



Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings and Related Disclosure Requirements

A Small Entity Compliance Guide¹

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1. Summary of Rule 506 Bad Actor Disqualification and Disclosure Requirements

On July 10, 2013, the Securities and Exchange Commission (the "Commission") adopted bad actor disqualification provisions for Rule 506 of Regulation D under the Securities Act of 1933, to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The disqualification and related disclosure provisions appear as paragraphs (d) and (e) of Rule 506 of Regulation D.

As a result of Rule 506(d) bad actor disqualification, an offering is disqualified from relying on Rule 506(b) and 506(c) of Regulation D if the issuer or any other person covered by Rule 506(d) has a relevant criminal conviction, regulatory or court order or other disqualifying event that occurred on or after September 23, 2013, the effective date of the rule amendments. Under Rule 506(e), for disqualifying events that occurred before September 23, 2013, issuers may still rely on Rule 506, but will have to comply with the disclosure provisions of Rule 506(e) discussed in part 6 of this guide.

This guide is designed as an outline to help issuers understand and comply with the "bad actor" disqualification and disclosure provisions of Rule 506 of Regulation D.

2. Covered Persons

Understanding the categories of persons that are covered by Rule 506(d) (which we refer to in this guide as "covered persons") is important because

issuers are required to conduct a factual inquiry to determine whether any covered person has had a disqualifying event, and the existence of such an event will either disqualify the offering from reliance on Rule 506 or will have to be disclosed to investors.

"Covered persons" include:

- the issuer, including its predecessors and affiliated issuers
- directors, general partners, and managing members of the issuer
- executive officers of the issuer, and other officers of the issuers that participate in the offering
- 20 percent beneficial owners of the issuer, calculated on the basis of total voting power
- 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 discussion that follows provides background on the different categories of "covered persons."

Issuers, predecessors and affiliated issuers: the issuer itself, any predecessor entities, and any "affiliated" issuers (that is, issuers that are in control of, are controlled by, or are under common control with the issuer).

Directors, general partners and managing members of the issuer: members of the Board of Directors (for issuers that are corporations), general partners (for issuers that are partnerships) and managing members (for issuers that are limited liability companies).

Executive officers and participating officers of the issuer.:

Executive officers. The term "executive officer" means a company's president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions.

Officers who participate in the offering. The term "officer" means a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, as well as any person who routinely performs corresponding functions. Participation in an offering would have to be more than transitory or incidental involvement, and could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents, and communication with the issuer, prospective investors or other offering participants.

20 percent beneficial owners of the issuer: Beneficial owners of 20% or more of the issuer's outstanding equity securities, calculated on the basis of total voting power rather than on the basis of ownership of any single class of securities.

Voting securities. Whether securities are "voting securities" depends 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. For example, the Commission would consider that securities that confer to

securityholders the right to elect or remove the directors or equivalent controlling persons of the issuer, or to approve significant transactions such as acquisitions, dispositions or financings, would be considered voting securities for purposes of the rule. Conversely, securities that confer voting rights limited solely to approval or changes to the rights and preferences of the class would not be considered voting securities for purposes of the rule.

Promoters: The category of "promoter" is broad. Securities Act Rule 405 defines a promoter as any person—individual or legal entity—that either alone or with others, directly or indirectly takes initiative in founding the business or enterprise of the issuer, or, in connection with such founding or organization, directly or indirectly receives 10% or more of any class of issuer securities or 10% or more of the proceeds from the sale of any class of issuer securities (other than securities received solely as underwriting commissions or solely in exchange for property). The test considers activities "alone or together with others, directly or indirectly"; therefore, the result does not change if there are other legal entities (which may themselves be promoters) in the chain between that person and the issuer.

Investment managers and principals of pooled investment fund issuers: For issuers that are pooled investment funds, the rule covers investment advisers and other investment managers of the fund; the directors, general partners, managing members, executive officers and other officers participating in the offering of such investment managers; and the directors, executive officers and other officers participating in the offering of the investment managers' general partners or managing members.

Compensated solicitors: Persons compensated for soliciting investors as well as their directors, general partners, managing members, executive officers and officers participating in the offering. This category covers any persons compensated for soliciting investors but will typically involve broker-dealers and other intermediaries.

3. Disqualifying Events

Under the final rule, disqualifying events include:

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

Many disqualifying events include a look-back period (for example, a court injunction that was issued within the last five years or a regulatory order that was issued within the last ten years). The look-back period is measured from the date of the disqualifying event—in the example, the issuance of the injunction or regulatory order—and not the date of the underlying conduct that led to the disqualifying event.

The discussion that follows provides background on the different categories of disqualifying events.

Criminal convictions: Disqualification is triggered by criminal convictions in connection with

- the purchase or sale of a security
- making a false filing with the SEC
- the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.

The criminal conviction must have occurred within ten years of the proposed sale of securities, or five years in the case of the issuer and its predecessors and affiliated issuers.

Court injunctions and restraining orders: Disqualification is triggered by court injunctions and restraining orders in connection with

- the purchase or sale of a security
- making a false filing with the SEC
- the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.

Disqualification only applies for injunctions and restraining orders that are in effect at the time of the proposed sale of securities and were entered within the preceding five years. Injunctions and court orders that have expired or are otherwise no longer in effect are not disqualifying, even if they were issued within the five-year look-back period. For example, an injunction that was issued four years before the proposed offering but lifted before the offering occurred would not be disqualifying.

Final orders of certain state and federal regulators: Disqualification is triggered by final orders of state regulators of securities, insurance, banking, savings associations or credit unions; federal banking agencies; the Commodity Futures Trading Commission and the National Credit Union Administration 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 and were issued within 10 years of the proposed sale of securities

Final orders. A "final order" is a written directive or declaratory statement issued by one of the federal or state regulatory agencies listed above, under applicable statutory authority that provides for notice and an opportunity for hearing, which constitutes a final disposition or action by that federal or state agency.

A final order may be subject to appeal. An order does not have to be non-appealable to be a "final order" under the bad actor rules.

Notice and an opportunity for hearing. There are no procedural requirements beyond the basic requirement that notice and opportunity for hearing be provided for in the statutes, rules and regulations under which an order is issued. No hearing need have occurred. For example, a settlement is considered to have been made after an opportunity for hearing.

Bars. Bars are orders issued by one of the specified regulatory authorities that have the effect of barring a person from association with an entity that is regulated by that authority;

from engaging in the business of securities, insurance or banking; or from engaging in savings association or credit union activities. Any final order that has one of those effects is a bar, regardless of whether it uses the term "bar." A bar is disqualifying only for as long as it has continuing effect. Thus, for example, a person who was barred indefinitely, with the right to apply to reassociate after three years, would be disqualified until such time as he or she is permitted to reassociate, assuming that the bar had no continuing effect after reassociation.

Fraudulent, manipulative, or deceptive conduct. The final rules do not provide a specific definition of "fraudulent, manipulative or deceptive conduct," and in particular do not limit it to matters involving knowing misconduct or scienter.

SEC disciplinary orders: Disqualification is triggered by Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons under Section 15(b) or 15B(c) of the Securities Exchange Act, or Section 203(e) or (f) of the Investment Advisers Act 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
- bar the person from being associated with any entity or from participating in the offering of any penny stock

Disqualification continues only for as long as some act is prohibited or required to be performed pursuant to the order. As a result, censures and orders to pay civil money penalties, assuming the penalties are paid in accordance with the order, are not disqualifying, and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires.

SEC cease-and-desist orders: Commission orders to cease and desist from violations and future violations of

- the scienter-based anti-fraud provisions of the federal securities laws, including, for example
 - Section 17(a)(1) of the Securities Act
 - Section 10(b) of the Securities Exchange Act and Rule 10b-5
 - Section 15(c)(1) of the Securities Exchange Act
 - Section 206(1) of the Investment Advisers Act
- Section 5 of the Securities Act

Disqualification applies to cease-and-desist orders that were issued within five years before the proposed sale of securities and remain in effect.

SEC stop orders: An offering is disqualified if any covered person (as a registrant or issuer) has filed a registration statement or Regulation A offering statement that was the subject of a Commission 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.

Similarly, an offering is disqualified if any covered person (as an underwriter of the securities proposed to be issued) was, or was named as, an underwriter of securities under a registration statement or Regulation A offering statement that was the subject of a Commission 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: Under the rule, an offering is disqualified if any covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, a securities self-regulatory organization or "SRO" (*i.e.*, a registered national securities exchange or national securities association, such as FINRA) for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.

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.

4. Reasonable Care Exception

The final rule provides an exception from disqualification when the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering.

The steps an issuer should take to exercise reasonable care will vary according to particular facts and circumstances. The instruction to the rule states that an issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualification exists.

5. Waivers

Waiver for good cause shown. The final rule provides for the ability to seek waivers from disqualification by the Commission. There are a number of circumstances that could, depending upon the specific facts, be relevant to the evaluation of a waiver request. Issuers may view past applications and waivers granted under Regulation A by referring to the following page: <http://www.sec.gov/divisions/corpfin/cf-noaction.shtml#3b>. Staff in the Office of Small Business Policy is also available to discuss potential waiver concerns over the phone at (202) 551-3460.

Waiver based on determination of issuing authority. Rule 506(d)(2) of Regulation D provides another way for issuers to request a waiver of disqualification. Disqualification will not arise if, before the relevant sale is made in reliance on Rule 506, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing—whether in the relevant judgment, order or decree or separately to the Commission or its staff—that disqualification under Rule 506 should not arise as a consequence of such order, judgment or decree.

6. Disclosure of Pre-Existing Events

Disqualification will not arise as a result of disqualifying events that occurred before September 23, 2013, the effective date of the rule amendments. Matters that existed before the effective date of the rule and would otherwise be disqualifying are, however, required to be disclosed in writing to investors. Issuers must furnish this written description to purchasers a reasonable time before the Rule 506 sale. Rule 506 is unavailable to an issuer that fails to provide the required disclosure, unless the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care,

could not have known that a disqualifying event was required to be disclosed.

Determining whether disclosure is required. The rule looks to the timing of the triggering event (*e.g.*, a criminal conviction or court or regulatory order) and not the timing of the underlying conduct. A triggering event that occurs after effectiveness of the rule amendments will result in disqualification, even if the underlying conduct occurred before effectiveness.

Form of disclosure. The Commission expects that issuers will give reasonable prominence to the disclosure to ensure that information about pre-existing bad actor events is appropriately presented in the total mix of information available to investors.

7. Transition Issues

The rules affect only sales of securities made on or after September

23, 2013. Sales of securities made before the effective date of the bad actor provisions will not be affected by the disqualification and disclosure requirements, even if such sales are part of an offering that continues after the effective date. Only sales made after the effective date of the amendments will be subject to disqualification and mandatory disclosure.

Disqualifying events that occur while an offering is underway. Sales made before the occurrence of the disqualifying event will not be affected by it, but sales made afterward will not be entitled to rely on Rule 506 unless the disqualification is waived or removed, or, if the issuer is not aware of a triggering event, the issuer may be able to rely on the reasonable care exception.

Disqualifying events that exist at the time the offering is commenced but are only discovered later trigger disqualification or a disclosure obligation. Sales will not be eligible for reliance on Rule 506, subject to the application of the reasonable care exception.

¹ This guide was prepared by the staff of the U.S. Securities and Exchange Commission as a "small entity compliance guide" under Section 212 of the Small Business Regulatory Enforcement Fairness Act of 1996, as amended. The guide summarizes and explains rules adopted by the SEC, but is not a substitute for any rule itself. Only the rule itself can provide complete and definitive information regarding its requirements.

<http://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide.htm>