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## Bad Actors

### Complying with the SEC's new Reg D Rules

*By Gary J. Kocher and Jason R. Jones*

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On July 10, 2013, the Securities and Exchange Commission ("**SEC**") adopted amendments to Rule 506 of Regulation D ("**Reg D**") that, among other things, prohibit issuers of securities from relying on Reg D if "bad actors" are involved in the offering. These provisions are embodied in paragraphs (d) and (e) of Rule 506 and are commonly referred to as the "**Bad Actor Rule.**" The Bad Actor Rule, which became effective on September 23, 2013, adds another hoop that issuers and related parties must jump through in connection with private placements under Reg D. This alert explains the Bad Actor Rule and what issuers must do to comply.

#### Disqualification Rules – 506(d) and (e)

The Bad Actor Rule provides that the Reg D private placement exemption from registration is not available for a sale of securities if any "**Covered Person**" has been involved in a "**Disqualifying Event.**"

Covered Persons include:

- The issuer, any predecessor of the issuer, or any affiliated issuer;
- Any director, executive officer, or other officer participating in the offering;
- A general partner or managing member of the issuer;
- Beneficial owners of 20 percent or more of the issuer's outstanding voting equity securities (calculated on the basis of voting power);
- Any promoter connected with the issuer in any capacity at the time of sale;
- Any person that has been paid or will be paid for solicitation of purchasers in connection with the sale and any director, officer, general partner, or managing member of any such solicitor.

Among other things, Disqualifying Events include:

- Felony or misdemeanor convictions relating to securities or false SEC filings;
- SEC disciplinary orders; and
- Being subject to an order, judgment, decree, suspension, expulsion, or bar of any court or state securities commission that restrains a Covered Person from participating in securities and other finance-related activities.

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### Application

To the extent any Covered Person engages in a Disqualifying Event after September 23, 2013 (the “**Effective Date**”), the issuer is not entitled to rely on the Reg D private placement exemption. Any Disqualifying Event that occurred prior to the Effective Date will not prevent the issuer from relying on Reg D; however, the issuer must furnish to each purchaser, within a reasonable time prior to the closing of the sale, a written description of any such Disqualifying Event.

Moreover, the rule provides that “*if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed,*” then the bad actor disqualification does not apply even if a Covered Person is, in fact, subject to a Disqualifying Event. The rule specifically states that an “issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, **factual inquiry** into whether any disqualifications exists.” A factual inquiry may or may not be enough, but it is certainly necessary to show reasonable care. The scope of the inquiry will vary based on facts and circumstances of the offering and its participants.

### Practical Considerations for Issuers

Because the Bad Actor Rule is new, the meaning of “reasonable care” will certainly evolve as the SEC and courts enforce and interpret the rule. However, issuers should take at least the following steps:

1. Identify each Covered Person.
2. Make a factual inquiry to determine whether each Covered Person has been involved in any Disqualifying Events, or matters that would have been Disqualifying Events, before or after Effective Date. At the very least, this should include sending a letter to Covered Persons explaining the Bad Actor Rule and requesting that the Covered Person (a) certify that he, she, or it has not been involved in any Disqualifying Event and (b) list any matter that would have been a Disqualifying Event had it occurred prior to Effective Date. Additional steps, including a background check, may be necessary depending on the circumstances.
3. If a Disqualifying Event took place prior to the Effective Date, furnish to each purchaser, within a reasonable time prior to the closing of the sale, a written description of such Disqualifying Event.

We attach to this alert a certification form that can be helpful to issuers in satisfying their obligation to make reasonable inquiry of its Covered Persons in connection with an offering under Reg D. The certification form explains the new Bad Actor Rule, enumerates a list of Disqualifying Events, and asks the Covered Person to certify to the issuer that the Covered Person is not subject to a Disqualifying Event.

*The attached certification letter is provided only as an example and should not be used without consulting appropriate legal counsel. K&L Gates makes no representation or claim that the attached certification letter will be suitable for satisfying the requirements for any given offering of securities.*

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### Certification and Agreement Regarding Disqualifying Events

The undersigned is delivering this certification and agreement (this “**Certification**”) to XYZ Corporation (the “**Company**”) in order to facilitate the Company’s offering of securities (the “**Offering**”) that is being conducted under Rule 506 of Regulation D under the Securities Act of 1933 (the “**Securities Act**”).

New Rule 506(d) disqualifies issuers of securities from relying on Rule 506 if certain felons and other “bad actors” are involved in the offering. Specifically, an issuer is not able to rely on Rule 506 if a “**Covered Person**” is subject to a “**Disqualifying Event**” that occurs on or after September 23, 2013 (the “**Effective Date**”). In addition, new Rule 506(e) requires issuers to provide written disclosure to purchasers, at a reasonable time prior to the sale, of matters that would have triggered disqualification but for the fact that they occurred prior to the Effective Date. In connection with the Company’s Offering, Covered Persons include the directors and executive officers of the Company; any other officers of the Company that are participating in the Offering; beneficial owners of 20 percent or more of the Company’s voting securities; promoters; and persons compensated (directly or indirectly) for soliciting investors in the Offering.

The undersigned has been identified by the Company as a “Covered Person” within the meaning of Rule 506(d). Any acts committed by a Covered Person that constitute a Disqualifying Event prior to the Effective Date must now be disclosed to prospective purchasers in the Offering, and any acts committed by a Covered Person that constitute a Disqualifying Event on or after the Effective Date would disqualify the Company from relying on the Rule 506 exemption for the Offering. In order to fulfill its obligations under Rule 506, the Company has required each Covered Person to provide this Certification.

By my signature below, I certify and confirm that I have not been subject to or experienced any Disqualifying Event described in **Annex A**. I also agree to notify the Company immediately by email to [name of officer] at [email address] if I become subject to or experience a Disqualifying Event or receive notice of any action or state of affairs that could reasonably be expected to result in becoming subject to or experiencing a Disqualifying Event in the future.

**I hereby certify the foregoing is true, accurate, and complete:**

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Print Name

Relationship to  
Company: \_\_\_\_\_

Date: \_\_\_\_\_

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### Annex A Disqualifying Events

Any of the following constitutes a “Disqualifying Event”:

Identify each Covered Person.

- i. Criminal convictions within the last 10 years (a) in connection with the purchase or sale of any security; (b) involving the making of any false filing with the Securities and Exchange Commission (the “SEC”); or (c) 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;
- ii. Court orders, judgments, or decrees entered within the past five years that restrain or enjoin a Covered Person from engaging in any conduct or practice: (a) in connection with the purchase or sale of any security; (b) involving the making of a false filing with the SEC; or (c) 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;
- iii. Final orders of a state securities, banking, or insurance regulator; federal banking agency; the National Credit Union Administration; or the Commodity Futures Trading Commission that either:
  - a. bar the Covered Person from (1) associating with an entity regulated by such commission, authority, agency, or officer; (2) engaging in the business of securities, insurance, or banking; or (3) engaging in savings association or credit union activities; or
  - b. constitute an order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within the past 10 years.
- iv. SEC disciplinary orders that (a) suspend or revoke a Covered Person's registration as a broker, dealer, municipal securities dealer, or investment adviser; (b) limit the activities, functions, or operations of the Covered Person; or (c) bar the Covered Person from being associated with any entity or participating in the offering of any penny stock;
- v. SEC cease-and-desist orders entered within the past five years that relate to the violation or future violation of (a) any anti-fraud provision of the federal securities laws that requires a particular intention, state of mind, or scienter; or (b) the requirement to register offerings of securities with the SEC under Section 5 of the Securities Act;
- vi. Suspension of, or expulsion from, membership in a securities self-regulatory organization (“SRO”) or from association with a member of a securities SRO (such as a U.S. registered national securities exchange or national securities association) for any act or omission constituting conduct inconsistent with just and equitable principles of trade;
- vii. SEC refusal or stop orders applicable to a registration statement under the Securities Act (and orders suspending a Regulation A exemption for an offering statement) filed by a Covered Person (as a registrant or Company) or in which a Covered Person was an underwriter, as well as pending investigations or proceedings to determine whether any such order should be issued; or

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viii. U.S. Postal Service (“USPS”) false representation orders or any temporary restraining orders or preliminary injunctions within the past five years concerning conduct alleged by the USPS to constitute a scheme for obtaining money or property through the mail by false representations.

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