OnPoint

Dechert LLP

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A Legal Update from Dechert LLP

SEC Approves Final Rules that (1) Permit General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings and (2) Disqualify "Bad Actors" from Using Rule 506 to Offer Securities

The SEC has amended[1] Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (Securities Act) to (1) permit, in certain circumstances, an issuer to engage in general solicitation and general advertising in connection with Rule 506 and Rule 144A offerings (General Solicitation Rules) and (2) disqualify securities offerings involving certain "felons" and other "bad actors" from relying on Rule 506 of Regulation D (Bad Actor Rules), whether or not the issuer is relying on the new General Solicitation Rules.[2] These rules will take effect on September 23, 2013 – 60 days after their publication in the Federal Register. The SEC also has proposed rules that are intended to enhance the SEC's ability to monitor how the General Solicitation Rules will affect the private offering market and to provide additional investor protection safeguards (Proposed Rules).[3] The new General Solicitation Rules and the Bad Actor Rules are discussed below. The Proposed Rules will be addressed in a separate OnPoint.

Permitting General Solicitation and General Advertising in Rule 506 Offerings

Background: The Pre-Existing Rule 506(b) Safe Harbor Remains Available

Many U.S. private placements rely on Rule 506(b),[4] a non-exclusive safe harbor under Section 4(a)(2) of the Securities Act, which exempts transactions by an issuer "not involving any public offering" from the

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1 Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44771 (July 24, 2013) (General Solicitation Release); and Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, 78 Fed. Reg. 44730 (July 24, 2013) (Bad Actor Release).

2 On August 29, 2012, the SEC proposed amendments to its rules to implement Section 201(a) of The Jumpstart Our Business Startups Act (JOBS Act), which directed the SEC to adopt rule amendments that would permit issuers to engage in general solicitation and general advertising in connection with Rule 506 and Rule 144A offerings. Release No. 33-9354, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (Aug. 29, 2012) (General Solicitation Proposing Release). See *DechertOnPoint,* SEC Proposes Amendments to Permit General Solicitation and General Advertising in Private Placements Under Rule 506 of Regulation D and Rule 144A, for further information regarding such proposed rule amendments. On May 25, 2011, the SEC proposed amendments to its rules to implement Section 926(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which directed the SEC to adopt rule amendments that would disqualify certain securities offerings from reliance on Rule 506. Release No. 33-9211, Disqualification of Felons and Other "Bad Actors" From Rule 506 Offerings (May 25, 2011) (Bad Actor Proposing Release). See *DechertOnPoint*, SEC Proposes Amendments to Disqualify "Bad Actors" from Rule 506 Private Placements, for further information regarding such proposed rule amendments.

3 Release No. 33-9416, Amendments to Regulation D, Form D and Rule 156 under the Securities Act (July 10, 2013).

4 See General Solicitation Release at 44773.

registration requirements of Section 5 of the Securities Act. The SEC has retained, in its current form, the existing Rule 506(b) safe harbor as a separate exemption that continues to prohibit general solicitation or general advertising.[5] Rule 506(c) represents a separate, but related, safe harbor under Rule 506 that permits an issuer to engage in general solicitation and general advertising (such as mass mailings, emails, public websites, social media, print media and broadcast media), subject to the conditions described further below.

Adopted Amendments to Rule 506: Creation of the Rule 506(c) Safe Harbor

The General Solicitation Rules create a new safe harbor that permits general solicitation and general advertising in connection with an offering of securities,[6] subject to the following conditions:

- The issuer takes **reasonable steps to verify** that the purchasers of the securities are accredited investors;
- **All purchasers of securities are accredited investors** either because they come within one of the eight enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes they qualify as such at the time of sale;[7] and
- The issuer meets all terms and conditions of Rule 501,[8] Rule 502(a)[9] and Rule 502(d).[10]

Reasonable Steps to Verify Accredited Investor Status

For issuers seeking to engage in general solicitation and general advertising under new Rule 506(c), it will be critical for such issuers to establish appropriate policies and procedures to satisfy the requirement of taking reasonable steps to verify accredited investor status.[11] In the General Solicitation Release, the SEC

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[5] Under the Rule 506(b) safe harbor, an issuer may offer and sell securities, without any limitation on the offering amount, to an unlimited number of "accredited investors," as defined in Rule 501(a) of Regulation D, and to no more than 35 non-accredited investors who meet certain "sophistication" requirements. The availability of the Rule 506(b) safe harbor is subject to a number of requirements and, pursuant to Rule 502(c), is conditioned on the issuer, or any person acting on its behalf, not offering or selling securities through any form of general solicitation or general advertising.

[6] The General Solicitation Release reaffirms previous guidance by the SEC regarding what constitutes general solicitation or general advertising, but does not provide further discussion. See General Solicitation Release at 44773.

[7] In the General Solicitation Release, the SEC confirmed that Section 201(a)(1) of the JOBS Act does not alter the existing "reasonable belief" standard. The General Solicitation Release notes that if a prospective investor were to provide an issuer with false information as to its accredited investor status within one of any of the eight enumerated categories in Rule 501(a), the issuer would not lose its ability to rely on Rule 506(c) for that offering, provided the issuer "took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor." See General Solicitation Release at 44782-783.

[8] Rule 501 provides the definitions used in Regulation D, including the multiple categories of accredited investors.

[9] Rule 502(a) outlines the factors to be considered in determining whether a Rule 506 offering should be integrated with another offering.

[10] Rule 502(d) provides that securities sold pursuant to Regulation D are restricted securities pursuant to the Securities Act and cannot be resold without registration pursuant to Securities Act or an exemption therefrom.

[11] It should be noted that, with respect to a Rule 506(c) issuer relying on the exclusion from the definition of an "investment company" available under Section 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act), the General Solicitation Rules do not increase existing diligence expectations in connection with such issuer's determination as to whether a prospective investor is a "qualified purchaser" as defined under the Investment Company Act.

described two possible means of determining that such verification procedures are reasonable. First, an issuer (or those acting on its behalf) may make this determination using a principles-based approach, whereby the issuer makes an "objective determination," based on the "particular facts and circumstances" of the applicable offering, in deciding what steps to take to verify a purchaser's accredited investor status.[12] The General Solicitation Release provides the following non-exhaustive and non-mandatory list of factors that may be appropriate for an issuer to consider:[13]

- Nature of the purchaser and the type of accredited investor the purchaser claims to be;
- Information that the issuer has about the purchaser; and
- Nature and terms of the offering.

The guidance provided in the General Solicitation Release (an extract of which is attached to this OnPoint as Appendix A) notes that, absent other information about the purchaser indicating accredited investor status, a questionnaire or executed form alone would not suffice for verification.[14] This guidance also addresses the different categories of purchasers (e.g., natural persons versus registered broker-dealers), and the extent to which publicly available information regarding a purchaser, third-party verification services and minimum investment requirements, among other items, are relevant in connection with an issuer's decision regarding what steps to take in verifying a purchaser's accredited investor status.

As an alternative to the principles-based approach, the General Solicitation Rules contain four specific non-exclusive methods of verifying accredited investor status for a natural person[15] that, if properly followed, are deemed to satisfy the reasonableness requirement of such verification:[16]

- Income – (1) reviewing copies of various Internal Revenue Service forms (e.g., Form W-2, Form 1099, Schedule K-1 of Form 1065 and a filed Form 1040) for the two previous years that report the income of the purchaser and (2) obtaining a written representation from the purchaser to the effect that he or she has a reasonable expectation, in the current year, of reaching the income level necessary to qualify as an accredited investor;
- Net Worth – (1) reviewing various types of documentation relating to the purchaser's net worth (e.g., bank statements, brokerage statements, certificates of deposit, tax assessments and appraisal reports), dated within the prior three months, (2) reviewing a credit or consumer report regarding the purchaser from at least one nationwide consumer reporting agency and (3) obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed;

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[12] See General Solicitation Release at 44778.

[13] The General Solicitation Release notes that "these factors are interconnected" and the more the "facts and circumstances" analysis of a purchaser indicates that the purchaser likely qualifies as an accredited investor, the fewer steps would be needed to verify accredited investor status. See *Id.*

[14] See General Solicitation Release at 44778-782.

[15] The General Solicitation Proposing Release did not include a specific list of verification methods. In response to commenters seeking greater certainty regarding how to properly satisfy the verification requirement, the SEC included a non-exclusive list of methods in the General Solicitation Release. See General Solicitation Release at 44780-782.

[16] The General Solicitation Release states, however, that actual knowledge of a purchaser's non-accredited investor status precludes an issuer or its agent from relying on these verification methods. See General Solicitation Release at 44780.

- Third Party – obtaining written confirmation from certain third parties (e.g., a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant) that (1) such third party has taken reasonable steps to verify the purchaser's accredited investor status within the prior three months and (2) such third party has made a determination that the purchaser is an accredited investor;[17] and

- Prior Investors – with respect to a purchaser who has previously invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of the General Solicitation Rules (and is currently an investor of the issuer), obtaining a certification by the purchaser at the time of the Rule 506(c) sale that he or she continues to qualify as an accredited investor.[18]

These methods are a non-exclusive safe harbor. Issuers utilizing other accredited investor verification means will not be deemed or presumed to have acted unreasonably but, instead, must consider whether the verification method selected is reasonable based on the principles-based approach described above.

Appendix A contains an excerpt from the discussion in the General Solicitation Release regarding both approaches to verification of accredited investor status. Issuers may wish to retain a copy of Appendix A for compliance purposes, given that it contains direct SEC guidance on the process of verifying an investor's accredited investor status.

Regardless of which verification procedure is employed by an issuer, it should be noted that any issuer claiming an exemption from the registration requirements of Section 5 of the Securities Act bears the burden of proving that such exemption was properly relied upon. Accordingly, it is important for issuers to maintain adequate records that document the steps they have taken to verify that a purchaser was an accredited investor at the time of purchase and to determine, to the extent that Rule 506(c) is being relied on, that their chosen verification method was appropriate.

Amendment to Form D

To help the SEC gather data on the use of general solicitation and general advertising in offerings relying on Rule 506(c), the SEC also adopted an amendment to Form D, which issuers are currently required to file with the SEC when they sell securities pursuant to Regulation D. The revised Form D adds a separate box for an issuer to check if it is claiming the new Rule 506(c) exemption. In addition, the Proposed Rules include certain proposed amendments to Form D, as well as other requirements applicable to the use of general solicitation in private offerings.

Permitting General Solicitation and General Advertising in Rule 144A Offerings

Prior to the adoption of the General Solicitation Rules, Rule 144A served as a non-exclusive safe harbor that provided an exemption from the registration requirements of the Securities Act for offers and sales of

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[17] The General Solicitation Release states that an issuer may also be entitled to rely on third-party verification of accredited investor status by a person or entity other than those listed in the General Solicitation Release, provided that any such third party takes reasonable steps to verify that purchasers are accredited investors, and the issuer has a reasonable basis to rely on such verification. See General Solicitation Release at 44781-782.

[18] The General Solicitation Release does not clarify whether this fourth method would be applicable to a purchaser of a sponsor's private fund (i.e., the issuer) that seeks to invest in that sponsor's successor private fund (i.e., the successor issuer). However, some members of the private fund industry are of the view that this fourth method should be available to a sponsor that is offering interests in a successor private fund under Rule 506(c).

securities by persons, other than the issuer, to Qualified Institutional Buyers (QIBs)[19] or persons reasonably believed to be QIBs. Prior to the adoption of the General Solicitation Rules, although Rule 144A did not explicitly prohibit general solicitation, offers were only permitted to be made to QIBs or persons reasonably believed to be QIBs.

Under the General Solicitation Rules, Rule 144A has been amended so that offers of securities to persons who are not QIBs would be permitted, including by means of general solicitation and general advertising, so long as the securities are sold only to QIBs or persons reasonably believed to be QIBs.[20] The General Solicitation Rules do not address what would constitute "reasonable belief" of QIB status. However, Rule 144A already contains a list of non-exclusive methods by which an issuer can establish whether a prospective purchaser is a QIB.

Implications of Rule 506(c) for Private Funds and their Investment Advisers

Exclusions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act

Private funds generally rely on the exclusions from the definition of an "investment company" available under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act (a Section 3(c)(1) Fund or Section 3(c)(7) Fund, as applicable). However, these exclusions are not available if a fund makes or proposes to make "a public offering of its securities." In the General Solicitation Release, the SEC confirmed that a private fund engaged in general solicitation and general advertising under Rule 506(c) would not be making a "public offering" for purposes of the Investment Company Act and, thus, would not forfeit its exclusion from registration under the Investment Company Act. In taking this view, the SEC reminded investment advisers to private funds that they are subject to Rule 206(4)-8 under the Investment Advisers Act of 1940 (Advisers Act) and that the SEC "may bring enforcement actions under the Advisers Act against advisers who defraud investors or prospective investors in those pooled vehicles." It should be noted, however, that the General Solicitation Release did not explicitly extend this confirmation to the new Rule 144A offerings, although many members of the private offering industry are of the view that such guidance should equally apply to Rule 144A offerings.

Transitional Matters

The General Solicitation Release confirms that if an issuer's ongoing Rule 506(b) offering commenced prior to the effective date of the new Rule 506(c), the issuer may proceed with the offering as either a Rule 506(b) offering or a Rule 506(c) offering. If the issuer opts to continue under Rule 506(c), any general solicitation that occurs after the effective date will not affect the exempt status of offers and sales of securities that occurred prior to the effective date in reliance on Rule 506(b).

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[19] QIB is defined in Rule 144A(a)(1) and includes specified institutions that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with such institutions. Banks and other specified financial institutions must also have a net worth of at least $25 million. A registered broker-dealer qualifies as a QIB if it, in the aggregate, owns and invests on a discretionary basis at least $10 million in securities of issuers that are not affiliated with the broker-dealer.

[20] The General Solicitation Release confirms that, with respect to ongoing Rule 144A offerings that commenced prior to the effective date of the General Solicitation Rule, the issuer may proceed with the offering after such effective date in accordance with the amended Rule 144A, without affecting the availability of Rule 144A for the portion of the offering that occurred prior to such effective date. See General Solicitation Release at 44786.

Integration of Domestic and Offshore Offerings

The General Solicitation Release provides that private domestic Rule 506(c) or Rule 144A offerings would not be integrated with Regulation S offshore offerings. Accordingly, issuers would be able to conduct a Rule 506(c) or Rule 144A offering concurrently with a Regulation S offering while employing general solicitation and general advertising in the United States, without violating the prohibition in Regulation S on "directed selling efforts" in the United States.

Integration of Domestic Offerings

While the General Solicitation Rules do not integrate private domestic Rule 506(c) or Rule 144A offerings with an offshore Regulation S offering, the General Solicitation Rules do not address whether an adviser's domestic Section 3(c)(7) Fund offering, using general solicitation and general advertising in accordance with Rule 506(c), would be integrated with the adviser's domestic Section 3(c)(1) Fund offering that is relying on Rule 506(b) and not using general solicitation and general advertising. If the SEC were to integrate the two offerings, the Section 3(c)(1) Fund would be held to the accredited investor verification standards of Rule 506(c) (regardless of whether the Section 3(c)(1) Fund was promoted through the use of general solicitation or general advertising).

Commodity Futures Trading Commission (CFTC) Regulation

Many private funds are also deemed to constitute commodity pools that are subject to the Commodity Exchange Act (CEA) and the CFTC regulations thereunder, as well as the rules of the National Futures Association, the designated derivatives self-regulatory organization. Certain operators or advisors to such commodity pools currently qualify for an exemption from registration as a commodity pool operator (CPO) pursuant to CFTC Rule 4.13(a)(3) or are registered as a CPO but qualify for operational exemptions pursuant to CFTC Rule 4.7 or 4.12(b)(e.g., disclosure, reporting, record keeping and advertising), provided that certain conditions are met (including with regard to the nature of the offering of interests in the pools and the pool participants). The CFTC has not yet provided guidance as to the extent to which the above exemptions may continue to be relied on by operators or advisors to private funds that are conducting Rule 506(c) offerings using general solicitation and general advertising.[21]

Rule 206(4)-8 under the Advisers Act

The General Solicitation Release reminds investment advisers to private funds that they are subject to Rule 206(4)-8 under the Advisers Act, which prohibits them from (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances in which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle, or (2) otherwise engaging in any fraudulent, deceptive or manipulative act with respect to any such investor or prospective investor. Accordingly, investment advisers seeking to employ general solicitation and general advertising in a Rule 506(c) offering should, in particular, ensure that they

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[21] In addition, it may be appropriate for the CFTC to provide guidance as to the effect that such use of general solicitation and general advertising by a CPO and/or a commodity trading advisor (CTA) may have on certain other exemptive provisions of the CEA and CFTC regulations, including: (1) with respect to CPOs, CFTC Rules 4.8, 4.13(a)(1), 4.13(a)(2) and 30.4(c); and (2) with respect to CTAs, CEA Sections 4m(1) and 4m(3) and CFTC Rules 4.14(a)(5), 4.14(a)(8)(i)(C), 4.14(a)(8)(ii)(B) and 4.14(a)(10).

have properly implemented policies and procedures that are reasonably designed to prevent violations of Rule 206(4)-8.[22]

Broker-Dealer Registration

While the General Solicitation Rules constitute a significant easing of the restrictions on the manner in which certain private funds are offered and sold, they do not ease the licensing requirements for those who engage in selling interests of such private funds. Recent public comments by the SEC staff, along with increased SEC enforcement activity, emphasize the need for those engaged in the sale of private funds to be registered as broker-dealers or to be associated with broker-dealers, unless an appropriate exemption is available.[23]

In addition, while Section 201(c) of the JOBS Act created an exemption from broker-dealer registration for investment portal operators,[24] reliance on that exemption when marketing private funds may be of limited use, as active marketing and transaction-based compensation, among other factors common in private fund distributions, would eliminate the availability of that exemption from broker-dealer registration.

Disqualifying Felons and Other Bad Actors from Rule 506 Offerings

Background: Dodd-Frank Act Requirement to Adopt "Bad Actor" Provisions

Acting on the mandate in Section 926(1) of the Dodd-Frank Act, the SEC adopted disqualification rules "substantially similar" to those in Rule 262 of Regulation A under the Securities Act.[25] The amendments to Rule 506 disqualify securities offerings involving certain "felons" and other "bad actors" from relying on Rule 506 of Regulation D where an issuer or certain "covered persons" have had a "disqualifying event."

The Bad Actor Rules as adopted by the SEC are generally consistent with the Bad Actor Proposing Release, except with respect to the following key modifications:

- Grandfathering – Disqualification now applies only to triggering events that occur on or after the amendments' effective date, whereas those that occur before the effective date are subject to mandatory disclosure to investors;
- Disqualifying events – The list of disqualifying events has been expanded to include certain SEC cease-and-desist orders and CFTC orders;
- Covered officers – Rather than all officers of the issuer being covered persons, only "executive officers" of the issuer and such other officers "participating in the offering" are covered persons;

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[22] Interestingly, the General Solicitation Release does not discuss Rule 206(4)-1 under the Advisers Act, which many people in the private offering industry believe is not applicable to a private fund's sales materials.

[23] See *DechertOnPoint*, Recent SEC Actions Focus on Broker-Dealer Activity of Private Funds, Highlight Perils, and Generate Controversy, regarding such recent SEC staff comments and increased SEC enforcement activity.

[24] See *DechertOnPoint*, Investment Portals Addressed in SEC Staff Guidance Under JOBS Act; No-Action Letters Also Issued, regarding this exemption from broker-dealer registration for investment portal operators.

[25] The Bad Actor Rules seek to incorporate the substance of Rule 262 under the Securities Act, while simplifying and revising its framework by including only one list of potentially disqualified persons and one list of disqualifying events.

- Covered beneficial owners – Rather than beneficial owners of 10% or more of any class of securities being covered persons, beneficial owners of 20% or more of an issuer's outstanding voting equity securities, calculated on the basis of voting power, are covered persons;[26] and

- Other covered persons – The list of covered persons has been expanded to include investment managers of private fund issuers and their principals.

"Covered Persons"

The disqualification provisions in the Bad Actor Rules generally apply to the following categories of persons:

- Investment managers of private fund issuers;

- The directors, executive officers, other officers participating in the offering, and general partners and managing members of such investment managers;

- The directors and executive officers of such general partners and managing members and their other officers participating in the offering;

- The issuer and any predecessor of the issuer or affiliated issuer;

- The directors, executive officers, other officers participating in the offering, and general partners or managing members of the issuer;

- Any 20% beneficial owner of an issuer's outstanding voting equity securities, calculated on the basis of voting power;

- Certain promoters; and

- Persons compensated for soliciting investors as well as the general partners, directors, executive officers, other officers participating in the offering and managing members of any compensated solicitor.

"Disqualifying Events"

Some of the "bad acts" in the Bad Actor Rules, which disqualify covered persons from relying on a Rule 506 exemption for a sale of securities, are those that result in any of the following:[27]

- SEC cease-and-desist orders barring or limiting such persons from engaging in certain enumerated activities under the federal securities laws;

- SEC cease-and-desist orders, entered into within the last five years, in connection with violations of anti-fraud provisions of the federal securities laws;

- Criminal convictions, entered within ten years before such sale (or five years in the case of issuers, their predecessors and affiliated issuers), in connection with the purchase or sale of any security, making any false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries such as underwriters and broker-dealers;

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[26] The determination as to whether an investor's private fund interest in a limited partnership or a limited liability company is a "voting security," as defined in Section 2(a)(42) of the Investment Company Act, can be complex because the definition is centered upon the investor's entitlement to vote for the election of "directors." See, e.g., *Wells Fargo Alternative Asset Management, LLC*, Interpretive Letter (Jan. 26, 2005).

[27] Other disqualifying events for purposes of the Bad Actor Rules include: (i) U.S. Postal Service false representation orders issued in the five years preceding the proposed sale of securities; and (ii) certain SEC orders which suspend an issuer's right to rely on the Regulation A offering exemption.

- Court restraining orders and injunctions, entered within five years before such sale, in connection with the purchase or sale of any security, making any false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries such as underwriters and broker-dealers;

- Suspension or expulsion from membership in, or restrictions on a covered person's ability to associate with members of, a securities self-regulatory organization; and

- Final orders of certain enumerated state and federal regulators (including the CFTC, federal banking agencies, state securities regulators and insurance, banking and savings associations) that (1) bar the covered person from associating with the above-referenced regulated entities, or (2) find a violation of any law or regulation prohibiting fraudulent, manipulative or deceptive conduct[28] and that were entered into within ten years before such sale.

Pre-Existing Event Disclosure

As proposed, the Bad Actor Rules would have applied to all Rule 506 offerings occurring after the effective date of the new provisions, even where the disqualifying event occurred before the effective date of such new provisions. In response to concerns that such retroactive applicability would result in unfair outcomes, the Bad Actor Release provides that only triggering events occurring on or following the effective date will trigger disqualification. However, triggering events occurring before the effective date must be disclosed to investors.[29]

Due Diligence Requirement

The Bad Actor Rules provide an exception from disqualification where the issuer can demonstrate that it did not know and, using reasonable care, could not have known that a covered person with a disqualifying event participated in the offering. The Bad Actor Release states that the steps an issuer should take in exercising reasonable care will "vary according to the particular facts and circumstances."[30] The SEC suggests that fund sponsors may wish to distribute "questionnaires or certifications" to certain management personnel and placement agents. Fund sponsors should carry out this due diligence prior to the effective date of the Bad Actor Rules, September 22, 2013 (which is 60 days after publication in the Federal Register).

Waivers

The Bad Actor Rules provide that the SEC may grant a waiver of disqualification where an issuer has shown good cause that it is not necessary, under the circumstances, that the registration exemption be denied.[31] In addition, disqualification of a covered person subject to a disqualifying event will not occur if, before the relevant sale is made pursuant to Rule 506, the court or regulatory authority that entered the relevant order, judgment or decree advises the SEC, in writing, that disqualification is inappropriate.

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[28] The Bad Actor Release notes that the final rules do not include a definition of "fraudulent, manipulative or deceptive conduct" and do not limit "fraudulent, manipulative or deceptive conduct" to matters involving scienter. See Bad Actor Release at 44742-743.

[29] This requirement applies to all Rule 506 offerings regardless of whether purchasers are accredited investors. Issuers should provide notice of such events at "a reasonable time prior to sale." See Bad Actor Release at 44748.

[30] See Bad Actor Release at 44746.

[31] The adopting release identifies a number of circumstances that could, depending on the specific facts, be relevant to the evaluation of a waiver request. See Bad Actor Release at 44747-748.

Amendment to Form D

Form D has been amended to require issuers claiming a Rule 506 exemption to certify that the offering is not disqualified by one of the disqualification provisions set forth in Rule 506(d).

SEC Rule Proposals

The SEC has proposed rules that are intended to enhance its ability to monitor how the General Solicitation Rules will affect the private offering market and to provide additional investor protection safeguards. If adopted, these rules would impose substantial changes to the manner in which private offerings are made. These rule proposals will be addressed in a separate OnPoint.

APPENDIX A

Extract from the General Solicitation Release [Release No.33-9415, Eliminating the Prohibition Against General Solicitation and General Advertising in the Rule 506 and Rule 144A Offerings (July 24, 2013)]

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II. Final Amendments to Rule 506 and Form D

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B. Reasonable Steps to Verify Accredited Investor Status

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3. Final Rule Amendment

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a. Principles-Based Method of Verification

Under Rule 506(c), issuers are required to take reasonable steps to verify the accredited investor status of purchasers. Consistent with the Proposing Release, whether the steps taken are "reasonable" will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction. Among the factors that issuers should consider under this facts and circumstances analysis are:

- 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; and
- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

As noted in the Proposing Release, these factors are interconnected and are intended to help guide an issuer in assessing the reasonable likelihood that a purchaser is an accredited investor – which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status. After consideration of the facts and circumstances of the purchaser and of the transaction, the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status, and vice versa. For example, if the terms of the offering require a high minimum investment amount and a purchaser is able to meet those terms, then the likelihood of that purchaser satisfying the definition of accredited investor may be sufficiently high such that, absent any facts that indicate that the purchaser is not an accredited investor, it may be reasonable for the issuer to take fewer steps to verify or, in certain cases, no additional steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by a third party.

Regardless of the particular steps taken, because the issuer has the burden of demonstrating that its offering is entitled to an exemption from the registration requirements of Section 5 of the Securities Act,[103] it

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[Footnotes numbered as in original]

[103] SEC v. Ralston Purina, 346 U.S. 119, 126 (1953) ("Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable.").

will be important for issuers and their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor.

Nature of the Purchaser. In determining the reasonableness of the steps to verify accredited investor status, an issuer should consider the nature of the purchaser of the offered securities. The definition of "accredited investor" in Rule 501(a) includes natural persons and entities that come within any of eight enumerated categories in the rule, or that the issuer reasonably believes come within one of those categories, at the time of the sale of securities to that natural person or entity. Some purchasers may be accredited investors based on their status, such as:

- a broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934 (the "Exchange Act");[104] or
- an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") or a business development company as defined in Section 2(a)(48) of that Act.[105]

Some purchasers may be accredited investors based on a combination of their status and the amount of their total assets, such as:

- a plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5 million;[106] or
- an Internal Revenue Code ("IRC") Section 501(c)(3) organization, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5 million.[107]

Natural persons may be accredited investors based on either their net worth or their annual income, as follows:

- a natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence;[108] 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 that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.[109]

As Rule 501(a) sets forth different categories of accredited investors, an issuer should recognize that the steps that will be reasonable to verify whether a purchaser is an accredited investor will vary depending on the type of accredited investor that the purchaser claims to be. For example, the steps that may be reasonable to verify that an entity is an accredited investor by virtue of being a registered broker-dealer –

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[104] See 17 C.F.R. §230.501(a)(1).

[105] See id.

[106] See id.

[107] See 17 C.F.R. §230.501(a)(3).

[108] See 17 C.F.R. §230.501(a)(5).

[109] See 17 C.F.R. §230.501(a)(6).

such as by going to FINRA's BrokerCheck website[110] – will necessarily differ from the steps that may be reasonable to verify whether a natural person is an accredited investor.

As we stated in the Proposing Release, the verification of natural persons as accredited investors may pose greater practical difficulties as compared to other categories of accredited investors, particularly for natural persons claiming to be accredited investors based on the net worth test. These practical difficulties likely will be exacerbated by privacy concerns about the disclosure of personal financial information. As between the net worth test and the income test for natural persons, we recognize that commenters have suggested that it might be more difficult for an issuer to obtain information about the assets and liabilities that determine a person's net worth – particularly the liabilities – than it would be to obtain information about a person's annual income,[111] although there could be privacy concerns with respect to either test. The question of what type of information would be sufficient to constitute reasonable steps to verify accredited investor status under the particular facts and circumstances will also depend on other factors, as described below.

Information about the Purchaser. The amount and type of information that an issuer has about a purchaser can also be a significant factor in determining what additional steps would be reasonable to take to verify the purchaser's accredited investor status. The more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it may have to take, and vice versa.[112] Examples of the types of information that issuers could review or rely upon – any of which might, depending on the circumstances, in and of themselves constitute reasonable steps to verify a purchaser's accredited investor status – include, without limitation:

- publicly available information in filings with a federal, state or local regulatory body – for example, without limitation:
  - the purchaser is a named executive officer of an Exchange Act registrant, and the registrant's proxy statement discloses the purchaser's compensation; or
  - the purchaser claims to be an IRC Section 501(c)(3) organization with $5 million in assets, and the organization's Form 990 series return filed with the Internal Revenue Service discloses the organization's total assets;[113]
- third-party information that provides reasonably reliable evidence that a person falls within one of the enumerated categories in the accredited investor definition – for example, without limitation:
  - the purchaser is a natural person and provides copies of pay stubs for the two most recent years and the current year; or

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[110] This website is available at: http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

[111] See letters from NASAA (stating that "[v]erification of net worth is more challenging because an individual could provide proof of assets but not liabilities."); P. Sigelman (Sept. 28, 2012).

[112] If an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer will not have to take any steps at all.

[113] Such an organization is required to make the Form 990 series returns available for public inspection. See Internal Revenue Service, Public Disclosure and Availability of Exempt Organizations Returns and Applications: Documents Subject to Public Disclosure, available at: http://www.irs.gov/Charities-&-Non-Profits/Public-Disclosure-and-Availability-of-Exempt-Organizations-Returns-and-Applications:-Documents-Subject-to-Public-Disclosure (last reviewed or updated April 28, 2013).

- specific information about the average compensation earned at the purchaser's workplace by persons at the level of the purchaser's seniority is publicly available; or

- verification of a person's status as an accredited investor by a third party, provided that the issuer has a reasonable basis to rely on such third-party verification.[114]

Nature and Terms of the Offering. The nature of the offering – such as the means through which the issuer publicly solicits purchasers – may be relevant in determining the reasonableness of the steps taken to verify accredited investor status. An issuer that solicits new investors through a website accessible to the general public, through a widely disseminated email or social media solicitation, or through print media, such as a newspaper, will likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party. We believe that an issuer will be entitled to rely on a third party that has verified a person's status as an accredited investor, provided that the issuer has a reasonable basis to rely on such third-party verification. We do not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.

The terms of the offering will also affect whether the verification methods used by the issuer are reasonable. We continue to believe that there is merit to the view that a purchaser's ability to meet a high minimum investment amount could be a relevant factor to the issuer's evaluation of the types of steps that would be reasonable to take in order to verify that purchaser's status as an accredited investor. By way of example, the ability of a purchaser to satisfy a minimum investment amount requirement that is sufficiently high such that only accredited investors could reasonably be expected to meet it, with a direct cash investment that is not financed by the issuer or by any third party, could be taken into consideration in verifying accredited investor status.

Commenters suggested a number of alternative approaches to implementing the verification mandate. Some commenters urged us to adopt a requirement that prescribes specific methods of verification that issuers must use, either because they believed such methods are needed for issuers seeking clarity on how to comply with this condition of Rule 506(c)[115] or because they believed that such methods are needed to maintain investor protection.[116] We have decided not to take such an approach. As we stated in the

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[114] For example, in the future, services may develop that verify a person's accredited investor status for purposes of new Rule 506(c) and permit issuers to check the accredited investor status of possible investors, particularly for web-based Rule 506 offering portals that include offerings for multiple issuers. This third-party service, as opposed to the issuer itself, could obtain appropriate documentation or otherwise take reasonable steps to verify accredited investor status. Several commenters, in fact, have recommended that the Commission take action to facilitate the ability of issuers to rely on third parties to perform the necessary verification. See letters from NASAA (July 3, 2012) (recommending that the Commission allow an issuer to obtain the necessary verification through registered broker-dealers, provided that there are independent liability provisions for failure to adequately perform the verification); Massachusetts Securities Division (July 2, 2012) (urging the Commission to adopt as a safe harbor or best practice the use of an independent party, such as a broker-dealer, bank, or other financial institution, that would verify the accredited investor status of purchasers). One commenter, however, expressed concerns that some of the websites that currently offer lists of accredited investors could be used to facilitate fraud, noting that some offer lists based on "ethnicity, gender, and lifestyle – presumably to make [it] easier for scammers to relate to marks – and ominously, 'seniors.'" Letter from I. Moscovitz and J. Maxfield (June 27, 2012).

[115] See, e.g., letter from Handler Thayer, LLP.

[116] See, e.g., letters from AARP; CII.

Proposing Release, we believe that, at present, requiring issuers to use specified methods of verification will be impractical and potentially ineffective in light of the numerous ways in which a purchaser can qualify as an accredited investor, as well as the potentially wide range of verification issues that may arise, depending on the nature of the purchaser and the facts and circumstances of a particular Rule 506(c) offering. We are also concerned that a prescriptive rule that specifies required verification methods could be overly burdensome in some cases, by requiring issuers to follow the same steps, regardless of their particular circumstances, and ineffective in others, by requiring steps that, in the particular circumstances, would not actually verify accredited investor status.

We believe that the approach we are adopting appropriately addresses the concerns underlying the verification mandate by obligating issuers to take reasonable steps to verify that the purchasers are accredited investors, but not requiring them to follow uniform verification methods that may be ill-suited or unnecessary to a particular offering or purchaser in light of the facts and circumstances. We also expect that such an approach will give issuers and market participants the flexibility to adopt different approaches to verification depending on the circumstances, to adapt to changing market practices, and to implement innovative approaches to meeting the verification requirement, such as the development of reliable third-party databases of accredited investors and verification services. In addition, we anticipate that many practices currently used by issuers in connection with existing Rule 506 offerings will satisfy the verification requirement for offerings pursuant to Rule 506(c).

b. Non-Exclusive Methods of Verifying Accredited Investor Status

In addition to adopting a principles-based method of verification, we are including in Rule 506(c) four specific non-exclusive methods of verifying accredited investor status for natural persons that, if used, are deemed to satisfy the verification requirement in Rule 506(c); provided, however, that none of these methods will be deemed to satisfy the verification requirement if the issuer or its agent has knowledge that the purchaser is not an accredited investor.[117] While the principles-based method of verification is intended to provide an issuer with the flexibility to address the particular facts and circumstances surrounding its offering, we appreciate the view of some commenters that the final rule should include a non-exclusive list of specific verification methods for natural persons that may be relied upon by those issuers seeking greater certainty that they satisfy the rule's verification requirement.[118] Accordingly, we are adding a non-exclusive list of specific verification methods to supplement our principles-based framework for verifying accredited investor status.[119] Issuers are not required to use any of the methods discussed below, and can apply the

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[117] Because an issuer must have a reasonable belief that the purchaser is an accredited investor, the issuer could not form such reasonable belief if it has knowledge that the purchaser is not an accredited investor. See Section II.C of this release for a discussion of the reasonable belief standard in the definition of accredited investor in Rule 501(a).

[118] See, e.g., letters from ACA (Sept. 27, 2012 and Dec. 11, 2012); Investor Advisory Committee; MFA (Sept. 28, 2012).

[119] Information and documentation collected for these verification purposes may be subject to federal and/or state privacy and data security requirements. See, e.g., Regulation S-P [17 CFR 248.1 – 248.30] (implementing notice requirements and restrictions on a financial institution's ability to disclose nonpublic personal information about customers); Privacy of Consumer Financial Information (Regulation S-P), Release No. 34-42974 (June 22, 2000) [65 FR 40334 (June 29, 2000)].

reasonableness standard directly to the specific facts and circumstances presented by the offering and the investors.[120]

First, in verifying whether a natural person is an accredited investor on the basis of income, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of any Internal Revenue Service ("IRS") form that reports income, including, but not limited to, a Form W-2 ("Wage and Tax Statement"), Form 1099 (report of various types of income), Schedule K-1 of Form 1065 ("Partner's Share of Income, Deductions, Credits, etc."), and a copy of a filed Form 1040 ("U.S. Individual Income Tax Return"),[121] for the two most recent years, along with obtaining a written representation from such person that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year. In the case of a person who qualifies as an accredited investor based on joint income with that person's spouse, an issuer would be deemed to satisfy the verification requirement in Rule 506(c) by reviewing copies of these forms for the two most recent years in regard to, and obtaining written representations from, both the person and the spouse.

Second, in verifying whether a natural person is an accredited investor on the basis of net worth, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by reviewing one or more of the following types of documentation, dated within the prior three months,[122] and by obtaining a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed. In the case of a person who qualifies as an accredited investor based on joint net worth with that person's spouse, an issuer would be deemed to satisfy the verification requirement in Rule 506(c) by reviewing such documentation in regard to, and obtaining representations from, both the person and the spouse. 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 are deemed to be satisfactory; and for liabilities: a consumer report (also known as a credit report) from at least one of the nationwide consumer reporting agencies is required.[123] Commenters did not provide examples of any other type of documentation that would, in our view, adequately evidence liabilities.[124] We recognize that it will be difficult for an issuer to determine whether it has a complete picture of a natural person's liabilities, and therefore, for purposes of this method, consistent with the suggestions of some commenters, we are

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[120] We expect that many issuers will conduct Rule 506(c) offerings in reliance on the principles-based method of verification, in light of its flexibility and efficiency.

[121] A person could provide a redacted version of an Internal Revenue Service form so as to disclose only information about annual income and to avoid disclosure of personally identifiable information, such as a Social Security number, or other information that would not be relevant to the determination of a person's annual income.

[122] A person could provide redacted versions of these documents so as to disclose only information about the amounts of assets and liabilities and to avoid disclosure of personally identifiable information, such as a Social Security number, or other information that would not be relevant to the determination of a person's net worth.

[123] We note that the Fair Credit Reporting Act ("FCRA") [15 U.S.C. 1681 et seq.] requires each of the nationwide consumer reporting agencies to provide a person with a free copy of his or her consumer report, upon request, once every 12 months. In addition, the FCRA permits third parties to access individual consumer reports with the written permission of the individual.

[124] One commenter suggested that the Commission "require the issuer to obtain a list of liabilities from the investor, which would include a sworn statement that all material liabilities are disclosed." Letter from NASAA. Another commenter noted that liabilities can be cross checked against UCC 1 filings, bankruptcy information on Public Access to Court Electronic Records (PACER), and credit reports. See letter from P. Sigelman (Sept. 28, 2012).

requiring a consumer report and a written representation from such person that all liabilities necessary to make a determination of net worth have been disclosed.

Third, an issuer is deemed to satisfy the verification requirement in Rule 506(c) by obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant 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.[125] While third-party confirmation by one of these parties will be deemed to satisfy the verification requirement in Rule 506(c), depending on the circumstances, an issuer may be entitled to rely on the verification of accredited investor status by a person or entity other than one of these parties, provided that any such third party takes reasonable steps to verify that purchasers are accredited investors and has determined that such purchasers are accredited investors, and the issuer has a reasonable basis to rely on such verification.

Fourth, with respect to any natural person who invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c) and remains an investor of the issuer, for any Rule 506(c) offering conducted by the same issuer, the issuer is deemed to satisfy the verification requirement in Rule 506(c) with respect to any such person by obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

We are including the first three methods in our non-exclusive list of methods that are deemed to satisfy the verification requirement in Rule 506(c) because we believe that there will likely be few instances in which they would not constitute reasonable steps to verify accredited investor status. With respect to the verification method for the income test, there are numerous penalties for falsely reporting information in an Internal Revenue Service form, and these forms are filed with the Internal Revenue Service for purposes independent of investing in a Rule 506(c) offering. Similarly, we believe that the various forms of documentation set forth in the verification method for the net worth test ordinarily are generated for reasons other than to invest in a Rule 506(c) offering (with the possible exception of appraisal reports) and, in combination with a consumer report and a written representation from the investor regarding his or her liabilities, constitute sufficiently reliable evidence that such person's net worth exceeds $1 million, excluding the value of the person's primary residence. With respect to the third-party verification method, we have included written confirmations from certain third parties in our non-exclusive list of verification methods because these third parties are subject to various regulatory and/or licensing requirements. Registered broker-dealers[126] and SEC-registered investment advisers[127] are regulated by the Commission; and in the

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[125] For purposes of this method, a licensed attorney must be in good standing under the laws of the jurisdictions in which the attorney is admitted to practice law, and a certified public accountant must be in good standing under the laws of the place of the accountant's residence or principal office.

[126] Registered broker-dealers are subject to a comprehensive system of oversight by the Commission as well as FINRA. In particular, registered broker-dealers, among other things, must maintain and preserve specified books and records, develop effective supervisory policies and controls, and comply with FINRA rules regarding registration and qualification requirements for their associated persons as well as general and specific conduct rules. In addition, registered broker-dealers are subject to examinations by both FINRA and Commission staff.

[127] An investment adviser must register with the Commission unless it is prohibited from registering under Section 203A of the Investment Advisers Act of 1940 [15 USC 80b-3a] (the "Advisers Act") or is exempt from registration under Advisers Act Section 203 [15 USC 80b-3]. Investment advisers that are prohibited from registering with the Commission instead may be subject to regulation by the states, but the antifraud provisions of the Advisers Act continue to apply to them. See Advisers Act Sections 203A(b) and 206 [15 USC 80b-3(a), 15 USC 80b-6]. SEC-registered investment advisers are subject to examinations by Commission staff.

United States, attorneys and certified public accountants are licensed at the state level and are subject to rules of professional conduct[128] as well as, to the extent they appear or practice before the Commission in any way, to the Commission's Rules of Practice.[129]

We are including the fourth method in our non-exclusive list of methods that are deemed to satisfy the verification requirement in Rule 506(c) because we acknowledge that existing accredited investors who purchased securities in an issuer's Rule 506(b) offering prior to the effective date of Rule 506(c) would presumably participate in any subsequent offering by the same issuer conducted pursuant to Rule 506(c) based on their pre-existing relationships with the issuer. Accordingly, for these existing investors who were accredited investors in a Rule 506(b) offering prior to the effective date of Rule 506(c), a self-certification at the time of sale that he or she is an accredited investor will be deemed to satisfy the verification requirement in Rule 506(c). This provision does not extend to existing investors in an issuer who were not accredited investors in a Rule 506(b) offering that was conducted prior to the effective date of Rule 506(c).

While we have not adopted the recommendations of commenters who believe that even more prescriptive verification requirements are needed, we do recognize the general concern regarding possible misuse of the new Rule 506(c) exemption to sell securities to those who are not qualified to participate in the offering. We will closely monitor and study the development of verification practices by issuers, securities intermediaries and others by undertaking a review of whether such practices are, in fact, resulting in the exclusion of non-accredited investors from participation in these offerings, and the impact of compliance with this verification requirement on investor protection and capital formation.

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[128] Attorneys are subject to state standards for professional competence and ethical conduct, such as those based on the American Bar Association ("ABA") Model Rules of Professional Conduct, which have been adopted by most states in the United States. For example, Rule 4.1 of the ABA Model Rules of Professional Conduct prohibits an attorney from knowingly making a false statement of material fact or law to a third person or failing to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client. Accountants are also subject to state standards for professional competence and ethical conduct, such as those based on the AICPA Code of Professional Conduct. See AICPA Code of Professional Conduct ET 201.01, 202.01; see also, e.g., The Uniform Accountancy Act (5th ed. 2007), available at: http://www.aicpa.org/Advocacy/State/StateContactInfo/uaa/DownloadableDocuments/UAA_Fifth_Edition_January_2008.pdf.

The Commission recognizes that there may be particular considerations a certified public accountant would need to take into account to comply with applicable professional standards for attestation engagements to provide a report that constitutes a confirmation in the context of this rule.

[129] See Rule 102(e) of the Rules of Practice [17 CFR 201.102(e)] (The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing and practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter: (i) Not to possess the requisite qualifications to represent others; or (ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or (iii) To have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.).

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Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Michael L. Sherman
Washington, D.C.
+1 202 261 3449
michael.sherman@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Richard Goldberg
New York
+1 212 649 8740
richard.goldberg@dechert.com

M. Holland West
Washington, D.C.
+1 212 698 3527
holland.west@dechert.com

Kenneth Rasamny
Orange County
+1 949 442 6040
kenneth.rasamny@dechert.com

David Eshmoili
New York
+1 212 698 3864
david.eshmoili@dechert.com

Nicholas DiLorenzo
Boston
+1 617 728 7171
nicholas.dilorenzo@dechert.com

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