

in the news

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SEC Adopts Rule Defining “Bad Actors” Disqualified from Using Rule 506 of Regulation D to Raise Capital

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On July 10, 2013, the U.S. Securities and Exchange Commission adopted amendments to Rule 506 and another provision of Regulation D to specify who is a “bad actor” and to provide that offerings involving a “bad actor” are disqualified from using the widely-relied on Rule 506 exemption. Rule 506 is the exemption of choice for hedge funds, private equity funds, venture capital funds, and small to mid-size operating companies seeking to raise capital by issuing unregistered securities. The amendments implement that part of the 2010 Dodd-Frank Act directing the SEC to issue rules, within one year after the law’s enactment, disqualifying from reliance on Rule 506 securities offerings by issuers that

have been, or that have officers, directors, affiliates or placement agents that have been the subject of certain criminal, civil, or administrative proceedings under federal or state laws. Prior to the effectiveness of the amendments, Rule 506 did not contain a bad actor disqualifier.

The amendments to Regulation D, which include the addition of this bad actor disqualification provision under new subsection (d) to Rule 506, are generally similar to those proposed by the SEC on May 25, 2011. The amendments will be effective on September 22, 2013.



In this Alert, we briefly discuss the amendments as they relate to:

- The covered persons that could trigger the disqualification with respect to an issuer's offering of securities in reliance on Rule 506;
- The events that trigger disqualification;
- The pre-effectiveness event exception; and
- Waivers and exclusions to disqualification.

We also discuss the ramifications of Rule 506 disqualification.

Covered Persons

In addition to covering the issuer, the bad actor disqualification of Rule 506(d) applies to the following persons that have had a disqualifying event:

- Predecessors to the issuer and its affiliated issuers;
- Directors, executive officers, other officers who will participate in the offering, general partners, or managing members of the issuer;
- Beneficial owners of 20% or more of the issuer's voting securities, calculated on the basis of voting power;
- Promoters connected with the issuer in any capacity at the time of sale;
- Investment managers of an issuer that is a pooled investment fund as well as general partners or managing members of such investment managers and their directors, executive officers, or other officers participating in the offering; and

- Persons that have been or will be paid (directly or indirectly) to solicit investors in connection with the proposed sale of securities (such as placement agents and finders) as well as the general partners or managing members of such solicitors and their directors, executive officers, or officers participating in the offering.

Disqualifying Events

Under Rule 506(d), the following actions are "disqualifying events:"

- Criminal convictions 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. The conviction must have occurred within ten years before the proposed sale of securities (or five years, in the case of issuers, their predecessors and affiliated issuers).
- Court injunctions and restraining orders 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. The injunction or restraining order





must have been entered within five years before the proposed sale of securities.

- Final orders of the Commodities Futures Trading Commission, federal banking agencies, the National Credit Union Association, or certain state regulators (such as state securities, banking and insurance regulators) that bar a covered person from associating with a regulated entity or engaging in specific regulated activities or are based on fraudulent, manipulative, or deceptive conduct and were issued within 10 years of the proposed sale of securities. With respect to a final order that is a bar, the bar must remain in effect at the time of the proposed sale.
- Certain SEC 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.
- SEC cease and desist orders related to certain anti-fraud violations and registration requirements of the federal securities laws.
- SEC stop orders and orders suspending a Regulation A exemption issued within five years before the proposed sale of securities.
- U.S. Postal Service false representation orders entered within five years before the proposed sale of securities.

In connection with the Bad Actor Amendments, the SEC adopted a revision to Form D to add a new certification to the signature block, whereby the issuer claiming the availability of the Rule 506 exemption will be required to confirm that the offering is not disqualified from reliance on

Rule 506 due to one of the reasons specified in Rule 506 (d).

The Pre-Effectiveness Event Exclusion

Unlike the initially proposed amendments, new Rule 506(d) carves out events that occurred prior to the effective date of the rule. Accordingly, events that pre-date the effective date of the amendments will not result in automatic disqualification. However, Rule 506(d) imposes an affirmative obligation on the issuer to disclose in writing matters that existed before the effective date of the rule that would otherwise have been a disqualifying event but for the carve-out. This obligation applies to all offerings under Rule 506, regardless of whether purchasers are accredited investors. In situations where this disclosure obligation is triggered, the SEC expects that "... issuers will give reasonable prominence to the disclosure to ensure that information about pre-existing bad actor events is appropriately presented in the total mix of information available to investors."

The failure to adequately make the required disclosure could result in the loss of the Rule 506 exemption, unless the issuer can establish that it did not know, and in the exercise of reasonable care could not have known of the existence, of the undisclosed matter. This reasonable care exception is similar to the reasonable care exclusion for post-effective events discussed below.





Waivers and Exclusions

The disqualification will not apply if the SEC determines upon a showing of good cause that it is not necessary under the circumstances that the Rule 506 exemption be unavailable. In addition, the disqualification will not apply if, before the relevant sale, the court or regulatory authority that triggered the particular disqualifying event advises the SEC in writing that the disqualification should not arise as a result of its order, judgment or decree.

The amendments include a “reasonable care” exclusion if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed. Instructions for this provision point out that an issuer will not be able to prove reasonable care unless it inquired into whether any disqualifications exist. The instructions also state that the nature and scope of the factual inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants.

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

Ramifications of Rule 506 Disqualification

The ramifications of Rule 506 disqualification can be profound for issuers under both federal and state securities laws. Rule 506 is the Regulation D exemption of choice for most issuers due in large part to the permissibility of effecting sales of an unlimited dollar amount of securities without Securities Act registration. The ability, beginning on September 22, 2013, to use general solicitation and

general advertising in Rule 506 offerings involving solely verified accredited investor purchasers pursuant to new Rule 506(c) will likely make the exemption even more popular with issuers. If an issuer is disqualified from using Rule 506, it may find alternative federal exemptions too restrictive or uncertain to effectively raise capital. Moreover, securities offered in reliance on Rule 506 have the status under the Securities Act as a federal “covered security” that means that the registration and qualification requirements under state securities or “blue sky” laws are preempted. In lieu of adhering to those state provisions, the issuer only has to file a post-sale notice and pay a fee to any state in which the securities are being sold.

If an offering is disqualified under Rule 506(d), the offering can still be conducted pursuant to the statutory exemption set forth in Section 4a(2) of the Securities Act, provided the offering complies with the statutory exemption, as construed by the SEC and the courts. However, an offering made in reliance on the statutory exemption provided by Section 4a(2) would not constitute an offering of a covered security and therefore state registration and review requirements would apply. Furthermore, issuers would then be subject to, and would still have to satisfy state exemption terms and conditions. These state exemption terms and conditions may include non-uniform pre-offer and post-sale filings and the imposition of required disclosure (including state-specific legends), suitability and other requirements. ■





For More Information

Companies and sponsors of funds needing assistance in evaluating the availability of the Rule 506 exemption in light of the SEC's bad actor disqualifier amendments should contact a member of Polsinelli's Corporate Finance and Securities practice group.



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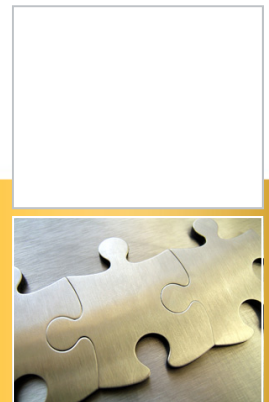
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