

SEC Adopts "Bad Actor" Disqualification for Rule 506 Private Placement Offerings

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July 23, 2013

On July 10, 2013, the Securities and Exchange Commission voted unanimously to adopt a "bad actor" disqualification for Rule 506 private placement offerings under Regulation D. Rule 506(d) will prevent issuers from relying on Rule 506 when certain "bad actors" are associated with the issuer. New Rule 506(d) will be effective 60 days after publication in the Federal Register.

Standards for Disqualification and Unavailability of the Exemption

Under Rule 506(d), the exemption under Rule 506 will not be available if a "Covered Person" has engaged in a "Disqualifying Event." "Covered Persons" include the following:

- The issuer, including any predecessor of the issuer and any affiliated issuer;
- Any director, executive officer, or other officer *participating in the offering*;
- Any general partner or managing member of the issuer;
- Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power, *even if not a control person of the issuer*;
- Any promoter connected with the issuer in any capacity at the time of such sale;
- Any investment manager of an issuer that is a pooled investment fund;
- Any person that has been or will be *paid, directly or indirectly, to solicit purchasers* in connection with the offering in question;
- Any general partner or managing member of such investment manager or solicitor; and
- Any director, executive officer or other officer *participating in the offering* of any such investment manager or solicitor or general partner or managing member of such investment manager or solicitor.

As adopted, Rule 506(d) sets forth some 18 separate "Disqualifying Events." Some of the major ones are as follows:

- A *conviction*, within the 10 years before such sale (or 5 years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:
 - ▶ in connection with the purchase or sale of any security
 - ▶ involving the making of any false filing with the SEC or
 - ▶ arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities;
- An *order, judgment or decree* of any court of competent jurisdiction, entered within 5 years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice:
 - ▶ in connection with the purchase or sale of any security
 - ▶ involving the making of any false filing with the SEC or
 - ▶ arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser

or paid solicitor of purchasers of securities;

- A final *order* of a state securities commission, a state authority that supervises or examines banks, savings associations, or credit unions, a state insurance commission, a federal banking agency, the U.S. Commodity Futures Trading Commission, or the National Credit Union Administration that at the time of such sale, bars the person from:
 - ▶ association with an entity regulated by such commission, authority or agency
 - ▶ engaging in the business of securities, insurance or banking or
 - ▶ engaging in savings association or credit union activities;
- An *order* of the Commission entered within 5 years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of:
 - ▶ any *scienter*-based (i.e., intentional) anti-fraud provision of the federal securities laws or
 - ▶ Section 5 of the Securities Act of 1933;
- *Suspension* or *expulsion* from membership in a registered national securities exchange or a registered national or affiliated securities association; and
- A United States Postal Service false representation *order* entered within 5 years before such sale.

Disqualifying Events Occurring Prior to Effectiveness of the Rule

The loss of exemption only applies to Disqualifying Events *occurring after the effective date* of the Rule. However, an issuer must furnish to each purchaser, prior to sale, a description in writing of any matters that would have triggered disqualification but pre-dated the rule's effective date. Failure to provide such written notice may cause the issuer to lose the availability of the Rule 506 exemption.

Amendment to Form D

The SEC amended Form D to require issuers to certify that they are not disqualified pursuant to Rule 506(d)'s "bad actor" provisions.

Due Diligence Required

Offerings will not be disqualified if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. The amendments require that an issuer make a factual inquiry into whether any disqualification exists. This effectively places the burden on the issuer to establish that reasonable care was exercised. The timing and nature of such inquiry must be "reasonable in relation to the circumstances of the offering and the participants." The SEC, in its adopting release, explicitly declined to adopt standards for demonstrating reasonable care. There is no "safe harbor."

In the context of long-lived, delayed and continuous offerings, the exercise of reasonable care requires updating the factual inquiry on a reasonable basis. The SEC stated that, in the absence of facts indicating that closer monitoring would be required, periodic updating could be sufficient. Accordingly, the requirement to exercise reasonable care in identifying "bad actors" extends through termination of such offerings.

Waiver Authority

Under Rule 506(d)(2)(ii), the SEC may grant waivers from disqualification upon a showing of "good cause" that it is not necessary under the circumstances that an exemption be denied.

What Should Issuers Do Now?

Rule 506(d) provides very narrow exceptions for avoiding the disqualification of a Rule 506 exemption when "bad actors" participate in the issue. Accordingly, issuers must make diligent factual inquiries prior to and during each Rule 506 offering. This is likely to be burdensome on smaller companies. Issuers may wish to consider the following:

- Issuers should take steps to establish that reasonable care has been exercised before a challenge arises. The adoption of robust policies and procedures to identify "bad actors" may help overcome the burden of proving reasonable care when "bad actors" are

inadvertently involved in a transaction. Desirable steps might include the periodic questioning of Covered Persons, written plans and policies, routine audits and consistent application of the company's "bad actor" policies.

- To the extent that acquisitions may result in the addition of "bad actors" to an issuer's Covered Persons, the potential for disqualification should be given particular attention in due diligence reviews related to acquisitions.
- For issuers with a dominant shareholder, special attention should be paid to minority shareholders when assessing the potential for disqualification. While significant, the 20% beneficial ownership threshold to qualify as a Covered Person may disqualify an issuer even where such beneficial owners exercise no meaningful control of the issuer.
- Public companies thinking of relying on the Rule 506 exemption should consider whether annual D&O questionnaires sufficiently address the types of information that would lead to disqualification. Modifications may be necessary to the extent that current questionnaires do not address all potential Disqualifying Events.

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