



SEC Proposes Rule Banning Bad Actors from Private Placements under Regulation D, Rule 506

By Karl A. Mohr

July 21, 2011

Almost one year after the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) was signed into law, the SEC (“Securities & Exchange Commission”) took further action to impose new restrictions on private placements or so-called Reg. D Offerings.

In a bid to implement the provisions of Section 926 of Dodd-Frank, the SEC proposed a new rule on May 25, 2011 that would keep issuers from relying on an exemption afforded under Regulation D, Rule 506, if there are convicted felons or other “bad actors” involved with their offering.

Who would be considered a “Bad Actor” under the proposed new rule?

The SEC would consider people who are actively involved in the issuance and promotion of an exempt offering under Regulation D, Rule 506, but also shareholders holding 10% or more of such an issuer’s equity (“Covered Persons”), and who were convicted of certain felonies or misdemeanors, or who were subject to sanctions as a result of administrative or regulatory proceedings in connection with the sale or purchase of securities (“Disqualifying Events”) to be bad actors.

Covered Persons

Covered Persons under the proposed new rule would include the issuer itself, including potential predecessors and affiliated issuers and

- officers, directors, general partners, and managing members of the issuer;
- beneficial owners of shareholdings in the issuer totaling 10% or more;
- promoters of the issuer and the offering, including any persons who are compensated for soliciting investments from investors, including officers, directors, general partners and managing members of any compensated promoter.

Disqualifying Events

There is a range of felonies, misdemeanors, and sanctions that would cause the perpetrator to be disqualified from participating in an offering, exempt from registration under Regulation D, Rule 506, once the proposed amendment takes effect:

- *Criminal Convictions in connection with the sale or purchase of a security or making a false filing with the SEC.* The revised rule would also include a 5-year look-back period

- for criminal convictions of issuers and a ten-year look-back period for criminal convictions of all other Covered Persons.
- *Court Injunctions and Restraining Orders.* Although Rule 262 already precludes issuers and other Covered Persons from relying on an exemption available under Regulation A, if they are subject to an injunction or restraining order in connection with the sale or purchase of securities or making of a false filing with the SEC, the proposed amendment to Rule 506 would further extend the reach of Rule 262 and also cover orders arising out of the conduct of paid promoters and intermediaries involved with soliciting investments in exempt offerings under the new Rule 506.
 - *Final Orders of Regulators.* SEC disqualification standards would also be applied to offerings, where any Covered Person is subject to a final order from a state securities commission, a state agency regulating banks, savings associations, credit unions, and insurance companies; any federal agency or the National Credit Union Administration. In order to constitute a Disqualifying Event, the order must be final and based on fraudulent, manipulative or deceptive conduct and bar the Covered Person from associating with such entity and from engaging in the business of securities, insurance, banking, savings association or credit union activities. Disqualifying events in this section would also be subject to a ten-year look-back period.
 - *SEC Disciplinary Orders.* The SEC has the authority to impose a variety of sanctions against registered brokers, dealers, municipal security dealers, and financial advisors under the Securities Exchange Act and Investment Advisor Act. Such sanctions include the suspension or revocation of their registration, censure, restricting the scope of their activities, imposing monetary penalties, and barring offending individuals from being associated with certain entities or the offering of certain equities (e.g. penny stocks). These disqualification periods typically remain in force and effect only for as long as the offending act, or while the required remedying act isn't performed. Therefore, by definition, censures are not disqualifying and a disqualification on the basis of a suspension or restriction of activities is set to expire when the suspension or restriction expires.
 - *Suspension or Expulsion.* The suspension or expulsion from membership in any Self-Regulatory-Organization ("SRO") or from being associated with an SRO member also constitutes a Disqualifying Event for as long as the suspension or expulsion remains in force and effect.
 - *Stop Orders and Orders Suspending Regulation A Exemption.* An issuer will be disqualified, if the issuer, its predecessor, or affiliated issuer filed a registration statement with the SEC that was subject to Commission refusal, a stop order, or an order suspending the Regulation A exemption within the last five years, or that is currently subject to proceedings to determine if such an order should be issued.
 - *U.S. Postal Service False Representation Orders.* The issuer can also be disqualified from relying on an exemption under Rule 506, if the issuer or a Covered Person is or was subject to a U.S. Postal Service false representation order. This also includes temporary restraining orders or preliminary injunctions in connection with alleged violations of the false representation statute concerning U.S. mail. Any offense will be subject to a 5-year look-back period.

How are issuers expected to comply with the proposed disqualification of bad actors?

The proposed amendment to Rule 506 will hardly facilitate capital raising efforts and issuer compliance. While some disqualifying events may be a matter of public record, the lack of a central repository aggregating all relevant state and federal court documents along with documents from other regulatory authorities (e.g. the U.S. Postal Service), will likely turn issuer compliance into a complex and time consuming process with rather questionable results.

In order to ease issuer compliance with bad actor disqualification provisions, the proposed rule will likely include a "reasonable care exception" according to which an issuer would not lose an exemption afforded under Rule 506, even if any Covered Person had any Disqualifying Events, if

the issuer can show that it was not aware of a Disqualifying Event and even by exercising reasonable care, could not have known that a Disqualifying Event existed.

To establish a reasonable care exception, an issuer would be expected to consider a variety of different circumstances, including, but not limited to the risk that bad actors could be present, the application of other screening and compliance procedures, and the cost and burden that such factual inquiries into the backgrounds of Covered Persons would impose on the issuer. At the very least, issuers would be expected to conduct a factual inquiry with the Covered Persons themselves, most likely by requiring them to complete questionnaires similar in form and substance to those that are already used to establish investor wealth and sophistication requirements under the rule. Issuers should be mindful of whether or not resorting to respective online background investigation services and databases will be reasonable and advisable.

The proposed amendment to Rule 506 also carries over current waiver provisions of Regulation A and enables the SEC to grant waivers to issuers that are believed to have shown good cause “that it is not necessary under the circumstances that the exemption be denied”.

As of when will issuers be required to comply with the proposed bad actor disqualification?

There will likely be no transition period or delay before issuers would be required to comply with Rule 506, as amended, once the proposed amendment has become effective.

Disqualifying Events that Predate the Proposed Rule

Under the proposal, the new rule would apply to all sales made under Rule 506; however, it would not apply to any transaction that was completed before the effective date. On the other hand, transactions conducted after the new rule becoming effective would be subject to disqualification for all disqualifying events that occurred in the relevant look-back periods, regardless of whether or not these events occurred before the enactment of Dodd-Frank. This retroactive application of the disqualification provisions is certainly one of the most controversial elements of the proposed rule and subject to rather heated debates.

Effect on Ongoing Offerings

The proposed bad actor disqualification provisions would apply to all sales of securities that were made in reliance on Rule 506 after the proposed amendments to Rule 506 went into effect. As mentioned above, sales of securities completed prior to the effective date would not be affected even if they were part of an offering that was intended to continue after Rule 506, as amended, had become effective.

Other Possible Amendments to Rule A, D, and E to Increase Uniformity

The SEC is currently considering additional amendments in order to more uniformly apply bad actor disqualification provisions, as they are currently proposed to be applied to Rule 506, to offerings under Regulation A, Regulation D, Rule 505, and Regulation E, all of which are already subject to bad actor disqualification provisions under Rule 262 or similar provisions based on that rule.

Uniform Look-Back Periods

The SEC is also considering possible amendments in order to provide for a uniform 10-year look-back period for all Disqualifying Events in order to align with the look-back period required under Dodd-Frank (i.e. 10 years for final orders of certain federal and state regulators, and for criminal convictions of Covered Persons other than the issuer, and 5-years for all other Disqualifying Events).

We will continue to monitor any new developments in connection with the “Dodd-Frank Wall Street Reform and Consumer Protection Act” and publish our comments accordingly here on JacksonSteiner.com. Please consider subscribing to Jackson Steiner News & Market Commentary Alerts at <http://www.jacksonsteiner.com/en/news/e-alerts.php> to be promptly notified of any new developments.

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