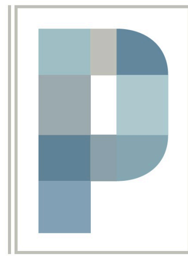

Rule 506(d) "Bad Actor Disqualification" Questions and Answers

The most significant amendments to Regulation D in its 32-year existence went into effect in September 2013. Along with new benefits and opportunities to raise capital without having to navigate the SEC registration process, new compliance burdens and restrictions were part of the newly adopted rules. Not everyone is eligible to take advantage of the old Rule 506(b) or new 506(c) exemptions. Because virtually all Regulation D offerings are set up to fall under Rule 506, it is critical for sponsors to understand these new restrictions so they can minimize the risk of blowing an offering's exemption. The purpose of this article is to answer some commonly asked questions about the new Rule 506(d) "bad actor disqualification" rules.

What is the purpose of Rule 506(d)?

The basic point of Rule 506(d) is that not everyone is entitled to benefit from the Rule 506 exemption. Companies and individuals (referred to as "Covered Persons") who have had compliance problems, been found guilty of violating the securities laws or other applicable criminal convictions or regulatory sanctions (referred to as "Disqualifying Events"). Accordingly, if a Covered Person has been involved with a Disqualifying Event, then the issuer is tainted with a "bad actor disqualification" and, therefore, will be unable to utilize the Rule 506 exemption. This can create a big problem for a real estate sponsor or small business trying to raise capital in the private markets because Rule 506 of Regulation D has been the most popular and cost-effective securities exemption for many years—by a wide margin.

In short, the Rule 506(d) bad actor disqualification rule is intended to promote a "race to the top" culture in the private placement industry as relates to securities compliance and investor protection.

Who is considered a "Covered Person" under Rule 506(d)?

The definition of a Covered Person under Rule 506(d) is broader than many realize at first glance. Here is a summary of who and what is considered a Covered Person:

1. The issuer (i.e., the entity issuing the securities being offered for sale in the offering), any predecessor of the issuer or any affiliated issuer;
   *** Perkins Law Note: The definition of "affiliated" is fairly broad itself and generally refers, at a minimum, to common ownership or control.*
2. Any director, executive officer, other officer participating in the offering, general partner or manager/managing member of the issuer;
3. Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities (calculated on basis of voting power);
4. Any promoter connected with the issuer in any capacity at the time of the sale;

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What is considered a "Disqualifying Event"?

Rule 506(d) defines the term "Disqualifying Event" to include the following:

1. Any criminal conviction within the last ten (10) years in connection with the purchase or sale of any security;

   ***Perkins Law Note: This reminds me of the colorful debate years ago among members of what was then known as the Tenant---in---Common Association as to whether TICs were real estate or securities);*

2. Any criminal conviction within the last ten (10) years involving the making if any false filing with the Securities and Exchange Commission ("SEC");

   **Perkins Law Note: This would include Form D. Query how diligent Reg. D issuers are in reviewing their Form D filings for accuracy.

3. Any criminal conviction within the last ten (10) years 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

   **Perkins Law Note: Expect this language to be broadly interpreted by authorities (as tends to be the case with investor protection laws).

4. Any court order, judgment, or decree entered within the past five (5) years that restrains or enjoins a Covered Person from engaging in any conduct or practice: in connection with the purchase or sale of any security;

   - involving the making of a false filing with the SEC; or
   - arising out of the conduct of conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities.

   **Perkins Law Note: Not surprisingly, the look---back period for civil judgments is only half as long as it is for criminal convictions

5. Any final order of a state securities, banking or insurance regulator, federal banking agency, the National Credit Union Administration, or the Commodity Futures Trading Commission that either:

   - bars a Covered Person from (i) associating with an entity regulated by such 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

   - constitutes an order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within the past ten (10) years.

What are the key timing issues for purposes of Rule 506(d)?

An event involving a Covered Person that occurred prior to September 23, 2013 will not be viewed by the SEC as a Disqualifying Event per se for purposes of applying Rule 506(d). However, an issuer must describe any such event in its offering disclosure to prospective investors. Any such event occurring after September 23, 2013 will disqualify an issuer from relying on either of the Rule 506 exemptions.

What happens if a sponsor discovers that a Disqualifying Event involving a Covered Person took place prior to September 23, 2013?

As noted above, the event must be disclosed to prospective investors. If such disclosure is not made, then the issuer's only hope to salvage its Rule 506 exemption is that it can demonstrate that it was not aware of the event and, in the exercise of reasonable care, could not have not known that such an event had occurred and needed to be disclosed. The rule looks to the timing of the triggering event (e.g., a criminal conviction) 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.

What happens if a Disqualifying Event occurs during the course of an offering?

Sales made before the occurrence of the Disqualifying Event will not be affected, but the offering must immediately cease until the Disqualifying Event is either waived by the SEC upon written application by the issuer or in a final order issued by a court or regulatory authority. In the alternative, an issuer seemingly could sever ties with the Covered Person in question—effectively curing the problem—and then recommence the offering. It is possible that a Disqualifying Event could occur and the issuer never becomes aware of it (and could not have reasonably been expected to find out about it), in which case the issuer may be able to rely on the reasonable care exception, but an issuer is unlikely to benefit from the "reasonable care" exception in such a context.

What happens if a Disqualifying Event that occurred prior to September 23, 2013 is discovered during the course of an offering?

The issuer should suspend the offering and supplement its disclosure document to include a description of the Disqualifying Event. The issuer should provide updated disclosure to existing investors in the offering who received inadequate disclosure. Although not specifically required, an issuer should consider offering rescission to those investors to reduce liability risk of claims being asserted by those early investors in the future. Again, rescission offers are not 100% effective as a cure when a compliance problem is discovered, but as a practical matter they are often effective in reducing risk and demonstrating an issuer's commitment to its investors.

What can a sponsor do to protect itself from a Rule 506(d) violation?

Sponsors must be more diligent than ever in knowing who it is doing business with (both internally and externally), conducting robust due diligence on any Covered Person associated with its Rule 506 offerings, utilizing detailed due diligence questionnaires, incorporating detailed representations and warranties in its agreements with its broker---dealers, wholesalers, and other consultants, and negotiating meaningful indemnity protections from those parties to manage the compliance risk associated with these new rules. Ultimately, it is the issuer that bears primary responsibility and liability risk, but to the extent some of this risk can be contractually shifted to relevant parties who are better positioned to manage that risk, the better off the issuer will be (at least in theory).

What happens if a violation of Rule 506(d) is discovered?

If an issuer becomes aware of a Disqualifying Event during the course of a Rule 506 offering, the best practice would be to promptly suspend the offering until all relevant facts could be gathered, analyzed, and discussed with the issuer's legal counsel so that appropriate steps could be taken to address the problem. Following a "wait and see" or "don't ask, don't tell" approach could prove disastrous to the issuer and others involved with the offering.