

Morgan Lewis

Bad Actor Disqualification in
Private Placements
New Rule 506(d)

The Vine

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Registration or Exemption

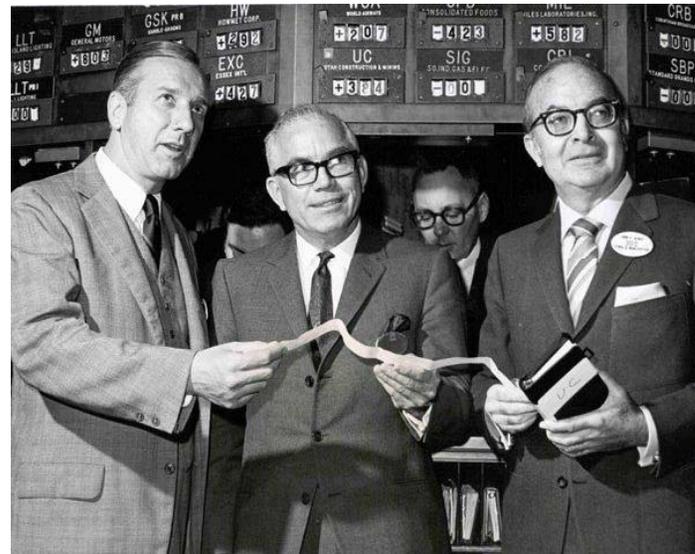
- Rule #1: Registration is Required Unless
 - Transaction doesn't involve a "security", or
 - Exempt Security, or
 - Exempt Transaction

Section 5 of the Securities Act of 1933:

- (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person,
- (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
 - (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

Registration or Exemption (cont'd)

- Rule #2: Most Common Exemption is “Private Placement”
Section 4:
The provisions of Section 5 shall not apply to—
 - (2) Transactions by an issuer not involving any public offering.
- Persistent question: What constitutes a “Public Offering”?
 - SEC unwilling to provide “no-action” guidance.



Reg D Safe Harbor

- Rule #3: Reg D Rule 506: Primary Safe Harbor for Private Placement
 - “Safe harbor” for the private offering exemption of Section 4(2).
 - Issuers can raise an unlimited amount of money.
 - Federal exemption preempts state “Blue Sky” laws.



Reg D Safe Harbor (cont'd)

– Requirements:

- Issuer cannot use “general solicitation” or advertising to market the securities
- Issuer may sell its securities to:
 - Unlimited number of “accredited investors,” PLUS
 - Up to 35 other purchasers, who alone or with a purchaser representative, must be “sophisticated” (sufficient knowledge and experience in financial and business matters to be able to evaluating the merits and risks of the prospective investment);
- Issuer can elect information to provide to accredited investors, so long as no violation of the antifraud rules;
- Issuer must give non-accredited investors disclosure generally the same as registered offerings (i.e., Form S-1);
- Issuer must be available to answer questions;
- Purchasers receive “restricted” securities (1-year hold period);
- Issuer must file a “Form D” with SEC and affected states.

“Bad Actor” Disqualification Rule

- 9/23/2013: SEC amended Rules 501 and 506 of Reg D.
- Implements section 926 of the Dodd-Frank Act.
- Prohibits use of Rule 506 exemption for securities offering in which “bad actors” are involved.
- Three Elements to the Test
 - “Covered Person” has engaged in
 - “Disqualifying Event” after
 - September 23, 2013

“Covered Person”

- The issuer, any predecessor of the issuer, and any affiliated issuer.
- Directors and executive officer, plus other officers who participate.
- General partners and managing members of the issuer.
- Beneficial owner of 20% of the issuer’s outstanding voting shares.
- Promoters connected with Issuer in any capacity at the time of sale.
 - Anyone who, alone or with others, takes initiative in founding the business, or who in connection with the founding of the business receives 10% or more of a class of issuer securities or 10% or more of the proceeds from the sale of a class of issuer securities.)
- Solicitors: Any person paid (directly or indirectly) to solicit purchasers in the offering, plus such person's general partners/managing members, and the directors, executive officers, other participating officers, general partners, and managing members of the solicitor or its general partner or managing member.
- Investment managers of issuers that are pooled investment funds, plus such investment manager's general partners and managing members, and the directors, executive officers, other officers participating in the offering, general partners, and managing members of such investment manager or its general partner or managing member.

Disqualifying Events

- Criminal convictions in connection with the purchase or sale of a security or the making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries.
 - Criminal conviction must have occurred within five years of the proposed sale of securities in the case of the issuer, its predecessors, and affiliated issuers, and within 10 years of the proposed sale of securities in the case of other covered persons.
- Court injunctions and restraining orders in connection with the purchase or sale of a security or the 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 five years of the proposed sale of securities.

Disqualifying Events (cont'd)

- Final orders of the CFTC, federal banking agencies, NCUA, or state regulators of securities, insurance, banking, savings associations, or credit unions that
 - Bar issuer from associating with regulated entity; engaging in business of securities, insurance, or banking; or engaging in savings association or credit union activities; or
 - based on violation of law or regulation prohibiting fraudulent, manipulative, or deceptive conduct and issued within 10 years of the proposed sale of securities.
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, investment advisers, and associated persons.
- SEC cease-and-desist orders, issued within 5 years before the sale of securities, that ordered the covered person to cease/desist from committing a violation of any scienter-based antifraud provision of federal securities laws or section 5 of the Securities Act.
- SEC stop orders and orders suspending Regulation A exemption, issued within 5 years of the proposed sale of securities and pending investigations or proceedings to determine whether a stop order or suspension order should be issued.
- Suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member.
- U.S. Postal Service false representation orders that were issued within five years before the proposed sale of securities and temporary or preliminary injunctions with respect to conduct alleged by the U.S. Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

Limitations to Bad Actor Disqualification

- Disqualification won't apply when the issuer can show that it did not know and, in the exercise of reasonable care, could not have known that a covered person who was the subject of a disqualifying event participated in the offering.
- Applies only to disqualifying events occurring after 9/23/2013.
 - But, issuer has obligation to disclose pre-9/23/2013 disqualifying events.
- Issuer may still rely on Section 4(2) “facts and circumstances” private placement exemption if Rule 506 is not available.
 - However, offering will be subject to Blue Sky laws, some of which require pre-offering filings.

Conclusion

- Potential for bad actor disqualification for Rule 506 offerings will require issuers, placement agents, and counsel to include in due diligence verification that no covered person is subject to a disqualification.
 - Selling agreements can be expected to include mutual representations regarding the absence of bad actor disqualifications.



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