SEC Disqualifies "Bad Actors" from Participating in a Rule 506 Offering

Rule 506 of Regulation D provides a limited offering "safe harbor" exemption under Section 4(a)(2) of the Securities Act of 1933 from registration of securities under the Securities Act. This exemption is frequently relied upon by issuers raising capital on a private placement basis, including private pooled investment funds. Rule 506 permits an unlimited dollar amount of securities to be sold to an unlimited number of accredited investors and up to 35 non-accredited investors, as long as specified conditions of that rule are met. The Dodd-Frank Wall Street Reform and Consumer Protection Act required the US Securities and Exchange Commission to adopt regulations, substantially similar to the bad actor disqualification provisions already contained in Rule 262 of Regulation A, prohibiting certain felons and other "bad actors" from using Rule 506. After initially proposing new rules in May 2011, on July 10, 2013, the SEC adopted rules to disqualify issuers offering securities involving specified felons and bad actors from relying on Rule 506.[1] The bad actor disqualification rule becomes effective 60 days after publication in the *Federal Register*.

At the same time, the SEC amended Rule 506 in accordance with the Jumpstart Our Business Startups Act, removing the prohibition on general solicitation or general advertising for securities being sold in reliance on Rule 506 as long as the issuer takes reasonable steps to verify that all purchasers are "accredited investors."

For more information on the general solicitation and advertising amendment, see our Legal Update dated July 17, 2013, entitled "SEC Eliminates Solicitation and General Advertising Prohibitions from Certain Private Placements."[2]

Summary of Rule 506 Bad Actor Disqualification. The SEC added new subsection (d) to Rule 506 to establish the parameters of the new bad actor disqualification. Under this provision, the covered persons whose actions could give rise to disqualification include:

- The issuer and predecessor and affiliated issuers;
- Directors, "executive officers," officers participating in the offering and general partners or managing members of the issuer;
- 20 percent beneficial owners of the issuer, calculated based on voting power (up from 10 percent under the original rule proposal);
- Promoters connected with the issuer in any capacity at the time of the sale;
- If the issuer relying on Rule 506 is a pooled investment fund, its investment manager(s) and any director, executive officer, participating officer, general partner or managing member of any such investment manager, as well as any director, executive officer or participating officer of any such general partner or managing member (a notable additional category of covered persons added since the original rule proposal); and

- Persons compensated for soliciting investors and any director, executive officer, participating officer, general partner or managing member of any such solicitor, as well as any director, executive officer or participating officer of any such general partner or managing member.

For purposes of determining whether an officer is "participating" in an offering, the SEC noted in the adopting release that this must entail more than mere "transitory or incidental involvement." Rather, the SEC explained that this "could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents, and communication with the issuer, prospective investors or other offering participants."

In explaining the 20 percent voting power standard, the SEC declined to incorporate the defined term "voting security" from the Investment Company Act of 1940 and instead explained that voting power in this context would include securityholders that "have or share the ability... to control or significantly influence the management and policies of the issuer through the exercise of a voting right." This voting right would apply not only to the ability to vote for the election of directors (or equivalent) but also the ability to vote to approve significant transactions such as acquisitions, dispositions or financings. The SEC also clarified that securities conferring voting rights limited solely to approval of changes to the rights and preferences of the class of securities would *not* be considered voting securities for these purposes.

Under the new rule, if any covered person has had a disqualifying event, a securities offering will be disqualified from relying on the exemption provided by Rule 506—in other words, an issuer would be effectively prohibited from relying on the safe harbor for private securities offerings provided by Rule 506 (unless another exemption from registration is available, which usually will not be the case for pooled investment funds). The SEC established the following eight categories of disqualifying events:

- **Criminal Convictions—**Criminal felony or misdemeanor convictions within ten years before a sale (five years for issuers and their predecessor and affiliated issuers) in connection with the purchase or sale of any security, involving any false filing with the SEC or arising out of the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- **Court restraining orders and injunctions—**Court orders within five years before a sale that, at the time of sale, restrain or enjoin the covered person from engaging in any conduct in connection with the purchase or sale of any security, involving any false filing with the SEC or arising out of the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- **Final regulatory orders—**Final orders from a state securities commission, state banking regulator, state insurance commission, federal banking agency, the Commodities Futures Trading Commission or the National Credit Union Administration that either at the time of a sale bars the person from association with an entity regulated by such authority, engaging in securities, insurance or banking business or engaging in savings association or credit union activities, or that constitutes a final order entered within ten years of such sale, based on a violation of a law or regulation that prohibits fraudulent, manipulative or deceptive conduct;
- **SEC disciplinary orders—**SEC disciplinary orders that, at the time of sale, suspend or revoke the person's registration as a broker, dealer, municipal securities dealer or investment adviser, limit the activities of such

person or bar such person from being associated with any entity or from participating in any "penny stock" offering (in resolving one ambiguity from the original rule proposal, the SEC explained in the adopting release that censures and orders to pay civil money penalties (assuming they are paid in accordance with the order) are not disqualifying events);

- **SEC cease and desist orders—**SEC cease and desist orders within five years of the sale that, at the time of the sale, order the person to cease and desist from violating either scienter-based anti-fraud provisions of federal securities laws or the Section 5 registration requirements of the Securities Act of 1933;
- **SRO suspension or expulsion—** Suspension from membership in, or association with, a registered national securities exchange or registered securities association for conduct inconsistent with just and equitable principles of trade;
- **SEC stop orders—**SEC stop orders relating to a registration statement or Regulation A offering statement filed with the SEC within five years before such sale, or at the time of such sale being the subject of a stop order investigation; and
- **Postal Service false representation orders—**United States Postal Service false representation orders entered within five years before such sale, or at the time of sale, being subject to a temporary restraining order or preliminary injunction for conduct alleged by the postal service to constitute a scheme for obtaining money or property through the mail by means of false representations.

The Rule 506 bad actor disqualification subsection has a "grandfather" provision. However, in a change from the original rule proposal, triggering events that occurred before the effective date of the rule will *not* disqualify an offering from reliance on the exemption provided by Rule 506. Instead, any such pre-existing disqualifying events must be prominently disclosed to purchasers in writing a reasonable time prior to a sale, regardless of whether the purchasers are accredited investors.

If an issuer establishes that it did not know that a disqualifying event existed and that, even with the exercise of reasonable care, it could not have known that a disqualifying event existed, an offering otherwise eligible to rely on Rule 506 for an exemption from registration will be able to rely on the exemption notwithstanding the existence of a disqualifying event. The SEC declined to specify what constitutes reasonable care, stating in the adopting release that "the steps an issuer should take to exercise reasonable care will vary according to the particular facts and circumstances." However, an issuer will not be able to establish that it has exercised reasonable care unless it has made a factual inquiry into whether any disqualifying event exists.

The adopting release also indicated that the "timeframe for inquiry should also be reasonable in relation to the circumstances of the offering and the participants." For ongoing offerings, the reasonable care procedures need to be updated from time to time. While frequency and degree of updating will depend on the circumstance of the issuer, the offering and the participants, the adopting release stated that the SEC "would expect that periodic updating could be sufficient." However, if an issuer has notice suggesting that closer monitoring is warranted, such as knowledge that a covered person is subject to a judicial or regulatory proceeding or that weaknesses exist in screening procedures, more frequent updating may be needed. The adopting release states that the SEC expects that issuers will manage this reasonable care requirement through "contractual covenants from covered persons to provide bring-down representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances."

If a court or regulatory authority issuing an order specifies that disqualification under Rule 506 should not be a consequence of that order, the order will not be a disqualifying event. In addition, the SEC has the power to waive a disqualifying event if, upon a showing of good cause (and without prejudice to any other action the SEC may be taking), it determines that it is not necessary under the circumstances to deny the availability of an exemption under Rule 506 for a securities offering. The SEC declined to articulate standards for granting such waivers although it left the door open for it to do so in the future after the SEC and its staff "have developed experience in handling waiver requests under the new Rule 506 disqualification rules."

Events relating to affiliates of issuers will not be disqualifying events for Rule 506 purposes if they pre-date the affiliate relationship as long as the affiliated entity in question is neither in control of the issuer nor under common control, together with the issuer, by a third party that controlled the affiliated entity at the time of the disqualifying events. While the new rule did not provide different treatment for entities that have undergone a change of control or implemented changes in policies and procedures designed to prevent the occurrence of activities that gave rise to disqualification (even where such policies and procedures have been approved by a regulator or a court), the adopting release indicated that it is expected that the SEC "staff will adopt procedures for the prompt issuance of waivers of Rule 506 disqualification upon a proper showing that there has been a change of control and the persons responsible for the activities resulting in a disqualification are no longer employed by the entity or exercise influence over such entity."

The SEC amended Form D to add a certification to the signature block so that issuers claiming a Rule 506 exemption must confirm that the offering is not disqualified from reliance on Rule 506 for one of disqualifying events described in Rule 506(d).

Practical Considerations. Issuers and financial intermediaries that anticipate being involved in private placements relying on Rule 506 should develop due diligence procedures to determine that no covered persons for such offerings have any disqualifying events. This process should begin before the effective date of the rule with respect to offerings that are intended to proceed under Rule 506 after the effective date of the bad actor disqualification rule.

The persons covered by the bad actor disqualification rules should be identified in advance of each such offering. Each of these persons should be asked to confirm, ideally in writing, that such person did not suffer a disqualifying event. In some cases it may be sufficient to make an inquiry of an entity, such as a registered broker-dealer acting as placement agent, with respect to specific officers and controlling persons.

Because reasonable care is a matter of facts and circumstances, in some situations it may be prudent for an issuer to go beyond direct questioning of the covered persons. For example, selected court or regulatory records and publicly available databases could be searched.

Issuers should consider drafting questionnaires to elicit information regarding bad actor disqualifications from covered persons. They should also consider drafting contractual provisions requiring such information to be certified and to be updated.

To the extent that an issuer is engaged in a private placement that is ongoing in nature, it should develop an updating procedure to confirm that no disqualifying events have arisen or been identified after the initial inquiry.

Financial intermediary entities involved in private placements should monitor their principals and key employees on an ongoing basis for events that could disqualify a private placement from a Rule 506 exemption. While

SEC-registered investment advisers (and "exempt reporting advisers") already may ask personnel a variety of questions for purposes of disclosing disciplinary events on Form ADV, these questionnaires should be reviewed to ensure they cover all of the relevant disqualifying events for Rule 506.

If an issuer anticipates that it will be relying on Rule 506 after the effective date of the bad actor disqualification rule and there is a covered person for such offering that had an event that would have triggered disqualification had it occurred after the effective date, the issuer should begin drafting appropriate disclosure and determine its placement and delivery method.

It may be advisable for acquisition due diligence to include inquiry as to the existence of any events that could disqualify reliance on the Rule 506 exemption. If any disqualifying events exist with respect to a target and the acquisition proceeds, the acquiring company should determine whether there are mitigating actions, such as terminating an implicated employee or changing supervisory policies and procedures to prevent a recurrence, that could form the basis for a waiver request should a subsequent Rule 506 offering be desired.

If you have any questions regarding the bad actor disqualification rule or Regulation D, please contact the authors of this Legal Update, Laura D. Richman, at +1 312 701 7304 or Michael L. Hermsen at +1 312 701 7960, or any of the lawyers listed below, or any other member of our Corporate & Securities group.

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Endnotes

[1] See Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities Act Release No. 9414 (July 10 2013), available at http://www.sec.gov/rules/final/2013/33-9414.pdf.

[2] Available at http://www.mayerbrown.com/SEC-Eliminates-General-Solicitation-and-General-Advertising-Prohibitions-from-Certain-Private-Placements-07-17-2013.