

Believe But Verify: Evaluating Accredited Investors Under the SEC's Proposed Rule 506(c)

6 September 2012

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Section 201(a)(1) of the Jumpstart Our Business Startups Act ("JOBS Act"), enacted April 5, 2012,¹ states:

Not later than 90 days after the date of enactment of this Act, the Securities and Exchange Commission shall revise its rules issued in section 230.506 of title 17, Code of Federal Regulations, to provide that the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors. Such rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission....

The statutory language in 201(a)(1) poses a number of interpretive ambiguities with regard to the mandated changes to rule 506. Some, but not all, of these have been addressed by the Securities and Exchange Commission in the amendments it proposed August 29, 2012.²

Statutory ambiguity one.

Where general solicitation or advertising is used, what is the meaning of the statutory language that all purchasers must be "accredited investors"?

The term accredited investors is not defined in the statute. In ordinary parlance, the words "accredited investor" are empty of meaning – the word accredited obviously calls out for an external definition. The fact that the statute requires amendment to rules 502(c) and rule 506 must mean that the term "accredited investors" as used in the statute has the meaning utilized in such rules. Rule 501(a) defines accredited investors as the term is used in rules 501 through 508. It provides that an accredited investor "shall mean any person who comes within any of the following categories [the definition goes on to enumerate eight categories of investors, including corporations having assets in excess of \$5 million and individuals meeting specified net worth or income tests]." Critically, however, the definition then states that an accredited investor shall also mean a person "who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person."

Thus, when the statute includes a proviso that the SEC rulemaking must require that where general solicitation or advertising is used, all purchasers be accredited investors, the reasonable reading is that all purchasers must either be within one of the eight categories specified in rule 501(a), or the issuer must "reasonably believe" that they are.

The SEC's proposed amendment to rule 506(c) adopts this approach, by adding a new paragraph (c)(2)(i) to specify a condition of the exemption that "all purchasers of securities sold in any offering under this §230.506(c) [an offering where general solicitation or advertising is used] are accredited investors." The definition of accredited investors in rule 501(a), including the reasonable belief element, applies to proposed rule 506(c).

Thus, in terms of ascertaining the nature of the purchasers, it suffices under the proposed rule, for this element of the exemption, that the issuer reasonably believes that all purchasers fall into one or more of the categories specified in rule 501(a)(1)-(8). It is not necessary that the purchasers actually fall into such categories.

Statutory ambiguity two.

When the statute says that the SEC's rules shall require (where general solicitation or advertising is used) that the issuer take reasonable steps to verify that purchasers of the securities are accredited investors, is that to be a condition of the rule 506 exemption?

The most natural reading of section 201(a)(1) is that the rulemaking must specify that, as a condition of maintaining the exemption for an offering using general solicitation or advertising, the issuer must take reasonable verification steps as to investor status. That is not the only possible reading, however. In fact, offerings under rule 506 are currently subject to a requirement that is not a condition of the exemption – a requirement that notice of sales be filed under rule 503. It would have been possible, consistent with the statutory language, for the SEC rulemaking to have specified a requirement of reasonable verification of investor status, without such requirement being a condition to availability of the exemption. Violation of this prohibition could have been treated in the same way as a violation of rule 503 – making the exemption unavailable for issuers who have been subject to a court order enjoining them from violating the provision.

However, the SEC opted not to proceed in this manner. Under proposed rule 506(c)(2)(ii), the reasonable verification requirement is incorporated as a condition to availability of the exemption.

Statutory ambiguity three.

What does it mean to take reasonable steps to verify that purchasers are accredited investors?

As discussed above, under the terms of the statute, in an offering using general solicitation or advertising, sales must be made solely to investors who either are or are reasonably believed to be, persons who fall within one or more of the eight categories specified in rule 501(a), thus meeting the definition of accredited investor.

However, in addition to demonstrating a "reasonable" belief,³ the statute requires, in the second sentence of section 201(a)(1), "verification" (an undefined term) of the fact that purchasers are accredited investors. As with the first sentence of 201(a)(1), the context strongly indicates that in the second sentence as well, the term accredited investors is used in the statute as defined in rule 501(a). Under the statutory language, then, steps must be taken to verify that an investor is

either in one of the eight specified categories, or to verify that the issuer reasonably believes that this is so. As a result, the statute uses a cumbersome and confusing formulation that layers a reasonable verification requirement on top of a reasonable belief element – requiring reasonable steps to verify that the issuer reasonably believes that the investor is in one of the enumerated categories.⁴

It is not at all clear what it would mean for an issuer to “verify” that it in fact has such a reasonable belief, beyond what is necessary to form a belief that is reasonable in the first place.

The SEC in its rulemaking could have addressed this point by providing that, as a condition of making a general solicitation/advertising offering, the issuer must take reasonable steps to verify that each purchaser is in one of the eight categories specified in rule 501(a). However, the proposed rule does not adopt this approach, instead tracking the statute, and requiring reasonable steps to verify that each purchaser is an accredited investor (as defined). The discussion of the provision in the release treats it as if it were worded as a requirement for verification that the purchaser is in one of the specified categories. The release is clear in making the point that verification requires something more than reasonable belief, which would be consistent with a requirement of verification that the investor has the categorical status, not verification that the issuer has a reasonable belief in the investor’s categorical status. The release does not appear sensitive to the difficulty in interpreting a requirement as expressed in proposed rule 506(c) for an issuer to verify that the issuer has a reasonable belief. It is to be hoped that this matter would be corrected in the final rulemaking.

Statutory ambiguity four.

What is the difference between reasonably verifying and reasonably believing?

As noted, the SEC rulemaking could be modified to make it clear that the exemption requires both a reasonable belief that the investor falls within one of the rule 501(a) categories and reasonable steps to verify that the investor falls within one of them. Even then, the rulemaking could be more effective in specifying what additional steps are required for verification of the objective facts beyond what is required for reasonable belief in the existence of such facts.

Currently, in rule 506 offerings, issuers ordinarily seek to be able to demonstrate a reasonable belief that investors fall within a rule 501(a) specified category, and are thus accredited, by using investor questionnaires. These questionnaires, drafted to track the various rule 501(a) categories, ask the investor to confirm by checking a box which of the described categories he falls under. In the absence of any information to the contrary, issuers customarily conclude that it is reasonable to rely on what they are being told by the investor, and therefore have a reasonable belief that the investor meets the categorical requirements.

Now, in new rule 506(c) offerings using general solicitation or advertising, the SEC clearly indicates in the proposing release that use of questionnaires likely will not be sufficient to constitute reasonable steps to verify.

However, notwithstanding the language in section 201(a)(1) of the statute, stating that verification shall require the use of “such methods as determined by the Commission,” the

proposed rule 506(c) determines no such methods. The rule requires only that the methods be “reasonable.” In the proposing release, the SEC indicates that examples of factors that would determine the reasonableness of verification methods are: the nature of the purchase and the type of accredited investor that the purchaser claims to be; the amount and type of information that the issuer has about the purchaser; the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering; and the terms of the offering, such as a minimum investment amount.

Notwithstanding such discussion in the proposing release, no particular verification steps are mandated in the proposed rule. Also, the SEC declined to propose in the rule a non-exclusive list of specified methods for satisfying the verification requirement, citing a concern that there could be circumstances where enumerated specified methods would not effect reasonable verification. Also, the SEC expressed a concern that a non-exclusive list of methods might be viewed by market participants as required methods.

The use of the term verification in proposed rule 506(c), the clear indication in the proposing release that verification in the SEC’s view means an undefined higher level of inquiry than what is required to form a reasonable belief, and the absence of the specification of steps that would be deemed to constitute reasonable verification, all threaten to undercut the utility of the elimination of the general solicitation and advertising requirement. Issuers faced with the uncertainty of how to comply with the reasonable verification requirement may very likely react by foregoing general solicitation and advertising so as to avoid this compliance risk. This would undermine the basic purpose of section 201(a)(1) of the statute.

* * * *

Section 201(a)(2) of the JOBS Act states:

Not later than 90 days after the date of enactment of this Act, the Securities and Exchange Commission shall revise subsection (d)(1) of section 230.144A of title 17, Code of Federal Regulations, to provide that securities sold under such revised exemption may be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.

This language is free of many of the ambiguities presented by 201(a)(1), and the SEC-proposed changes to rule 144A are far more straightforward than the changes to rule 506. The proposed rules simply delete the current requirement in rule 144A that an offer pursuant to the rule be made to persons reasonably believed to be qualified institutional buyers. Under the proposed change, offers can be made to any persons. Sales are required to be made only to persons reasonably believed to be qualified institutional buyers. While the rule does not expressly state that such offers can be made by general solicitation or advertising, this is implicit in the absence of any requirement limiting the manner or object of the offer.

* * * *

The SEC's proposing release expressed the view (not incorporated in any rulemaking) that an offering under proposed rule 506(c) would not be considered a public offering so as to render unavailable the exclusions from investment company status under sections 3(c)(1) and 3(c)(7) of the Investment Company Act.⁵ Nor would the general solicitation and advertising in an exempt rule 506(c) offering be considered to impair the availability of Regulation S for concurrent offshore offerings.

Comments on the proposed rules are due 30 days after publication in the *Federal Register*.

¹ Pub. L. No. 112-106, 126 Stat. 306.

² Release No. 33-9354.

³ It may be expected that issuers will rely upon the reasonable belief element because of the lower risk that it could later be determined that that this criterion was not met, as opposed to the more absolute criterion of meeting the subjective category requirements, which is more subject to demonstration of error by hindsight.

⁴ This result could have been avoided if the second sentence of section 201(a)(1) had been drafted to require reasonable steps to verify that investors fall within one of the categories specified in rule 501(a).

⁵ These sections exclude certain private funds from the definition of investment company, but are not available if the fund is making a public offering of its securities.

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