FREQUENTLY ASKED QUESTIONS RELATING TO THE DISQUALIFICATION PROVISIONS OF REGULATION A, REGULATION CF AND REGULATION D: BAD ACTORS

Introduction

What are the "Disqualification Provisions"?

The Disqualification Provisions of Regulation A may be found in Rule 262. The Disqualification Provisions of Regulation CF ("crowdfunding") may be found in Rule 503 of Regulation CF. The Disqualification Provisions of Regulation D may be found in Rule 505 and Rule 506. These rules make these exemptions from registration unavailable for an offering if the issuer or certain "covered persons" is or has been subject to a relevant criminal conviction, regulatory or court order or other disqualifying event. In these cases, the offering participants must rely on a different exemption from registration, if one is available.

In a Regulation A offering, do the Disqualification Provisions apply to both Tier 1 and Tier 2 offerings?

Yes. They apply in both cases.

In a Regulation D offering, do the Disqualification Provisions apply to offerings that involve a "general solicitation" and those that do not?

Yes. They apply in both cases.

How do the Disqualification Provisions differ in the case of Rule 505 and Rule 506 Regulation D offerings?

In the case of Rule 505 (which limits sales to $5 million in a one-year period), the Disqualification Provisions are generally designed to be comparable to those of Regulation A, and Rule 505(b)(2)(iii) cross-references the relevant provisions. For Rule 506 offerings (offerings unlimited in amount), we discuss the Disqualification Provisions in more detail below.

What Disqualification Provisions exist under Section 4(a)(7) of the Securities Act?

In December 2015, the U.S. Congress enacted Section 4(a)(7) of the Securities Act, which "codifies" an exemption similar to the 4(a)(1 ½) exemption. (*See* our Frequently Asked Questions Relating to Rule 144A: http://media.mofo.com/files/Uploads/Images/FAQRule144A.pdf)

Section 4(a)(7) may not be relied upon when a seller, or any compensated solicitor, is subject to an event that would disqualify an issuer or other covered person under Rule 506(d)(1).

Identifying Covered Persons

Who is a "covered person"?

The Disqualification Provisions apply to:

- the issuer and any predecessor;
- any affiliated issuer;
- any director, executive officer, other officer participating in the offering, general partner, or managing member of the issuer;
- any beneficial owner of 20% or more of any class of the issuer's outstanding voting equity securities, calculated on the basis of voting power (as per Exchange Act Rule 13d-3) prior to the completion of the offering in question;
- any promoter (as defined in SEC Rule 405) connected with the issuer in any capacity at the time of the sale (or time of filing or after qualification, in the case of Regulation A);
- any investment manager of an issuer that is a pooled investment fund (in the case of Regulation D);
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale of securities (a "compensated solicitor");
- any general partner or managing member of any investment manager (in the case of Regulation D) or compensated solicitor; or
- any director, executive officer or other officer participating in the offering of an investment manager or compensated solicitor or general partner or managing member of that investment manager (in the case of Regulation D) or compensated solicitor.

What is an affiliated issuer?

An "affiliated issuer" is an affiliate of the issuer that is issuing securities in the same offering, including offerings that are subject to integration under Rule 502(a) of Regulation D.

How does the SEC view affiliated entities within the same fund family for purposes of these rules?

The SEC has clarified that the term "affiliated issuer" refers to an offering made by an affiliate "that is issuing securities in the same offering." The SEC referred to prior guidance in which it provided examples of offerings involving co-issuers or multiple issuers, such as a master fund offering conducted through feeder funds created to invest the proceeds in the master fund. As a result, the term "affiliated issuer" would generally not include an affiliate of a fund, such as a portfolio company, unless that affiliate was issuing securities in the same offering.

In contrast, a fund organized to invest in a master fund that is organized and managed by an unrelated party should not be considered an affiliated issuer of the master fund, unless the new "feeder" fund owns a sufficient interest in the master fund to be an "affiliate."

How are the rules applied to an entity that was not an affiliate of the relevant issuer at the time the relevant events?

Rule 262(c), Rule 503(c) of Regulation CF and Rule 506(d)(3) provide that the Disqualification Provisions do not apply to events relating to any affiliated issuer that occurred before the affiliation arose if the affiliated entity is not (a) in control of the issuer or (b) under

common control with the issuer by a third party that was in control of the affiliated entity at the time of the relevant events.

What does it mean to have an officer "participate" in the offering?

Participation in an offering means more than transitory or incidental involvement. The term could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents, providing structuring or other advice, and communication with the issuer, prospective investors or other offering participants. Participation in an offering is not limited to solicitation of investors. Administrative functions, such as opening brokerage accounts, wiring funds, and bookkeeping activities, are generally not deemed to be participating in the offering. The SEC has also indicated that persons whose sole involvement with an offering is as members of a compensated solicitor's deal or transaction committee that is responsible for approving the entity's participation in the offering are not "participating" in the offering.

How do the definitions of "covered person" differ as to Regulation A and Regulation CF, on the one hand, and Regulation D, on the other hand?

Any investment manager of an issuer that is a pooled investment fund and any director, executive officer or other officer participating in the offering of any such investment manager or general partner or managing member of such investment manager is a covered person included in Rule 506(d), but not included in Regulation A and Regulation CF. This is because an "investment company" can be eligible to issue securities under Regulation D, but not under Regulations A and CF. Note also that Regulations D and CF contemplates "compensated solicitors," while Regulation A contemplates "underwriters."

Are operators of matchmaking portals deemed to be compensated solicitors that are subject to the Disqualification Provisions?

Probably not, if they are not receiving transaction-based compensation. Section 4(b)(1) of the Securities Act provides an exemption from broker-dealer registration for operators of matchmaking portals for Rule 506 offerings, provided, among other things, that those persons do not receive compensation in connection with the purchase or sale of those securities. In C&DI 260.17, the SEC noted that compensated solicitors are not limited to brokers who are subject to registration under Section 15(a)(1) of the Exchange Act. The SEC stated that "all persons who have been or will be paid, directly or indirectly, remuneration for solicitation of purchasers are covered by Rule 506(d), regardless of whether they are, or are required to be registered under … Section 15(a)(1) …." Although not directly addressed by the SEC, it appears that a matchmaking portal that satisfies the exemption from broker or dealer registration provided by Section 4(b)(1) could not be operated by a person that is a compensated solicitor as to the offering.

What additional types of persons are disqualified from acting as intermediaries under the crowdfunding regulations?

Under Rule 503(c) of Regulation CF, a person that is subject to a statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act) may not act as, or be an associated person of, an intermediary in a crowdfunding transaction unless permitted by an SEC rule or order. The Section 3(a)(39) provisions bar certain

persons from becoming a member in a self-regulatory organization such as FINRA, and Rule 503(c) is principally directed at funding portals.

Understanding Disqualifying Events

What are the types of disqualifying events?

There are eight categories of disqualifying events. They are:

- criminal convictions;
- court injunctions and restraining orders;
- "final orders" of certain state regulators (such as securities, banking and insurance) and federal regulators, including the U.S. Commodity Futures Trading Commission (the "CFTC");
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- certain SEC cease and desist orders;
- suspension or expulsion from membership in, or suspension or barring from association with, a member of, a securities self-regulatory organization ("SRO");
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

What types of criminal convictions constitute a "disqualifying event"?

Rule 262(a)(1), Rule 503(a)(1) of Regulation CF and Rule 506(d)(1)(i) provide for disqualification if any covered person who has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security, involving the making of any false filing with the SEC 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. In the case of Regulation CF, activities in acting as a funding portal would also be included.

The rules include a five-year look-back period for criminal convictions of issuers, their predecessors and affiliated issuers, and a ten-year look-back period for other covered persons.

Do orders and judgments occurring outside of the United States imposed by non-U.S. regulators result in Disqualifying Events?

No. *Source:* SEC CD&I, 260.20.

What types of court injunctions and restraining orders constitute a Disqualifying Event?

Rule 262(a)(2), Rule 503(a)(2) of Regulation CF, and Rule 506(d)(1)(ii) disqualify any covered person if the covered person is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before the sale (or the filing, in the case of Regulation A or CF), that, at the time of the sale (or filing), restrains or enjoins that person from engaging in or continuing any conduct or practice (i) in connection with the purchase or sale of any security, (ii) involving the making of a false filing with the SEC or (iii) arising out of the conduct of business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities. In the case of Regulation CF, as in the above discussion of criminal

convictions, activities in acting as a funding portal would also be included.

What types of final orders of certain regulators constitute a disqualifying event?

Final orders of regulatory agencies or authorities are covered by Rule 262(a)(3), Rule 503(a)(3) of Regulation CF, and Rule 506(d)(1)(iii). Those sections disqualify any covered person who is subject to a final order of a state securities commission (or an agency or officer of a state performing similar functions); a state authority that supervises or examines banks, savings associations or credit unions; a state insurance commission (or an agency or an officer of a state performing similar functions); an appropriate federal banking agency; the CFTC; or the National Credit Union Administration. The order must be final, and (A) at the time of the sale (or filing), bars the person from (i) association with an entity regulated by that commission, authority, agency or officer; (ii) engaging in the business of securities, insurance or banking; or (iii) engaging in savings association or credit union activities; or (B) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct entered within ten years of that sale (or filing).

What is a "final order"?

Rule 261, Rule 503(a)(3) of Regulation CF, and Rule 501(g) define a "final order" as a written directive or declaratory statement issued by a federal or state agency described in Rule 262(a)(3), Rule 503(a)(3) of Regulation CF, or Rule 506(d)(1)(iii) under applicable statutory authority that provides for notice and an opportunity for a hearing, which constitutes a final disposition or action by that federal or state agency. (The definition is based on the FINRA definition set forth in FINRA's forms.)

Rule 262(a)(3)(ii), Rule 503(a)(3)(ii) of Regulation CF and Rule 506(d)(1)(iii)(B) provide that disqualification must result from final orders of the relevant regulators that are "based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct." Despite the suggestions of commenters, the SEC did not define "fraudulent, manipulative or deceptive conduct," did not exclude technical or administrative violations and did not limit the Disqualification Provisions to matters involving scienter.

Rule 262(a)(4), Rule 503(a)(4) of Regulation CF and Rule 506(d)(1)(iv) will also disqualify a Covered Person if that person is subject to an order under Section 15(b) or 15B(c) of the 1934 Act, or Section 203(e) or (f) of the Investment Advisers Act, that, at the time of the offering or the filing: (i) suspends or revokes the person's registration as a broker, dealer, municipal securities dealer or investment adviser (or funding portal, in the case of Regulation CF); (ii) places limitations on the activities, functions or operations of that person; or (iii) bars that person from being associated with any entity or from participating in the offering of any penny stock.

What kind of SEC cease and desist orders constitute "Disqualifying Events"?

Under Rule 262(a)(5)(i), Rule 503(a)(5) of Regulation CF and Rule 506(d)(1)(v), an offering will be disqualified if any covered person is subject to any order of the SEC entered within five years before the sale (or in the case of Regulation A or Regulation CF, the filing) that, at the time of the sale (or filing), orders the person to cease

and desist from committing or causing a future violation of (i) any scienter-based anti-fraud provision of the federal securities laws, including Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, Section 15(c)(1) of the Exchange Act and Section 206(1) of the Investment Advisers Act, or any other rule or regulation thereunder; or (ii) Section 5 of the Securities Act. Note that the disqualification provision for Section 5 of the Securities Act does not require scienter, which is consistent with the strict liability standard imposed by Section 5.

Does suspension or expulsion from SRO membership or association with an SRO member constitute a "Disqualifying Event"?

Yes. Rule 206(a)(6), Rule 503(a)(6) of Regulation CF, and Rule 506(d)(1)(vi) disqualify any covered person that is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade. This provision does not include a look-back period.FRO

What types of other orders will result in a disqualification?

Under Rule 206(a)(7), Rule 504(a)(7) of Regulation CF, and Rule 506(d)(vii), a Covered Person will be disqualified if that person has filed (as a registrant or an issuer) or was named as an underwriter in a registration statement or offering statement filed with the SEC that, within five years before the sale (or the filing of the offering statement) was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of sale (or filing), the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.

What is a U.S. postal service false representation order?

The U.S. False Representation Statute (39 U.S.C. § 3005) is used to protect the public from monetary loss where proving fraudulent intent is difficult. The Postal Service may sue a promoter that has made false representations in order to obtain money or property through the mail. If a judge rules that the promotion violates the statute, a false representation order ("FRO") is issued by the Judicial Officer of the Postal Service. It directs the postmaster in the city where the promoter is receiving mail to return to the senders all mail connected with the promotion.

How are disqualifying events treated if they occurred prior to the adoption of the relevant rules?

Rule 262(b), Rule 503(b) of Regulation CF and Rule 506(d)(2)(i) provide that disqualification will not arise as a result of events that occurred prior to June 19, 2015, in the case of Regulation A, May 16, 2016, in the case of Regulation CF, and September 23, 2013, in the case of Regulation D.

However, in the case of Regulation A, these matters must be disclosed in writing to investors in Part II of Form 1-A. In the case of Regulation CF, these matters must be disclosed in their offering materials. In the case of Regulation D, Rule 506(e) requires written disclosure to purchasers, at a reasonable time prior to the sale, of matters that would have triggered disqualification except that they occurred prior to the rule's effective date. (This disclosure requirement applies to all Rule 506 offerings, regardless of whether purchasers are accredited investors.) Failure to make these disclosures will not be an "insignificant deviation" as contemplated

by the relevant exemption; consequently, relief under that rule will not be available for the failure. Unlike some of the other aspects of the Disqualifying Provisions, the disclosure provisions are not subject to the potential for waivers.

The SEC has indicated that Rule 506(e) does not require disclosure of past events that would no longer trigger a disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years prior to an offering.

Determining Whether a Disqualifying Event Has Occurred

Do the Disqualifying Provisions apply if the existence of a disqualifying event was not known by the issuer?

It depends. Rule 262(b)(4), Rule 203(b)(4) of Regulation CF, and Rule 506(d)(2)(iv) create a reasonable care exception that would apply if an issuer can establish 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.

In order to rely on the reasonable care exception, the issuer must conduct a factual inquiry, the nature of which depends on the facts and circumstances of the issuer and the other offering participants. In this inquiry, an issuer should consider various factors, such as the risk that bad actors present, the presence of screening and other compliance mechanisms, the cost and burden of the inquiry, whether other means used to obtain information about the covered persons are adequate, and whether investigating publicly available information is reasonable.

What practical steps can issuers and placement agents take to determine whether any disqualifying events have occurred?

As a practical matter, issuers and placement agents must implement procedures in connection with any relevant offering, in order to identify any disqualifying events on the part of the issuer, any existing or potential placement agent or any other covered person. Knowledge of any disqualifying event (or any event or proceeding that could, with the passage of time, ripen into a disqualifying event) is essential in determining whether the issuer can proceed with the offering, whether it can use a potential placement agent, and whether any pre-effective disqualifying events will need to be disclosed.

To address these issues, issuers have:

- Added additional questions to D&O questionnaires;
- Asked 20% or greater shareholders to complete questionnaires;
- Required placement agents to complete a questionnaire or provide a representation;
- Require other participants (that may be covered persons) to complete questionnaires or provide representations; and
- For funds or other issuers engaged in continuous or delayed offerings, refreshing or updating their diligence, such as through periodic scheduled bring-down representations, questionnaires and certifications, negative consent letters, periodic scheduled re-checking of public databases and other steps, depending on the circumstances.

To address these issues, placement agents:

- Prior to any Rule 506 offering, conduct diligence on issuers and other offering participants so that any disqualifying events that occurred prior to the effectiveness of the amendments can be properly disclosed, and determine whether the new representations described above can be made (including discussing the potential impact of any event that, with the passage of time, could become a disqualifying event); and
- Review Forms U-4, U-5 and U-6 filed with FINRA and compare any events described in those forms to the applicable disqualifying events, in preparation for the possibility of either disclosing those events as pre-effectiveness disqualifying events or to confirm compliance with any of the new representations described above.

A typical pre-offering diligence investigation should uncover many of the disqualifying events, as the documentary diligence request list would normally ask for any communications with regulators. Those drafting a documentary diligence request list for an offering should ensure that the list includes all relevant covered persons; i.e., the list should list out each of those persons, and not use any shorthand reference to the rule. Issuers may not be familiar with all of the potential covered persons. Disqualifying events uncovered by the diligence investigation will require a new level of analysis prior to commencing the offering.

Broker-dealers and other compensated solicitors will have on file various forms, such as FINRA Form U4 and Form ADV, which require disclosure by their employees and others of "bad acts" similar to those that may constitute a disqualification event. Reviewing those forms is likely to be helpful in identifying any covered person that may be subject to a disqualification event. Some of the responses required by those forms, however, may list past acts that would not constitute a disqualification event. As a result, a respondent who provides a "yes" answer to the disclosure questions of Form U4 or Form ADV will not necessarily be disqualified from participating in an offering under Regulation A, Regulation CF or Regulation D. Conversely, there are also some disqualification events under these rules that are not contemplated by Form U4 or Form ADV; accordingly, review of these forms will not be sufficient to ensure that all types of disqualification events are known.

Did the SEC adopt specific rules indicating how to comply with the reasonable care standard?

No. The SEC did not prescribe particular steps as being necessary or sufficient to establish reasonable care. However, the SEC has noted that if the circumstances give an issuer reason to question the veracity or accuracy of the responses to its inquiries, then reasonable care would require the issuer to take further steps or undertake additional inquiry to provide a reasonable level of assurance that no disqualifications apply.

Disqualification Events During an Offering

If a placement agent or one of its covered control persons becomes subject to a disqualifying event while an offering is still ongoing, could the issuer continue to rely on Rule 506 for that offering?

Yes. The issuer could 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 the future sales. Alternatively, if the triggering 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 those 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).

Source: SEC CD&I, 206.15.

Waivers from Disqualification Events

If a Covered Person is a disqualified person, are waivers available?

Yes, upon a showing of good cause. The SEC has articulated its standards for granting these waivers on its website:

http://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml

Waivers will also apply under Rule 262(b)(3), Rule 203(b)(2) of Regulation CF, and Rule 506(d)(2)(iii), if, before the relevant sale (or filing of an offering statement, in the case of Regulation A), the court or regulatory authority that entered the relevant order, judgment or decree advises in writing (whether contained in the relevant judgment, order or decree or separately to the SEC or its staff) that disqualification under Rule 262(a), Rule 203(b)(3) of Regulation CF, or Rule 506(d)(1) should not arise as a result of that order, judgment or decree.

Certifications as to Disqualifications

Must an issuer certify that it is not subject to the Disqualification Provisions?

Yes. For Regulation A offerings, the required Form 1-A, Item 3, requires the issuer to certify that no disqualifying events have occurred and to indicate whether related disclosure will be included in the offering's offering circular. The form of offering statement for use in Regulation CF offerings contains a similar certification. The signature block of current Form D contains a certification that applies to transactions under Rule 505 and Rule 506, confirming that the offering is not disqualified from reliance on Rule 505.

By Lloyd S. Harmetz, Partner,
and Bradley Berman, Of Counsel,
Morrison & Foerster LLP