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Practice Group(s):
Emerging Growth and
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Corporate/M&A

Reasonable Steps to Verify Third Party Certification Procedure Designed to Comply with New SEC Rules Permitting General Solicitation in Reg D Private Offerings

By Gary J. Kocher

Overview

On July 10, 2013, the Securities and Exchange Commission (“SEC”) adopted rules to eliminate the prohibition against general solicitation and general advertising in certain securities offerings under Rule 506 of Regulation D (“Reg D”) under the Securities Act of 1933, as amended (“Securities Act”), as mandated by the Jumpstart Our Business Startups Act (“JOBS Act”). These rules, which became effective on September 23, 2013, provide significant opportunities for start-ups and other private issuers to expand the scope of marketing activities in connection with private placements under Reg D. However, with these expanded opportunities, the SEC has increased the level of diligence that issuers must undertake to verify the status of purchasers as “accredited investors” within the meaning of Rule 501.

Following the enactment of the new rules and the related SEC guidance, there has been significant adverse reaction in the angel capital community in respect of investors having to provide highly sensitive, personal financial information to start-ups as a means of satisfying the accredited investor test in Reg D private placements utilizing general solicitation. This Client Alert focuses on the verification provisions of new Rule 506(c) and provides a proposed certification letter that can be completed by trusted third party advisors that is designed to allow issuers to comply with their obligation to take reasonable steps to verify the status of purchasers of their securities.

For a more detailed description of the scope and effect of the new rules and additional proposed changes to rules affecting Rule 506 offerings, please see our prior Client Alert on this topic published on July 19, 2013 which can be found at <http://www.klgates.com/sec-adopts-rule-amendments-to-permit-general-solicitation-in-certain-private-offerings-07-19-2013/>.

Offerings Involving Use of General Solicitation -- New Rule 506(c)

Under new Rule 506(c), an issuer may use general solicitation and general advertising in a securities offering that satisfies the other applicable requirements of Reg D if the issuer takes **reasonable steps to verify** that all of the purchasers are accredited investors.

An issuer generally is required to consider all relevant facts and circumstances to assess whether the verification steps taken are reasonable for purposes of relying on Rule 506(c). Rule 506(c) mandates an objective, principles-based verification process in lieu of rigid rules. Under this standard, issuers are required to consider the particular conditions surrounding the offering to determine whether the process used to verify each purchaser’s accredited investor status is sufficient, including:

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- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser;
- the manner in which the purchaser was solicited to participate in the offering; and
- the terms of the offering, such as minimum investment amount.

The adopted guidance sets forth a flexible approach toward assessing these factors, including a nonexclusive list of methods that may be used to verify that purchasers who are natural persons are accredited investors. An issuer shall be deemed to have taken reasonable steps to verify accredited investor status if the issuer uses one of the following methods of verifying (provided that the issuer does not know that the person is not accredited):

- reviewing copies of Internal Revenue Service forms reporting a purchaser's income for the two most-recent years and obtaining the purchaser's written representation that the purchaser has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;
- reviewing one or more of the following types of documentation, dated within the prior three months, and obtaining the purchaser's written representation that all liabilities necessary to make a determination of net worth have been disclosed:
 - for assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and
 - for liabilities: a credit report from at least one of the nationwide consumer reporting agencies;
- obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant (a "**Permitted Third Party Verifier**") that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor; or
- for any natural person who purchased an issuer's securities as an accredited investor prior to the effective date of Rule 506(c) and remains an investor of the issuer at the time of the Rule 506(c) offering conducted by the same issuer, obtaining the purchaser's written certification that the purchaser is an accredited investor.

Reaction to New Rule in Angel Capital Community

Following the enactment of the new rules, there has been significant adverse reaction in the angel capital community in respect of investors having to provide highly sensitive, personal financial information to start-ups as required by the rules. Indeed, many issuers are also not anxious to take on responsibility for handling and preserving the confidentiality of sensitive information of this nature collected from its investors. The Angel Capital Association has prepared helpful information and guidance for its members on the topic of verification and other JOBS Act issues, which can be accessed at www.angelcapitalassociation.org/aca-public-policy-jobs-act/?utm_source=website+list&utm_medium=email&utm_term=email-link&utm_content=html&utm_campaign=EAG+Memo+for+Ents+and+White+Paper.

As noted above, the guidance provided by the SEC allows Permitted Third Party Verifiers to review information on behalf of investors as a means of dealing with concerns of both investors and issuers

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over the exchange of personal financial information. However, initial reactions from people that qualify as Permitted Third Party Verifiers have been cautious due to (i) reluctance of non-lawyers being tasked with interpreting complex legal requirements governing status as an accredited investor and (ii) liability concerns over providing a status certification. We are starting to see a number of independent platforms come into existence that can provide the status verification under the rules. However, many of these platforms require the exchange of voluminous amounts of information to a new entity, with whom the investor has no prior relationship. Accordingly, there is still reluctance among the angel investor community to utilizing such platforms.

As written, the guidance places the obligation for determining the legal status of an investor as accredited on the Permitted Third Party Verifier. However, we believe that it should be sufficient, within the SEC's principles based approach, to allow Permitted Third Party Verifiers to limit their involvement to certifying the underlying information on which the legal determination is made and for the ultimate legal determination of accredited status to be made by the issuer and its legal counsel.

Consistent with this view, we have prepared the attached sample Status Certification Letter that is designed to allow an individual investor to approach one of his or her **existing trusted advisors** that is a Permitted Third Party Verifier (lawyer, CPA, etc.) to provide a certification of the underlying information on which **the issuer** may base its determination of the status of the investor. The form is designed so that a non-lawyer can easily check a box as to the level of income/net worth and type of information that has been reviewed within the scope of the rule. Because the certification can be made by an existing trusted advisor, the advisor may already be in possession of the information on which the certification is made, thereby reducing the burden on the investor. The form also clearly specifies that the Permitted Third Party Verifier assumes no liability for (i) the accuracy of the information provided by the investor or (ii) the ultimate determination as to whether the investor meets the requirements to be accredited.

Our proposed Status Certification Letter should help alleviate concerns of both (i) investors who are reluctant to provide sensitive personal financial information to start ups that may be ill-equipped to deal with it or to third parties with whom they have not had any prior relationship, and (ii) Permitted Third Party Verifiers who are reluctant to provide certifications due to fear of liability for making a legal determination of the status of an investor as accredited. We believe this approach should provide issuers with a practical method to comply with the verification requirements in connection with Reg D private placements under new Rule 506(c).

The attached Status Certification Letter is provided only as an example and should not be used without consulting appropriate legal counsel. As noted above, the SEC takes a facts-based approach to each individual offering conducted under Rule 506. K&L Gates makes no representation or claim that the attached letter will be suitable for satisfying the requirements for any given offering of securities.

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STATUS CERTIFICATION LETTER

_____ [insert name of client] (“**Client**”) has requested that the undersigned provide [Name of Company] (the “**Company**”) with this Status Certification Letter (this “**Status Letter**”) to assist the Company in its verification of Client’s status as an “accredited investor” within the meaning of Rule 501(a) of the Securities Act of 1933, in connection with Client’s potential purchase of securities (the “**Securities**”) offered for sale by the Company.

[I/We] hereby certify that [I/we] [am/are] (**please check the appropriate box**):

- a registered broker-dealer, as defined in the Securities Exchange Act of 1934;
- an investment adviser registered with the Securities and Exchange Commission;
- a licensed attorney in good standing under the laws of the jurisdictions in which I am admitted to practice law; or
- a certified public accountant in good standing under the laws of the place of my residence or principal office.

Based solely on a review of the Client Materials (as defined below), the undersigned hereby advises you that Client satisfies one or more of the following criteria (**check all boxes that apply**):

- a natural person whose individual “net worth,”¹ or joint net worth with Client’s spouse, exceeds \$1,000,000; or
- a natural person who had an individual income in excess of \$200,000 in each of the two most-recent years or joint income with Client’s spouse in excess of \$300,000 in each of those years.

In connection with this Status Letter, the undersigned has reviewed the original or photocopies of the following documents as supplied by Client (the “**Client Materials**”).

(**please check the appropriate box or boxes**)

- Form 1040 filed with the Internal Revenue Service by Client [and [his/her] spouse] for the two most-recent years;
- Form 1099 filed with the Internal Revenue Service by Client [and [his/her] spouse] for the two most-recent years;
- Schedule K-1 of Form 1065 filed with the Internal Revenue Service by Client [and [his/her] spouse] for the two most recent-years;
- Form W-2 issued by the Internal Revenue Service to Client [and [his/her] spouse] for the two most recent-years;

¹ “Net worth” means the excess of total assets at fair market value over total liabilities. For the purposes of determining “net worth,” the value of Client’s primary residence is excluded as an asset. In addition, any liabilities secured by Client’s primary residence are included in total liabilities for purposes of this calculation only if and to the extent that: (1) such liabilities exceed the fair market value of the residence; or (2) such liabilities were incurred within 60 days before the date hereof (other than as a result of the acquisition of the residence).

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Other Internal Revenue Service documents **(please specify)**:

bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, or appraisal reports issued by independent third parties to Client, dated within three months of the date of this Status Letter;

a consumer or credit report from at least one of the nationwide consumer reporting agencies indicating Client's liabilities, dated within three months of the date of this Status Letter;

other documents (please specify):

Disclaimers and Limitations:

In delivering this Status Letter, [I/we] have relied upon and assumed the accuracy of the Client Certifications below. [I/We] do not have any basis which causes [me/us] to believe the Client Materials are not accurate or complete; however, [I/we] have not conducted any independent investigation or evaluation of the Client Materials or the underlying information reflected therein. [I/We] make no representation or warranty that Client Materials were accurately prepared, agree with source documents, or were properly filed, or otherwise vouch for the accuracy of the Client Materials.

This Status Letter is limited to the matters expressly set forth herein and speaks only as of the date set forth below. Nothing may be inferred or implied beyond the matters expressly contained herein. This Status Letter may be relied upon by the Company in connection with the offering and sale of the Securities. This Status Letter may not be used, quoted from, referred to, or relied upon by the Company or by any other person for any other purpose. The undersigned assumes no obligation to update this letter. The undersigned assumes no obligation or liability for the Company's determination of the status of Client as an accredited investor.

Dated: _____

Name

Signature

By: _____ (if applicable)

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Title: _____ (if applicable)

CLIENT CERTIFICATIONS

The undersigned, being the Client identified above, by my signature below, hereby represents and warrants that the following statements are true, correct, and complete as of the date of my signature below (the “**Certification Date**”):

- All Client Materials referenced above are true, correct and complete as of the Certification Date;
- I have fully and accurately disclosed all liabilities that are required to be included in the calculation of my net worth as described above; and
- If I am relying on my income and/or that of my spouse to satisfy the requirements for being an accredited investor, I have a reasonable expectation of reaching individual income in excess of \$200,000 or joint income with my spouse in excess of \$300,000 in the current year.

I hereby affirm that the foregoing is accurate and complete.

Dated: _____

Client Name _____

Client Signature _____

By: _____ (if applicable)

Title: _____ (if applicable)

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