose of making that investment and has made at least one prior investment in securities (whether in a primary offering or in the secondary market)."

A number of major law firms concur with SIFMA's approach. Of course, SIFMA's guidance is not binding on the SEC, which may interpret Rule 506(c) differently.

For a link to SIFMA's Rule 506(c) verification guidance, click [here](#).

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