



441 G St. N.W.
Washington, DC 20548

B-325015

August 8, 2013

The Honorable Tim Johnson
Chairman
The Honorable Michael D. Crapo
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Jeb Hensarling
Chairman
The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives

Subject: *Securities and Exchange Commission: Disqualification of Felons and Other “Bad Actors” From Rule 506 Offerings*

Pursuant to section 801(a)(2)(A) of title 5, United States Code, this is our report on a major rule promulgated by the Securities and Exchange Commission (Commission) entitled “Disqualification of Felons and Other ‘Bad Actors’ From Rule 506 Offerings” (RIN: 3235-AK97). We received the rule on July 11, 2013. It was published in the *Federal Register* as a final rule on July 24, 2013. 78 Fed. Reg. 44,730.

The final rule adopts amendments to the Commission rules to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).¹ Section 926 requires the Commission to adopt rules that disqualify securities offerings involving certain “felons and other ‘bad actors’” from reliance on Rule 506 of Regulation D. The rules must be “substantially similar” to Rule 262 under the Securities Act, which contains the disqualification provisions of Regulation A under the Securities Act, and must also cover matters enumerated in Section 926 of the Dodd-Frank Act (including certain state regulatory orders and bars). The stated effective date for this final rule is September 23, 2013.

Enclosed is our assessment of the Commission’s compliance with the procedural steps required by section 801(a)(1)(B)(i) through (iv) of title 5 with respect to the rule. Our review of the procedural steps taken indicates that the Commission complied with the applicable requirements.

¹ Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (July 21, 2010) (codified at 15 U.S.C. 77d note).

If you have any questions about this report or wish to contact GAO officials responsible for the evaluation work relating to the subject matter of the rule, please contact Shirley A. Jones, Assistant General Counsel, at (202) 512-8156.

signed

Robert J. Cramer
Managing Associate General Counsel

Enclosure

cc: Elizabeth M. Murphy
Secretary
Securities and Exchange Commission

REPORT UNDER 5 U.S.C. § 801(a)(2)(A) ON A MAJOR RULE
ISSUED BY THE
SECURITIES AND EXCHANGE COMMISSION
ENTITLED
"DISQUALIFICATION OF FELONS AND OTHER
'BAD ACTORS' FROM RULE 506 OFFERINGS"
(RIN: 3235-AK97)

(i) Cost-benefit analysis

The Securities and Exchange Commission (Commission) considered the effects of this final rule, including the benefits and costs of Section 926 of the Dodd-Frank Act as well as the incremental costs and benefits of the rules and rule amendments associated with the exercise of its discretion in implementing Section 926. The Commission stated that the costs and benefits attributable to the statutory mandate and those attributable to its discretion may not be entirely separable to the extent that its discretion is exercised to realize the benefits that the Commission believes were intended by the Dodd-Frank Act.

Section 2(b) of the Securities Act¹ requires the Commission, when engaging in rulemaking where it is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The Commission considered those issues as part of its economic analysis.

Section 926 of the Dodd-Frank Act requires the Commission to adopt rules excluding felons and other bad actors from participation in Rule 506 offerings. The Commission states that the disqualification provisions of Rule 506 were intended to and should lead to enhanced investor protection by reducing the number of offering participants who have previously engaged in fraudulent activities or who previously violated securities, insurance, banking or credit union laws or regulations, and by providing an additional deterrent to future fraudulent activities. The disqualification rules the Commission adopted in this final rule should alter industry practice by inducing issuers and other covered persons to implement additional measures to restrict bad actor participation in Rule 506 offerings.

The Commission states that to the extent the new disqualification provisions result in a reduction of fraud in the Rule 506 offering market, investor losses to fraud will be reduced and investor willingness to participate in the Rule 506 market could increase. According to the Commission, this should lower the issuance costs for Rule 506 offerings to the extent that new disqualification standards lower the risk premium associated with the presence of bad actors in securities offerings. The Commission believes that lower costs in the Rule 506 offering market could improve conditions for capital formation, benefitting both issuers and investors. In this regard, commenters to the Commission also emphasized investor protection and increased participation in the private placement market as the main benefits of the rule. The Commission also addressed other commenter concerns about various other costs and benefits, but stated that it is difficult to provide any standardized estimates of the costs involved with the factual

¹ 15 U.S.C. § 77b(b).

inquiry for determining disqualification from the Rule 506 exemption, and the Commission is currently unable to accurately estimate the burdens and costs for issuers in a verifiable way. The Commission states that it expects that the costs to issuers may be higher or lower depending on the size of the issuer and the number and roles of covered persons.

(ii) Agency actions relevant to the Regulatory Flexibility Act (RFA), 5 U.S.C. §§ 603-605, 607, and 609

The Commission prepared a Final Regulatory Flexibility Act Analysis for this final rule. The analysis included a discussion of (1) the reasons for, and objectives of, the final rule; (2) significant issues raised by public comment; (3) small entities subject to the final rule; (4) reporting, recordkeeping, and other compliance requirements; (5) duplicative, overlapping or conflicting federal rules; and (6) significant alternatives to minimize effect on small entities. The amendments will affect issuers (including both operating businesses and investment funds that raise capital under Rule 506) and other covered persons, such as financial intermediaries, that are small entities. The final amendments will apply to all issuers that conduct offerings under Rule 506 and will affect small issuers (including both operating businesses and pooled investment funds that raise capital under Rule 506) relying on this exemption from Securities Act registration. All issuers that sell securities in reliance on Regulation D are required to file a Form D with the Commission reporting the transaction. For the year ended December 31, 2012, 16,067 issuers made 18,187 new Form D filings, of which 15,208 relied on the Rule 506 exemption. Based on information reported by issuers on Form D, there were 3,958 small issuers relying on the Rule 506 exemption in 2012. This number likely underestimates the actual number of small issuers relying on the Rule 506 exemption, however, because over 50 percent of issuers declined to report their size.

(iii) Agency actions relevant to sections 202-205 of the Unfunded Mandates Reform Act of 1995, 2 U.S.C. §§ 1532-1535

As an independent regulatory agency, the Commission is not subject to the Act.

(iv) Other relevant information or requirements under acts and executive orders

Administrative Procedure Act, 5 U.S.C. §§ 551 et seq.

On May 25, 2011, the Commission published a proposed rule. 76 Fed. Reg. 31,518 (published in the *Federal Register* on June 1, 2011). The Commission received approximately 44 comment letters and 3 advance comment letters commenting on Section 926 before the publication of the proposing release, from individuals, groups and constituencies, including state securities regulators, professional and trade associations, lawyers, academics, and individual investors. The comments included general support, but many suggested modifications regarding the proposed rule. The Commission responded to public comments in the final rule.

Paperwork Reduction Act (PRA), 44 U.S.C. §§ 3501-3520

The Commission determined that this final rule contains an information collection requirement under the Act. The title of this information collection requirement is "Regulation D Rule 506(e) Felons and Other Bad Actors Disclosure Statement," and it has been submitted to the Office of Management and Budget (OMB) for review. The Commission estimates the total annual increase in paperwork burden for all affected Rule 506 issuers to comply with the proposed

collection of information requirements to be approximately 22,108 hours of company personnel time for a cost of \$264,000 for the services of outside professionals.

Statutory authorization for the rule

The Commission promulgated this final rule under the authority of the Securities Act of 1933, as amended, 15 U.S.C. §§ 77d(a)(2), 77s and 77z-3, Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 926, 124 Stat. 1376, 1851 (July 21, 2010) (codified at 15 U.S.C. § 77d note), and sections 4A and 4B of the Securities Exchange Act of 1934, 15 U.S.C. § 78d-1, 78d-2.

Executive Order No. 12,866 (Regulatory Planning and Review)

As an independent regulatory agency, the Commission is not subject to the Order.

Executive Order No. 13,132 (Federalism)

As an independent regulatory agency, the Commission is not subject to the Order.