

SEC Proposes New Rules for Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings

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On May 25, 2011, the Securities and Exchange Commission (“SEC”) proposed amendments to rules (the “Release”)[1] to disqualify certain private offerings of securities involving “felons and other bad actors” from reliance on the safe harbor provisions provided by Rule 506 of Regulation D for exemption from registration under the Securities Act of 1933 (the “Securities Act”).[2] The Release implements Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), which was designed to address concerns that fraudsters and other bad actors could be exploiting the exemptions from federal and state securities registration in order to perpetrate securities frauds.[3]

Comments on the Release are due by July 14, 2011.

A. Background

Regulation D of the Securities Act provides three exemption rules from the registration requirements of the Securities Act for limited and private offerings. In particular, Rule 506 is the most widely used Regulation D exemption, accounting for more than 90 percent of all Regulation D offerings. Rule 506 allows a qualifying issuer to raise unlimited capital from an unlimited number of “accredited investors” and up to 35 non-accredited investors without general solicitation or advertising so long as certain

other conditions of the rule are met.[4] Under the current law, Rule 506 does not impose any disqualification requirements for bad actors under federal law and since the securities are “covered securities” the state level bad actor disqualification rules do not apply.

B. Covered Persons

The proposed rule would apply to the following persons:

- The issuer, including its predecessors and affiliated issuers;
- Any director, officer, general partner or managing member of the issuer;
- Any beneficial owner of 10 percent or more of any class of issuer's equity securities;
- Any promoter connected with the issuer in any capacity at the time of the sale;
- Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and
- Any director, officer, general partner, or managing member of any such compensated solicitor.

C. Disqualifying Events

The proposed rule would disqualify offerings from reliance on Rule 506 in the event that any covered person:

- Was convicted of a felony or misdemeanor:
 - (i) in connection with the purchase or sale of any security; (ii) involving the making of any false filing with the SEC; or (iii) arising out of the conduct of certain types of financial intermediaries, including underwriters, brokers, dealers, municipal securities dealers or investment advisers. This disqualifying event would have to have occurred within ten years before the date of the proposed sale of securities (or five years, in the case of issuers, their predecessors and affiliated issuers).
- Is subject to any court order, judgment or decree that enjoins or restrains the covered person from engaging in any conduct or practice: (i) in connection with the purchase or sale of any security; (ii) involving the making of any false filing with the SEC; or (iii) arising out of the conduct of certain types of financial intermediaries. This disqualifying event would have to have occurred within five years of the proposed sale of securities.
- Is subject to any final order from certain state regulators (such as state securities, banking, and insurance regulators) and federal banking regulators or the National Credit Union Association that bars the covered person at the time of sale of securities from: (i) associating with an entity regulated by such authorities; (ii) engaging in the business of securities, insurance or banking; or (iii) engaging in savings association or credit union activities. This disqualifying event also includes final orders that are based on fraudulent, manipulative, or deceptive conduct and issued within ten years before the proposed sale of securities.
- Is subject to certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, or investment advisers that, at the time of such sale of securities: (i) suspends or revokes such person's registration; (ii) places limitations on the activities, functions or operations of such person; or (iii) bars such person from being associated with any entity or from participating in the offering of any penny stock. This disqualifying event extends for the period of suspension or revocation.
- Is suspended or expelled from membership in, or association with a member of, a registered national securities exchange or a registered national securities association for acts or omissions constituting conduct inconsistent with just and equitable principles of trade, which would be disqualifying for the period of suspension or expulsion.
- Has filed as a registrant or issuer, or was an underwriter in, any registration statement or Regulation A offering statement filed with the SEC, that within five years of the proposed sale of securities was the subject of a refusal order, stop order or order suspending a Regulation A exemption, or that at the time of the proposed sale is the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.
- Is subject to a U.S. Postal Service false representation order issued within five years before the proposed sale of securities.

D. Reasonable Care Exception

The proposed rule provides an exception from disqualification for offerings, despite the existence of a disqualifying event, if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. The issuer has the burden of establishing that it exercised reasonable care by making a factual inquiry of the facts and circumstances of the issuer and the other offering participants. The Release states that, in some circumstances, factual inquiry of covered persons, for example by including additional questions in questionnaires may be adequate, but advises issuers to consider whether investigating publicly available databases is reasonable and warns that, in some circumstances, further steps may be necessary.

E. Pre-Existing Disqualifying Events

Under the proposed rule, bad actor disqualification would apply to sales of securities that take place after the effective date of the new rule based on all disqualifying events that occurred within the relevant time periods. This would include events that occurred before the enactment of the Dodd-Frank Act or effectiveness of the amendments to Rule 506.

F. Waivers

The proposed rule would allow issuers to seek waivers from disqualification. However, waivers would have to be issued by a direct order of the SEC itself, unlike waivers under Regulation A, which may be granted by the Director of the Division of Corporation Finance under delegated authority.

G. Amendments to Increase Uniformity Across Other Exemptive Rules

The SEC is requesting comment on other possible amendments to the rules, including: (i) applying the new bad actor disqualification provisions for Rule 506 offerings on a uniform basis for other Securities Act exemptive rules that are subject to bad actor disqualification, namely Regulation A, Regulation D and Regulation E⁵, and (ii) making uniform all

of the look-back periods that apply to disqualifying events that have an express look-back period.

H. Practice Point

Assuming that the rules are adopted substantially as proposed, issuers should take certain steps to be able to rely on Rule 506, despite the existence of a disqualifying event. For example, an officer of a large broker-dealer may have a disqualifying event in their past that would subject the entire offering to disqualification. In order to establish the exercise of "reasonable care" that would qualify an issuer to claim an exception from disqualification, issuers should:

- undertake an inquiry of all covered persons;
- modify existing due diligence questionnaires;
- take appropriate action to remove any existing disqualifications;
- seek waivers of disqualification, if necessary;
- check publicly available databases; and
- undertake other factual inquiries, as appropriate.

ENDNOTES

- ¹ Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Securities & Exchange Commission Release No. 33-9211 (May 25, 2011), available at: <http://www.sec.gov/rules/proposed/2011/33-9211.pdf>.
- ² This Release proposes amendments to Rules 501 and 506 and Form D to implement Section 926 of the Dodd-Frank Act.
- ³ To that effect, Section 926 of the Dodd-Frank Act requires the SEC to issue disqualification rules for Rule 506 offerings that are "substantially similar" to the bad actor disqualification provisions of Rule 262 of Regulation A. Regulation A is a limited offering exemption that permits public offerings of securities not exceeding \$5 million in any 12-month period by companies that are not required to file periodic reports with the SEC.
- ⁴ Offerings under Rule 506 are subject to all the terms and conditions of Rules 501 and 502, including limitations on the manner of offering, limitations on resale and, if securities are sold to any non-accredited investors, specified information requirements. In addition, any non-accredited investors must satisfy the investor sophistication requirements for Rule 506(b)(2)(ii). Offerings under Rule 506 must also comply with the notice of sale requirements of Rule 503.
- ⁵ Regulation E is an exemption for offerings up to \$5 million by small business investment companies and business development companies.

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