



# REGULATION D EXEMPTIONS AND BAD ACTOR DISQUALIFICATION

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# OVERVIEW

On September 23, 2013, an amendment to Rule 506 of Regulation D, concerning exemption from registration requirements for private placement offerings, went into effect. This amendment incorporates “bad actor” or “bad boy” provisions, which disqualify an offering from relying on the exemptions if a “covered person” has a relevant criminal conviction, regulatory or court order or other disqualifying event that occurred on or after September 23, 2013. An issuer must also disclose any disqualifying events that occurred before September 23, 2013, within a reasonable time before sale. The disqualification provisions do not apply if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed.

A wide variety of disqualifying events can trigger disclosure obligations and threaten the exemption from registration under Rule 506 and Regulation A+. As a result, anyone involved in the private placement marketplace should be familiar with the complexities of these new rules.

## WHAT QUALIFIES AS A DISQUALIFICATION EVENT?

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The following constitute disqualifying events, with respect to a covered person:

1. Within ten years before the sale (five years in the case of issuers, their predecessors and affiliated issuers), a felony or misdemeanor criminal conviction in connection with the purchase or sale of a security; involving the making of a false filing with the U.S. Securities and Exchange Commission (SEC); or arising out of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of investors;
2. A court order entered within five years before the sale, that, at the time of such sale, restrains the covered person from engaging in any conduct connected with the purchase or sale of a security; involves the making of a false filing with the SEC; or arises out of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of investors;
3. A final order issued by a state securities commission; a state authority that supervises banks, savings associations or credit unions; a state insurance commission; an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that:
  - a. at the time of such sale, bars the person from associating with an entity regulated by such authority; engaging in the business of securities, insurance or banking; or engaging in savings association or credit union activities; or
  - b. constitutes a final order based on a violation of any law or rule that prohibits fraudulent or manipulative conduct entered into within ten years before such sale;
4. An SEC order entered pursuant to Section 15(b) or 15B(c) of the Securities Exchange Act of 1934 or Section 203(e) or (f) of the Investment Advisers Act, that, at the time of such sale, suspends or revokes such person's registration as a broker, dealer, municipal securities dealer or investment adviser; places limitations on the person's activities; or bars the person from being associated with any entity or from participating in any penny stock offering;
5. An SEC order entered within five years before the sale that, at the time of such sale, orders the person to cease and desist from violating any scienter-based anti-fraud provision of federal securities laws, any other rule thereunder or the registration provisions of the Securities Act of 1933;
6. Suspension or expulsion from membership in a registered national securities exchange or registered national or affiliated securities association—or bar from associating with a member thereof—for conduct inconsistent with just and equitable principles of trade;

7. Filing or being named as an underwriter in any registration statement or Regulation A offering that, within five years before the sale, was the subject of a refusal, stop or suspension order or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop or suspension order should be issued; or
8. Subjection to a U.S. Postal Service false representation order entered within five years before the sale or to a temporary restraining order or preliminary injunction with respect to conduct alleged by the Postal Service to constitute a scheme for obtaining money or property through the mail by means of false representations.
9. Disqualifying events vary and the specific terms of each disqualification event differ slightly according to the nature of the event and the body issuing the order. Further, some of these disqualifying events do not necessarily stem from fraudulent behavior but can arise from other regulatory or compliance violations. With respect to regulatory bars or limitations on a person's professional activities, disqualifying events remain for as long as the bars are in effect or for so long as some act is prohibited or required to be performed according to the order's terms.

## WHO ARE COVERED PERSONS OR WHAT ENTITIES MAY TRIGGER DISQUALIFICATION?

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The term covered person includes the following persons:

- 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% 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<sup>1</sup>;
- 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<sup>2</sup>.

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1 - Promoter is defined in Rule 405 as any person or entity that directly or indirectly takes initiative in founding the business or enterprise of the issuer, or in connection with the founding or organization receives 10% or more of any class of issuer securities (other than those received as underwriting commissions). The language "indirectly" means that the result does not change if there are legal intermediaries (who may also be promoters) between the promoter and the issuer.

2 - Broker-dealers and their registered representatives are "covered persons." The language of the amended rule uses the term "any person" who has or will be paid, even indirectly, and SEC guidance has suggested that even those not personally subject to registration requirements, including associated persons of broker-dealers, are considered covered solicitors.

## BAD ACTOR DISQUALIFICATION EXEMPTIONS

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This amendment provides four exemptions to bad actor disqualification. If an exemption does not apply, the offering will be deemed to have lost its exemption and the issuer and persons involved with the offering will be subject to regulatory actions, including rescission, and civil liabilities.

Disqualification is not triggered under the following circumstances:

1. The conviction, order, judgment, decree, suspension, expulsion or bar occurred or was issued before September 23, 2013. However, for disqualifying events that occurred before September 23, 2013, the issuer shall furnish to each purchaser, at a reasonable time before sale, a description in writing of the disqualifying matter.
2. The SEC determines that it is not necessary to deny an exemption but only upon a showing of good cause and that the SEC will suffer no prejudice to any other action.
3. Before the relevant sale, the court or regulatory authority entering the order advises in writing (either in the order itself or in a separate writing to the SEC) that disqualification should not arise as a result of the order, judgment or decree. If the order or judgment itself contains this language, it is self-executing, and it is not necessary to seek an order from the SEC to the same effect.
4. The issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. An issuer will not be able to establish that it has exercised reasonable care unless it factually inquired into the existence of any disqualifications. The nature, scope and ultimate reasonableness of that inquiry will vary based on the facts and circumstances, including but not limited to, surrounding the issuer and the other offering participants.

## WHAT ARE THE IMPORTANT TAKEAWAYS FOR ISSUERS?

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Because the existence of disqualifying events before the effective date results in mandatory disclosure, issuers (in conjunction with issuer's securities counsel) must determine if any applicable covered persons have disqualifying events requiring disclosure in offering materials. If there are any events of this kind, the issuer (in conjunction with issuer's securities counsel) should prepare the necessary disclosure materials.

Issuers must revise due diligence procedures in connection with proposed Rule 506 and Regulation A+ offerings and enhance disclosures in placement agent, finder or similar agreements. Doing so can help reduce the risk that a disqualifying event exists with respect to covered persons, including the issuer's

or broker-dealer's relevant principals, any promoters and any paid solicitors or their relevant principals.

To assist with enhanced due diligence, some securities attorneys will supply the issuer with a due diligence questionnaire that an issuer can have all covered persons complete for the purpose of determining whether any of the "bad actor" provisions are implicated.

## ABOUT THE AUTHOR

As a results-oriented dealmaker, Jason enjoys creating solutions that bring together great people, projects and capital.

When working on sophisticated business and financing transactions, Jason focuses on the big picture to ascertain his clients' strategic business direction and formulate risk mitigation strategies to protect corporate capital and profitability. His extensive experience includes advising businesses, lenders, investors, startups, and real estate investment companies and developers across the United States, on business transactions from formation to exit, acquisition, due diligence, real estate securities offerings, joint ventures, disposition and financing of real estate.

Passionate about real estate investing, Jason frequently speaks, writes and teaches on the topic, and is also a real estate investor himself. He has authored two books about private money lenders and is working on an eBook focusing on real estate syndication. Jason leads Foster Garvey's Real Estate Funds & Syndications Team.

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