PUBLICATION

Beware the "Bad Actor" - SEC Disqualification and Disclosure Requirements Affect Private Offering Issuers

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Effective September 23, 2013, the Securities and Exchange Commission (SEC) implemented Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which provided for expanded liability for "bad actors" in offerings made under Rule 506 (i.e., private offerings made without regard to the dollar amount of the offering) of Regulation D of the Securities Act of 1933 (the Securities Act). New Rule 506(d) now imposes disqualification requirements on a wide range of actors (covered persons) and events (disqualifying events). Rule 506(e) imposes *disclosure* requirements on issuers for disqualifying events that occurred before September 23, 2013 (although such pre-rule events are *not* themselves disqualifying). The SEC has been active in releasing near-monthly interpretive guidance to clarify these rules and affected companies should take a careful look at this new guidance.

Significantly, the new rules provide that a Rule 506 offering is disqualified from the exemption from registration if the "issuer or any other person covered by Rule 506(d) has a relevant criminal conviction, regulatory or court order, or other disqualifying event that *occurred on or after* the effective date of the rule amendments." The list of covered persons includes, among others:

- The issuer;
- Directors, general partners, and managing members of the issuer;
- Executive officers of the issuer;
- Beneficial owners of more than 20 percent of the issuer's equity; and
- Promoters connected to the issuer.

Disqualifying events, which may be subject to certain "look-back" periods, may adversely affect an issuer's private offering and include:

- Certain criminal convictions;
- Certain court injunctions and restraining orders;
- Final orders of certain state and federal regulators;
- Certain SEC disciplinary orders;
- Certain SEC cease-and-desist orders;
- SEC stop orders;
- Suspension or expulsion from membership in a self-regulatory organization (SRO), such as FINRA; and
- U.S. Postal Service false representation orders.

If an issuer, in connection with a sale of securities made on or after September 23, 2013, encounters a covered person having been subject to a disqualifying event existing before the effective date of the rule, then Rule 506(e) mandates that the disqualifying event be disclosed in writing to investors.

Prior to the adoption of Rules 506(d) and 506(e), covered persons participating in a disqualifying event typically subjected an issuer to disqualification only for a failure to file a Form D. But with the promulgation of these new rules, all offerings relying upon the traditional Rule 506 exemption are affected. The impact of Rules 506(d) and 506(e) is potentially serious for an issuer's proposed or existing private offering. The new rules are significant for issuers because disqualification from Rule 506 may cause the entire offering to become ineligible under federal and state securities registration exemptions. An issuer who is unable to rely on the federal "covered securities" preemption under Section 18(b)(4)(E) of the Securities Act could thus face the registration requirements of the various state "Blue Sky" securities laws. Registration under state law would impose significant business and financial hardships on an issuer expecting to rely on a private placement exemption.

Rule 506(d) provides an *exception from disqualification* when the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering. The steps an issuer should take to exercise reasonable care will vary according to particular facts and circumstances. The instruction to the rule states that an issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualification exists. To demonstrate an exercise of reasonable care, the issuer could, for example, require covered persons to make certain representations that they do not run afoul of Rule 506(d)'s requirements, accomplished by the completion and submission of a questionnaire or other covered person certification.

The SEC recently noted that "if an offering is continuous, delayed or long-lived, the issuer must update its factual inquiry periodically through bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances." This administrative guidance particularly applies to open-ended funds whose offerings may span years-long periods without any definite termination date. Accordingly, under the SEC's current direction such issuers would be required to undertake burdensome and potentially costly diligence depending on the size of the offering and the number of possible covered persons involved.

Companies and their management who often rely on the Rule 506 private placement exemption are advised to review the new rules governing these disqualification and disclosure issues, both with respect to existing and forthcoming offerings of securities. Continued SEC interpretive guidance will also add further clarity and comfort for issuers facing concerns over "bad actors" and their effect on business and capital prospects.

Should you wish to discuss the impact of Rules 506(d) and 506(e) on your particular facts and circumstances, please do not hesitate to contact any of the following attorneys in the Firm's Securities and Corporate Governance Group.