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Securities issuers, beware of 'bad actors'

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Under new Securities and Exchange Commission "bad actor" rules, companies raising capital from investors can't rely on Rule 506 for their securities offerings if their "covered persons" have undergone "disqualifying events."

Associating with "bad actors" can disqualify companies of all sizes — from startups conducting seed-round offerings with friends-and-family or angel investors to public corporations doing private investment in public equity offerings — from relying on the Rule 506 safe harbors for the private-placement exemption from securities registration requirements.

Securities offerings must be registered unless they qualify for an exemption. Registered offerings, such as IPOs, are very expensive and result in ongoing public company reporting requirements. Offerings that meet the clear requirements of Rule 506 of Regulation D are exempt from registration as private placements under Section 4(a)(2) of the Securities Act of 1933.

A further benefit is that securities issued in Rule 506 offerings are deemed "covered securities," pre-empting state-level registration requirements. And now that it has two separate safe harbors, Rule 506 is even more attractive.

Rule 506(b) — or "old" Rule 506 — continues to provide a safe-harbor for the private-placement exemption for offerings of securities in any amount to up to 35 non-accredited investors and an unlimited number of accredited investors. An accredited investor includes any company with total assets of more than $5 million and any individual whose net worth (or joint net worth with spouse) exceeds $1 million (excluding primary residence) or whose income exceeded $200,000 (or joint income with spouse exceeded $300,000) in each of the past two years, with the reasonable expectation of the same level of income the current year.

One drawback of Rule 506(b) for issuers with any non-accredited investors is that increased financial and other disclosures to all investors are required. Also, the long-standing prohibition on "general solicitation and advertising" remains in place under Rule 506(b).

The new safe harbor in Rule 506(c) also permits raising an unlimited amount of capital without registering securities, but in addition it lifts the prohibition on general solicitation if all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that.

An issuer relying on Rule 506(c) must file Form D before selling any securities, whereas Form D is due 15 days after the first sale under Rule 506(b). Rule 506(c)'s lifting of the ban on general solicitation is likely to be popular, which increases the importance of the new bad actor disqualification rules for Rule 506 offerings.

The 2010 Dodd-Frank Act mandated the SEC adopt rules disqualifying companies from offering securities under Rule 506 if they are related in various ways to felons or other bad actors. A similar bad actor prohibition exists for the (largely unused) Regulation A "mini-offering" exemption, and others have been proposed for the forthcoming Regulation A+ and "crowdfunding" exemptions.

The two key concepts in the new bad actor rules, found in Rule 506(d), are "covered persons" and "disqualifying events." Covered persons are related to the issuing company when the offering occurs, and disqualifying events make the covered persons who undergo them bad actors. Both elements are required for Rule 506(d) to prevent a company from using the Rule 506(b) or 506(c) safe-harbors.

"Covered persons" include the issuer and its affiliates (i.e., individuals and companies that control, are controlled by or are under common control with the issuer). They also include directors, general partners or managing members of the issuer as well as beneficial owners of at least 20 percent of the issuer's outstanding voting securities; promoters, investment managers and principals of issuers that are pooled-investment funds; and broker-dealers or other intermediaries that are compensated for soliciting investors.

"Covered persons" also include "executive officers" — defined as a president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance) or any other person who performs similar policy-making functions.

They also include any officer (i.e., president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer or any person routinely performing corresponding functions) with more than transitory or incidental participation in the offering — e.g., involvement in due diligence activities, preparing disclosure documents and communicating with prospective investors.

"Disqualifying events" include criminal convictions, court injunctions and restraining orders that involve the purchase or sale of a security, making a false filing with the SEC or acting as an underwriter, broker-dealer or investment adviser. Criminal convictions must occur in the 10 years before the sale or the past five years for the issuer or its affiliate. Injunctions and restraining orders must be entered in the past five years and effective at the time of the sale.

"Disqualifying events" also include final orders of various state and federal securities, insurance and banking regulators that bar the covered person from associating with a regulated entity or that are based on fraudulent, manipulative or deceptive conduct and issued in the past 10 years. "Disqualifying events" also include certain SEC disciplinary, cease-and-desist and stop orders. The regulator entering a judgment, order or decree may waive any resulting disqualification from Rule 506.

There's no disqualification from Rule 506 when the issuer can show that it did not know, and using reasonable care could not have known, that a covered person with a disqualifying event participated in the offering. Disqualification from Rule 506 will also not arise as a result of disqualifying events occurring before Sept. 23, 2013, when Rule 506(d) took effect. However, an issuer must disclose any earlier event that would otherwise be disqualifying, or Rule 506 will not be available unless the issuer can show that it did not know, and using reasonable care could not have known, that disclosure was required.

The upshot is that the Rule 506 safe harbors are important to companies issuing securities in private offerings, but the new bad actor rules can make them unavailable. Those companies would be well-advised to investigate whether their covered persons have disqualifying events and to consider severing their relationships with any bad actors before selling securities, if they want to rely on Rule 506.