

Rule 506(c) - Accredited Investors

Companies raising capital using Rule 506(c) for their offering of securities have several options as to how to verify whether their investors are indeed “accredited investors.” This post will briefly explain Rule 506(c) and describe some of the options companies have to verify its investors as accredited investors.

Rule 506(c) provides an exemption from registering an offering of securities when the company issuing securities (usually called an “issuer”) only sells securities to accredited investors and the issuer takes *reasonable steps* to ensure that each purchaser is an accredited investor.

Using Rule 506(c) an issuer may generally solicit potential investors, which allows issuers to engage in a variety of public solicitations, such as internet postings, presentations at conferences, or other forms of advertisement.

The biggest hurdle to using Rule 506(c) successfully is usually complying with the requirement to take “reasonable steps” to verify each investor’s status as an accredited investor.

At first glance, verifying investors yourself may seem like the easiest path. However, in practice, numerous issues may arise which can divert resources away from important aspects of an issuer’s business.

Appropriate due diligence will need to be exercised to ensure that the correct documents were reviewed and that the review indeed establishes that the investors are accredited investors.

Issuer’s counsel would usually perform this task. But often complications arise. The investors may be resistant to providing the documentation needed. For example, an investor may not want to disclose its tax returns for the past two years or submit to a credit check to verify its liabilities. Or, the investor’s net worth may stem from its ownership in a business which is very difficult to value without an appraisal (and it’s almost certain an investor will not pay for an appraisal just so they can invest in your offering).

Other difficulties occur when an investor is an entity. An entity is an accredited investor when either (1) all of its equity owners are accredited

investors or (2) its assets exceed \$5 million and the entity was not formed for the specific purpose of investing in the issuer.

In this situation, the issuer would then need to either (1) follow the above safe harbors for each equity holder or (2) verify the entity has over \$5 million in assets (and obtain a representation that the entity was not formed for the specific purpose of investing in an issuer).

The two alternatives to an issuer verifying its investors' accredited investor status itself provide much easier solutions for a busy entrepreneur.

The first alternative is requiring an investor to provide a letter from his or her accountant or lawyer (or other professional) which makes the representation that the professional has taken reasonable steps to verify the investor's net income or net worth and that the professional has determined that the investor is an accredited investor.

The second alternative is the issuer could outsource all verification to a third-party verification service. This would entail contracting with a third-party verification service to obtain and review the information needed from potential investors and verifying each investors' status.

The added benefit of either option is that these third parties make the representation that they have taken reasonable steps to verify the investors' status in compliance with Rule 506(c). Thus, the issuer has shifted the burden of taking "reasonable steps" to a third-party.

As you can see from a few brief examples, while Rule 506(c) has distinct advantages, the verification process can prove difficult. Before deciding to pursue an offering in reliance on Rule 506(c), you should consult with your attorney.

The relatively new Rule 506(c) offers a further advantage to issuing companies: the ability to engage in general solicitation or public advertising.

Companies may hesitate to proceed under 506(c) because of the additional requirements that the company must verify that anyone who actually invests is an accredited investor, and that the investors themselves must prove they are accredited to participate in the offering.

Issuing companies can greatly broaden their reach when advertising their offering and can thereby raise more money faster. This broad market exposure also clues the company in on the relative strength of the offering.

On the other side, investors can more easily search for suitable placements without needing connections to insider networks.

The opportunity space is huge for both sides—large enough that it should not be overlooked if the only concern is compliance with Rule 506(c) accredited investor verification requirements.

Accreditation Information. This is where the process differs greatly. They are not allowed to self-certify under Rule 506(c). Their assets, liabilities, and income needs to be verified a third party. Include sections on the form to reference the documents that were viewed to verify the information and attach a copy of them.

This can be tax returns, W2s, bank statements, credit reports etc. If a third party is providing the verification that they are accredited, they need to provide a signed and dated letter attesting to that fact.

The third party can be their CPA, a licensed broker dealer, or financial adviser.

Keep all of this information on file for the duration of their investment.