

ALERT

Corporate Finance and Securities

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Look Who's Not Coming to Dinner: Felons and Bad Actors

In its initial action to implement Section 926 of the Dodd-Frank Act, the SEC recently issued proposed amendments to Rule 506 of Regulation D of the Securities Act to disqualify private placements involving certain felons and other "bad actors" from the safe harbor of Rule 506. The proposed amendments are available [here](#).

What Is The Safe Harbor of Rule 506?

Rule 506 permits the sale of an unlimited dollar amount of securities to an unlimited number of "accredited investors" and up to 35 "non-accredited investors," provided that the conditions of Rule 506, including the prohibition against a general solicitation of interest and the provision of a sufficient amount of information to non-accredited investors, are satisfied. Rule 506 does not currently have any "bad actor" disqualification provisions which prohibit issuers and their directors, officers, shareholders, underwriters, placement agents and other finders from participating in private placements. Such "bad actor" disqualification provisions could include past convictions or court or administrative sanctions for securities fraud or other violations of certain laws, which are the crux of the proposed amendments.

To Whom Would The Proposed Amendments Apply?

The proposed amendments to Rule 506 would apply to the following "covered persons":

- The issuer, any predecessor of the issuer or any 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 private placement;
- Any person that has been or will be paid, directly or indirectly, remuneration for solicitation of purchasers in a private placement; or
- Any director, officer, general partner or managing member of any compensated solicitor.

For purposes of the proposed amendments, the term "officer" would include "a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer and any person routinely performing corresponding functions with respect to any organization." Conversely, the proposed amendments would provide that investment advisers of issuers, or the directors, officers, general partners, or managing members of such investment advisers are not covered by the proposed rule and amendments.

What Are The Disqualifying Events For Covered Persons?

The proposed amendments set forth seven categories of disqualifying events, which include:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state and federal regulators;
- SEC disciplinary orders;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization such as FINRA, NYSE or NASDAQ;
- SEC stop orders; and
- U.S. Postal Service false representation orders.

Each of these seven categories would be subject to specific terms and conditions and would potentially be subject to a look-back period, typically for periods of either five or 10 years.

Would There Be Any Exceptions From, And Waivers Of Disqualification?

Yes. The proposed amendments provide for a reasonable care exception that would apply if an issuer can demonstrate to the SEC that it did not know and, in the exercise of reasonable care, that it could not have known of the disqualification arising from the participation of a covered person in a private placement. To rely upon the reasonable care exception, an issuer would need to conduct a factual inquiry, the nature of which would depend upon the facts and circumstances of the issuer and the other participants. In addition, an issuer may also seek a waiver from disqualification from the SEC if the issuer is able to demonstrate good cause "that it is not necessary under the circumstances that the [registration] exemption . . . be denied."

Would There Be A Transition Period?

Yes, though the proposed amendments would not affect any private placement that was completed before the effective date of the proposed amendments, there would be a transition period. Private placements that commence after the effective date of the proposed amendments would be subject to disqualification for all disqualifying events that occurred within the relevant look-back periods, regardless of whether the events occurred before enactment of the Dodd-Frank Act. With respect to continuous private placements, application of the disqualification provisions would apply only to sales of securities made in reliance on Rule 506 after the proposed amendments become effective. If disqualifying events occur during the conduct of an ongoing private placement, only those sales that were consummated after the disqualifying event will be impacted.

Would There Be Any Amendments To Form D?

Yes. The proposed amendments would require issuers who are claiming a Rule 506 exemption to certify on Form D that the private placement is not disqualified.

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