

Also Visit – LawCast.com
The Securities Law Network

April 21, 2015



SEC Division of Corporation Finance Issues Guidance
On Bad Actor Waivers

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Last month the SEC's Division of Corporation Finance issued guidance on the granting waivers for the bad actor disqualifications under Regulation A and Rules 505 and 506 of Regulation D.

The Dodd-Frank Act required the SEC to implement rules which disqualify certain Rule 506 offerings based on the individuals involved in the issuer and related parties. On July 10, 2013, the SEC adopted such rules by amending portions of Rules 501 and 506 of Regulation D, promulgated under the Securities Act of 1933. The new rules went into effect on September 23, 2013. The rule disqualifies the use of Rule 506 as a result of certain convictions, cease and desist orders, suspensions and bars ("disqualifying events") that occur on or after September 23, 2013, and adds disclosure obligation in Rule 506(e) for disqualifying events that occurred prior to September 23, 2013.

On July 31, 2013, I summarized the final rules, which summary can be read [HERE](#). On December 4, 2013, January 3, 2014 and January 23, 2014, the SEC updated its C&DI's and issued guidance on the bad actor disqualifications, which was the topic of a prior blog and which I have summarized again at the end of this blog.

Background

Rules 262 and 505 of the Securities Act of 1933, as amended ("Securities Act") disqualify the use of offerings under Regulation A and Rule 505 of Regulation D if an issuer, its predecessor, or an affiliate of the issuer is considered a "bad actor" as defined by such rules. In particular, the rules disqualify the issuer if the specified covered person is subject to certain administrative orders, industry bars, an injunction

involving certain securities law violations or certain specified criminal convictions. “Covered persons” under the rules extends to the issuer, predecessor, affiliate, directors, officers, general partners, 10% or greater beneficial owners, promoters, underwriters, persons compensated for soliciting purchases, or any of the underwriters’ partners, directors, or officers.

Rule 506 provides that disqualifying events committed by a list of specified “covered persons” affiliated with the issuer or the offering would result in disqualification from using Rule 506 or require disclosure to investors prior to their purchasing securities. In particular, covered persons include:

The issuer and any predecessor of the issuer or affiliated issuer;

Any director, general partner or managing member of the issuer and executive officers (i.e., those officers that participate in policymaking functions) and officers who participate in the offering (participation is a question of fact and includes activities such as involvement in due diligence, communications with prospective investors, document preparation and control, etc.);

Any beneficial owner of 20% or more of the outstanding equity securities of the issuer calculated on the basis of voting power (voting power is undefined and meant to encompass the ability to control or significantly influence management or policies; accordingly, the right to elect or remove directors or veto or approve transactions would be considered voting)(note that the threshold under Rules 262 and 505 is 10% beneficial ownership);

Investment managers of issuers that are pooled investment funds; the directors, executive officers, and other officers participating in the offering; general partners and managing members of such investment managers; the directors and executive officers of such general partners; and managing members and their other officers participating in the offering (i.e., the hedge fund coverage; the term “investment manager” is meant to encompass both registered and exempt investment advisers and other investment managers) (note that this category of covered persons is not included in Rules 262 and 505);

Any promoter connected with the issuer in any capacity at the time of the sale (a promoter is defined in Rule 405 as “any person, individual or legal entity, that either alone or with others, directly or indirectly takes initiative in founding the business or

enterprise of the issuer, or, in connection with such founding or organization, directly or indirectly receives 10% or more of any class of issuer securities or 10% or more of the proceeds from the sale of any class of issuer securities other than securities received solely as underwriting commissions or solely in exchange for property”);

Any person who has been or will be paid, either 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.

Disqualifying events include:

Criminal convictions (felony or misdemeanor) within the last five years in the case of issuers, their predecessors and affiliated issuers, and ten years in the case of other covered persons, in connection with the purchase or sale of any security; involving the making of a false filing with the Commission; or 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;

Court injunctions and restraining orders, including any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any security; involving the making of a false filing with the Commission; or 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;

Final orders issued by a state securities commission (or any agency of a state performing like functions), a state authority that supervises or examines banks, savings and associations, or credit unions, state insurance regulators, federal banking regulators, the CFTC, or the National Credit Union Administration that, at the time of the sale, bars the person from association with any entity regulated by the regulator issuing the order or from engaging in the business of securities, insurance or banking or engaging in savings association or credit union activities; or constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the last ten years before the sale (note this category is not included in the Rules 262 and 505 bad actor bars);

Any order of the SEC entered pursuant to Section 15(b) or 15B(c) of the Exchange Act or section 203(e) or (f) of the Investment Advisors Act that, at the time of such sale, suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment advisor; places limitations on the activities, functions or operations of such person; or bars such person from being associated with any entity or from participating in the offering of any penny stock;

Is subject to any order of the SEC entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation of future violation of any scienter-based anti-fraud provision of federal securities laws (including, without limitation, Section 17(a)(10) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 15(c)(1) of the Exchange Act and Section 206(1) of the Advisor Act, or any other rule or regulation thereunder) or Section 5 of the Securities Act (note this category is not included in the Rules 262 and 505 bad actor bars);

Suspension or expulsion from membership in, or suspension or bar from association with, a member of an SRO, i.e., a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade;

Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; and

U.S. Postal Service false representation orders, including temporary or preliminary orders entered within the last five years.

The rule includes an exception from disqualification for offerings in which the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person. Moreover, the SEC can grant a waiver of disqualification if it determined that the issuer has shown good cause that disqualification is not necessary under the circumstances.

Division of Corporation Finance Guidance on the Granting of Waivers

Last month the SEC's Division of Corporation Finance issued guidance on the granting of waivers for the bad actor disqualifications under Regulation A and Rules 505 and 506 of Regulation D.

The SEC may grant a waiver to the bad actor disqualifications under Rules 262, 505 or 506 if, upon a showing of good cause, the SEC determines it is not necessary under the circumstances that the use of Regulation A or Rules 505 or 506 be denied. SEC waivers may be qualified or unconditional and may include specific conditions or limitations.

The SEC will consider all facts and circumstances in granting a waiver including, but not limited to, the nature of the violation or conviction, whether it involved the offer and sale of securities, and whether the conduct involved a criminal conviction or scienter-based violation as opposed to a civil or technical or administrative matter. The burden of establishing good cause to grant a waiver rests firmly on the applicant and where the underlying issue involved a criminal conviction or scienter-based violation, the burden will be significantly increased.

The party requesting a waiver must submit a complete package to the SEC addressing the factors that the SEC will consider, as described below, as part of a waiver application.

The SEC will consider the following factors in determining whether to grant a waiver to the bad actor prohibitions:

Who was responsible for the misconduct? The SEC will consider the party responsible for the misconduct and the role that the bad actor waiver applicant had with respect thereto. For example, the SEC will consider whether the applicant was the direct responsible party and if the applicant continues to maintain a control position over the issuer. Moreover, the SEC will consider the course of conduct during the underlying investigation and proceedings that led up to the order resulting in the bad actor prohibition, such as cooperation with investigators, changes to internal controls and the disassociation with parties responsible for violations.

What was the duration of the misconduct? The SEC will consider whether the misconduct occurred over a period of time or was a one-time isolated incidence.

What remedial steps have been taken? The SEC will consider remedial measures taken by the applicant, including when such measures began and the impact or results of such measures relative to the violations. For example, the SEC will consider changes in personnel, training and internal controls, policies, procedures and practices. The SEC will give greater consideration to changes that are designed to, and likely will prevent, future security law violations and will protect investors, clients and customers.

Impact if the waiver is denied. The SEC will consider the severity of the impact on the issuer and third parties, such as investors, if the waiver is not granted.

SEC C&DI Guidance

A summary of the SEC C&DI guidance on bad actor disqualifications includes:

Issuers must determine if they are subject to bad actor disqualification any time they are offering or selling securities in reliance on Rule 506. However, an issuer may reasonably rely on a covered person's agreement to provide notice of a potential or actual disqualifying event under a contractual agreement, bylaw requirement, undertaking in a questionnaire or certification or the like. For a continuous, delayed or long-lived offering, the issuer must update its factual inquiry periodically through bring-downs of representations, questionnaires and certifications, negative consent letters or database searches. The C&DI does not specify a recommended frequency for such updates.

If a placement agent becomes subject to a disqualifying event while an offering is ongoing, the issuer could continue to rely on Rule 506 for future sales in that offering if the "engagement with the placement agent was terminated and the placement agent did not receive compensation for future sales." Alternatively, if the disqualifying event affected only the covered control persons of the placement agent, the issuer could continue to rely on Rule 506 for that offering if such persons were terminated or no longer performed roles with respect to the placement agent that would cause them to be covered persons for purposes of Rule 506(d).

Under Rule 506(d), an "affiliated issuer" is an affiliate of the issuer "that is issuing securities in the same offering, including offerings subject to integration" pursuant to Rule 502(a) of Regulation D. This provision implies that hedge fund issuers will not have to make inquiry of their portfolio companies regarding disqualifying events.

The bad actor disqualification rules apply to all compensated solicitors, whether licensed as a broker-dealer or not and whether or not required to be licensed as a broker-dealer.

A covered person does not include persons whose sole involvement with a Rule 506 offering is as members of a compensated solicitor's deal or transaction committee that is responsible for approving such compensated solicitor's participation in the offering.

Participation in an offering is not limited to solicitation of investors. Examples of participation in an offering include participation or involvement in due diligence activities or the preparation of offering materials (including analyst reports used to solicit investors), providing structuring or other advice to the issuer in connection with the offering, and communicating with the issuer, prospective investors or other offering participants about the offering. To constitute participation for purposes of the rule, such activities must be more than transitory or incidental. Administrative functions, such as opening brokerage accounts, wiring funds, and bookkeeping activities, would generally not be deemed to be participating in the offering.

Convictions, orders, bars and suspensions in jurisdictions other than the United States do not trigger disqualification.

Disqualification is triggered only by orders to cease and desist from violations of scienter-based provisions of the federal securities laws, including scienter-based rules. An order to cease and desist from violations of a non-scienter-based rule would not trigger disqualification, even if the rule is promulgated under a scienter-based provision of law. For example, an order to cease and desist from violations of Exchange Act Rule 105 would not trigger disqualification, even though Rule 105 is promulgated under Exchange Act Section 10(b).

It is not necessary to seek a waiver of Rule 506(d) from the SEC staff if the relevant court or administrative order includes language stating that disqualification under Rule 506(d) should not arise as a result of the order.

The reasonable care exception applies whenever the issuer can establish that it did not know and, despite the exercise of reasonable care, could not have known that a disqualification existed under Rule 506(d)(1). This may occur when, despite the exercise of reasonable care, the issuer was (i) unable to determine the existence of a disqualifying event, (ii) was unable to determine that a particular person was a covered

person, or (iii) initially reasonably determined that the person was not a covered person but subsequently learned that that determination was incorrect.

Issuers will still need to consider what steps are appropriate upon discovery of Rule 506(d) disqualifying events and covered persons throughout the course of an ongoing Rule 506 offering. An issuer may need to seek waivers of disqualification, terminate the relationship with covered persons, provide Rule 506(e) disclosure, or take such other remedial steps to address the Rule 506(d) disqualification.

No waiver may be sought or granted from the disclosure obligation under 506(e).

Rule 506(e) requires only disclosure of events that would have triggered disqualification at the time of the offering had Rule 506(d) been applicable. Because events outside the applicable look-back period and orders that do not have continuing effect would not trigger disqualification, Rule 506(e) does not mandate disclosure of such matters in order for the issuer to be able to rely on Rule 506.

Issuers are required to provide all investors with the Rule 506(e) disclosure for all compensated solicitors who are involved with the offering at the time of sale and their covered control persons.

Rule 506(d) disqualification does not apply if the issuer is not offering securities at the time, and no disclosure need be made relating to compensated solicitors who are no longer involved in the offering at the time of sale.

The Author

Attorney Laura Anthony
Founding Partner
Legal & Compliance, LLC
Corporate, Securities and Going Public Attorneys
LAnthony@LegalAndCompliance.com

Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

Contact Legal & Compliance, LLC. Inquiries of a technical nature are always encouraged. Follow me on Facebook, LinkedIn, YouTube, Google+, Pinterest and Twitter.

Download our mobile app at iTunes and Google Play.

Disclaimer

Legal & Compliance, LLC makes this general information available for educational purposes only. The information is general in nature and does not constitute legal advice. Furthermore, the use of this information, and the sending or receipt of this information, does not create or constitute an attorney-client relationship between us. Therefore, your communication with us via this information in any form will not be considered as privileged or confidential.

This information is not intended to be advertising, and Legal & Compliance, LLC does not desire to represent anyone desiring representation based upon viewing this information in a jurisdiction where this information fails to comply with all laws and ethical rules of that jurisdiction. This information may only be reproduced in its entirety (without modification) for the individual reader's personal and/or educational use and must include this notice.

© Legal & Compliance, LLC 2015

Legal & Compliance, LLC
330 Clematis Street, West Palm Beach, FL 33401
Local: 561-514-0936 Toll-Free: 800-341-2681
LAnthony@LegalAndCompliance.com
www.LegalAndCompliance.com
www.SecuritiesLawBlog.com
www.LawCast.com