
REGULATION D: SEC PROVIDES CLARIFICATION ON “ACCREDITED INVESTOR” DEFINITION AND VERIFICATION RULES

Under the Securities Act of 1933, any offer to sell securities must either be registered with the Securities and Exchange Commission (the “SEC”) or meet certain qualifications that exempt the securities from such registration. Regulation D (or, “Reg D”) contains the rules providing exemptions from the registration requirements, thereby allowing some companies to offer and sell their securities without having to register the securities with the SEC.

Reg D – In General

Reg D sets forth the various qualifications needed in order to exempt from registration the issuance of securities. Reg D consists of eight rules (501 through 508), three (3) of which (504-506) establish generally the exemptions from the registration requirements. These exemptions vary in terms of dollar size, disclosure requirements, the number and nature of permitted investors and the manner in which investors can be solicited.

The first exemption, Rule 504, exempts offerings which do not exceed \$1 Million during any twelve (12)-month period. Under Rule 504, companies are permitted under federal law to conduct a limited public offering up to \$1 Million without limitation on the number or nature of investors or the requirement to deliver a prescribed disclosure document.

The next exemption, Rule 505, covers offerings not exceeding \$5 Million during any twelve (12)-month period. Unlike the Rule 504 exemption, there can be no more than thirty-five (35) “non-accredited investors” purchasing the offered securities. An “accredited investor” is defined to include eight (8) categories of investors, including: (i) directors,

executive officers and managers of the issuer; (ii) natural persons whose net worth, either individually or jointly with a spouse, equals or exceeds \$1 million (excluding the value of a primary residence); and (iii) natural persons with annual income in excess of \$200,000 in each of the two (2) most recent years (\$300,000 jointly with a spouse) and who reasonably expect the same level of income in the current year. Under Rule 505, a company may sell to an unlimited number of accredited investors and a maximum of thirty-five (35) non-accredited investors.

The final offering exemption is Rule 506, which exempts offerings without any limitation on the dollar amount of securities which can be sold. The requirements of the Rule 506 exemption are substantially identical to Rule 505, including the thirty-five (35) non-accredited investor limitation. The primary difference between the two rules is an additional requirement that Rule 506 non-accredited investors must also have sufficient knowledge and experience in financial and business matters in order to be capable of evaluating the merits and risks of the proposed investment. These “sophistication” requirements, together with the slightly more comprehensive disclosure requirements, are the distinguishing features of Rule 506.

2013 Amendments

On July 10th, 2013, the SEC issued additional regulations, which allow public advertising and solicitation of Reg D offers to accredited investors. These new regulations add Rule 506(c) in order to allow general solicitation and advertising for a private placement offering. However, in a Rule

506(c) private offering, all of the purchasers must be accredited investors and the issuer must take reasonable steps to determine that the purchaser is an accredited investor.

2014 Clarifications

On July 3, 2014, the SEC provided further clarification regarding the “accredited investor” definition under Reg D and the verification process under Rule 506(c). More particularly, the SEC provided the following clarifications and guidance:

1. For purposes of determining whether a purchaser's income meets the accredited investor income test, the SEC clarified that, for income not reported in U.S. dollars, the issuer may use either the exchange rate that is in effect on the last day of the year for which income is being determined or the average exchange rate for that year.

2. For purposes of determining whether a purchaser satisfies the accredited investor net worth test, the SEC clarified that accounts or property held jointly (but not with a spouse) can be included in the net worth determination to the extent of the purchaser's percentage ownership interest in the account or property.

3. Rule 506(c)(2)(ii)(A) sets forth a non-exclusive method of verifying that a purchaser is an accredited investor by, among other things, reviewing any Internal Revenue Service form that reports the purchaser's income for the "two most recent years." However, to the extent that such an Internal Revenue Service form is not yet available for the recently completed year, the issuer may not rely on this verification method by reviewing the Internal Revenue Service forms for the two (2) prior years that are available. However, the SEC provided guidance on the verification process, and advised that an issuer could reasonably conclude that a purchaser is an accredited investor and

satisfies the verification requirement of Rule 506(c) under the principles-based verification method by:

- reviewing the Internal Revenue Service forms that report income for the two years preceding the recently completed year; and
- obtaining written representations 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) specify 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.

4. The SEC provided further guidance on the verification process when a purchaser is not a U.S. taxpayer and therefore cannot provide an Internal Revenue Service form that reports income. The SEC advised that, although the safe harbor provided under Rule 506(c)(2)(ii)(A) is not available for tax forms from foreign jurisdictions, an issuer could reasonably conclude that a purchaser is an accredited investor and satisfy the verification requirement of Rule 506(c) under the principles-based verification method by reviewing filed tax forms that report income where the foreign jurisdiction imposes comparable penalties for falsely reported information.

Additional information regarding Reg D and the SEC's recent clarifications can be found here: <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

Concluding Comments

In light of the SEC's recent clarifications, it is imperative that companies seeking to exempt securities from registration pay close attention to

the definition of “accredited investor” and the verification process in order to confirm compliance with Reg D. Under Reg D, to the extent that it is determined that a company failed to comply with the requirements of Reg D, not only can a loss of exemption for such offer or sale of securities be imposed, but the issuer can be precluded from utilizing Reg D in connection with future issuances of securities.

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