Corporate Type

by John Okray

Disqualification of Bad Actors from Section 506 Securities Offerings

To raise money from investors, issuers extensively use Rule 506 of Regulation D as an exemption from costlier registered securities offerings. On July 10, 2013, the U.S. Securities and Exchange Commission (SEC or commission) adopted final rules to address the liberalization of the advertising rules[1] and the disqualification of bad actors[2] in certain securities offerings.

Congress passed the Jumpstart Our Business Startups Act (JOBS Act) in April 2012 to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies. Section 201(a)(1) of the JOBS Act directed the SEC to eliminate the prohibition on general solicitations or advertising for Rule 506 and Rule 144A securities offerings provided that issuers limit sales to eligible investors. To address concerns raised by market regulators and investor protection advocates, Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to also adopt rules prohibiting the use of the Rule 506 exemption for securities offerings that involve "bad actors."

While these two issues are related, and in-house counsel will want to be familiar with both, this article focuses on the new bad actors prohibition rule (final rule), which is expected to take effect in September 2013.[3] The purpose of the final rule was described as follows:

> The disqualification provisions of Rule 506 were intended to and should lead to enhanced investor protection by reducing the number of offering participants who have previously engaged in fraudulent activities or who previously violated securities, insurance, banking or credit union laws or regulations, and by providing an additional deterrent to future fraudulent activities. … To the extent the new disqualification provisions result in a reduction of fraud in the Rule 506 offering market, investor losses to fraud will be reduced and investor willingness to participate in the Rule 506 market could increase. This should lower the issuance costs for Rule 506 offerings to the extent that new disqualification standards lower the risk premium. Lower costs in the Rule 506 offering market could improve conditions for capital formation, benefitting both issuers and investors. [4]

Covered Persons

The final rule applies to the entities/persons in the chart on the opposite page.

Disqualifying Events/Look-back Periods

Disqualifying events under the final rule include the following:

- **Criminal convictions** in connection with the purchase or sale of a security, making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries; the criminal conviction must have occurred within 10 years of the proposed sale of securities (or five years in the case of the issuer and its predecessors and affiliated issuers)
- **Court injunctions and restraining orders** in connection with the purchase or sale of a security, making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries; the injunction or restraining order must have occurred within five years of the proposed sale of securities
- **Final orders** from the Commodity Futures Trading Commission, federal banking agencies, the National Credit Union Administration, or state regulators of securities, insurance, banking, savings associations, or credit unions that (1) bar the issuer from associating with a regulated entity; engaging in the business of securities, insurance, or banking; or engaging in savings association or credit union activities or (2) are based on fraudulent, manipulative, or deceptive conduct and are issued within 10 years of the proposed sale of securities
- **Certain SEC disciplinary orders** relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons
- **SEC cease-and-desist orders** related to violations of certain antifraud provisions and registration requirements of the federal securities laws
- **SEC stop orders** and orders suspending the Regulation A exemp-

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tion issued within five years of the proposed sale of securities
- **Suspension or expulsion** from membership in a self-regulatory organization (SRO) or from association with an SRO member
- **U.S. Postal Service false representation orders** issued within five years before the proposed sale of securities

Reasonable Care Exception and Waivers

If an issuer can demonstrate that it did not know and, after exercising reasonable care, could not have known that a covered person had a disqualifying event, the SEC may exclude the offering from disqualification. The commission did not define reasonable care or what specific factual inquiry was required, but noted the following:

- Issuers should have an in-depth knowledge of their own executive officers and other officers participating in securities offerings throughout the employment relationship.
- Factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants, and undertakings, may be sufficient in some circumstances, particularly if no information or other indicators suggest bad actor involvement.
- In the case of a registered broker–dealer acting as placement agent, it may be sufficient to make inquiry of an entity concerning the relevant set of covered officers and controlling persons and to consult publicly available databases concerning the past disciplinary history of the relevant persons (e.g., the Financial Industry Regulatory Authority (FINRA), BrokerCheck).

The commission also noted that for continuous, delayed, or long-lived offerings, reasonable care includes updating the factual inquiry on a reasonable basis.

The final rule also gives issuers the ability to apply to the SEC for a waiver where there is "good cause" from prohibition under certain limited circumstances. This may include, for example, a change in control or supervisory personnel where the person(s) responsible for the activity are no longer employed by or no longer exercise influence over the entity.

Disclosure of Pre-existing Disqualifying Events

The proposed rule would have imposed prohibitions for disqualifying events that occurred prior to the effectiveness of the final rule. However, under the final rule, disqualifying events that occurred within the applicable look-back period but before the effectiveness of the final rule are only subject to mandatory disclosure obligations. The commission instructs issuers to give such disclosures about previous bad actor events reasonable prominence and an appropriate presentation within the information available to investors.

Conclusion

Losing the ability to use the Section 506 offering exemption could have a profoundly negative impact on an issuer, particularly without the availability of an acceptable alternative exemption. Issuers and intermediaries involved in Section 506 securities offerings should ensure their due diligence policies and procedures are robust, well-documented, and ongoing as applicable to all covered persons. ⊙

Endnotes

[1]17 CFR Parts 230, 239, and 242 (2013) (SEC), *available at* www.sec.gov/rules/final/2013/33-9415.pdf.

[2]17 CFR Parts 200, 230, and 239 (2013) (SEC), *available at* www.sec.gov/rules/final/2013/33-9414.pdf, hereinafter referred to as "final rule."

[3]Sixty days after publication in the *Federal Register*.

[4]Final rule at 112-114.

Entity/Person	Comments
The issuer, including its predecessor and affiliate issuers	• Generally, the final rule excludes otherwise disqualifying events related to affiliates that predate the affiliation with the issuer. • No special treatment is afforded to entities that have undergone a change in control or policy.
Directors and certain officers, general partners, and managing members of the issuer	• The final rule covers only executive officers of covered entities and officers who participate in the offering. • Participation in an offering is defined as more than incidental involvement and 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.
Promoters	• Defined as any person—individual or legal entity—that either alone or with others directly or indirectly takes initiative in founding the business or enterprise of the issuer or, in connection with such founding or organization, directly or indirectly receives 10 percent or more of any class of issuer securities or 10 percent or more of the proceeds from the sale of any class of issuer securities (other than securities received solely as underwriting commissions or solely in exchange for property). • In terms of the final rule, "indirectly" means the analysis does not change if there are other legal entities (which may themselves be promoters) in the chain between that person and the issue
20 percent beneficial owners of the issuer	• The final rule includes beneficial owners of 20 percent or more of the issuer's outstanding equity securities, calculated on the basis of voting power. • The SEC's previously issued proposed rule had included any beneficial owner of 10 percent or more of any class of the issuer's equity securities.
Investment managers and principals of pooled investment funds	• The proposed rule had included the term "investment advisers," but the final rule uses the broader "investment managers" term, which covers the management of investments other than securities, such as commodities, real estate, and certain derivatives.
Persons compensated for soliciting investors as well as the general partners, directors, officers, and managing members of any compensated solicitor	• In addition to underwriters, this includes placement agents and finders.