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Morrison & Foerster: SEC Staff Provides Rule 506(c) Verification Guidance.

The SEC Staff recently provided further guidance on the provisions of Rule 506(c) of Regulation D which permit the use of general solicitation and general advertising when sales are made only to accredited investors and the issuer verifies the accredited investor status of the purchasers. The Staff has now clarified certain aspects of the verification process through a series of new Securities Act Rules Compliance and Disclosure Interpretations.

When a purchaser holds assets in an account jointly or holds property jointly with an individual that is not the person's spouse, the Staff has said that the assets in the account or property held jointly can be taken into account for the net worth test set forth in Rule 501(a)(5), but only to the extent of the purchaser's percentage ownership of the account or property (Question 255.49).

The Staff has indicated that in a situation where a purchaser's annual income is not reported in U.S. dollars, the issuer may use 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 the year (Question 255.48). If a purchaser is not a U.S. taxpayer and therefore cannot provide an IRS form to report income, the non-exclusive method for verification set forth in Rule 506(c)(2)(ii)(A) would not be available; however, the Staff has said that the principles-based verification method could be utilized where an issuer could reasonably conclude that a purchaser is an accredited investor based on a review of tax forms that report income in a foreign jurisdiction which imposes penalties for falsely-reported information that are comparable to those of the U.S (Question 260.36).

If an issuer is seeking to rely on the non-exclusive method for verification set forth in Rule 506(c)(2)(ii)(A) and thus wants to review the purchaser's income as reported on IRS forms for the two most recent years, but the most recent year is not yet available, it would not necessarily be appropriate for the issuer to then review years prior to the two most recent years. However, the Staff believes that an issuer could reasonably conclude that a purchaser is an accredited investor and satisfy the verification requirement under the principles-based verification approach by:

- reviewing the Internal Revenue Service forms that report income for the two years preceding the recently completed year; and
- obtaining written representations from the purchaser that (i) an Internal Revenue Service form that reports the purchaser's income for the recently completed year is not available, (ii) specify the amount of income the purchaser received for the recently completed year and that such amount reached the level needed to qualify as an accredited investor, and (iii) the purchaser has a reasonable expectation of reaching the requisite income level for the current year. (Question 260.35).

With respect to the review of tax assessments for the purposes of determining an accredited investor's net worth under the non-exclusive verification method set forth in Rule 506(c)(2)(ii)(B), the Staff notes that reviewing a tax assessment that is more than three months old would not be appropriate when relying on the verification safe harbor. That said, the Staff believes that an issuer

could reasonably conclude that a purchaser is an accredited investor and satisfy the verification requirement of Rule 506(c) under the principles-based verification method, if the issuer uses the most recently available tax assessment when determining whether the purchaser has the requisite net worth (Question 260.37).

Lastly, in reviewing consumer reports for the purposes of determining a purchaser's liabilities under the non-exclusive verification method set forth in Rule 506(c)(2)(ii)(B), the Staff indicates that while a consumer report from a non-U.S. entity would not work for the purposes of the safe harbor, an issuer could reasonably conclude that a purchaser is an accredited investor and satisfy the verification requirement under the principles-based verification method by reviewing a foreign report and taking any other steps necessary to determine the purchaser's liabilities (such as a written representation from the purchaser that all liabilities have been disclosed) in determining whether the purchaser has the requisite net worth (Question 260.38).

In those interpretation where the Staff noted that an issuer could reasonably conclude that a purchaser is an accredited investor based on the principles-based verification method, the Staff further noted that when the issuer has reason to question the information that is being considered or, depending on the test, the purchaser's net income or net worth, then additional verification measures may be necessary in order to verify that the purchaser is an accredited investor.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

July 14 2014

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