

Corporate & Financial Weekly Digest

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SEC Proposes Rules for Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings

On May 25, the Securities and Exchange Commission issued proposed rule amendments that disqualify securities offerings involving certain "felons and other 'bad actors'" from reliance on the safe harbor from registration under Section 4(2) of the Securities Act of 1933 provided by Rule 506 of Regulation D to reflect the requirements of Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 926 of the Dodd-Frank Act requires that that the SEC issue disqualification rules for Rule 506 offerings that are "substantially similar" to the disqualification rules provided by Rule 262 of the Securities Act, which apply to securities offerings under Regulation A.

The proposed rules would apply to the following "covered persons":

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the 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.

The SEC notes that while a significant percentage of issuers in Rule 506 offerings are funds, the proposed rules do not apply to investment advisers of issuers, or the directors, officers, general partners or managing members of such investment advisers, as those persons are not currently covered by Rule 262. The SEC also notes that disqualifying events that pre-date the affiliation with the issuer of an affiliated issuer, with certain exceptions, would not be deemed disqualifying. The SEC is also specifically soliciting comments on whether "officer" should be "executive officer."

The proposed rules include the following types of disqualifying events:

- criminal convictions;
- court injunctions and restraining orders;

- final orders of certain state regulators (such as state securities, banking and insurance regulators) and federal regulators;
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons;
- suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization;
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

The proposed rules also provide for a "reasonable care" exception under which an issuer would not lose the benefit of the Rule 506 safe harbor, despite the existence of a disqualifying event, if it can show that it did not know and, in the exercise of reasonable care (which must include a "factual inquiry"), could not have known of the disqualification of another covered person.

Similar to Rule 262, the proposed rules also permit issuers to seek waivers from disqualification under Rule 506 from the SEC.

The proposed rules would apply to all sales made under Rule 506 after the effective date of the new provisions for all disqualifying events that occurred within the relevant look-back periods, regardless of whether the events occurred before the enactment of the Dodd-Frank Act, or the proposal or the effectiveness of the amendments to Rule 506. Sales of securities made before the effective date of the amendments to Rule 506 would not be affected by any disqualification that arises as a result of the adoption of the amendments, even if such sales were part of an offering that was intended to continue after the effective date.

The proposed rules also seek public comment on whether the proposed disqualification standards under Rule 506 should apply uniformly to all offerings under Regulation A, Regulation D and Regulation E.

Comments on the proposed rules should be received on or before July 14.

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