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Bad Actors can Spoil Your Capital Raise

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The Dodd-Frank Act both liberalized and constrained through Rule 506. Readers may recall that in our previous WIB Directors Digest article, we discussed the recent liberalization of Rule 506(c) that allows companies for the first time to use general advertising in heretofore private placements. On the other side of the coin, the SEC added sections 506(d) and (e). These so-called "bad actor" rules renders the Rule 506 exemption unavailable in certain situations. This article will discuss the additions of subsections (d) and (e) that prove the old adage, that the Government giveth and the Government taketh away.

Rule 506 is one of the most widely used exemptions from registration under the '33 Act for private sales of securities because an issuer can raise an unlimited amount of money under the rule. Subsections (d) and (e) identify "bad actors" and "bad actions" that justify loss of the exemption. In short, an issuer cannot use the Rule 506 exemption if the issuer or a covered person has a relevant criminal conviction, regulatory or court order or other disqualifying event. The determination of whether a company is disqualified because of a bad actor is made each time an issuer is either offering or selling securities pursuant to Rule 506.

Potential "Bad Actors"
Rule 506(d) sweeps within its coverage the following persons:

- The issuer, including its predecessors and affiliated issuers
- Directors, general partners and managing members of the issuer
- "Executive officers" of the issuer as defined by the SEC, and other "officers" of the issuer that participates in the offering
- 20 percent beneficial owners of the issuer, calculated on the basis of total voting power, excluding shares purchased in the offering in question
- Promoters connected to the issuer
- For pooled investment fund issuers, the fund's investment manager and its principals
- Persons compensated for soliciting investors, including their directors, general partners and managing members

The list of potential bad actors in an offering is long, includes both directors and officers and even reaches to the investment bankers you might hire to assist in the offering. In other words, the net is cast wide.

Disqualifying Events – Potential "Bad Actions"
Now that we know who is covered by the new rules, it is important to understand what events

related to those covered persons will trigger disqualification. The disqualifying events include:

Criminal convictions, court injunctions or restraining orders related to the purchase or sale of a security, making a false filing with the SEC or the conduct of the business of raising capital for others (i.e., underwriter, broker, dealer), subject to certain look-back periods.

Final orders of certain state and federal regulators that bar the covered person from associating with a regulated entity, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or are based on fraudulent, manipulative, or deceptive conduct, subject to certain look-back periods.

SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies and investment advisers and their associated persons that suspend or revoke the person's registration as a broker, dealer, municipal securities dealer or investment adviser, place limitations on the person's activities, functions or operations, or bar the person from being associated with any entity or from participating in the offering of any penny stock.

SEC cease-and-desist orders for violations and future violations of Section 5 of the Securities Act or the anti-fraud provisions of the federal securities laws, including, for example Section 10(b) of the Securities Exchange Act and Rule 10b-5.

SEC stop orders: An offering is disqualified if any covered person (as a registrant or issuer or as a named underwriter) has filed, or was named as an underwriter in, a registration statement or Regulation A offering statement that was the subject of a SEC refusal order, stop order or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine whether such an order should be issued.

Suspension or expulsion from membership in an SRO or from association with an SRO member of any covered person for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade in a particular offering.

U.S. Postal Service false representation orders: An offering is disqualified if the issuer or another covered person is subject to a U.S. Postal Service false representation order entered within the preceding five years, or to a temporary restraining order or preliminary injunction with respect to conduct alleged to have violated the false representation statute that applies to U.S. mail.

Reasonable Care Exception – *Really, we didn't KNOW he was a bad guy!*
If an issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering, then 506(d) provides an exemption from disqualification. As with many such concepts from the SEC, what constitutes "reasonable care" is not set forth in the rule. Rather, the SEC states that "the steps an issuer should take to exercise reasonable care will vary according to particular facts and circumstances." What is clear is that an issuer must make some level of affirmative factual inquiry to satisfy the "reasonable care" standard. Pursuant to the SEC's CD&I 260.14:

> ...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.

To support claims of reasonable care, issuers and their advisers are using new contract provisions and bad actor questionnaires in current Rule 506 offerings. We also expect that a series of bad actor questions will find their way into year-end director and officer questionnaires, and have ourselves included such questions in our forms.

Waivers – *We know he's bad, but can we use the exemption anyway?*
If an issuer would be disqualified because of a bad actor, it may apply to the SEC for a waiver from disqualification, which will be decided on a case-by-case basis. If the disqualifying order or injunction was issued by someone other than the SEC, an issuer alternatively may apply to that issuing authority for a determination that no disqualification from Rule 506 should occur. One would assume that waivers of any type will be difficult to secure.

Disclosure of Pre-Existing Events – *Even if we aren't disqualified, we must still expose our bad actor*
Only disqualifying events that occur after September 23, 2013, bar reliance on Rule 506. However, disqualifying events that occurred before September 23, 2013, must be disclosed by the issuer in any Rule 506 offering. Such disclosure may have a chilling effect on the attempted capital raise, so it is important that companies determine well in advance if any of its "covered persons" have ever had a disqualifying event.

Practical Takeaways
The bad actor changes to Rule 506 have created an important due diligence step in any capital raise in which a company plans to use the private placement exemption of that rule. These new hurdles are further examples of the increased compliance burden placed on banks and bank holding companies by the Dodd-Frank Act. A company will be responsible not only for knowing disqualifying events about itself, but making a reasonable inquiry into its directors, executive officers, officers participating in the offering and investment bankers assisting in the offering.

Banks and their holding companies should incorporate appropriate bad actor questions into their annual company and officer and director questionnaires. Further, your investment bankers should be required to make specific representations about the existence, or lack thereof, of any disqualifying events under Rule 506. Finally, all officers and directors should be required to complete bad actor questionnaires at the time of a private placement to ensure compliance. The loss of the Rule 506 exemption could threaten an otherwise successful capital raise. However, careful forethought, appropriate due diligence and updated contract provisions should prevent bad actors from spoiling your Rule 506 offering.

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