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SEC Eases Verification Burdens in Rule 506(c) Offerings

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The SEC's Division of Corporation Finance recently issued an interpretive letter[1] providing additional insight as to what constitutes "reasonable steps" to verify an investor's accredited investor status under Rule 506(c) of Regulation D, a private offering exemption that permits general solicitation. Compared to Rule 506(b), which does not permit general solicitation, Rule 506(c) is not relied upon frequently.[2] Use of Rule 506(c) has been deterred to some degree because of the burdens and uncertainty surrounding compliance. The SEC Staff's interpretive letter addresses some of the uncertainty that had deterred widespread use of Rule 506(c), opening the door to broader utilization. Though a welcome clarification of how the SEC Staff would interpret Rule 506(c)'s conditions, the interpretive letter leaves several questions unanswered, including whether it can be applied to particular types of investors.

Background: The Verification Challenge

Rule 506(c) allows issuers to engage in general solicitation in connection with an unregistered offering if the issuer takes "reasonable steps" to verify that all investors are accredited investors. In adopting Rule 506(c), the SEC stated that if the minimum investment amount is sufficiently high, then the issuer may not need to take additional steps to verify "accredited investor status," absent contrary facts, but it did not indicate the minimum investment amounts that might qualify for such treatment.

Historically, many issuers avoided 506(c) offerings due to the lack of guidance on what minimum investment amount would be sufficient for the issuer not to undertake an additional verification process that in many cases would require extensive diligence into an investor's "accredited investor" status. For example, in the case of certain investors qualifying on the basis of their assets or income, Rule 506(c) expressly provides that an issuer satisfies its diligence requirements if it reviews the investors' bank statements or tax returns (which is considered burdensome for some investors and also raises privacy and data security concerns), or relies on certifications by specified market intermediaries such as registered investment advisers, broker-dealers, accountants or attorneys (many of whom are unwilling to provide them). While the inclusion in the rule text of specific information an issuer could review may have been intended to operate as a "bright line" and aid compliance, the practical difficulties made the verification process unappealing in many cases. The interpretive letter provides additional guidance that should facilitate the diligence required under Rule 506(c).

Key Takeaways

The SEC Staff's agreed that, when accepting investments from certain types of investors, absent an issuer's knowledge of contrary facts, an issuer may reasonably conclude that it has taken "reasonable steps" to verify the investor's accreditation if:

- Investors must make a minimum investment of at least the amounts specified below:
    - $200,000 for natural persons
    - $1,000,000 for certain entities
- The issuer obtains written representations from investors confirming:
    - The investor is an accredited investor under Rule 501(a)
    - The investment is not financed by third parties for the specific purpose of making the investment
- The issuer does not have actual knowledge contradicting these representations

Which Investors Are Covered?

The new guidance applies to most categories of accredited investor that are subject to an asset test, including:

- Individuals[3]
- Corporations, partnerships, LLCs or similar entities[4]
- Trusts [5]
- Other entities not separately covered by another prong of the accredited investor definition that have not been formed for the specific purpose of making the investment[6]
- Family offices[7]
- Entities entirely owned by other accredited investors meeting the conditions described in the letter[8]

Because the relief provided by this interpretive letter does not explicitly encompass all categories of accredited investors, issuers in Rule 506(c) offerings must still take care to identify any investors that fall outside of this guidance so that additional verification can be performed if necessary.

Implications for Fundraising Beyond the US

Even though the SEC's guidance may allow issuers or fund sponsors to exercise greater freedom for aspects of their US fundraising activities, if they are seeking to raise capital in non-US countries then they should be mindful of the regulatory regimes in these countries as well. For example, if an issuer or fund sponsor engages in more publicized fundraising activities in the US, this could impact its ability to rely on a reverse solicitation exemption in countries outside the US. This would be a key consideration if the fund sponsor were seeking to raise capital from investors in the European Economic Area or the UK as these regimes apply the requirements of the Alternative Investment Fund Managers Directive. Therefore, issuers and fund sponsors seeking to raise capital from non-US as well as US investors should factor in the requirements of these non-US countries before they engage in any more liberal marketing initiatives as a consequence of the new SEC guidance.

The new guidance is a staff interpretive letter, which is not a formal, binding interpretation of the SEC. Although the SEC can ordinarily be expected to respect the staff's guidance absent differing facts, a court is not required to rely on, or defer to, the letter.

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[1] Available at: https://www.sec.gov/rules-regulations/no-action-interpretive-exemptive-letters/division-corporation-finance-no-action/latham-watkins-503c-031225

[2] 17 CFR 230.506(c).

[3] 17 CFR 230.501(a)(5) and (6). Rule 501(a)(6) allows individuals to qualify on the basis of income, rather than assets.

[4] 17 CFR 230.501(a)(3).

[5] 17 CFR 230.501(a)(7).

[6] 17 CFR 230.501(a)(9).

[7] 17 CFR 230.501(a)(12).

[8] 17 CFR 230.501(a)(8).

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