Every Rule Must Play Its Part, But This Part Is A Sad One

There is much to dislike in the SEC’s recent “bad actor” rule amendments. While Congress conceived the idea of disqualifying bad actors (Section 926 of the Dodd-Frank Act), the SEC was more than a midwife. Here are a few reasons why I believe that the SEC’s naughty thespian rule amendments will make the world of Rule 506 offerings a more treacherous place for issuers trying to raise much needed capital:

1. The list of “bad actors” is long and ambiguous.

The SEC chose to include the categories of persons covered by Rule 262, the rule governing disqualification in Regulation A offerings. While this can be justified by
Section 926’s reference to Rule 262, Congress made it clear that the new rule need not match Rule 262 exactly. Indeed, the SEC’s rule amendments added categories of miscreant performers to those in Rule 262. If the SEC has authority to add players, there is no reason why it couldn’t remove a few from the stage. By my count, there are approximately 20 categories of persons who are subject to potential disqualification. The actual number of persons could be quite large. Moreover, some categories are ambiguous. For example, what does it mean to “participate” in the offering? In the adopting release, the SEC downplayed the difficulty of this determination, but provided no guidance on what participation might include. Other categories could require extensive analysis. For example the adopting release states “In particular, the definition [of promoter in Rule 405] requires issuers to look through entities and makes it unnecessary for us to separately cover officers, directors and other control persons that qualify as promoters.”

2. The list of disqualifying events is long and complicated.

Again, the SEC looked to Rule 262 in formulating the list of disqualifying events. While Rule 506 is used by large, sophisticated issuers it will be also used by a great many start-up and small companies. I’d be surprised that the average founder of a start-up could tell you which provisions of the Securities Act, Securities Exchange Act and Investment Advisers Act are “scienter-based anti-fraud” provisions.

3. The list of disqualifying events is inconsistent with the disclosures mandated by Item 401 of Regulation S-K.

Reporting companies also rely on Rule 506 (e.g., in Rule 144A transactions). These companies are subject to disclosure of various bad acts pursuant to Item 401 of Regulation S-K. The Item 401 disclosures, however, are not the same as the Rule 506 disqualifying events. While this isn’t entirely illogical, it is inconvenient and adds to the complexity of disclosure in an extremely complex disclosure regime.

4. The SEC’s use of “facts and circumstances” to determine reasonable care is decidedly unhelpful.

From a regulatory perspective, it is useful to provide a very general standard and then state that compliance must be determined on a “facts or circumstances” basis. This gives maximum flexibility to the regulator while providing no guidance to the person subject to the rule. I suspect that many people will try to establish reasonable care by the use of questionnaires or certifications, but the SEC has said only that this “may be sufficient in some circumstances”. Issuers may check on-line databases, but the SEC admits that “there is no central repository that aggregates information from all the federal and state courts and regulatory authorities that would be relevant in determining whether covered persons have a disqualifying event in their past.” Another question will be “how deep should we put in the plow?” Again, the SEC offers no useful guidance, saying only that “in general” issuers should make factual inquiry of covered persons but that it may be sufficient to make inquiry of an entity concerning the relevant set of covered persons.

5. The SEC’s burden and cost estimates are unrealistic.
The SEC’s cost estimates that 19,908 Rule 506 issuers will spend on average only one additional hour of time conducting the factual inquiry necessary to establish reasonable care. Given the size of the list of covered persons and the complexity of disqualifying events, this estimate is wholly unrealistic.

4. The amendments make Rule 506 very perilous.

The effect of the SEC’s rule amendments is to make Rule 506 unavailable for the sale of a security if any covered person suffers from a disqualifying event. This disqualification will apply to “traditional” Rule 506 offerings as well as offerings in which there is a permitted “general solicitation”. While Rule 506 is a non-exclusive safe harbor, the loss of the exemption means that the issuer also loses preemption of state securities laws under Section 18 of the Securities Act. This may prove to be particularly problematical for issuers who take advantage of the impending rule changes permitting general solicitations because state exemptions may be conditioned on the absence of a general solicitation (e.g., Cal. Corp. Code § 25102(f)).

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National Law Review, Volume III, Number 228

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