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Rule 506(c) And The Future Of Private Placement Practices

Law360, New York (August 02, 2013, 2:17 PM ET) -- As the securities bar carefully parses the language of the July 10 U.S. Securities and Exchange Commission release (the adopting release) implementing new Rule 506(c), which removes the bar on general solicitation and advertising in private placements, the implications of the new rule and the fundamental changes to long-standing practices that it will cause are coming into better focus.

The most significant of these relate to how an issuer can verify accredited investor status without relying only on an investor's bald assertions. Below are some observations and predictions regarding how these new practices will develop.

An Election Between the New 506(c) and the Traditional 506(b) Exemptions Is Required

If an issuer wants to engage in general solicitation or advertising, then a Form D with the appropriate box checked indicating reliance on 506(c) must be filed within 15 days after the first sale. The issuer relying on the traditional 506(b) exemption must file the Form D with the 506(b) box checked within the same time period. The SEC made clear in the adopting release that an issuer cannot check both boxes, so an election as to which exemption to rely on has to be made.

However, despite the SEC's clear intent to force an election, issuers still could, in some circumstances, straddle the fence and keep their options open at least up to the time of the first sale. An issuer that intends to conduct a traditional private placement without general solicitation or advertising could, in many cases, also comply with the new 506(c) accredited investor verification requirements without substantial additional effort.

If that compliance is achieved, then up to the time of the Form D filing, 15 days after the first sale, that issuer would retain the flexibility to change course and rely on the 506(c) exemption if general solicitation or advertising inadvertently occurred or instead, rely on the traditional 506(b) exemption if it wanted to sell to some nonaccredited investors.

The SEC also proposed changes to the Form D filing requirements at the same time it finalized the new Rule 506(c). The proposed changes would require, among other things, that the Form D for a Rule 506(c) offering be filed (with the 506(c) box checked) 15 days before the first general solicitation.

This would force the election between a 506(b) offering and a 506(c) offering to occur before the offering begins, which would eliminate the ability of issuers to keep their options open during the offering.

Bald Assertions by Purchasers No Longer Work

Rule 506(c) introduces the concept of verification of accredited investor status to Rule 506 and provides alternative means for an issuer to do so. These nonexclusive means of verifying an accredited investor's status generally require corroboration from third parties or from documents filed under penalty of perjury.

They do not allow for verification based solely on the bald assertions of the investor. Indeed, in the adopting release, the SEC emphasized this point with the statement that "we do not believe that an issuer will have taken reasonable steps to verify accredited investor status if it required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status."

So having a purchaser check a box indicating that he/she/it meets the income test, or the net worth test, or the total assets test, is clearly no longer adequate. While requiring minimal corroboration is quite reasonable on its face, the fact is that common practice in small private placements for decades has been precisely what the SEC condemns — i.e., an investor merely has to check a box to indicate that it is an accredited investor and is sometimes asked to provide minimal balance sheet information and/or answer a few simple questions intended to demonstrate sophistication and experience in investing.

It has not been common practice to require outside corroboration of these assertions. But it is clear that this routine reliance on the bald assertions of the investor cannot continue in Rule 506(c) offerings given this pointed statement from the SEC.

Can the practice of relying on the investor's bald assertions continue even outside of 506(c) offerings? Taking reasonable steps to verify that purchasers are accredited investors is a new concept in rule 506(c). In contrast, traditional 506(b) requires only that issuers reasonably believe that purchasers are accredited investors.

Given the strong criticism by the SEC of exclusive reliance on the bald assertions of purchasers, can issuers relying on the traditional 506(b) exemption now reasonably believe that the purchaser is an accredited investor based solely on the purchaser saying that he is? This issue is the subject of spirited debate within the securities bar, but it seems likely that more cautious 506(b) issuers will gravitate toward requiring the same type verification methods as are now provided in the safe harbors under 506(c).

Third-Party Confirmations Will be the Preferred Verification Method

New Rule 506(c) provides that various tax return documents can be used to verify a person's status as an accredited investor on the basis of income. However, many investors will undoubtedly be extremely reluctant to provide such highly sensitive information. The SEC notes in the adopting release the possibility of redacting nonessential information from the tax documents, but this will not help in most situations. The reluctance to provide sensitive tax return documents will push purchasers to other means of verifying their accredited investor status.

The third-party confirmation process, on the other hand, is relatively flexible and straightforward, only requiring that the confirming person or entity be registered or licensed as appropriate and make a written confirmation that it has taken reasonable steps to verify, and has determined, that the relevant

purchaser is an accredited investor. The confirming party is not required to provide any backup documentation or any specification of the steps taken to verify.

It is likely that wealth management providers eventually will become accustomed to providing these confirmations for their clients and that they become the norm for verifying accredited investor status. Entrepreneurs are already analyzing the financial viability of businesses that would compile and maintain nationwide databases of accredited investors.

What Form Will Third-Party Confirmations Take?

Given the apparent attractiveness and relative simplicity of utilizing third-party professionals to confirm accredited investor status, it should be expected that there will be substantial focus in the coming months on the content of these written confirmations. It is likely that relatively standardized confirmation forms will develop over time, but many questions will need to be addressed and resolved before that can be achieved.

The confirmations will likely contain qualifiers that the confirming person's belief is based on information actually made known to him, rather than on any constructive knowledge standard. While this is unobjectionable, issuers should anticipate more creative assumptions, qualifiers and conditions that may raise issues as to whether the confirmation has been effectively assumed away.

Another question is whether reasonable steps by the confirming professional include obtaining first-hand knowledge of the purchaser's income, assets and/or liabilities or whether, and if so, to what extent, they can rely on the now discredited bald assertions of the purchaser.

Creeping Expansion of the Safe Harbor Verification Methods

The SEC goes to great lengths throughout the adopting release and in Rule 506(c) to emphasize that the listed methods of verifying accredited investor status are nonexclusive and are not intended to be a list of required methods.

At the same time, the SEC has made clear that bald assertions by the purchaser are not acceptable under new Rule 506(c). Given the push for more objective verification methods, it seems likely that reliance on the safe-harbor methods will, in fact, develop over time into the common practice.

The safe harbors provided in Rule 506(c) apply by their terms expressly to purchasers that are natural persons, yet the requirement to verify accredited investor status applies to all purchasers in a 506(c) offering, including entities.

The SEC justified limiting the safe-harbor methods to natural persons because "the potential for uncertainty and the risk of participation in private offerings by non-accredited investors was highest with respect to natural persons." Whether or not this makes sense, issuers are faced with the need to verify that entities are accredited investors without the benefit of the safe harbor.

The most common way for an entity to qualify as an accredited investor is the $5 million total asset test. The third-party professional confirmations of net worth provided for in the safe harbors would seem to be reasonable verification methods in this situation as well, and it is likely that cautious private placement issuers will, in the future, require some comparable type of third-party verification of the $5 million total asset level for entities.

Conclusion

The SEC used the loosening of general solicitation and advertising prohibitions as an opportunity to tighten up practices surrounding verifying accredited investor status. The new requirements surrounding verification do not appear unreasonable or unworkable, and it is likely that they will become standard practice well beyond their express applicability.

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