SEC Proposed “Bad Actor” Rules: Hard On Startups And Early Stage Companies

by StartUpAdmin on November 9, 2011

The Securities and Exchange Commission (SEC) has proposed new rules that will make it substantially more costly and difficult for startups and early stage companies to raise capital. These rules are designed to ensure that what they have labeled as “bad actors” are not involved in the securities offering business. No, these rules won’t spare you from any bad movies.

Why does this matter to you as the founder of or investor in a startup? Because your startups could be disabled from using Rule 506, the most commonly used securities law exemption by startups, because of these rules.

If you are not aware of Rule 506, it is the most commonly used securities law exemption for private companies raising capital. As stated by the SEC:

Rule 506 is one of three exemptive rules for limited and private offerings under Regulation D. It is by far the most widely used Regulation D exemption, accounting for an estimated 90-95% of all Regulation D offerings and the overwhelming majority of capital raised in transactions under Regulation D. Rule 506 permits sales of an unlimited dollar amount of securities to be made, without registration, to an unlimited number of accredited investors …, so long as there is no general solicitation, appropriate resale limitations are imposed, any applicable information requirements are satisfied and the other conditions of the rule are met.

The SEC's proposed "bad actor" rules are so onerous that four committees of the American Bar Association manned with very busy people took the time to publish a 23 page letter to the SEC plan in October of this year criticizing many important aspects of this proposal. The ABA letter said:

"We are particularly concerned that an overly broad implementation of the Section 926 ["bad actor"] directive could undermine the utility of Rule 506 as the most widely used exemptive safe harbor for private placements of securities, thereby materially and adversely affecting the ability of many companies, including many private companies and smaller reporting companies, to obtain capital".

Now, no one would argue that keeping "bad actors" out of the securities offering business is a bad idea. The problem is the new rules are regulatory overkill. They are especially too much for small companies that are raising small amounts of money.

In short, the proposed rules will punish a lot of good people in order to get the bad people. *This is bad policy*.

What Will the New Rules Require Startups To Do?

First, before any startup can raise money in a Rule 506 offering, the startup will have to identify all potentially "covered persons." Next, the company will have to investigate whether these "covered persons" have done anything in the past (up to potentially as long as 10 years ago) that is a "disqualifying act."

This sounds simple, right? Not really. The list of covered persons can be, in fact, extremely long. The new

rules capture, for example, as “covered person” 10% or greater shareholders. As the SEC helpfully remarked in the proposed rules:

“the number of covered persons whose presence or participation could be disqualifying may be quite large…”

Suppose you accept funds from an investor in your seed round. The investor owns 15% of the company. Later, in an action unrelated to your startup, the 15% shareholder gets in trouble with another company and becomes a “bad actor.” This could result in your company no longer being able to use Rule 506 in the future!

As stated in the ABA letter:

“We note that by reason of the broad scope of the “bad actor” classification, an injunction or other penalty with respect to securities law violations by an investor in connection with a wholly unrelated matter would, under the proposed rule, disqualify an issuer in which the investor is an over 10% owner from conducting a Rule 506 offering. Not only do we not see any means by which the issuer would be able to avoid this consequence under the proposed rule, we also believe that there exists the possibility that, unless the issuer actively monitors all litigation events affecting its larger security holders, the issuer may not even be aware of the issuance of the injunction or other penalty.

How fair is that for startup companies? Not…fair…at…all.

I agree with the ABA letter: “inclusion of ‘any beneficial owner of 10% or more of any class of the issuer’s equity securities’ within the list of persons whose prior bad acts may disqualify an issuer from use of the Rule 506 exemption…is unnecessary.”

As you might have guessed, the process of complying is actually going to be time consuming, uncertain and complex. The list of potentially disqualifying events includes a lot of things that don’t necessarily make you “bad.”

For example, mere technical errors, such as a late securities filing, could potentially turn you into a “bad actor” under these proposed rules.

In their letter, the ABA Committees asked the SEC to consider the “very broad covered persons definition” and adjust the rules to reflect the relative involvement of covered persons in an offering.

We've provided a flow chart below to help you more accurately navigate the process of determining a covered person and disqualifying act.

What Are the Consequences of Failing to Comply with the New Rules?

If you raise money under Rule 506 and later discover that there was a covered person who had engaged in a disqualifying event in the past, you will find that you didn't have a securities law exemption for your offering at all. This can result in all sorts of bad consequences. In the words of the ABA comment letter:

"In the worst case scenario, a post-offering determination that Rule 506 was not available for the offering would constitute a registration violation and trigger related rescission rights for all purchasers in the offering, a draconian remedy…"

How can startups protect themselves from this outcome? The proposed rules provide an out if you used reasonable care to investigate covered persons, but the proposed rules impose on an issuer a "did not know, and in the exercise of reasonable care could not have known" standard. The rules go on to say, onerously, that an issuer "will not be able to establish that it has exercised reasonable care unless it has made factual inquiry into whether any disqualifications exist."

In its current form, Rule 506 does not require issuers to investigate whether there are any bad actors involved in the private offering. This regulatory burden being imposed on startups and other stock issuers is brand new. And it is significant. It will slow down the capital raising process, and hurt the economy.

What's the Big Picture?

Rule 506 is a critical part of the law for the startup and early stage ecosystem. Without it, we wouldn't have nearly as many exciting startups in America today. We need to preserve the simplicity and ease of Rule 506 for startups, which are frequently not raising a lot of money.

For example, on a $500,000 fund-raise startups don't want to spend several thousand dollars of that on due diligence investigations of "covered persons." We don't need another cottage industry like the 409A valuation industry that popped up when IRC Section 409A was enacted, resulting in new fees that startups had to pay for these "new" services. We just don't need excessive rules.

What Can You Do?

The ABA letter was filed after the SEC's deadline for comments, but we really hope the SEC will pay attention to the careful reasoning contained in that letter. The SEC is no longer formally accepting comments on the new proposed rules on its website, but we recommend you write the SEC and ask the SEC to simplify the rules. No startup should have to spend thousands of dollars investigating "covered persons" in a small offering.

Let's hope that the SEC will seriously consider the recommendations of all the commentators and make the following changes in the finalized rules:

- Covered persons should only include executive officers *involved* in offerings; not all officers of the issuer, and not 10% shareholders.
- Shareholders should only be covered if they exercise control over the company.
- Predecessor entities and affiliates should not be covered persons.
- Bad acts that didn't require "scienter"—that is, a knowing or reckless disregard for the law– should not be included in the definition of "disqualifying acts."
- Injunctions that didn't require that the "covered person" be given notice shouldn't be considered disqualifying events.
- There should be a complete carve out for small offerings–such as those less than $1M total. In general, the burden of complying should be commensurate with the total capital raised.
- The reasonable investigation standard should be made to conform with the current standard for accepting money from accredited investors. Currently, if you raise money from someone you reasonably believe to be accredited, no further investigation is required. There is no "did not know, and in the exercise of reasonable care could not have known" burden placed on startups to determine if their investors were, in fact, accredited. The same standard should apply in investigating whether "covered persons" are bad actors. A startup should be able to rely on a declaration executed by a covered person that they haven't been involved in any disqualifying acts.
- http://www.scribd.com/doc/57457163/Bad-Actor-Flowchart

This advisory is a publication of Davis Wright Tremaine LLP. Our purpose in publishing this advisory is to inform our clients and friends of recent legal developments. It is not intended, nor should it be used, as a substitute for specific legal advice as legal counsel may only be given in response to inquiries regarding particular situations.