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IMPORTANT INDUSTRY UPDATE

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"Bad Actor" Disqualification from Regulation D Exemptions

On September 23, 2013, an amendment to Rule 506 of Regulation D, concerning exemption from registration requirements for private placement offerings, went into effect. Colloquially referred to as the "bad actor" rule, the amendment potentially eliminates the private placement safe harbor if any "covered person" associated with the offering has been involved in a "disqualifying event." Importantly, the scope of possible disqualifications are potentially much broader than what might appear at first glance and could have major implications for broker-dealers, issuers and financial professionals involved in the sale of private placements.

Because a wide variety of technically-defined disqualifying events can trigger disclosure obligations and threaten the validity of an exemption from registration under Rule 506, anyone involved in the private placement market should be familiar with the complexities of these new rules.

I. What Acts Constitute Disqualifying Events?

The bad actor amendment encompasses a wide range of regulatory and judicial actions relating to the purchase, sale, and registration of securities, and not just those involving fraud or classic instances of "bad" intent. These include the following:[1]

- Felony or misdemeanor convictions within ten years of the relevant sale (or five years in the case of issuers, predecessors, and affiliated issuers): in connection with the purchase or sale of any security; involving the making of a 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 of purchasers of securities.

- Any court order, judgment, or decree within five years before the relevant sale, that is in effect at the time of such sale, that restrains or enjoins such person from engaging in any conduct or practice: in connection with the purchase or sale of any security; involving the making of a 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 of purchasers of securities.

[1] This Article summarizes, non-exhaustively, the relevant provisions of newly amended 17 C.F.R. § 230.506.

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- Any final order of a state securities commission (or similar agency or officer)[2] that:
    - At the time of the relevant sale, bars the person from: association with an entity regulation by such commission; engaging in the business of securities, insurance, or banking; engaging in savings association or credit union activities.
    - Constitutes a final order, entered within ten years before the relevant sale, based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct.[3]

- Certain orders of the SEC entered within the prior ten years that, at the time of the relevant sale: suspends or revokes a person's registration as a broker, dealer, municipal securities dealer, or investment adviser; places limitations on the activities, functions, or operations of such a person; or bars a person from being associated with any entity or from participating in a penny stock offering.

- Any order of the SEC within five years before the relevant sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of: any intent-based anti-fraud provision of the federal securities laws or using interstate communications concerning unregistered, non-exempt securities.

- Any current suspension or expulsion from membership in, or bar from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission constituting conduct inconsistent with just and equitable principles of trade.

- Other stop orders or temporary restraining orders relating to a Regulation A filing or a U.S. Postal Service false representation order.

As a review of this non-exhaustive summary shows, the range of disqualifying events varies, and the specific terms of each disqualification event differ slightly according to the nature of the event, and the body issuing the order. Furthermore, a number of these disqualifying events, such as state or federal bars from certain activities, or SEC "limitations" on the activities or operations of a person, do not necessarily stem from fraudulent behavior, but can arise from other regulatory or compliance violations. Furthermore, as to regulatory bars or limitations on a person's professional activities, those remain disqualifying events for as long as the bars have continuing effect or for so long as some act is prohibited or required to be performed according to the order's terms.[4]

The relevant time periods referenced in the "disqualifying events" definitions are measured from the date of the order, not the date of the underlying conduct leading to the order, and a

[2] There are additional non-securities regulatory bodies also listed in the Regulation.
[3] SEC guidance has stated that the rule does not specifically define "fraudulent, manipulative or deceptive conduct" and is not limited to matters involving knowing misconduct or scienter. Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings and Related Disclosure Requirements: A Small Entity Compliance Guide (September 19, 2013), available at: http://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide.htm.
[4] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings and Related Disclosure Requirements: A Small Entity Compliance Guide (September 19, 2013).

triggering event occurring after September 23, 2013 will be disqualifying even if the underlying conduct occurred before then.[5] As long as the sales occurred before September 23, 2013, they are not affected by the rule revisions even if the larger offering continues after the effective date. In other words, only sales made after the effective date are subject to the disqualification/disclosure provisions. However, any sales made after the effective date and after a disqualifying event will not be entitled to rely on the Rule 506 exemption without compliance with the rule's disclosure provisions.

II. Covered Persons or Entities Who May Trigger Disqualification from Exemption

The recent amendments also provide a long list of entities and persons who, if subject to one of the various orders discussed above, may disqualify an investment from exemption:

- The issuer, predecessor of the issuer, or any affiliated issuer;
- Any director, executive officer, other officer participating in the offering, or general partner or managing member of the issuer;
- Any owner of 20% or more of the issuer's outstanding voting equity securities measured by voting power;
- Any promoter connected with the issuer in any capacity at the time of sale;
- Any person who has been or will be paid, directly or indirectly, for solicitation of purchasers of such securities; and
- Any general partner or managing member of any such investment manager or solicitor, and any director, executive officer or other officer participating in the offering of such manager/solicitor participating.

Two categories of "covered persons" have significant ramifications for the securities industry. The first is "any person who has been or will be paid [] for solicitation." Although such language is subject to interpretation, broker-dealers and their registered representatives are "covered persons." The language of the amended rule does use the term "any person" who has or will be paid, even indirectly, and SEC guidance has suggested that even those not personally subject to registration requirements, including associated persons of broker-dealers, are considered covered solicitors.[6] SEC guidance further states that this category covers "any persons compensated for soliciting investors but will typically involve broker-dealers and other intermediaries."[7]

The second is "promoter," which Rule 405 in turn defines as any person or entity that directly or indirectly takes initiative in founding the business or enterprise of the issuer, or in

[5] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings and Related Disclosure Requirements: A Small Entity Compliance Guide (September 19, 2013).
[6] Question 260.17, published in 4D Tax-Advantaged Securities, Appendix F1.
[7] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings and Related Disclosure Requirements: A Small Entity Compliance Guide (September 19, 2013)

connection with the founding or organization receives 10% or more of any class of issuer securities (other than those received as underwriting commissions). The language "indirectly" means that the result does not change if there are legal intermediaries (who may also be promoters) between the person and the issuer.

III. Exceptions to Bad Actor Disqualification

There are only four circumstances in which the amendment will not apply to threaten an offering's exemption because of a disqualifying event of a covered person. Unless one of these four situations applies, the offering will be deemed to have lost its exemption from registration, exposing the issuer and others involved to regulatory action and civil liabilities, including possible rescission and disgorgement.

First, disqualification is not triggered if the conviction, order, judgment, decree, suspension, expulsion or bar occurred or was issued before September 23, 2013. However, for disqualifying events that occurred before September 23, 2013, the issuer shall furnish to each purchaser, a reasonable time prior to sale, a description in writing of the disqualifying matter (a "Bad Actor Disclosure," unless the issuer reasonably did not know of the existence of the undisclosed matter or matters, in which case the failure to provide such a disclosure will not prevent an issuer from relying on that safe harbor to avoid disqualification).

Second, disqualification is not triggered if the SEC determines that it is not necessary to deny an exemption, but upon a showing of good cause and without prejudice to any other action by the Commission. This is known as the "waiver" ground.

Third, no disqualification is triggered if, before the relevant sale, the court or regulatory authority entering the order advises in writing (either in the order itself or in a separate writing to the SEC) that disqualification should not arise as a result of the order, judgment, or decree. If the order or judgment itself contains this language, it is self-executing, and it is not necessary to seek an order from the SEC to the same effect.[8]

Fourth, disqualification is not triggered if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. An issuer will not be able to establish that it has exercised reasonable care unless it has made factual inquiry into the existence of any disqualifications. The nature, scope, and ultimate reasonableness of that factual inquiry will vary based on the facts and circumstances, including but not limited to the issuer and the other offering participants. We do not believe that the "exercise of reasonable care" exception applies to broker-dealers.

IV. Practical Considerations

First, this change in the law requires that firms (and investment sponsors) evaluate each person in the chain of sale to see if he or she has a disqualifying event and may need to make a Bad Actor Disclosure. This can be done in several ways, but we recommend seeking the advice of counsel on whether such disclosure is necessary and how to make the disclosure.

[8] Question 260.22, published in 4D Tax-Advantaged Securities, Appendix F1.

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Second, each firm should review its current registered representatives' regulatory histories and CRD records to see if any of them may be deemed Bad Actors, so going forward disclosure will be made prior to any private placements being sold. In addition to that, firms should consider requiring registered representatives to complete attestations that indicate that the CRD information is current and complete. It may or may not be sufficient to review CRD records for an individual registered representative, but a good starting point for this review would be to look at every representative's U-4s, U-5s and U-6s. Counsel can advise you regarding what rules you need to put in place to make sure that this rule is comprehensively adhered to and what additional review would be required, in addition to preparing any Bad Actor disclosures if they are necessary.

Third, if a firm or registered representative is currently under investigation by any regulator or involved in litigation, it is imperative that if the matter settles, exculpatory language indicating that the settlement is not intended to serve as a basis for disqualification is included in any settlement or final order. The negotiation regarding including or excluding this language may be the difference between a decision to settle or to litigate the charges.

Fourth, in terms of retaining or "on boarding" any new registered representatives, a firm should determine what additional background checks and public records searches are necessary to ensure compliance with this rule.

Fifth, to the extent that a firm may have inadvertently violated the rule by selling a private placement without making the appropriate disclosure, that party should seek counsel on the best way to remediate the problem. The cost of failure to remediate could be significant since the entire investment may lose its exemption and be subject to rescission, which potentially could give rise to (a) liability to customers or any losses they suffered plus interest; and (b) indemnity to any sponsors. In general, it is our view that remediating in current favorable market conditions may be a much better approach then waiting to see what happens. Moreover, being pro-active about remediation will benefit the sponsors with whom the firm does business.

Sixth, the Bad Actor disclosures are going to require documentation between issuers and broker-dealers. Broker-dealers should ensure that uniform disclosure documents are prepared and implemented and that their written supervisory procedures are modified to incorporate the process for ensuring compliance. In addition, broker-dealers' disclosure and attestation forms should be comprehensive, covering all disclosure requirements or disqualification events during the relevant time periods. Broker-dealers also should determine what level of independent verification is necessary beyond representations of the participants. This is especially important for broker-dealer firms because, as discussed above, unlike the sponsors, they do not have the benefit of a good faith defense to the failure to comply.

V. Litigation Related Risks

The revisions to Rule 506 give rise to additional bases for investors to invoke their rescission remedy when they are unhappy with their investment. The effect of rescission would be to undo any transactions and return the investment to the sponsor and the funds to the investor plus interest. Depending on the amount of the offering, and the invested amounts, this could have devastating impact on a firm. We anticipate that there will be solicitation of potential claimants or plaintiffs by plaintiff-side law firms relating to these new rules.

Secondly, in existing litigation, these new rules will give Claimants a compelling argument that they are entitled to obtain all regulatory matters addressed by a firm or its registered representatives going back 10 years. For example, if an investor who buys an investment after September 2013 alleges that a private placement is unsuitable and unregistered with no exemption, that investor is arguably entitled to discovery for (a) all potential disqualifying events going back 10 years for the broker-dealer; (b) all potential disqualifying events for the registered representative involved in the sale going back 10 years; and (c) all disqualifying events for any other registered representative who sold the same investment going back 10 years. In addition to that we would expect discovery to be directed to the sponsor and other broker dealers who sold the same investment to determine if the requirements of the exemption were met. Firms need to be prepared for this additional level of discovery as a result of these developments.

VI. Conclusion

The recent "bad actor" amendments establish categories of broadly-defined "covered persons" who can invalidate exemptions under Regulation D and trigger registration or rights to rescission. Numerous individuals involved in the private placement process can trigger disclosure obligations or disqualification from exemption and each triggering event is subject to its own particular terms and time periods. The "bad actor" amendments raise a host of new questions and implications for financial professionals engaged in settlement negotiations before courts and regulatory agencies. Those subject to past orders should likewise examine such orders to determine the implications for current offerings.

Anyone who would like additional information or guidance about navigating the issues discussed in this article should feel free to contact us.

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