



[More Thoughts On The SEC's New Draft Bad Boy Rules](#)

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The SEC has proposed new regulations to implement the “bad boy” provisions of the Dodd-Frank Act.

Under those provisions, startup companies would have a new, fairly significant due diligence burden to ensure that certain persons^[1] are not “bad boys”^[2] under the Act.

This new due diligence burden is unfortunate. Under current law, startups can raise capital very efficiently under Rule 506 of Regulation D if they raise money solely from accredited investors. Under Reg D, there is no current burden to conduct “factual inquiries” whether any covered persons are “bad boys.”

The affirmative due diligence obligation created by the new regulations will be new to Reg D offerings, and the SEC admits it might take a substantial amount of time. (“Issuers could potentially devote substantial amounts of time and incur significant costs in making factual inquiries.”) This will slow down capital formation, and slow down job creation. The SEC knows this, and this is the reason it proposed the reasonable care exception.

“We are proposing a reasonable care exception out of a concern that the benefits of Rule 506—which, among other things, is intended to create a cost-effective method of raising capital, particularly for small businesses—may otherwise be **substantially** reduced.”

I believe that the SEC should back off on the requirement to conduct “factual inquiries” when it considers comments to the draft rules. One of the SEC’s questions in its draft rules was: “Are there any circumstances in which factual inquiry should not be required?”

I believe the answer is yes. And I would suggest that there are at least 2 circumstances in which no factual inquiry should be required: (1) for small offerings (less than \$10M), and (2) for offerings in which no broker-dealer or finder is utilized. There are probably other exceptions that ought to be suggested to the SEC as well. If you care about the startup company ecosystem, I encourage you to give this question some thought and write the SEC.

[1]Persons covered include (i) the issuer, (ii) any predecessor of the issuer; (iii) any affiliated issuer; (iv) any director, officer, general partner or managing member of the issuer; (v) any beneficial owner of 10% or more of any class of the issuer’s equity securities; (vi) any promoter connect with the issuer in any capacity at the time of such sale; (vii) any person that has been or will be paid (directly or indirectly) remuneration for solicitation of



purchasers in connection with such sale of security; or (viii) any general partner, officer or managing member of any such solicitor.

[2]Meaning:

(i) Has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the Commission; or

(C) 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;

(ii) Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five 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:

(A) In connection with the purchase or sale of any security;

(B) Involving the making of any false filing with the Commission; or

(C) 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;

(iii) Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; or the National Credit Union Administration that:

(A) At the time of such sale, bars the person from:

(1) Association with an entity regulated by such commission, authority, agency, or officer;

(2) Engaging in the business of securities, insurance or banking; or

(3) Engaging in savings association or credit union activities; or

(B) Constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale;



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(iv) Is subject to an order of the Commission entered pursuant to section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b) or 78o-4(c)) or section 203(e) or (f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(e) or (f)) that, at the time of such sale:

(A) Suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser;

(B) Places limitations on the activities, functions or operations of such person; or

(C) Bars such person from being associated with any entity or from participating in the offering of any penny stock;

(v) Is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

(vi) Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or

(vii) Is subject to a United States Postal Service false representation order entered within five years before such sale, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

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