More New Rules for Startups to Follow

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The SEC has **proposed draft rules** to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Section 926 of the Dodd-Frank bill required the SEC to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from reliance on the safe harbor from Securities Act registration provided by Rule 506 of Regulation D.

These new rules are going to make life more difficult for startups raising capital. Why?

Because now startups are going to have to investigate "covered persons" to determine whether they are "bad actors." These inquiries are going to take time, and require companies to take affirmative action—a burden that doesn't exist under the current law.

It sounds innocuous enough, and well meaning—shouldn't we prohibit startups with "bad actors" involved from accessing the Rule 506 securities law exemption?

Of course we should, you say. That makes all the sense in the world—bad actors are, well, bad!

The trouble is that what if a startup doesn't realize that one of the "covered person(s)" is a "bad actor." What if it doesn't interrogate its new 15% stockholder to discover whether that person has been convicted of a crime (including a misdemeanor) in connection with the purchase or sale of any security?

Well then, the startup wouldn't have a securities law exemption for its offering and its directors and officers could potentially be exposed to personal liability.

So, the new rules sound good, at first blush, but make no mistake–they make life more difficult for startups.

The new rules still allow startups to access Rule 506 even if turns out that there is a violation of the new rules if the startup "establishes that it did not know, *and in the exercise of reasonable care could not have known*, that a disqualification existed under paragraph (c)(1) of this section."

Significantly, the instructions to this rule state that a startup "will not be able to establish that it has exercised reasonable care unless it has made factual inquiry into whether

any disqualifications exist. The nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and the other offering participants."

Thus, the new rules are going to require issuers involved in Rule 506 offerings to conduct factual inquries of "covered persons."

The SEC acknowledges that "[i]ssuers could potentially devote substantial amounts of time and incur significant costs in making *factual inquiries*." "To establish reasonable care, the issuer would be expected to conduct a factual inquiry, the nature and extent of which would depend on the facts and circumstances of the situation."

The SEC elaborates:

"In some circumstances, factual inquiry of the covered persons themselves (for example, by including additional questions in questionnaires issuers may already be using to support disclosures regarding directors, officers and significant shareholders of the issuer) may be adequate. Issuers should also consider whether investigating publicly available databases is reasonable. In some circumstances, further steps may be necessary."

The proposed disqualification provisions of Rule 506(c) would cover the following "covered persons":

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid (directly or indirectly) remuneration for
- solicitation of purchasers in connection with sales of securities in the offering; and
- any director, officer, general partner, or managing member of any such compensated solicitor.

If any of the above "covered persons" have been involved in any of the following types of disqualifying events, then the issuer could not rely on Rule 506:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state regulators (such as state securities, banking and insurance regulators) and federal regulators;
- Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons;
- Suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization;
- Commission stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

The SEC is seeking comments on these rules. Now would be the time to comment that the new rules ought not to burden startups with significant due diligence obligations. That such due diligence obligations will slow capital raising down–and that capital raising by startups creates jobs.

The actual proposed rule is quoted below.

(c) “Bad Actor”disqualification.
(1) No exemption under this Section 506 shall be available for a sale of securities if the issuer; any predecessor of the issuer; any affiliated issuer; any director, officer, general partner or managing member of the issuer; any beneficial owner of 10% or more of any class of the issuer’s equity securities; any promoter connected with the issuer in any capacity at the time of such sale; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; or any general partner, director, officer or managing member of any such solicitor:
(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;
(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.

(2) Paragraph (c)(1) of this section shall not apply:
(i) Upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is not necessary under the circumstances that an exemption be denied; or
(ii) If the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed under paragraph (c)(1) of this section.

Instruction to paragraph (c)(2)(ii). An issuer will not be able to establish that it has exercised reasonable care unless it has made factual inquiry into whether any disqualifications exist. The nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and the other offering participants.

(3) For purposes of paragraph (c)(1) of this section, events relating to any affiliated issuer that occurred before the affiliation arose will be not considered disqualifying if the affiliated entity is not:
(i) In control of the issuer; or
(ii) Under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.