Rule 506 “Bad Actor” Disqualification Provisions

Teleconference

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Presenter:

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1. Presentation


The Disqualification Provisions of Regulation D

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Although the aspect of the JOBS Act that has received the most attention relates to changes to the IPO process, in large measure, the JOBS Act related changes affecting the private market may be more significant:

- Title V and Title VI changes to the Exchange Act Section 12(g) threshold
- Changes to Rule 506
- Legal certainty for matchmaking platforms

Taken together, these measures have the effect of permitting companies to stay private longer and to rely on exempt offerings (while enabling companies to contact a broader range of potential investors) for their capital-raising.
Even pre-JOBS Act, based on various studies, it was already the case that more capital was being raised in reliance on Regulation D and Rule 144A (in aggregate) than in SEC-registered offerings—according to the SEC’s Division of Economic Research and Analysis (DERA), in 2014, for example, the total raised in registered offerings was $1.35 trillion whereas the total raised through all private offerings was more than $2.0 trillion.

- Amounts for private offerings are likely to be understated given that many issuers fail to file Form Ds and amounts raised in 4(a)(2) offerings are not reported.
- The amounts raised in registered offerings include debt offerings, whereas the majority of Reg D offerings involve equity or “new capital.”
- These trends are likely to have become more pronounced since 2014.
• Many companies that were able to deregister following the JOBS Act have done so
  • Since the JOBS Act, approximately 90 banks have deregistered
  • These banks will now have to rely on private or exempt offerings in order to raise capital going forward
• Companies are choosing to defer their IPOs and rely on private financing for much longer than in the past
  • This is evident from various IPO reports
  • For example, based on statistics for the period from 1/1/12 through 9/30/15, the median market cap for IPO issuers was approximately $386 million, and the average was $1.4 billion
  • Fewer than 2.5% of IPO issuers have a market cap of $50 million or less
- CB Insights reports that in 2015 global private companies raised $90 billion from investors (an increase of 26% over 2014)
- Looking at the tech sector, U.S. venture-backed tech companies have raised more capital in the private market ($51 billion) than the public market ($6 billion) in 2015 (*CB Insights*)
- The number of tech IPOs in 2015 declined to 22
Recent high profile pre-IPO private placements

- Palantir: $500M
- Airbnb: $1.5B
- Spotify: $526M
- SpaceX: $1.0B
- Pinterest: $367M
- Snapchat: $537M
- Uber: $2.8B
- Dropbox: $350M
- FanDuel: $275M
- DraftKings: $300M
There may be a variety of different motivations for a late stage or pre-IPO private placement:

- Company may want to defer IPO and need to raise additional capital prior to the IPO.
- Company may want to take out early friends and family and angel investors and “clean up” balance sheet or provide partial liquidity for longstanding holders.
- Company may want to bring in strategic investors.
- Company may be advised that it should prepare itself for the IPO by gaining support and validation from key sector investors that are opinion leaders.
- Company and bankers may want to “de-risk” IPO by bringing in cross-over investors that will also invest in the IPO.
- Company may be advised that an up round will make higher IPO pricing easier for IPO investors to accept.
- May be quite sector dependent.
Bad Actor Rules
Unlike Rule 505 of Regulation D, Regulation E and Regulation A, Rule 506 of Regulation D historically did not contain “bad actor” disqualification provisions.

In May 2011, the SEC proposed amendments to rules promulgated under Regulation D to implement Dodd-Frank Act Section 926’s provision regarding the “bad actors” for Regulation D.

Final bad actor rule was adopted in conjunction with the adoption of final rule relating to Rule 506 offerings; the rule became effective September 2013.
“Bad Actor” Disqualification (cont’d)

- The amendment added a new Section 506(d) to Regulation D.
- This section encompasses disqualification provisions that are substantially similar in their effect to the bad actor disqualification provisions that are codified in Rule 262 of Regulation A and Rule 503 of Regulation CF (crowdfunding).
- The provisions are applicable only in the context of Rule 506 offerings.
- Applicable to Rule 506, whether or not general solicitation is used under Rule 506(c).
- Not applicable to a Section 4(a)(2) private placement.
- Section 4(a)(7) of the Securities Act is not available if a seller or any compensated solicitor is subject to an event that would disqualify an issuer under Rule 506(d)(1).
The disqualification provisions apply to the following “covered persons”:

- The issuer and any predecessor of the issuer or affiliated issuer;
- Any director, executive officer, other officer participating in the offering process, general partner, or managing member of the issuer;
- Any beneficial owner of 20 percent or more of any class of the issuer’s voting equity securities, calculated on the basis of voting power;
- Any investment manager to an issuer that is a fund and any director, executive officer, officer participating in the offering, general partner, or managing member of the manager, as well as any director, executive officer or officer participating in the offering of any such general partner or managing member;
- Any promoter connected with the issuer in any capacity at the time of the sale;
- Any person that has been or will be paid, directly or indirectly, remuneration for solicitation of purchasers in a securities offering; or
- Any director, executive officer, other officer participating in the offering, general partner, or managing member of any compensated solicitor.
Affiliated Issuers

• an affiliate of the issuer that is issuing securities in the same offering, including offerings that are subject to integration under Rule 502(a) of Regulation D

• this would encompass the guarantor for an issuance of a guaranteed debt security

Pre-affiliation disqualification events

• 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
  • in control of the issuer or
  • under common control with the issuer by a third party that was in control of the affiliated entity at the time of the relevant events
What does “participation in an offering” mean?

- Must be more than transitory or incidental involvement
  - participation or involvement in due diligence activities;
  - involvement in the preparation of disclosure documents;
  - providing structuring or other advice, and
  - communication with the issuer, prospective investors or other offering participants

- Participation in an offering is not limited to solicitation of investors

- These activities are not participation in an offering:
  - administrative functions, such as opening brokerage accounts, wiring funds and bookkeeping activities
  - persons whose sole involvement with an offering is as members of a compensated solicitor’s deal or transaction committee that is responsible for approving the entity’s participation in the offering
Voting Equity Securities

• The original standard:
  • In the adopting release, the SEC declined to adopt a bright line definition of the term “voting equity securities.” Rather, they stated that the term turned on “whether securityholders have or share the ability, either currently or on a contingent basis, to control or significantly influence the management and policies of the issuer through the exercise of a voting right.”

• The revised bright line standard consistent with the definition of “voting securities” in Rule 405 of the Securities Act, March 2015:
  • “Voting equity securities,” for purposes of Rule 506(d)(1), Rule 505 and Rule 262(a) of the Securities Act, include only those voting equity securities which, by their terms, currently entitle the holders to vote for the election of directors. The right to vote must be presently exercisable.
  • To clarify any confusion over the extinct “control or significantly influence” standard, the SEC stated that “‘voting equity securities’ should be interpreted based on the present right to vote for the election of directors, irrespective of the existence of control or significant influence.”
Beneficial Ownership

- The term “beneficial owner,” as used in Rule 506(d), is interpreted the same way as under Rule 13d-3 under the Securities Exchange Act of 1934; beneficial ownership includes both direct and indirect interests, determined as under Rule 13d-3
- Consequently, one must look through entities to their controlling persons
- If there is 20% beneficial ownership of the issuer’s voting equity securities by shareholders that have formed a group, the disqualification or disclosure obligations will apply to triggering events that apply only to the group itself, assuming that no member of the group is a 20% beneficial owner
  - Here, the SEC used the example of a group being formed by means of a voting agreement. If any party to the voting agreement has or shares power to vote or direct the vote of shares beneficially owned by other parties to the agreement, then beneficial ownership of such shares will be attributed to that party
  - In those circumstances, one would look not only at the group itself, but also through the group to the parties to the voting agreement and determine whether any such party is a 20% beneficial owner due to such aggregated voting power and whether that party is subject to a disqualification event
Disqualifying Events

The rule includes the following categories of disqualifying events

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state regulators (such as securities, banking, and insurance) and federal regulators;
  - The CFTC was added to the list of regulatory agencies;
  - A definition of “final order” was added to Rule 501
- SEC 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”);
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders
What types of criminal convictions are disqualifying events?

- 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 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.

- 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.

- Orders and judgments occurring outside of the United States imposed by non-U.S. regulators are not disqualifying events.
What types of injunctions and restraining orders are disqualifying events?

Rule 506(d)(1)(ii) provides that any order, judgment or decree of any court of competent jurisdiction, entered within five years before the sale, that, at the time of the sale, restrains or enjoins that person from engaging in or continuing 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 business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities
Rule 506(d)(1)(iii) 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 similar 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 similar functions);
- an appropriate federal banking agency;
- the CFTC; or
- the National Credit Union Administration.
• The order must be final, and
• at the time of the sale, bars the person from
  • association with an entity regulated by that commission, authority, agency or officer;
  • engaging in the business of securities, insurance or banking; or
  • engaging in savings association or credit union activities; or
• 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 that sale
What is a final order?

- 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 FINRA definition set forth in FINRA’s forms.
- 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 the disqualification provisions to matters involving scienter.
What is a disqualifying SEC order?

- Rule 506(d)(1)(iv) will also disqualify a Covered Person if that person is subject to an order under Section 15(b) or 15B(c) of the Exchange Act, or Section 203(e) or (f) of the Investment Advisers Act, that, at the time of the offering:
  - suspends or revokes the person’s registration as a broker, dealer, municipal securities dealer or investment adviser;
  - places limitations on the activities, functions or operations of that person; or
  - bars that person from being associated with any entity or from participating in the offering of any penny stock.
• Under Rule 506(d)(1)(v), an offering will be disqualified if any covered person is subject to any order of the SEC entered within five years before the sale that, at the time of the sale, orders the person to cease and desist from committing or causing a future violation of:
  • any scienter-based anti-fraud provision of the federal securities laws, including Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, Section 15(c)(1) of the Exchange Act and Section 206(1) of the Investment Advisers Act, or any other rule or regulation thereunder; or
  • Section 5 of the Securities Act
• 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
Does suspension or expulsion from SRO membership or association with an SRO member constitute a “Disqualifying Event”?

- 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
- What types of other orders will result in a disqualification?
- Under Rule 506(d)(vii), a Covered Person will be disqualified if that person has filed (as a registrant or an issuer) or was named as an underwriter in a registration statement or Regulation A offering statement filed with the SEC that, within five years before the sale was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued
Rule 506(d)(2)(i) provides that disqualification will not arise as a result of events that occurred prior to September 23, 2013.

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 these disclosures will not be an “insignificant deviation” as contemplated by Rule 506; consequently, relief under that rule will not be available for the failure.
- Unlike some of the other aspects of the disqualifying provisions, the disclosure provisions are not subject to the potential for waivers.
- The SEC has indicated that Rule 506(e) does not require disclosure of past events that would no longer trigger a disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years prior to an offering.
The final rule contains a reasonable care exception that applies 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 issuer would need to conduct a factual inquiry; the SEC notes that the type of inquiry will depend on the facts and circumstances.

The SEC did not prescribe particular steps as being necessary or sufficient to establish reasonable care.

However, the SEC has noted 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.
Satisfying Reasonable Care Burden

• Issuers must implement new procedures in connection with any Rule 506 offering
  • This may be especially burdensome for private funds that regularly conduct private offerings in reliance on Rule 506
• When is an issuer required to determine whether a disqualification event applies?
• Issuers must determine if they are subject to bad actor disqualification any time they are offering or selling securities in reliance on Rule 506
• An issuer may reasonably rely on a covered person’s agreement to provide notice of a potential or actual bad actor triggering event pursuant to, for example, contractual covenants, bylaw requirements, or an undertaking in a questionnaire or certification
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.

The SEC has not identified a specific timeline.

Issuers may consider:

- Adding additional questions to D&O questionnaires
- Requiring placement agents to complete a questionnaire or provide a representation
- Requiring other participants (that may be covered persons) to complete questionnaires or provide representations
- For funds or other issuers engaged in continuous or delayed offerings, refreshing or updating their diligence
To address these issues, placement agents should:

- If in a continuous offering program, including an issuer covenant in the placement agent agreement to the effect that the issuer has exercised reasonable care to determine whether any covered person is subject to a bad actor disqualification;

- The issuer will notify the placement agent in writing of any bad actor disqualification relating to any covered person, or any event that would, with the passage of time, become such a disqualification event; and

- Include in the placement agent agreement an issuer covenant to periodically update its factual inquiries of any covered persons.
Prior to any Rule 506 offering, conduct 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 determine whether the new representations described above can be made; and

Review Forms U-4, U-5 and U-6 filed with FINRA and compare any events described in those forms to the applicable disqualifying events, in preparation for the possibility of either disclosing those events as pre-effectiveness disqualifying events or to confirm compliance with any of the new representations described above

Note that some of the events in Forms U-4 and ADV may not be disqualifying events under Rule 506, and some of the Rule 506 disqualifying events are not covered by those forms
If a placement agent or one of its covered control persons becomes subject to a disqualifying event while an offering is still ongoing, could the issuer continue to rely on Rule 506 for that offering?

- Yes. The issuer could rely on Rule 506 for future sales in that offering if the engagement with the placement agent was terminated and the placement agent did not receive compensation for the future sales.
- Or, if the triggering disqualifying event affected only the covered control persons of the placement agent, the issuer could continue to rely on Rule 506 for that offering if those persons were terminated or no longer performed roles with respect to the placement agent that would cause them to be covered persons for purposes of Rule 506(d).
If a Covered Person is a disqualified person, are waivers available?

- Yes, upon a showing of good cause
- The SEC published its standards for granting these waivers on its website: http://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml

Waivers will also apply 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 SEC or its staff) that disqualification under Rule 506(d)(1) should not arise as a result of that order, judgment or decree.
What factors will the SEC consider in evaluating whether a party seeking a waiver under Rule 506(d)(ii) has shown good cause that it is not necessary under the circumstances that the exemption provided by the rule be denied:

The SEC will consider the *nature of the conviction or violation* giving rise to the disqualification, and will ask the following questions:

- Was the offer or sale of securities involved?
- Was the violation a criminal conviction or a scienter based violation, as opposed to a civil or administrative non-scienter based violation?
- If the violation was a criminal or a scienter based violation involving the sale of securities, the burden on the party seeking a waiver is greater
The SEC also will consider the following factors in determining the **applicant’s fitness to participate in exempt offerings**:

- **Who was responsible** for the misconduct?
  - Is the party seeking the waiver the bad actor?
  - If so, does the bad actor continue to exert control over the operations of the applicant?
  - Does the misconduct reflect more broadly on the applicant as a whole?
    - Were warning signs ignored?
    - Did the “tone at the top” of the applicant ignore, condone or encourage the misconduct?
    - Did actions or omissions by the applicant or its affiliates obstruct the regulatory or law enforcement investigation?
  - Has the applicant removed the parties involved in the misconduct?
    - Removal of the bad actors would work in favor of the waiver request
• What was the duration of the misconduct?
  • Was the misconduct an isolated incident or did it occur over an extended period of time?
• What remedial steps have been taken?

• How do the remedial steps relate to the applicant’s ability to prevent future misconduct and future harm to investors, clients or customers?
  • When did the remedial steps begin?
  • Are the remedial steps likely to prevent a recurrence of the misconduct and mitigate the possibility of future violations?
  • Has there been a change in control of the applicant?
  • Are the bad actors still employed by the applicant?
  • Have the applicant’s training, policies, practices and procedures been improved?
• What is the **impact on the applicant if the waiver is denied?**
  • What would be the severity of the impact of denying the waiver request on the issuer or third parties, such as investors, clients or customers?
  • The SEC will weigh any such impact against the facts and circumstances relating to the misconduct to assess whether disqualification would be a disproportionate hardship in the light of the parties involved in, and the nature of, the misconduct.
Common themes for waivers that were granted before the SEC published its new standards:

- None of the disqualifying events had to do with a Regulation D offering;
- The applicants had already paid fines to the SEC in connection with the disqualifying events pursuant to the relevant order or judgment;
- Some of the applicants had neither admitted nor denied the allegations in the order or judgment, or stipulated to some, but not all, of the facts therein;
- Most of the applicants took remedial action to address the alleged behavior;
- Disqualification from the use of Rule 506 would adversely and disproportionately affect the applicant and third parties, such as affiliates of an issuer for which Rule 506 would be unavailable and, for placement agents, potential clients/issuers contemplating Rule 506 offerings; and
- For a period of five years from the date of the judgment or order, the applicants agreed to furnish to potential investors a written description of the judgment or order a reasonable time prior to any sale.
Certifications As To Disqualifications

Must an issuer certify that it is not subject to the disqualification provisions?
  • The signature block of current Form D contains a certification that applies to transactions under Rule 506, confirming that the offering is not disqualified from reliance on Rule 506
Rule 506 is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D.

Traditional requirements of a Rule 506 private placement include:

- No dollar limit on size of transaction.
- Unlimited number of accredited investors and no more than 35 unaccredited investors.
- No general solicitation or advertising (the prohibition against general solicitation has been eliminated for 506(c) offerings).
- Resale limitations.
- Disclosure required for non-accredited investors.
- Form D filing within 15 days of first sale of securities.
- Good faith effort to comply (Rule 508).
“Traditional” Rule 506 offering

**Amount of offering:** unlimited

**By?** Rule 506(b) can be used by reporting and non-reporting issuers, so long as issuer and other covered persons are not subject to bad actor disqualification

**Who can invest?** Accredited investors and a limited number of non-accredited investors; in practice, offerings are limited to accredited investors

**What is the investor cap?** None.

**Is an intermediary required?** Not technically required; however, given that the issuer cannot use general solicitation or general advertising, the issuer could raise capital from investors with whom it has a pre-existing substantive relationship

**Manner of offering:** the offering cannot involve general solicitation

**Reporting following the offering:** filing of a Form D
• **Bad actor disqualification:** the issuer will be required to obtain information from all covered persons

• **Documentation:** there may or may not be an offering memorandum; the investors will sign a securities purchase agreement with the issuer; each investor will make payment to the issuer directly generally

• **State blue sky:** securities sold pursuant to Rule 506(b) are “covered securities” – but notice filings and fees may apply
Many “matchmaking portals” rely on Rule 506(b) to conduct internet-based offerings solely to accredited investors.

These offerings are structured such that the matchmaking portal makes an offer only to accredited investors with which the portal has established or has a pre-existing substantive relationship.

Issuer specific or offering specific information is not generally available and is made available only to “members” or on a password-protected basis to those investors known to the portal.

An accredited investor crowdfunded offering relies on the guidance provided in pre-JOBS Act no-action letters (IPONet, Lamp Technologies, etc.) and affirmed recently in C&DIs on general solicitation, as well as in a recently issued no-action letter, CitizensVC.
Rule 506(c) permits the use of general solicitation, subject to the following conditions:

- The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
- All purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and
- The conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied
- Reasonable steps to verify investor status
• Principles-based guidance includes a list of factors to consider:
  • *The nature of the purchaser.* The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities
  • *The nature and amount of information about the purchaser.* Simply put, the SEC states that “the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa”
  • *The nature of the offering.* The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status, *i.e.*, issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or email

*Rule 506(c), cont’d.*
Final rule does not provide for a safe harbor; however, it does set out a supplemental non-exclusive list of methods that may be used to satisfy the verification requirement, including:

- A review of IRS forms for the two most recent years and a written representation regarding the individual’s expectation of attaining the necessary income level for the current year;
- A review of bank statements, brokerage statements, tax assessments, etc. to assess assets, and a consumer report or credit report from at least one consumer reporting agency to assess liabilities;
- A written confirmation from a registered broker-dealer, RIA, CPA, etc.
- For existing investors (pre-506(c) effective date), a certification
• **Amount of offering:** unlimited

• **By?** Rule 506(c) can be used by reporting and non-reporting issuers, so long as issuer and other covered persons are not subject to bad actor disqualification

• **Who can invest?** Accredited investors only

• **What is the investor cap?** None

• **Is an intermediary required?** Not technically required; easier for an issuer to conduct a Rule 506(c) offering on its own

• **Manner of offering:** involves general solicitation

• **Reporting following the offering:** filing of a Form D

• **Bad actor disqualification:** the issuer will be required to obtain information from all covered persons

• **Documentation:** there may or may not be an offering memorandum; the investors will sign a securities purchase agreement with the issuer; each investor will make payment to the issuer directly generally

• **State blue sky:** securities sold pursuant to Rule 506(b) are “covered securities” – but notice filings and fees may apply
Weeding Out Bad Actors: The Rule 506 Bad Actor Provisions and Capital Markets Practice – One Year Later

As we approach the anniversary of the effectiveness of the Rule 506 bad actor provisions (if you don’t happen to have it marked on your calendar, the new rules went into effect on September 23, 2013), it is a good time to survey how issuers and placement agents have adapted in response to the new rules.

Since the new rules became effective, the Securities and Exchange Commission Division of Corporation Finance has issued several sets of Compliance and Disclosure Interpretations (C&DI 260.14 – 260.32). Some of the C&DI is applicable to Rule 506 continuous offering programs.

The Compliance and Disclosure Interpretations

For example, C&DI 260.14 states, in part:

When is an issuer required to determine whether bad actor disqualification under Rule 506(d) applies?

**Answer:** Rule 506(d) disqualifies an offering of securities from reliance on a Rule 506 exemption from Securities Act registration. Issuers must therefore determine if they are subject to bad actor disqualification any time they are offering or selling securities in reliance on Rule 506... An issuer may reasonably rely on a covered person's agreement to provide notice of a potential or actual bad actor triggering event pursuant to, for example, contractual covenants, bylaw requirements, or an undertaking in a questionnaire or certification. However, 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.

A placement agent in a continuous offering program should consider including an issuer covenant in the placement agent agreement to the effect that the issuer has exercised reasonable care to determine whether any covered person is subject to a bad actor disqualification, and that the issuer will notify the placement agent in writing of any bad actor disqualification relating to any covered person, or any event that would, with the passage of time, become such a disqualification event. The placement agent may wish to include in the placement agent agreement an agreement that the placement agent will provide a written representation to the issuer that they have received a satisfactory disqualification status update.

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1 The Compliance and Disclosure Interpretations can be found at: http://www.mofo.com/~/media/Files/Articles/140915CDI2601432Rule506BadActor.pdf.
agreement an issuer covenant to periodically update its factual inquiries of any covered persons. Similarly, the
issuer may want to include a mirror representation from the placement agent regarding periodic inquiries of any
of the placement agent’s covered persons.

The timing of periodic updates by an issuer or a placement agent in a continuous offering program remains open;
the SEC has not, and probably will not, identify a specific timeline. The SEC previously stated that “[t]he
timeframe for inquiry should also be reasonable in relation to the circumstances of the offering and the
participants.”2

Despite careful diligence by an issuer of its covered persons, there may be times during a continuous offering
program when the issuer discovers that a covered person is subject to a disqualification. If, despite the exercise of
reasonable care, the issuer was unable to determine the existence of a disqualifying event or that a particular
person was a covered person, or initially reasonably determined that the person was not a covered person but
subsequently learned that that determination was incorrect, then the reasonable care exception of
Rule 506(d)(2)(iv) will be available for the issuer. The issuer must then consider what steps are appropriate upon
discovery of the Rule 506 disqualifying event. The SEC suggested that those steps might include seeking waivers
of disqualification, termination of the relationship with the covered person or persons, providing Rule 506(e)
disclosure, or taking other remedial steps to address the disqualification to ensure that the Rule 506 exemption
will remain available.3,4

Many continuous offering programs have multiple placement agents. Any of those agents may have agreements
with other registered dealers to place the securities. Not all of these agents and dealers may be involved with a
particular placement of the issuer’s securities. At a reasonable time prior to the sale of the securities, the issuer
must determine which agents and dealers will be involved in the sale. If any of these agents and dealers were the
subject of any matters that would have disqualified them from using Rule 506 prior to the effectiveness of Rule
506(d) (i.e., prior to September 23, 2013), then Rule 506(e) disclosure must be made to all investors in the
offering – whether or not they purchased the securities from the issuer through the particular agent or dealer that
is the subject of the disclosure. No disclosure of such pre-effective bad actor events relating to a placement agent
on the program that is not involved in the offering need be made to investors in that offering.5

Other valuable guidance was provided by the new C&DI s, some of which is summarized below:

- An “affiliated issuer,” for purposes of Rule 506(d), is an affiliate (as defined in Rule 501(b)) of the issuer
  that is issuing securities in the same offering, including offerings subject to integration pursuant to Rule
  502(a).6

- Persons whose sole involvement with a Rule 506 offering is as members of a compensated solicitor’s deal
  or transaction committee that is responsible for approving such compensated solicitor’s participation in
  the offering are not “participating” in a Rule 506 offering, for purposes of Rule 506(d)(1).7

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2 Release 33-9414 (July 10, 2013) (the “Adopting Release”) at 67. The Adopting Release is available at:
3 See C&DI 260.23
4 A detailed discussion of the types of provisions that should be added to placement agent agreements for Rule 506 offerings,
and other suggested diligence actions to be conducted as part of a program to ensure compliance with Rule 506, can be found
Items for Issuers and Placement Agents.”
5 See C&DI s 260.26-27
6 See C&DI 260.16
7 See C&DI 260.18
• Actions taken in jurisdictions other than the United States, such as convictions, court orders, injunctions in a foreign court, or regulatory orders issued by foreign regulatory authorities will not trigger a disqualification under Rule 506(d).8

• Rule 506(e) does not mandate disclosure of past events that would no longer trigger a disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years prior to an offering or a ban that is no longer in effect at the time of the offering.9

• A shareholder that becomes a 20% beneficial owner of the issuer’s voting equity securities upon completion of the sale of securities in a Rule 506 offering is not a 20% beneficial owner at the time of the sale, for purposes of determining who is a covered person with respect to that offering.10

• The term “beneficial owner,” as used in Rule 506(d), is interpreted the same way as under Rule 13d-3 under the Securities Exchange Act of 1934; beneficial ownership includes both direct and indirect interests, determined as under Rule 13d-3. Consequently, one must look through entities to their controlling persons.11

• If there is 20% beneficial ownership of the issuer’s voting equity securities by shareholders that have formed a group, the disqualification or disclosure obligations will apply to triggering events that apply only to the group itself, assuming that no member of the group is a 20% beneficial owner. Here, the SEC used the example of a group being formed by means of a voting agreement. If any party to the voting agreement has or shares power to vote or direct the vote of shares beneficially owned by other parties to the agreement, then beneficial ownership of such shares will be attributed to that party.12 In those circumstances, one would look not only at the group itself, but also through the group to the parties to the voting agreement and determine whether any such party is a 20% beneficial owner due to such aggregated voting power and whether that party is subject to a disqualification event.13

There are still some open issues relating to Rule 506(d) offerings that have not been addressed by the new C&DI's. For example:

**Matchmaking portals.** Are operators of matchmaking portals compensated solicitors subject to the disqualification provisions?

• Most likely not, if they are not receiving transaction-based compensation. Section 4(b)(1) of the Securities Act of 1933 provides an exemption from broker-dealer registration for persons operating what is commonly known as a matchmaking portal for Rule 506 offerings of securities to accredited investors, provided, among other requirements, that those persons receive no compensation in connection with the purchase or sale of such securities. In C&DI 260.17, the SEC noted that compensated solicitors are not limited to brokers who are subject to registration under Section 15(a)(1) of the Exchange Act. The SEC stated that “all persons who have been or will be paid, directly or indirectly, remuneration for solicitation

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8 See C&DI 260.20
9 See C&DI 260.25
10 See C&DI 260.28
11 See C&DI 260.29 and 260.30
12 The SEC stated, in another C&DI, that “in order for one party to the voting agreement to be treated as having or sharing beneficial ownership of securities held by any other party to the voting agreement, evidence beyond formation of the group under [Exchange Act] Rule 13d-5(b) would need to exist.” See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting C&DI 105.06.
13 See C&DI 260.31. The beneficial ownership rules should be carefully analyzed in more complicated situations, such as determining whether investment advisers to multiple funds or to a fund of funds, or certain trusts, depending on their structure, are subject to a disqualification event.
of purchasers are covered by Rule 506(d), regardless of whether they are, or are required to be registered under ... Section 15(a)(1) ....”14 Although not directly addressed by the SEC, it appears that a matchmaking portal that satisfies the exemption from broker or dealer registration provided by Section 4(b)(1) of the Securities Act could not be operated by a person that is a compensated solicitor with respect to the subject offering.

Diligence by placement agents. Most of what the SEC has said about diligence procedures is in the context of a reasonable investigation by the issuer. In the Adopting Release, the SEC stated that they anticipated that “financial intermediaries and other market participants will develop procedures for assisting issuers in gathering the information necessary to satisfy the issuer’s factual inquiry requirement.”15

- It seems reasonable that placement agents and other compensated solicitors in a Rule 506 offering should be able to rely on the same sources of information used by the issuer in making its factual inquiry. The SEC’s advice in C&DI 260.14 (discussed above), that an issuer’s reliance on a certification is reasonable, should also cut in favor of a placement agent or other compensated solicitor relying on a periodic certification by any of its directors, executive officers or other officers participating in the offering, its general partner or managing member (if so structured), or any director, executive officer, or other officer participating in the offering of such general partner or managing member.

Rule 506(d)(2)(ii) Waiver of Disqualification

Since September 23, 2013, the SEC has granted a number of waivers from the disqualification provisions of Rule 506(d) upon a showing of good cause.16 The issuers and placement agents receiving waivers were subject to various SEC orders or judgments described in Rule 506(d)(1)(ii) or (iv), or, in one case, plead guilty to a felony or misdemeanor described in Rule 506(d)(1)(i). Each of those actions constituted a disqualifying event under Rule 506(d)(1). Waivers are granted under Rule 506(d)(2)(ii).

The arguments presented in the waiver requests have common themes:

- None of the disqualifying events had to do with a Regulation D offering;
- The applicants had already paid fines to the SEC in connection with the disqualifying events pursuant to the relevant order or judgment;
- Some of the applicants had neither admitted nor denied the allegations in the order or judgment, or stipulated to some, but not all, of the facts therein;
- Most of the applicants took remedial action to address the alleged behavior;
- Disqualification from the use of Rule 506 would adversely and disproportionately affect the applicant and third parties, such as affiliates of an issuer for which Rule 506 would be unavailable and, for placement agents, potential clients/issuers contemplating Rule 506 offerings; and

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14 See C&DI 260.17
15 Adopting Release at 68.
16 The waivers can be found at http://www.sec.gov/divisions/corpfin/cf-noaction.shtml under “Section 3(b) – Rules 262 and 505 Disqualification” commencing on November 25, 2013. These waivers also covered disqualifications under Regulation A and Rule 505.
For a period of five years from the date of the judgment or order, the applicants agreed to furnish to potential investors a written description of the judgment or order a reasonable time prior to any sale.\textsuperscript{17}

In each case, the Commission granted the waiver request and did not disqualify the applicant from the use of the Rule 506 exemption.

Some large financial institutions that service hedge funds have made the argument in their waiver applications that a disqualification from future Rule 506 offerings would disproportionately harm them and their clients. Absent a waiver, these institutions would be shut out from acting as placement agents for hedge funds for which they act as placement agents. For example, one large financial institution had launched over 20 hedge funds that rely on Rule 506 for continuous offerings through that institution.\textsuperscript{18}

Another large financial institution was recently barred from offering private equity and hedge fund investments to its clients. There, the bank was the victim of bad timing that caused the result of the original conduct to be bounced from what would have been just a disclosure obligation of past acts under Rule 506(e) to an outright disqualification event. The original “bad acts” occurred in 2006-2007 and had to do with selling collateralized debt obligations. The bank had reached a settlement with the SEC in 2011, which was rejected by the Southern District of New York. The Second Circuit overturned the district court in August 2014, resulting in the SEC disqualifying the bank from using Rule 506. If the district court had accepted the original settlement in 2011, which was prior to the effectiveness of the bad actor amendments, the bank would not have been disqualified and would have had to disclose the pre-effective bad acts to investors. This run of circumstances may be a factor in favor of the bank if the SEC grants a waiver from disqualification.\textsuperscript{19}

At the present time, the SEC has not issued any written standards regarding waivers or what constitutes a showing of good cause. In the adopting release for the Rule 506 amendments, the SEC stated that “it would be premature to attempt to articulate standards for granting waivers, although we may consider doing so ....”\textsuperscript{20} The SEC put forth a non-exhaustive list of circumstances that could be relevant to a waiver request: “a change of control, change of supervisory personnel, absence of notice and opportunity for hearing, and relief from a permanent bar for a person who does not intend to apply to reassociate with a regulated entity ....”\textsuperscript{21}

In a recent letter to The Honorable Sherrod Brown, SEC Chair Mary Jo White stated that a written policy statement regarding waivers under Rule 506 is currently under consideration by the staff, and that the staff is also completing a formal written policy setting forth the factors that it considers in determining whether good cause has been shown to grant relief from disqualifications that may arise under Regulation A, Rule 505 or 506.\textsuperscript{22}

Other Regulatory Schemes – Overlap, Harmony and Dissonance

Placement agents and other compensated solicitors will have on file various forms, such as FINRA Form U4 and Form ADV, which require disclosure by their employees and others of “bad acts” similar to those that may

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\textsuperscript{17} This disclosure is required under Rule 506(e) for bad acts that would have been disqualifications under Rule 506(d), but occurred prior to September 23, 2013. Rule 506(e) does not have a look-back limitation. Rule 262 of Regulation A and Rule 505 do not have an analogous provision.


\textsuperscript{19} See “Bad actor rule is a ‘big deal’ for hedge funds,” Risk.net (Sept. 9, 2014).

\textsuperscript{20} Adopting Release at 71.

\textsuperscript{21} Id. at 72.

constitute a disqualification event under Rule 506(d). As discussed in our Client Alert cited above, a review of
those forms will be helpful in identifying any covered person that may be subject to a disqualification event.23
Some of the responses required by those forms, however, may sweep in past acts that would not constitute a
disqualification event under Rule 506(d).24 Consequently, a respondent who provides a “yes” answer to the
disclosure questions of Form U4 or Form ADV will not necessarily be disqualified from participating in a Rule 506
offering. There are also some Rule 506(d) disqualification events that are not contemplated by Form U4 or Form
ADV. These differences are due to the varying regulatory objectives of the Exchange Act, the Investment Advisers

In this regard, a covered person would be disqualified under Rule 506(d)(1)(i) if that person has:

been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and
affiliated issuers), 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.

A review of responses to Items 11A or 11B of Form ADV, or Questions 14A or 14B of Form U4, which require
disclosure of criminal events, would be helpful in determining whether a covered person is subject to a
disqualifying event under Rule 506(d)(1)(i). However, the disclosure items in those two forms cast a much wider
net than does Rule 506(d)(1). Items 14A and 14B of Form U4 have no time limit on the requested criminal
disclosure and cover, in addition to convictions, guilty pleas and pleas of no contest to any type of felony. Those
items also cover felony and misdemeanor convictions, and pleas in foreign and military courts (foreign courts are
specifically excluded from the scope of Rule 506(d)(1) under C&DI 260.20, as discussed above), and
misdemeanors involving investments or investment-related business, or any fraud, false statements, or omissions,
wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or conspiracy to commit any of
those offenses. Item 11 of Form ADV covers the same events, but has a ten-year look-back period. Both Form U4
and Form ADV also cover being charged with any of the felonies or misdemeanors described in those items.

Item 14D(2) of Form U4, which has no counterpart in Form ADV, requests disclosure of final orders issued by
various regulatory authorities. This item differs from Rule 506(d)(1)(iii) only in that a final order of the U.S.
Commodity Futures Trading Commission (“CFTC”) is not covered in Item 14D(2) of Form U4 and that item is
open-ended in terms of past violations. Rule 506(d)(1)(iii) is limited to a ten-year look-back period.

Consequently, a “yes” answer to Item 14D(2) might not constitute a disqualification event under
Rule 506(d)(1)(iii), and a “no” answer might not capture a CFTC violation that would be a disqualification event.
Also, a “final order” is defined somewhat differently by FINRA than in Rule 501(g).25 The SEC definition requires
that the statutory authority that issued the final order provided for notice and an opportunity for a hearing.

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23 The SEC pointed to these types of forms as a source of information for financial intermediaries and other market
participants when assisting an issuer in satisfying its factual inquiry requirement. See the Adopting Release at 68.
24 Many of the disclosure items in Form U4 and Form ADV are identical, or substantially identical.
25 The FINRA definition of “final order” can be found at:
Further, a review of responses to Form U4 and Form ADV would not pick up disqualification events covered by Rule 506(d)(1)(vii) or (viii), which cover stop orders and orders suspending the Regulation A exemption, and U.S. Postal Service false representation orders, respectively.

**Rule 506 Compliance Guide**


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*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*
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”). 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. 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. 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.

3 In a separate rulemaking required under Section 201(a) of the Jumpstart Our Business Startups 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.4

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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4 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;
  o 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);
  o Non-public companies should contact their transfer agent and registrar;

• Requiring placement agents to complete a questionnaire or provide a representation;
  o 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§; 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;
  o 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.

§ 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.

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For a jump start on the JOBS Act, please visit our MoFoJumpstarter blog: [www.mofojumpstarter.com](http://www.mofojumpstarter.com).

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FREQUENTLY ASKED QUESTIONS
RELATING TO THE DISQUALIFICATION
PROVISIONS OF REGULATION A,
REGULATION CF AND REGULATION D:
BAD ACTORS

Introduction

What are the “Disqualification Provisions”?
The Disqualification Provisions of Regulation A may be found in Rule 262. The Disqualification Provisions of Regulation CF (“crowdfunding”) may be found in Rule 503 of Regulation CF. The Disqualification Provisions of Regulation D may be found in Rule 505 and Rule 506. These rules make these exemptions from registration unavailable for an offering if the issuer or certain “covered persons” is or has been subject to a relevant criminal conviction, regulatory or court order or other disqualifying event. In these cases, the offering participants must rely on a different exemption from registration, if one is available.

In a Regulation A offering, do the Disqualification Provisions apply to both Tier 1 and Tier 2 offerings?
Yes. They apply in both cases.

In a Regulation D offering, do the Disqualification Provisions apply to offerings that involve a “general solicitation” and those that do not?
Yes. They apply in both cases.

How do the Disqualification Provisions differ in the case of Rule 505 and Rule 506 Regulation D offerings?
In the case of Rule 505 (which limits sales to $5 million in a one-year period), the Disqualification Provisions are generally designed to be comparable to those of Regulation A, and Rule 505(b)(2)(iii) cross-references the relevant provisions. For Rule 506 offerings (offerings unlimited in amount), we discuss the Disqualification Provisions in more detail below.

What Disqualification Provisions exist under Section 4(a)(7) of the Securities Act?
In December 2015, the U.S. Congress enacted Section 4(a)(7) of the Securities Act, which “codifies” an exemption similar to the 4(a)(1 ½) exemption. (See our Frequently Asked Questions Relating to Rule 144A: http://media.mofo.com/files/Uploads/Images/FAQRule144A.pdf)

Section 4(a)(7) may not be relied upon when a seller, or any compensated solicitor, is subject to an event that would disqualify an issuer or other covered person under Rule 506(d)(1).
Identifying Covered Persons

Who is a “covered person”?

The Disqualification Provisions apply to:

- the issuer and any predecessor;
- 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% or more of any class of the issuer’s outstanding voting equity securities, calculated on the basis of voting power (as per Exchange Act Rule 13d-3) prior to the completion of the offering in question;
- any promoter (as defined in SEC Rule 405) connected with the issuer in any capacity at the time of the sale (or time of filing or after qualification, in the case of Regulation A);
- any investment manager of an issuer that is a pooled investment fund (in the case of Regulation D);
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale of securities (a “compensated solicitor”);
- any general partner or managing member of any investment manager (in the case of Regulation D) or compensated solicitor; or
- any director, executive officer or other officer participating in the offering of an investment manager or compensated solicitor or general partner or managing member of that investment manager (in the case of Regulation D) or compensated solicitor.

What is an affiliated issuer?

An “affiliated issuer” is an affiliate of the issuer that is issuing securities in the same offering, including offerings that are subject to integration under Rule 502(a) of Regulation D.

How does the SEC view affiliated entities within the same fund family for purposes of these rules?

The SEC has clarified that the term “affiliated issuer” refers to an offering made by an affiliate “that is issuing securities in the same offering.” The SEC referred to prior guidance in which it provided examples of offerings involving co-issuers or multiple issuers, such as a master fund offering conducted through feeder funds created to invest the proceeds in the master fund. As a result, the term “affiliated issuer” would generally not include an affiliate of a fund, such as a portfolio company, unless that affiliate was issuing securities in the same offering.

In contrast, a fund organized to invest in a master fund that is organized and managed by an unrelated party should not be considered an affiliated issuer of the master fund, unless the new “feeder” fund owns a sufficient interest in the master fund to be an “affiliate.”

How are the rules applied to an entity that was not an affiliate of the relevant issuer at the time the relevant events?

Rule 262(c), Rule 503(c) of Regulation CF and Rule 506(d)(3) provide 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 (a) in control of the issuer or (b) under
common control with the issuer by a third party that was in control of the affiliated entity at the time of the relevant events.

What does it mean to have an officer “participate” in the offering?

Participation in an offering means more than transitory or incidental involvement. The term could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents, providing structuring or other advice, and communication with the issuer, prospective investors or other offering participants. Participation in an offering is not limited to solicitation of investors. Administrative functions, such as opening brokerage accounts, wiring funds, and bookkeeping activities, are generally not deemed to be participating in the offering. The SEC has also indicated that persons whose sole involvement with an offering is as members of a compensated solicitor’s deal or transaction committee that is responsible for approving the entity’s participation in the offering are not “participating” in the offering.

How do the definitions of “covered person” differ as to Regulation A and Regulation CF, on the one hand, and Regulation D, on the other hand?

Any investment manager of an issuer that is a pooled investment fund and any director, executive officer or other officer participating in the offering of any such investment manager or general partner or managing member of such investment manager is a covered person included in Rule 506(d), but not included in Regulation A and Regulation CF. This is because an “investment company” can be eligible to issue securities under Regulation D, but not under Regulations A and CF. Note also that Regulations D and CF contemplates “compensated solicitors,” while Regulation A contemplates “underwriters.”

Are operators of matchmaking portals deemed to be compensated solicitors that are subject to the Disqualification Provisions?

Probably not, if they are not receiving transaction-based compensation. Section 4(b)(1) of the Securities Act provides an exemption from broker-dealer registration for operators of matchmaking portals for Rule 506 offerings, provided, among other things, that those persons do not receive compensation in connection with the purchase or sale of those securities. In C&DI 260.17, the SEC noted that compensated solicitors are not limited to brokers who are subject to registration under Section 15(a)(1) of the Exchange Act. The SEC stated that “all persons who have been or will be paid, directly or indirectly, remuneration for solicitation of purchasers are covered by Rule 506(d), regardless of whether they are, or are required to be registered under … Section 15(a)(1) ….” Although not directly addressed by the SEC, it appears that a matchmaking portal that satisfies the exemption from broker or dealer registration provided by Section 4(b)(1) could not be operated by a person that is a compensated solicitor as to the offering.

What additional types of persons are disqualified from acting as intermediaries under the crowdfunding regulations?

Under Rule 503(c) of Regulation CF, a person that is subject to a statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act) may not act as, or be an associated person of, an intermediary in a crowdfunding transaction unless permitted by an SEC rule or order. The Section 3(a)(39) provisions bar certain
persons from becoming a member in a self-regulatory organization such as FINRA, and Rule 503(c) is principally directed at funding portals.

Understanding Disqualifying Events

**What are the types of disqualifying events?**

There are eight categories of disqualifying events. They are:

- criminal convictions;
- court injunctions and restraining orders;
- “final orders” of certain state regulators (such as securities, banking and insurance) and federal regulators, including the U.S. Commodity Futures Trading Commission (the “CFTC”);
- SEC 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”);
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

**What types of criminal convictions constitute a “disqualifying event”?**

Rule 262(a)(1), Rule 503(a)(1) of Regulation CF and Rule 506(d)(1)(i) provide 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 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. In the case of Regulation CF, activities in acting as a funding portal would also be included.

The rules include 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.

**Do orders and judgments occurring outside of the United States imposed by non-U.S. regulators result in Disqualifying Events?**


**What types of court injunctions and restraining orders constitute a Disqualifying Event?**

Rule 262(a)(2), Rule 503(a)(2) of Regulation CF, and Rule 506(d)(1)(ii) disqualify any covered person if the covered person is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before the sale (or the filing, in the case of Regulation A or CF), that, at the time of the sale (or filing), restrains or enjoins that 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. In the case of Regulation CF, as in the above discussion of criminal
convictions, activities in acting as a funding portal would also be included.

What types of final orders of certain regulators constitute a disqualifying event?

Final orders of regulatory agencies or authorities are covered by Rule 262(a)(3), Rule 503(a)(3) of Regulation CF, and Rule 506(d)(1)(iii). Those sections disqualify any covered person who is subject to a final order of a state securities commission (or an agency or officer of a state performing similar 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 similar 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 the sale (or filing), bars the person from (i) association with an entity regulated by that commission, authority, agency or officer; (ii) engaging in the business of securities, insurance or banking; or (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 that sale (or filing).

What is a “final order”?

Rule 261, Rule 503(a)(3) of Regulation CF, and Rule 501(g) define a “final order” as a written directive or declaratory statement issued by a federal or state agency described in Rule 262(a)(3), Rule 503(a)(3) of Regulation CF, or 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 FINRA definition set forth in FINRA’s forms.)

Rule 262(a)(3)(ii), Rule 503(a)(3)(ii) of Regulation CF and Rule 506(d)(1)(iii)(B) provide 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 the Disqualification Provisions to matters involving scienter.

Rule 262(a)(4), Rule 503(a)(4) of Regulation CF and Rule 506(d)(1)(iv) will also disqualify a Covered Person if that person is subject to an order under Section 15(b) or 15B(c) of the 1934 Act, or Section 203(e) or (f) of the Investment Advisers Act, that, at the time of the offering or the filing: (i) suspends or revokes the person’s registration as a broker, dealer, municipal securities dealer or investment adviser (or funding portal, in the case of Regulation CF); (ii) places limitations on the activities, functions or operations of that person; or (iii) bars that person from being associated with any entity or from participating in the offering of any penny stock.

What kind of SEC cease and desist orders constitute “Disqualifying Events”?

Under Rule 262(a)(5)(i), Rule 503(a)(5) of Regulation CF and Rule 506(d)(1)(v), an offering will be disqualified if any covered person is subject to any order of the SEC entered within five years before the sale (or in the case of Regulation A or Regulation CF, the filing) that, at the time of the sale (or filing), 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 Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, Section 15(c)(1) of the Exchange Act and Section 206(1) of the Investment 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.

**Does suspension or expulsion from SRO membership or association with an SRO member constitute a “Disqualifying Event”?**

Yes. Rule 206(a)(6), Rule 503(a)(6) of Regulation CF, and Rule 506(d)(1)(vi) disqualify 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.FRO

**What types of other orders will result in a disqualification?**

Under Rule 206(a)(7), Rule 504(a)(7) of Regulation CF, and Rule 506(d)(vii), a Covered Person will be disqualified if that person has filed (as a registrant or an issuer) or was named as an underwriter in a registration statement or offering statement filed with the SEC that, within five years before the sale (or the filing of the offering statement) was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of sale (or filing), the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.

**What is a U.S. postal service false representation order?**

The U.S. False Representation Statute (39 U.S.C. § 3005) is used to protect the public from monetary loss where proving fraudulent intent is difficult. The Postal Service may sue a promoter that has made false representations in order to obtain money or property through the mail. If a judge rules that the promotion violates the statute, a false representation order (“FRO”) is issued by the Judicial Officer of the Postal Service. It directs the postmaster in the city where the promoter is receiving mail to return to the senders all mail connected with the promotion.

**How are disqualifying events treated if they occurred prior to the adoption of the relevant rules?**

Rule 262(b), Rule 503(b) of Regulation CF and Rule 506(d)(2)(i) provide that disqualification will not arise as a result of events that occurred prior to June 19, 2015, in the case of Regulation A, May 16, 2016, in the case of Regulation CF, and September 23, 2013, in the case of Regulation D.

However, in the case of Regulation A, these matters must be disclosed in writing to investors in Part II of Form 1-A. In the case of Regulation CF, these matters must be disclosed in their offering materials. In the case of Regulation D, 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 these disclosures will not be an “insignificant deviation” as contemplated.
by the relevant exemption; consequently, relief under that rule will not be available for the failure. Unlike some of the other aspects of the Disqualifying Provisions, the disclosure provisions are not subject to the potential for waivers.

The SEC has indicated that Rule 506(e) does not require disclosure of past events that would no longer trigger a disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years prior to an offering.

What practical steps can issuers and placement agents take to determine whether any disqualifying events have occurred?

As a practical matter, issuers and placement agents must implement procedures in connection with any relevant offering, in order to identify any disqualifying events on the part of the issuer, any 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) is essential in determining whether the issuer can proceed with the offering, whether it can use a potential placement agent, and whether any pre-effective disqualifying events will need to be disclosed.

To address these issues, issuers have:

- Added additional questions to D&O questionnaires;
- Asked 20% or greater shareholders to complete questionnaires;
- Required placement agents to complete a questionnaire or provide a representation;
- Require other participants (that may be covered persons) to complete questionnaires or provide representations; and
- For funds or other issuers engaged in continuous or delayed offerings, refreshing or updating their diligence, such as through periodic scheduled bring-down representations, questionnaires and certifications, negative consent letters, periodic scheduled re-checking of public databases and other steps, depending on the circumstances.
To address these issues, placement agents:

- Prior to any Rule 506 offering, conduct due 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 determine 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

- Review Forms U-4, U-5 and U-6 filed with FINRA and compare any events described in those forms to the applicable disqualifying events, in preparation for the possibility of either disclosing those events as pre-effectiveness disqualifying events or to confirm compliance with any of the new representations described above.

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 an offering should ensure that the list includes all relevant covered persons; 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 the offering.

Broker-dealers and other compensated solicitors will have on file various forms, such as FINRA Form U4 and Form ADV, which require disclosure by their employees and others of “bad acts” similar to those that may constitute a disqualification event. Reviewing those forms is likely to be helpful in identifying any covered person that may be subject to a disqualification event. Some of the responses required by those forms, however, may list past acts that would not constitute a disqualification event. As a result, a respondent who provides a “yes” answer to the disclosure questions of Form U4 or Form ADV will not necessarily be disqualified from participating in an offering under Regulation A, Regulation CF or Regulation D. Conversely, there are also some disqualification events under these rules that are not contemplated by Form U4 or Form ADV; accordingly, review of these forms will not be sufficient to ensure that all types of disqualification events are known.

**Did the SEC adopt specific rules indicating how to comply with the reasonable care standard?**

No. The SEC did not prescribe particular steps as being necessary or sufficient to establish reasonable care. However, the SEC has noted 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.
Disqualification Events During an Offering

If a placement agent or one of its covered control persons becomes subject to a disqualifying event while an offering is still ongoing, could the issuer continue to rely on Rule 506 for that offering?

Yes. The issuer could rely on Rule 506 for future sales in that offering if the engagement with the placement agent was terminated and the placement agent did not receive compensation for the future sales. Alternatively, if the triggering disqualifying event affected only the covered control persons of the placement agent, the issuer could continue to rely on Rule 506 for that offering if those persons were terminated or no longer performed roles with respect to the placement agent that would cause them to be covered persons for purposes of Rule 506(d).

Source: SEC CD&I, 206.15.

Waivers from Disqualification Events

If a Covered Person is a disqualified person, are waivers available?

Yes, upon a showing of good cause. The SEC has articulated its standards for granting these waivers on its website:


Waivers will also apply under Rule 262(b)(3), Rule 203(b)(2) of Regulation CF, and Rule 506(d)(2)(iii), if, before the relevant sale (or filing of an offering statement, in the case of Regulation A), 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 SEC or its staff) that disqualification under Rule 262(a), Rule 203(b)(3) of Regulation CF, or Rule 506(d)(1) should not arise as a result of that order, judgment or decree.

Certifications as to Disqualifications

Must an issuer certify that it is not subject to the Disqualification Provisions?

Yes. For Regulation A offerings, the required Form 1-A, Item 3, requires the issuer to certify that no disqualifying events have occurred and to indicate whether related disclosure will be included in the offering’s offering circular. The form of offering statement for use in Regulation CF offerings contains a similar certification. The signature block of current Form D contains a certification that applies to transactions under Rule 505 and Rule 506, confirming that the offering is not disqualified from reliance on Rule 505.

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