

# **Felons and Bad Actors Prohibited From Using the Rule 506 Exemption**

**July 2013**

On July 10, 2013, the Securities and Exchange Commission approved final rules that disqualify securities offerings from relying on the safe harbor provided by Rule 506 of Regulation D under the Securities Act of 1933 if certain felons or other bad actors are involved in the offering. The rules were required by Section 926 of the Dodd-Frank Act, which was enacted on May 25, 2011. As required by Section 926, the new rules define several disqualifying events for issuers and covered persons and are substantially similar to the “bad actor” disqualification provisions of Rule 262 of Regulation A, which exempts certain small offerings from registration.

While issuers have historically been mindful of maintaining associations with so called “bad actors” for fear of suffering adverse reputational consequences, prior to the passage of the final rules, there had been no “issuer qualification” restricting use of the Rule 506 exemption. The stakes for issuers are now much greater as under new Rule 506(d), an issuer will not be able to rely on the Rule 506 exemption for an offering if any person covered by the rule was involved in a “disqualifying event.” Issuers must now certify, in their Form D filings, that the offering is not disqualified under Rule 506(d).

Fund managers should note that, as set forth below, the general partners, managing members and investment managers (as well as certain of their affiliated persons) of pooled investment funds are covered persons under Rule 506(d). Therefore, the pooled investment fund will be prohibited from relying on Rule 506 when offering its interests if any such person is subject to a disqualifying event.

## **Covered Persons**

Persons covered by Rule 506(d) include:

- The issuer, including predecessors and affiliated issuers.
- Any director, executive officer, any other officer participating in the offering, general partners and managing members of the issuer.
- Any beneficial owners of 20% or more of the issuer's outstanding voting equity securities.



- Any investment manager to an issuer that is a pooled investment fund and any director, executive officer, other officer participating in the offering, general partner or managing member of any such investment manager, as well as any director, executive officer or officer participating in the offering of any such general partner or managing member of such investment manager.
- Any promoter connected with the issuer at the time of sale.
- Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; as well as any director, executive officer, other officer participating in the offering, general partner, or managing member of any such compensated solicitor.

Fund managers should note that they will likely need to obtain additional representations and perform additional due diligence with respect to any third-party marketers they engage to raise capital for their funds.

### **Disqualifying Events**

Under Rule 506(d), disqualifying events include:

- Criminal convictions in connection with the purchase or sale of a security, making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries. The criminal conviction must have occurred within 10 years of the proposed sale of securities (or 5 years in the case of the issuer and its predecessors and affiliated issuers).
- Court injunctions and restraining orders in connection with the purchase or sale of a security, making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries. The injunction or restraining order must have occurred within 5 years of the proposed sale of securities.
- Final orders from the CFTC, federal banking agencies, the National Credit Union Administration, or state regulators of securities, insurance, banking, savings associations or credit unions that (i) bar the issuer from associating with a regulated entity or engaging in the business of securities, insurance or banking, or (ii) are based on fraudulent, manipulative or deceptive conduct and are issued within 10 years before the proposed offering.
- Certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies and investment advisers and their associated persons, which would be disqualifying for as long as the order is in effect.
- SEC cease-and-desist orders arising out of any scienter-based anti-fraud violation or violation of the registration requirements of the Securities Act.



- Suspension or expulsion from membership in a self-regulatory organization or from an association with an SRO member for any act or omission constituting conduct inconsistent with just and equitable principles of trade, which would be disqualifying for the period of suspension or expulsion.
- SEC stop orders and orders suspending a Regulation A exemption issued within 5 years before the proposed offering.
- US Postal Service false representation orders issued within five years before the proposed offering.

The relevant look-back periods in the rule are measured from the date of conviction or sanction, not from the date of the conduct that led to the conviction or sanction.

### **Exceptions from Disqualification**

Rule 506(d) provides certain exceptions from disqualification, including if:

- The disqualifying event occurred before the rule's effective date. However, under Rule 506(e), the issuer must disclose in writing any disqualifying events that occurred before the effective date to all prospective purchasers in the offering a reasonable time before completing the sale.
- An issuer can prove that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. To satisfy this burden, the issuer will need to show that it conducted a factual inquiry tailored to the facts and circumstances of the particular offering and its participants.
- Upon a showing of good cause and without prejudice to any other action by the SEC, if the SEC determined that it is not necessary under the circumstances that an exemption be denied.
- The court or other authority that issued the order, injunction or decree indicates or advised the SEC that it should not constitute a Rule 506(d) disqualifying event.

New Rule 506(d) applies to sales made after the effective date of the rule. It will not apply to any sales made before the effective date even if the offering continues after the effective date.

Note that nothing in the rules prevents a disqualified Rule 506 offering from potentially being completed as a registered offering or under another registration exemption or safe harbor that is not subject to bad actor disqualification. An issuer should also be able to regain Rule 506 eligibility if it terminates its relationship with the disqualifying person.

The final rules will become effective 60 days after publication in the Federal Register.



To discuss further, please contact your primary Kleinberg Kaplan attorney or:

Lawrence D. Hui  
212.880.9837  
lhui@kkwc.com

Eric S. Wagner  
212.880.9845  
ewagner@kkwc.com

Jonathan A. Ain  
212.880.9869  
jain@kkwc.com

**This Legal Update provides general information only and is not intended as legal advice.**

©2013 Kleinberg, Kaplan, Wolff & Cohen, P.C.  
All rights reserved.  
Attorney Advertising