Arnall Golden Gregory LLP

Client Alert

Contact Attorneys Regarding This Matter:

Lorelei D. Cisne
404.873.8748 - direct
lorelei.cisne@agg.com

Matthew T. Harris
404.873.8118 - direct
matthew.harris@agg.com

Arnall Golden Gregory LLP
Attorneys at Law

171 17th Street NW
Suite 2100
Atlanta, GA 30363-1031

Two South Biscayne Boulevard
One Biscayne Tower 2690
Miami, FL 33131

1775 Pennsylvania Avenue NW
Suite 1000
Washington DC 20006

www.agg.com

Bad Boy Disqualifiers Are Coming Soon: Time to Upgrade Diligence Procedures Now

Over two years ago, the Dodd-Frank Act instructed the SEC to impose "bad boy disqualification" on Rule 506 private placements. Proposed rules were published, but we are still waiting for the final rules, which were due over a year ago.

Despite the long wait, the SEC has placed the final rules on its 2013 rulemaking agenda. Further, the JOBS Act, enacted last year, instructed the SEC to amend Rule 506 to lift the ban on general solicitation. This rulemaking is also overdue but anxiously awaited. The then-Director of the SEC's Division of Corporation Finance stated recently, as have several other commentators, that the SEC needs to impose the bad boy disqualification before it lifts the ban on general solicitation. We therefore think there is a high chance these changes to Rule 506 will get finalized at the same time.

The bad boy disqualifiers have the power to halt your offering in its tracks, immediately upon adoption. We therefore think this is a good time to refresh your memory about the coming changes, and talk about what you can do now to get ready.

Overview of the Rule.

Under the new rules as proposed, an issuer may not rely on Rule 506 if certain individuals or entities associated with the offering have a history that includes a past violation of securities law or similar infraction. This so-called "bad boy disqualifier" is modeled after similar disqualifiers that apply to offerings under Regulation A and Rule 505 of Regulation D. In fact, Congress required that the Rule 506 disqualifier be "substantially similar" to Regulation A's disqualifier (which is also applicable to Rule 505 offerings), and then went on to mandate additional disqualifications. This means that the final rules are likely to look a lot like the proposed rules, since the SEC has limited discretion under the statute.

Wide Scope.

While the concept behind the rule is straightforward, several aspects of the rule hide traps for the unwary. First, the scope of the rule is much wider than you might expect. It is not limited to executive officers and directors of

the issuer. If adopted as proposed, the rule would disqualify offerings based on the history of a very large number of persons associated with the offering, including:

- The issuer and any predecessor of the issuer or affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of the 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; and
- any director, officer, general partner or managing member of any such compensated solicitor.

While the rule as proposed does not include investment advisers per se, the SEC solicited comment on this point, and they may add certain categories of investment advisers before they finalize the rule.

Note that the list includes, among others, the placement agent as well as its directors, officers, general partners and managing members. It does not matter whether the individual in question works on the offering. Throughout, the rule refers merely to officers and not to "executive officers," potentially capturing lower-level employees with no actual policymaking role. The list even includes passive investors in the issuer, if they own 10% or more. Finally, "affiliated issuers" are also included. An affiliate can be any person who controls the issuer, is controlled by the issuer, or is under common control with the issuer. Thus under some circumstances, this could pull in surprising persons such as portfolio companies or sister entities.

While there have been calls to modify the rule to address some of its seemingly overbroad applications, it is unclear whether this will happen. It is important to keep in mind that the SEC has only a small amount of room under the statute to alter the content of the disqualifications.

Similarly, you might assume that only serious criminal convictions would hold the power to disqualify an issuer. That is not so. The proposed rule applies to any felony or misdemeanor: (A) in connection with the purchase or sale of any security; (B) involving the making of any false filing with the Commission; or (C) arising out of conduct of the business of an underwriter, broker, or dealer. In some jurisdictions, it is possible to be convicted of a misdemeanor without any proof of fraudulent intent. In New York, for example, an issuer could, at least in theory, be convicted of a misdemeanor based on an inadvertent failure to file a notice form.

Further, the "bad acts" covered by the rule go beyond securities-related criminal convictions to include:

- Court orders that bar the individual from engaging in certain types of securities-related activities;
- Certain agency orders that are based on a violation of anti-fraud laws, or that bar the individual from engaging in certain types of securities-, banking-, or insurance-related activities;
- Certain SEC orders that suspend or revoke registration, or that impose certain kinds of limitations and

bars on certain securities-related activities;
- Suspensions or expulsions from (or from associating with a member of) a national securities exchange or registered securities association, for conduct inconsistent with just and equitable principles of trade;
- SEC stop orders or suspension orders relating to a Reg A offering – as well as currently pending investigations and proceedings to consider issuing one;
- Certain U.S. Postal Service orders relating to conduct alleged to violate anti-fraud laws.

As proposed, the coverage is extremely broad. For example, as drafted, the rule would forbid participation by a broker-dealer who was previously subject to an order issued by a state regulatory agency, even though the broker-dealer is still registered and legally operating in that state. It would disqualify an offering due to a pending investigation to consider issuing a stop order in connection with a Reg A offering, even if such an order is never issued.

The rule also does not require that the "bad acts" be of recent vintage. In many instances, the rule looks back as far as ten years. The proposal does not provide any grandfathering for disqualifying events that took place before the rule's adoption.

Waivers.

As proposed, the rule would make limited allowance for waivers, upon application to the SEC. The standard is fairly subjective, and would require the issuer to demonstrate "good cause" and lack of prejudice to any other SEC action. The SEC would have to conclude that it would not be "necessary under the circumstances" to deny the use of Rule 506 to the issuer. While it's hard to say how difficult it would be to get such a waiver, we think it would be difficult to convince the SEC to grant a waiver of a disqualification that was discovered late in the game because the issuer had failed early on to conduct adequate due diligence, discussed below.

Due Diligence Defense.

There is one important exception to the disqualification rules, and that is for an issuer who exercised "reasonable care" to discover the disqualifying facts but was unable to, despite having conducted the requisite due diligence. This means that an issuer who discovers a disqualifying event mid-way through an offering will not necessarily lose the ability to rely on Rule 506, so long as it could not have discovered it sooner through the exercise of reasonable care.

Unlike the waiver provision, the issuer is not required to make an application to the SEC to rely on this exception. However, if challenged by the SEC or some other party, the issuer will bear the burden of proof to show that it met the conditions of the exception and that its due diligence had indeed been adequate. This means that the adequacy of the diligence will in every instance be judged in hindsight, and in circumstances

where the diligence in fact failed to uncover a disqualifying event. We suspect that any issuer that ought to have been subject to a disqualifying event, yet failed to discover it, is likely to face an uphill battle convincing the SEC or a court, after the fact, that their diligence was nonetheless adequate.

Most 506 issuers, we hope, already do a certain amount of diligence to uncover bad acts by associated persons for disclosure purposes. We do not think these historical practices will be adequate anymore. As currently proposed, the new rules cover many types of persons and "bad acts" that would not necessarily require disclosure in a private placement memorandum, due to a lack of actual impact on the offering. We also think the new rules will ultimately be interpreted to require a deeper diligence than what is typically employed right now to uncover possible disclosure issues. For example, most issuers probably do not make inquiries about non-executive officers at a participating broker-dealer, who are not actually involved in the current offering, but these individuals would be covered under the new rules, at least as proposed. Finally, the issuer will bear the burden of proof under the new rules to show that it engaged in adequate diligence, whereas in an anti-fraud lawsuit, it will be less clear whether the issuer had a duty to inquire and if so to what extent.

The proposed rules do not provide bright-line tests for establishing due diligence. They do make it clear, however, that the issuer has a duty to make factual inquiry into whether any disqualifications exist. The release also states that depending on the circumstances, representations in agreements and questionnaires may not be adequate. Investigating publicly available databases may also be required, or even "further steps." The release does not expand upon what is meant by "further steps."

We also note that diligence may need to be conducted on an ongoing basis. If an individual is convicted or becomes subject to an order or other disqualifying event in the midst of an offering, this will disqualify all future sales in the offering. Similarly, because investors who own 10% or more in the issuer are covered by the rule, the issuer may need to monitor ownership levels by investors on an ongoing basis.

We think few issuers are likely to have already implemented a diligence program on this scale.

Immediate Disqualification.

As proposed, the rule would disqualify an offering from relying on Rule 506 even for bad acts committed before the rule's adoption. It appears that it will also apply to pending offerings, even if there have already been sales in the offering. While we believe the new disqualification rules could not be made to apply to historical sales in the offering prior to the adoption of the rules, unless revisions are made to the rule prior to adoption, we think the disqualification rules will immediately apply to all future sales occurring after the date of the adoption. The reason is, as noted above, the disqualification rules are drafted in such a way as to apply to individual sales, rather than the offering as a whole. Thus, unless the SEC provides some transition relief, an offering that is ongoing when the rule is adopted may have to be suspended in order to ensure compliance with the new rule.

Don't Wait Any Longer.

If you have been putting off an upgrade to your due diligence program, we think the time has come to go ahead and do it. The disqualification rules are required by clear statutory mandate, and while the SEC has some limited ability to alter the rules around the edges, the SEC cannot make large changes to the rule. Final rules are already extremely overdue, and so it is now only a matter of time. Because these rules are likely to be implemented before or at the same time as the lift of the ban on general solicitation – also overdue – there is added pressure on the agency to finalize these rules. We therefore think they could be handed down any day now.

An issuer who has not yet begun any of the diligence required to establish reasonable care runs the risk that it may have to halt its offering and wait while the diligence is conducted. Since the diligence will require more than simply passing around questionnaires, this could amount to a significant lag in time. Furthermore, if a disqualifying event is uncovered, this could disqualify the entire offering. While it may under some circumstances be possible to cure the problem by, for example, eliminating the person who is "tainting" the offering, this will not always be possible. For example, if the covered person is a passive investor in the issuer, it may not be possible to force the investor out, unless the issuer has a mandatory redemption right.

Further, because of the way the securities laws work, once a Rule 506 offering has been commenced, it may be difficult to find alternative exemptions for the offering if Rule 506 is lost, as discussed below.

Goodbye 506, Hello Blue Sky

A key important aspect of Rule 506 is that it preempts state "blue sky" offering regulation, and it is the loss of this preemption that will likely cause the most difficulty for the issuer. On the federal level, many 506 offerings may also qualify for an exemption under Section 4(2) of the Securities Act of 1933. However, because 506 allows such a large number of offerees and an unlimited offering amount, many 506 offerings may not qualify for an exemption under Section 4(2). Further, Section 4(2) offerings do not come with federal preemption.

State blue sky regulation of offerings is extremely burdensome. These laws are different from state to state, and the law of every state where an offer is made will apply. A large offering may therefore be subject to the individual laws of all 50 states. If blue sky laws apply, the first step will be to search for an exemption under each state law. Often, there will not be one for a private offering that was intended to comply with Rule 506, again due to the often extremely large number of offerees and large dollar amounts.

If there is no exemption, then registration (often called "qualification") is required. This is often a very time-consuming and burdensome process, in which each state regulator conducts 'merit review' of the offering, and often has the power to completely disallow the offering if it decides that the company or the offer is not

good enough – no matter how well the risks are disclosed. If your offering is already completed, then it is too late to register. And even if the offering is only half-way begun, it may still be too late, because generally it is illegal to make an offer before the offering has been registered (qualified). Also, many states have bad boy disqualification provisions of their own.

Concluding Thoughts.

The bad boy disqualifiers introduce a new level of uncertainty to Rule 506 offerings. Previously, Rule 506 offered safe harbor protection for issuers who were, for the most part, able to easily control compliance with each of the elements of the rule, in order to acquire a high level of comfort that the exemption was in place. The scope of the new bad boy disqualifiers erodes at this certainty and creates a very real risk that issuers could lose the exemption due to facts of which they are not even aware.

Loss of a Rule 506 exemption will often be extremely difficult or impossible to remedy. The only real way to mitigate this risk is by implementing a sensible but thorough diligence program. Because the rule is likely to be effective immediately when implemented, and because the SEC has limited discretion to modify the rule, it would be prudent to begin implementing diligence now.