



Thompson Coburn LLP | One US Bank Plaza | St. Louis, MO 63101

## **"Bad Actor" Disqualification from Rule 506 Offerings**

On May 27, 2011, the Securities and Exchange Commission, as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act, released a proposed rule<sup>1</sup> which would disqualify an entity from using the Rule 506 private offering safe harbor if the entity or a "covered person" associated with the entity is or had been involved in a "disqualifying event," specified violations of securities laws or the regulations of securities administrators or certain related entities.

Although currently only a proposed rule, the revisions are significant, as Rule 506 is by far the most widely used SEC-sanctioned securities offering exemption and one of the most cost-efficient ways for small businesses to raise equity capital. For a non-public issuer with a current or future need to raise equity capital in excess of \$1,000,000, an inability to use Rule 506 could very well imperil that issuer's future. Additionally, if an offering thought to be exempt under Rule 506 turns out not to be due to "bad actor" disqualification, the issuer could face action from either the SEC or its investors.

*Covered Persons.* As proposed, "covered person" would currently include:

- the issuer itself;
- any predecessor;
- any affiliate;
- any director, officer, general partner or managing member;
- any beneficial owner of 10% or more of any class of equity securities;
- any promoter connected in any capacity at the time of such sale;
- any person that has been or will be paid remuneration for solicitation of purchasers; and
- any general partner, director, officer or managing member of any such solicitor.

*Disqualifying Event.* The "disqualifying events" are currently defined as:

- within the past ten years, being convicted of any felony or misdemeanor (five years in the case of issuers, predecessors and affiliates), or within the past five years, being subject to any court order that enjoins activities (a) in connection with securities purchases or sales; (b) involving false filings with the SEC; or (c) arising out of the conduct of

the business of certain securities professionals (including brokers, dealers, investment advisers, and paid securities solicitors);

- within the past five years, being subject to a final order that: (a) bars the covered person from engaging in securities, insurance, banking, savings associations or credit union activities or associating with those entities; or (b) is based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct;
- at the time of the offering, being subject to an SEC order that: (a) suspends or revokes registration as a broker, dealer, municipal securities dealer or investment adviser or limits the covered person's activities in those areas; or (b) bars the covered person from being associated with any entity or participating in any penny stock offering;
- at the time of the offering, being suspended or expelled from membership in, or association with a member of, a registered national securities exchange or association;
- within the past five years, having filed or served as an underwriter in any registration statement or Regulation A offering that was subject to a refusal order, stop order, or order suspending the Regulation A exemption, or is subject to a stop order or suspension investigation; or
- within the past five years, being subject to a United States Postal Service false representation order, or a temporary restraining order or preliminary injunction with respect to charge of mail fraud.

*Reasonable Care Exception.* The proposed rule allows an issuer an escape from disqualification if it can establish that it did not know, and could not have known using reasonable care, that a covered person was the subject of a disqualifying event. The issuer will, however, be required to make factual inquiries of offering participants to take advantage of this exception.

*What to Do.* When the rule becomes effective, issuers may want to consider changing their governing documents to require a greater than 10% shareholder that becomes subject to a disqualifying event to sell a sufficient number of shares such that its ownership falls below the 10% level. Issuers may also want to review their employment arrangements with officers and resignation and retention policies for managers or directors to provide for resignation or removal should those persons be subject to a disqualifying event. Issuers should also consider modifying their existing processes for hiring and vetting placement agents, offering participants and potential investors to include soliciting questionnaires or obtaining representations regarding their past and present involvement with disqualifying events.

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<sup>1</sup> Release 33-9211—Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings (May 25, 2011.)

If you have questions regarding this proposed rule or any Dodd-Frank concern, contact your Thompson Coburn attorney or one of the Corporate & Securities attorneys below:

Barry L. Fischer

[View Resume](#)

[bfischer@thompsoncoburn.com](mailto:bfischer@thompsoncoburn.com)

Robert LaRose

[View Resume](#)

[rlarose@thompsoncoburn.com](mailto:rlarose@thompsoncoburn.com)

Thompson Coburn LLP

Chicago | St. Louis | Southern Illinois | Washington, D.C.

[www.thompsoncoburn.com](http://www.thompsoncoburn.com)

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