Compliance with the Rule 506(d) "Bad Actor" Obligations in Private Offerings

By: John P. Cleary | 619.515.3221 | john.cleary@procopio.com

Companies conducting private offerings normally rely on Regulation D of the Securities Act of 1933, as amended (the "Securities Act"), to provide a safe harbor from the registration requirements applicable to all securities offerings. Pursuant to Section 926 of the Dodd-Frank Wall Street Reform Act, the Securities and Exchange Commission (SEC) recently adopted Rule 506(d), which disqualifies a company from relying Regulation D if certain felons and other "bad actors" are involved in the company or the offering. This "bad actor" provision is an investor protection mechanism that prevents persons who have a history of "bad acts" from taking a meaningful role in the capital raising process.

Specifically, Rule 506(d) prohibits reliance on Regulation D's safe harbor if any "covered person" has a "disqualifying event." Importantly, any disqualifying event that occurred before September 23, 2013 will not prohibit a company's reliance on Regulation D, but instead only require specified disclosure obligations.

Who are "Covered Persons"?

First, Rule 506(d) looks at the people involved in the private offering. "Covered Persons" include:

- The company issuing the securities, and its affiliated companies;
- Directors;
- Executive officers, and all other persons who participate in the offering;
- 20% beneficial owners of the company's stock;
- Promoters; and
- Persons compensated for soliciting investors.

When commencing an offering, a company must consider the history of all of its officers and directors and obtain assurances they are not "bad actors". Importantly, companies need to be aware of the legal and regulatory history of its large shareholders, because even though he may not be involved in the offering, if a 20% or more shareholder is a bad actor, the company will be prohibited from reliance on Regulation D.

Companies should pay careful attention to each person that participates in the offering, even at a tangential level. In order to be deemed a Covered Person, the level of participation must be "more than transitory or incidental involvement," but includes activities such as involvement in due diligence, preparation of disclosure documents, and communication with prospective investors. Companies should be particularly mindful of the history of finders and other consultants hired in connection with the offering, not only for purposes of the bad actor rule but for compliance with other securities laws related to such consultants (http://www.procopio.com/news/the-risks-of-using-finders-to-raise-capital).

What are "Disqualifying Events"?

To be deemed a bad actor, a Covered Person must be subject to a "Disqualifying Event", as defined in Rule 506(d). These include:

- Criminal convictions within the last 10 years, or court orders, judgments or decrees entered into within the last 5 years either: (a) in connection with a securities transaction; (b) involving the making of any false filing with the SEC; 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;
- Final orders of a state securities, banking or insurance regulator, or a banking agency or the Commodity Futures Trading Commission, that either (a) bars the Covered Person from associating with an entity regulated by such authority, (b) engaging in the securities, banking or insurance business, or (c) engaging in savings association or credit union activities, or (d) constitutes an order based on violation of any law prohibiting fraudulent, manipulative or deceptive conduct within the last 10 years;
- SEC disciplinary orders that (a) suspend or revoke a Covered Person's registration as a broker, dealer or investment adviser, (b) limit the activities of the Covered Person, or (c) bar the Covered Person from being associated with any entity offering a "penny stock"; and
- Certain SEC cease-and-desist orders entered within the last 5 years;
- Suspension or expulsion from membership in a self-regulatory organization, such as FINRA;
- SEC refusal or stop order applicable to registration statements under the Securities Act; and
- False representation and other orders from the U.S. Postal Service.

As noted above, if a Covered Person is subject to a Disqualifying Event that occurred before September 23, 2013, the company is not prohibited from relying on Regulation D. However, the company must disclose to investors the identity of the Covered Person and the nature of the Disqualifying Event.

The SEC has provided an exception from disqualification when the company can 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. Based on recent guidance, companies engaged in private offerings should obtain a Certification and Agreement Regarding Disqualifying Events from each Covered Person in connection with the offering, each shareholder owning more than 20% of the company's stock, and each prospective investor that, upon closing of the funding, will own 20% or more of the Company's stock.

In certain circumstances, companies may seek a waiver from disqualification in the event a Covered Person is subject to a Disqualifying Event. If, before any sale is made in reliance on Regulation D, the authority responsible for the Disqualifying Event advises in writing that Rule 506(d) disqualification should not occur as a consequence of such Disqualifying Event, a company will likely obtain the necessary waiver. More generally, Rule 506(d)(ii) provides that disqualification "shall not apply… 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." The SEC has granted a waiver of disqualification thirteen (13) times since the adoption of Rule 506(d). In those instances, the positions most often taken by the companies were as follows:

- The Disqualifying Event was unrelated to a private offering of securities;
- Disqualification would have a material adverse impact on the company and other third parties;
- Remedial steps were and continue to be undertaken to address the conduct at issue; and
- The alleged misconduct was not a scienter (i.e., intent)-based violation.

John is the leader of the firm's Business and Technology Team and concentrates in the areas of corporate, securities, mergers and acquisitions and venture financing. John has significant experience in securities offerings, both public and private, and represents publicly-traded companies in capital raising, reporting and general business matters. His M&A experience includes representation of buyers and sellers in mergers, stock and asset purchases, joint ventures and related transactions. John acts as outside general counsel for numerous local companies.