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506(c) Offerings:
Practical Guidance for Broker-Dealers/Registered Investment Advisers

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Rule 506(c) allows issuers to conduct their private placement offerings utilizing general solicitation to find investors on the condition that those issuers have taken reasonable steps to verify the accredited investor status of their investors.

Rule 506(c)(2)(ii)(C)(1) allows issuers to fulfill their obligations to verify accredited investor status of its investors by, among other things, “obtain[ing] a written confirmation from [a registered broker-dealer] that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months...” The same applies for a registered investment adviser pursuant to Rule 506(c)(2)(ii)(C)(2).

This article will explore some of the procedures and policies that broker-dealers and registered investment advisors¹ should take into consideration when providing issuers with such written confirmation.

As discussed in our prior Article regarding 506(c) offerings, if it turns out that the purchaser was not in fact an accredited investor, the issuer does not lose the exemption from registration provided in Rule 506(c). However, broker-dealers could open themselves up to claims if their policies and procedures to verify the accredited investor status of its client were either (i) inadequate to demonstrate they had taken reasonable steps or (ii) they did not follow those policies and procedures.

For broker-dealers and investment advisers who wanted to provide investor verification services as permitted under Rule 506(c)(2)(ii)(C), the Securities Industry and Financial Markets Association (“SIFMA”) published helpful guidance (the “Guidance”) in June 2014². The Guidance provides some verification methods that broker-dealers and investment advisers could use to comply with the requirements of Rule 506(c)(2)(ii)(C) for both natural persons as well as entities. For individual investors, SIFMA recommends one of two methods for verifying accredited status:

¹ Throughout this article, we will use the terms “broker-dealer” and “registered investment advisor” interchangeably.

² SIFMA Guidance on Rule 506(c) Verification published June 23, 2014. www.sifma.org/resources/general/sifma-guidance-on-rule-506c-verification/.

- (1) Account balance method: holding an account that has at least a certain amount of cash and marketable securities may be sufficient to constitute reasonable steps to verify accredited investor status (SIFMA recommends at least \$2 million, assuming \$1 million of liabilities)³; or
- (2) Investment amount method: investing or committing (which commitment is unconditional and callable at any time) at least \$250,000 and provided certain representations that the proposed investment is less than 25% of their net worth.⁴

Either of the two methods would additionally require an investor to have maintained an account with the broker-dealer for at least six months to allow the firm to get to know the client⁵ and provide written representations that the investor is not borrowing money to make the investment and it is an accredited investor. The broker-dealer would also need to be unaware of any facts that the client is not accredited.

For entities, the Guidance notes that certain entities (banks, insurance companies, etc.) may qualify as accredited investors solely on the basis of their status. For entities that do not qualify solely based upon their status, the Guidance notes that the registered broker-dealer could take reasonable steps to verify the client's status as an "institutional account" or as a Qualified Institutional Buyer ("QIB").⁶ In the event the entity client's status may not be verified as either an "institutional account" or QIB, the accredited investor status of an entity may nevertheless be verified so long as it did each of the following: (i) made an investment in the offering in excess of \$5 million, (ii) provided a written representation it was not formed for the purpose of making the investment and (iii) has made at least one prior investment in securities.⁷

Since the Guidance was released the Securities and Exchange Commission ("SEC") has issued subsequent guidance in Release 33-10763 (the "Release") regarding Rule 506(c) verification requirements.⁸ The SEC indicated that Rule 506(c) provides a "principles-based method for verification of accredited investor status." The SEC indicated that the provision of the non-exclusive verification methods may be creating uncertainty and inadvertently encouraging issuers and their agents to rely only on the non-exclusive list. The Release stated that Rule 506(c) includes a non-exclusive list of verification methods but that issuers are not required to use any of the specific methods.

The SEC went on to indicate that they were providing guidance on what was considered "reasonable steps" to verify an investors status which may "reduce concerns that

³ Id. at 6.

⁴ Id. at 7.

⁵ SIFMA notes that depending upon the individual facts and circumstances, six months may or may not be the correct timeframe.

⁶ Id. at 8.

⁷ Id.

⁸ This position was confirmed in Release 33-10884.

an issuer's method of verification may be second guessed by regulators or other market participants without regard to the analysis performed by the issuer in making the determination and to encourage more issuers to rely on additional verification methods tailored to their specific facts and circumstances." The goal was to provide issuers with significant flexibility in verifying a person's accredited investor status. The SEC went on to further indicate that "the reasonable steps determination may not be substantially different from an issuer's development of a "reasonable belief" for Rule 506(b) purposes." The Release indicates that the receipt of a representation from an investor that they are an accredited investor could meet the "reasonable steps" requirement if there was a prior substantive relationship with that investor.

Another consideration for broker-dealers looking to provide verification services is the content and operational procedures of the written supervisory procedures (WSPs) of the firm. Designation of the person who is permitted to sign off on any verifications and the forms and representations to be required from the investors in order to document the steps necessary to verify should be included. Issuers should understand who is making the verification certification and ask about the policies and procedures used in obtaining such certification.

A verification from an individual registered representative or investment adviser certifying the accredited investor status of investors without compliance or supervisory affirmation should be more carefully examined. Instead, we believe that such certifications should be made at the chief compliance officer level or persons designated by the chief compliance officer and noted in the WSPs. Those WSPs should spell out the steps necessary for the firm to be in a position to make the certification and those WSPs should be followed each and every time. Documenting the process in the client's files is also important for recordkeeping and diligence purposes.

When firms enter into selling agreements with issuers, they should also review the obligations of each party with respect to verifying the accredited investor status of investors. If there are ambiguities with respect to who is undertaking the obligations (and the liabilities), clarify them so that each party understands the scope of its respective duties and responsibilities.

The methods described above are only examples of ways that broker-dealers and investment advisers can be involved in 506(c) offerings and the process by which investors are determined to be accredited investors. In addition, Rule 506(c)(2)(ii)(C)(3) and (4) allows attorneys and CPAs to provide confirmation of accredited investor status of investors to issuers. These are not exclusive and reflect some general ideas as to ways that some in the industry are currently operating.

We welcome additional ideas of ways that you and your firm are handling these issues but believe that, as an industry, we can implement these processes to protect all participants and provide necessary investment products for investors.

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