

## Client Alert

July 15, 2013



## Dodd-Frank Update: SEC Adopts Bad Actor Disqualifications for Private Placements under Regulation D

On July 10, 2013, the Securities and Exchange Commission (the “SEC” or “Commission”) adopted amendments to rules promulgated under Regulation D to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).<sup>1</sup> The amendments add “bad actor” disqualification requirements to Rule 506 of the Securities Act of 1933 (the “Securities Act”), which prohibit issuers and others such as underwriters, placement agents, directors, executive officers, and certain shareholders of the issuer from participating in exempt securities offerings, if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. The amendments were originally proposed on May 25, 2011.<sup>2</sup> The final rules will go into effect 60 days after their publication in the Federal Register.

The new disqualification provisions will apply to all Rule 506 offerings, regardless of whether general solicitation is used.

### Background

Rule 506 permits sales of an unlimited amount of securities, without registration, to any number of accredited investors and up to 35 non-accredited investors, if the appropriate resale limitations are imposed, any applicable information requirements are satisfied and the other conditions of the rule are met.<sup>3</sup> Rule 506 is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D.

Section 926 of the Dodd-Frank Act requires the SEC to adopt rules that would make the Rule 506 exemption unavailable for any securities offering in which certain “felons” or other “bad actors” are involved. The new provisions generally track those in Section 926 of the Dodd-Frank Act and Rule 262 of Regulation A under the Securities Act.

<sup>1</sup> Release No. 33-9414 (July 10, 2013) (the “Adopting Release”). The Adopting Release is available at <http://www.sec.gov/rules/final/2013/33-9414.pdf>.

<sup>2</sup> Release No. 33-9211 (May 25, 2011) (the “Proposing Release”). The Proposing Release is available at <http://www.sec.gov/rules/proposed/2011/33-9211.pdf>.

<sup>3</sup> In a separate rulemaking required under Section 201(a) of the Jumpstart Our Business Startup Act, the SEC adopted final rules allowing, under new Rule 506(c) and subject to certain conditions, general solicitation in a Rule 506 offering. Issuers still have the option to conduct a Rule 506 offering without general solicitation.

## The Amendments

### *Covered Persons*

The disqualification provisions in Rule 506(d)(1) apply to the following “covered persons”:

- the issuer and any predecessor of the issuer;
- any affiliated issuer;
- any director, executive officer, other officer participating in the offering, general partner, or managing member of the issuer;
- any beneficial owner of 20 percent or more of any class of the issuer’s outstanding voting equity securities, calculated on the basis of voting power;
- any promoter (as defined in Rule 405) connected with the issuer in any capacity at the time of the 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) remuneration for solicitation of purchasers in connection with such sale of securities (a “compensated solicitor”);
- any general partner or managing member of any such investment manager or compensated solicitor; or
- any director, executive officer or other officer participating in the offering of any such investment manager or compensated solicitor or general partner or managing member of such investment manager or compensated solicitor.

In the case of financial intermediaries likely to be involved in a private placement under Rule 506, the SEC applied the current standards in Rule 505. Because Rule 505 transactions do not involve underwritten public offerings but rather the use of compensated placement agents and finders, the term “underwriters” in Rule 262 is replaced with “any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers” (compensated solicitors).

Rule 506(d)(3) provides that the disqualification provisions do not apply to events relating to any affiliated issuer that occurred before the affiliation arose 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.

Two key changes from the categories of covered persons discussed in the Proposing Release are the inclusion in Rule 506(d)(1) of “executive officers” (i.e., those performing policy-making functions) of the issuer and the compensated solicitor, instead of just “officer,” and a change to 20 percent from 10 percent shareholders of the issuer.

### *Disqualifying Events*

The final rule includes eight categories of disqualifying events. They are:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders (as defined in Rule 501(g)) of certain state regulators (such as securities, banking, and insurance) and federal regulators, including the U.S. Commodity Futures Trading Commission (the “CFTC”);

- Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- Certain SEC cease and desist orders;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization (“SRO”);
- Commission stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

A discussion of each of these categories appears below.

#### *Criminal Convictions*

Rule 506(d)(1)(i) provides for disqualification if any covered person who has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security, involving the making of any false filing with the Commission 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.

The rule includes a five-year look-back period for criminal convictions of issuers, their predecessors and affiliated issuers, and a ten-year look-back period for other covered persons.

#### *Court Injunctions and Restraining Orders*

Similar to Rule 262, Rule 506(d)(1)(ii) disqualifies any covered person from relying on the exemption for a sale of securities if such covered person 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 in or continuing any conduct or practice (i) in connection with the purchase or sale of any security, (ii) involving the making of a false filing with the SEC or (iii) arising out of the conduct of business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.

#### *Final Orders of Certain Regulators*

Final orders of regulatory agencies or authorities are covered by Rule 506(d)(1)(iii). That section disqualifies any covered person who 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 an officer of a state performing like functions); an appropriate federal banking agency; the CFTC; or the National Credit Union Administration. The order must be final, and (A) at the time of such sale, bar the person from (i) association with an entity regulated by such commission, authority, agency or officer; (ii) engaging in the business of securities, insurance or banking; (iii) 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 of such sale.

In a change from the Proposing Release, the rule also added CFTC final orders as disqualification triggers. In adding CFTC final orders, the Commission noted that the CFTC (rather than the Commission) has authority over investment managers of pooled investment funds that invest in commodities and certain derivative products. The Commission reasoned that, absent adding CFTC final orders as a disqualifying trigger, regulatory sanctions against those investment managers would not likely trigger disqualification.

- Final Orders

Rule 501(g) defines a “final order” as “a written directive or declaratory statement issued by a federal or state agency described in [Rule 506(d)(1)(iii)] under applicable statutory authority that provides for notice and an opportunity for a hearing, which constitutes a final disposition or action by that federal or state agency.” The definition is based on the Financial Industry Regulatory Authority, Inc. definition.

- Fraudulent, Manipulative, or Deceptive Conduct

Rule 506(d)(1)(iii)(B) provides that disqualification must result from final orders of the relevant regulators that are “based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct.” Despite the suggestions of commenters, the SEC did not define “fraudulent, manipulative or deceptive conduct,” did not exclude technical or administrative violations and did not limit Rule 506(d)(1)(iii) to matters involving scienter.

#### *Commission Disciplinary Orders*

Currently under Rule 262(b)(3), issuers and other covered persons that are subject to an SEC order entered pursuant to Section 15(b), 15B(a), or 15B(c) of the Securities Exchange Act of 1934 (the “Exchange Act”), or Section 203(e) or (f) of the Investment Advisers Act of 1940 (the “Advisers Act”), are disqualified from relying on the exemption available under Regulation A. Under the cited provisions of the Exchange Act and the Advisers Act, the SEC has the authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers, and investment advisers, including the suspension or revocation of registration, censure, placing limits on their activities, imposing civil money penalties and barring individuals from being associated with specified entities and from participating in the offering of any penny stock.

The SEC and its staff have historically required disqualification periods to run only for as long as some act is prohibited or required to be performed pursuant to an order. Therefore, censures are not disqualifying and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires.

Rule 506(d)(1)(iv) codifies this position, but removes the reference to Section 15B(a) of the Exchange Act. No lookback period was added to the rule.

#### *Certain Commission Cease and Desist Orders*

Although not required by Section 926 of the Dodd-Frank Act, the Commission added an additional disqualification trigger, using its existing authority previously used to create bad actor provisions.

Under Rule 506(d)(1)(v), an offering will be disqualified if any covered person is subject to any order of the Commission entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a future violation of (i) any scienter-based anti-fraud provision of the federal securities laws, including without limitation Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 206(1) of the Advisers Act, or any other rule or regulation thereunder; or (ii) Section 5 of the Securities Act. Note that the disqualification provision for Section 5 of the Securities Act does not require scienter, which is consistent with the strict liability standard imposed by Section 5.

#### *Suspension or Expulsion from SRO Membership or Association with an SRO Member*

Rule 506(d)(1)(vi) disqualifies any covered person that is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade. This provision does not include a look-back period.

### *Stop Orders and Orders Suspending the Regulation A Exemption*

Rule 506(d)(1)(vii) imposes disqualification on an offering if a covered person has filed (as a registrant or issuer), 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.

#### *U.S. Postal Service False Representation Orders*

The final disqualification provision is enumerated in Rule 506(d)(1)(viii), which disqualifies any covered person that is subject to a U.S. Postal Service false representation order entered within five years preceding the sale of securities, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the U.S. Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

#### **Reasonable Care Exception**

Rule 506(d)(2)(iv) creates a reasonable care exception that would apply if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person. The reasonable care exception helps preserve the intended benefits of Rule 506 and avoids creating an undue burden on capital-raising activities, while giving effect to the legislative intent to screen out felons and bad actors.<sup>4</sup>

In order to rely on the reasonable care exception, the issuer would need to conduct a factual inquiry, the nature of which would depend on the facts and circumstances of the issuer and the other offering participants. In such an inquiry, an issuer would need to consider various factors, such as the risk that bad actors present, the presence of screening and other compliance mechanisms, the cost and burden of the inquiry, whether other means used to obtain information about the covered persons is adequate, and whether investigating publicly available information is reasonable.

#### **Transition Issues**

##### *Disqualifying Events that Predate the Rule*

Although the lookback provisions of Rule 506(d) reach back to disqualifying events prior to the effectiveness of the rule, Rule 506(d)(2)(i) provides that disqualification will not arise as a result of triggering events that occurred prior to the date of the amendments. However, Rule 506(e) requires written disclosure to purchasers, at a reasonable time prior to the sale, of matters that would have triggered disqualification except that they occurred prior to the rule's effective date. This disclosure requirement applies to all Rule 506 offerings, regardless of whether purchasers are accredited investors. Failure to make such disclosures will not be an "insignificant deviation" within the meaning of Rule 508; consequently, relief under that rule will not be available for such failure.

#### **Action Items for Issuers and Placement Agents**

As a practical matter, issuers and placement agents will be required to implement new procedures in connection with any Rule 506 offering, with a view to ferreting out any disqualifying events on the part of the issuer, any

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<sup>4</sup> Regulation D already has a provision, Rule 508, under which "insignificant deviations" from the terms, conditions, and requirements of Regulation D will not result in the loss of the exemption if the person relying on the exemption can show that: (i) the failure to comply did not pertain to a term, condition or requirement directly intended to protect that individual or entity; (ii) the failure to comply was insignificant with respect to the offering as a whole; and (iii) a good faith and reasonable attempt was made to comply. The Commission does not believe that Rule 508 would cover circumstances in which an offering was disqualified under Rule 506(d).

existing or potential placement agent or any other covered person. Knowledge of any disqualifying event (or any event or proceeding that could, with the passage of time, ripen into a disqualifying event) will be essential in determining whether the issuer can proceed with the Rule 506 offering, whether it can use a potential placement agent, and whether any pre-effective disqualifying events will need to be disclosed.

Issuers should consider:

- Adding additional questions to D&O questionnaires;
- Having 20% or greater shareholders complete questionnaires;
  - Public companies should be able to determine their 20% holders through their public filings (Form 10-K, Form 3 filings, Schedule 13D and 13G filings);
  - Non-public companies should contact their transfer agent and registrar;
- Requiring placement agents to complete a questionnaire or provide a representation;
  - For example, in a placement agent agreement for a Rule 506 offering, the issuer and the placement agent could make mirror representations that (i) they are not subject to a disqualifying event, have obtained a waiver from disqualification or have fully disclosed any disqualifying event that occurred prior to the effective date of the amendments and (ii) have informed the other party of any event or proceeding that could, with the passage of time, become a disqualifying event;
- Require other participants (that may be covered persons) to complete questionnaires or provide representations<sup>5</sup>; and
- For funds or other issuers engaged in continuous or delayed offerings, refreshing or updating their diligence, such as through bring-down representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases and other steps, depending on the circumstances;
  - For issuers engaged in continuous or delayed Rule 506 offerings, such as a national bank offering securities exempt under Section 3(a)(2) of the Securities Act and issuing such securities under Part 16.7 of the Office of the Comptroller of the Currency's (the "OCC") securities offering rules (12 C.F.R. Part 16.7), which provides an exemption from OCC registration for securities offerings conducted under Rule 506, the issuer should consider amending its placement agent agreement to add the mirror representations described above.

Placement agents should consider:

- Prior to any Rule 506 offering, conducting diligence on issuers and other offering participants so that any disqualifying events that occurred prior to the effectiveness of the amendments can be properly disclosed and determining whether the new representations described above can be made (including discussing the potential impact of any event that, with the passage of time, could become a disqualifying event); and
- Reviewing Forms U-4, U-5 and U-6 and comparing any events described in those forms to the disqualifying events enumerated in Rule 506(d)(1), in preparation for the possibility of either disclosing such events as pre-effectiveness disqualifying events or to confirm compliance with any of the new representations described above.

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<sup>5</sup> The Adopting Release states that "factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings, may be sufficient in some circumstances, particularly if there is no information or other indicators suggesting bad actor involvement." Adopting Release at page 67.



A typical pre-offering diligence investigation should uncover many of the disqualifying events, as the documentary diligence request list would normally ask for any communications with regulators. Those drafting a documentary diligence request list for a Rule 506 offering should ensure that the list includes all relevant covered persons listed in Rule 506(d)(1); i.e., the list should list out each of those persons, and not use any shorthand reference to the rule. Issuers may not be familiar with all of the potential covered persons. Disqualifying events uncovered by the diligence investigation will require a new level of analysis prior to commencing a Rule 506 offering.

The Commission chose not to prescribe particular steps as being necessary or sufficient to establish reasonable care. However, the Adopting Release notes that if the circumstances give an issuer reason to question the veracity or accuracy of the responses to its inquiries, then reasonable care would require the issuer to take further steps or undertake additional inquiry to provide a reasonable level of assurance that no disqualifications apply.

### **Waivers**

Currently, issuers may seek waivers of disqualification under Regulation A if the issuer shows good cause. Rule 506(d)(2)(ii) carries over the current waiver provisions of Regulation A. The rule does not articulate any standard for issuing such a waiver. Waivers under the new rule will be issued by the Commission.

Waivers will also be issued, under Rule 506(d)(2)(iii), if, before the relevant sale, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing (whether contained in the relevant judgment, order or decree or separately to the Commission or its staff) that disqualification under Rule 506(d)(1) should not arise as a consequence of such order, judgment or decree.

### **Amendment to Form D**

The signature block of current Form D contains a certification that applies to transactions under Rule 505, confirming that the offering is not disqualified from reliance on Rule 505. This certification will be broadened, so that issuers claiming a Rule 506 exemption will also be required to confirm that the offering is not disqualified from reliance on the Rule 506 exemption.

### *Effect on Ongoing Offerings and Timing of Implementation*

The new disqualification provisions will apply only to sales of securities made in reliance on Rule 506 after the rule amendments go into effect. If disqualifying events occur while an offering is underway, only sales made after the rule's effective date will be affected.

### **Author**

Bradley Berman  
New York  
(212) 336-4177  
[bberman@mofocom](mailto:bberman@mofocom)

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Please also see our general client alert on the SEC's amendments to Rule 506 here:  
<http://www.mofocom/files/Uploads/Images/130710-Goldilocks-Porridge-and-General-Solicitation.pdf>

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