

## **SEC Issues Interpretive Advice About Verification Safe Harbors Under Rule 506(c)**

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### **Background**

The availability of the private placement exemption under SEC Rule 506 depends in large measure upon determinations that purchasers are “accredited investors” under the rules. Where there is no general solicitation, Rule 506(b) applies, and accredited investors have been able to self-certify their status, typically by checking a box about the basis for their accredited investor status in the subscription documents prepared by the issuer of the securities.

However, if the Rule 506 transaction involves general solicitation, new Rule 506(c) is applicable, and issuers are required to comply with an accredited investor verification process that requires more than the simple completion of an investor questionnaire. In explaining its position on verification, the SEC Staff has generally been quite strict about application by issuers of the four non-exhaustive “safe harbors” which include, among other things, the use of tax records to verify investor income, third party statements and credit reports to verify net worth and written confirmations from registered broker-dealers and other professionals.

### **Newly Issued Interpretations**

On July 3, 2014, the Staff of the SEC’s Division of Corporation Finance issued six new Compliance and Disclosure Interpretations (CDIs) to clarify the application of the safe harbors under Rule 506(c) involving the following topics:

#### *Applicable Exchange Rate When Investor’s Income is Not in Dollars*

In determining whether a purchaser’s income, reported in a foreign currency, meets the income test for qualifying as an accredited investor (and in all likelihood, in determining the value of assets and liabilities for the net worth test), the issuer may use either (a) the exchange rate that is in effect on the last day of the year for which income is being determined or (b) the average exchange rate for that year.

#### *Accounts and Property Jointly Held With Individuals Other Than One’s Spouse*

An account or property owned jointly by the purchaser and another individual who is not the spouse can be included in the calculation to determine qualification under the net worth test. However, only the purchaser’s percentage ownership of the account or property should be included in the calculation.

#### *Internal Revenue Service Forms Used to Verify Income*

If the issuer does not have Internal Revenue Service forms for the purchaser’s income for the “two most recent years,” the issuer cannot rely on the tax report verification safe harbor. Interestingly, in the absence of other dispositive tax forms, this means that the income safe harbor would not be available in 2014 for a purchaser who has extended the due date for filing his 2013 federal tax return until October 2014, as only 2012 and 2011 filings would be available in 2014. That won’t work, says the Staff.

However, having stated the problem with safe harbor compliance, the Staff then observes that the issuer could still reasonably conclude that a purchaser is an accredited investor using “principles-based” verification methods by:

- Reviewing the Internal Revenue Service forms that report income for the two years preceding the recently completed year; and
- Obtaining a written representation 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) specifies 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.

#### Foreign Tax Forms Used to Verify Income

The tax report verification safe harbor is not available for purchasers who cannot provide an Internal Revenue Service form that reports income. The Staff expressed its concern that in many jurisdictions the penalties for false reports are not comparable to U.S. sanctions. However, the issuer could satisfy the verification requirement using the principles-based verification method by reviewing filed tax forms that report income where the foreign jurisdiction imposes “comparable penalties for falsely reported income.” (We note that the Staff's concern may be somewhat misplaced, as it seems unlikely that a foreign filer would falsely over-report his taxable income.)

#### Tax Assessments Over Three Months Old Used to Verify Net Worth

Once again the Staff strictly limits the applicable safe harbor, noting that a tax assessment that is more than three months old does not fall under the third party statement safe harbor. However, the most recently available tax assessment can be used under the principles-based verification method in determining whether an investor is accredited.

#### Foreign Consumer Reporting Agencies Used to Verify Net Worth

While the applicable safe harbor verification method for determining the purchaser's liabilities includes examination of a report from one of the “nationwide consumer reporting agencies,” such a report from a non-U.S. agency cannot be used to satisfy the third party statement verification safe harbor. However, such reports can be used to satisfy the principles-based verification method to determine if the net worth test is met. The Staff says that the issuer will need to review the foreign report and take 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 all of the foregoing cases, additional steps should be taken to verify the status of the purchaser where the issuer has reason to question the purchaser's claim to be an accredited investor after reviewing materials provided in reliance on the principles-based verification method.

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In short, the Staff has strictly interpreted the safe harbors under Rule 506(c), and issuers should be mindful that deviations from the delineated safe harbors will prevent them from relying on the applicable safe harbor. However, the Staff seems quite willing to let issuers use the very same information, and such other investigation as it deems appropriate, to verify the accredited status of investors under the principles-based verification method.

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