

**SEC PROPOSES RULES TO DISQUALIFY FELONS AND OTHER “BAD ACTORS”
FROM RULE 506 OFFERINGS**

June 8, 2011

Last month, the Securities and Exchange Commission (the “SEC”) proposed rules to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).¹ Section 926 requires the SEC to adopt rules that disqualify securities offerings involving certain felons and other “bad actors” from reliance on the safe harbor for exemption from registration under the Securities Act of 1933, as amended (the “Securities Act”), provided by Rule 506 of Regulation D. Following the adoption of final SEC rules, a significantly greater number of exempt securities offerings will be subject to bad actor disqualification requirements, increasing the diligence burden on issuers with respect to possible disqualifying events and potentially affecting their ability to raise capital without registration.² The SEC is soliciting comments on the proposed bad actor disqualification rules through July 14, 2011. This client alert summarizes certain key aspects of the proposed rules.

Background

Rule 506 is the most commonly used exemption for limited and private offerings under Regulation D and permits unregistered sales of an unlimited dollar amount of securities to an unlimited number of accredited investors and up to 35 non-accredited investors, so long as certain conditions of the rule are satisfied. Unlike certain other registration exemptions under the Securities Act, Rule 506 does not currently impose any bad actor disqualification requirements. So-called “bad actor” or “bad boy” disqualification requirements prohibit issuers and certain individuals from participating in an exempt securities offering if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specific laws. Because securities sold under Rule 506 are “covered securities” that are preempted from state-level registration requirements, state securities law bad actor disqualifications also do not apply.

Covered Persons

Under the proposed rules, the bad actor disqualification provisions 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;

¹ Disqualification of Felons and other “Bad Actors” from Rule 506 Offerings, SEC Release No. 33-9211 (May 25, 2011), available at <http://www.sec.gov/rules/proposed/2011/33-9211.pdf>. See our earlier client alert regarding the Dodd-Frank Regulation D “bad actor” provisions at: <http://www.wcsr.com/resources/pdfs/cs072810.pdf> (July 28, 2010).

² Offerings by issuers that cannot rely on Rule 506 because of the bad actor disqualification provisions could potentially still be effected by relying on another available exemption (such as Section 4(2) of the Securities Act) or on a registered basis; alternatively, issuers may regain Rule 506 eligibility if they are able to terminate the relationship with the bad actor whose involvement triggers disqualification.

- 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 or will (directly or indirectly) receive compensation for the 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.

Notably, as proposed, the definition of “officer” under the Securities Act is particularly broad, and includes not only those making policy-making decisions for a covered person, but also potentially includes a large number of employees at financial institutions or other placement agents who hold the title of “vice president” or “secretary” and who may or may not have any actual involvement with the offering. Additionally, the definition of “covered person” does not include investment advisors of issuers, or the directors, officers, general partners or managing members of such investment advisors, who often control private funds. The SEC is requesting comment on both of these issues prior to the adoption of final rules.

Disqualifying Events

The proposed rules include the following types of disqualifying events:

- Criminal convictions of any felony or misdemeanor (a) in connection with the purchase or sale of any security, (b) involving the making of any false filing with the SEC or (c) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment advisor or paid solicitor of purchasers of securities, in each case within 10 years (or five years, in the case of issuers, their predecessors and affiliated issuers) before the sale of securities;
- Orders, judgments or decrees entered within five years before the sale of securities that, at the time of such sale, restrain or enjoin such person from engaging or continuing to engage in any conduct or practice (a) in connection with the purchase or sale of any security, (b) involving the making of any false filing with the SEC or (c) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment advisor or paid solicitor of purchasers of securities;
- Final orders of certain state regulators (such as state securities, banking and insurance regulators) and federal regulators that (a) at the time of the sale of securities, bar the person from (1) association with an entity regulated by such commission, authority, agency or officer, (2) engaging in the business of securities, insurance or banking or (3) engaging in savings association or credit association activities, or (b) constitute a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct entered within 10 years before such sale;
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons at the time of the sale of securities;
- Suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization at the time of the sale of securities;
- SEC stop orders and orders suspending a Regulation A exemption within five years before the sale of securities; and

- U.S. Postal Service false representation orders within five years before the sale of securities.

Reasonable Care Exception; Waivers

Importantly, under the proposed rules, an issuer would not lose the benefit of the Rule 506 safe harbor, even if a disqualifying event exists, if it can show that it did not know and, despite the exercise of reasonable care, could not have known of the disqualification at the time of the sale of securities. While the concept of what constitutes reasonable care will depend on the facts and circumstances of the situation (including the risk that bad actors could be present, the presence of other screening and compliance mechanisms and the cost and burden of the inquiry), the SEC has indicated that a reasonable factual inquiry is required. Depending on the circumstances, it may be sufficient to conduct a factual inquiry of the covered persons themselves by including additional questions in the questionnaires the issuer uses to support disclosures regarding directors, officers and significant shareholders. The SEC has also indicated that an issuer's investigation of publicly available databases may be appropriate and that, depending upon the circumstances, further steps may be required. The proposed rules would also permit the SEC to grant a waiver of the bad actor disqualification requirements if the issuer can demonstrate that denial of the exemption is not necessary under the circumstances.

Implementation

The bad actor disqualification requirement would apply to all sales made under Rule 506 after the effective date of the rule amendments but would not affect any transaction completed before such time. Offerings of securities made in reliance on Rule 506 after the rule amendments go into effect would be subject to disqualification for all disqualifying events that had occurred within the relevant look-back periods, regardless of whether the events occurred before enactment of the Dodd-Frank Act or the related SEC rulemaking. The proposed rules provide that disqualifying events that occur while an offering is underway do not affect any sales made prior to the disqualifying event; however, sales thereafter are disqualified unless and until the disqualification is waived or removed.

Other Potential SEC Actions

In the proposing release, the SEC also indicated that it is considering additional amendments to make its bad actor disqualification provisions more uniform across other exemptive rules, such as Rule 505 of Regulation D and Regulation A. In addition, the SEC said it is considering extending the bad actor disqualification rules to apply to offerings under Rule 504 of Regulation D, which currently does not include any federal bad actor disqualification provisions.³

Recommended Actions; Contact Information

Companies that plan to continue to rely on the safe harbor from registration provided by Rule 506 of Regulation D should evaluate their diligence processes and procedures in light of the proposed bad actor disqualification requirements. In particular, companies should consider revising their diligence questionnaires and processes to ensure that they address all persons subject to the bad actor disqualification requirement and solicit the necessary information to determine whether a disqualifying event has occurred. Companies may also wish to review applicable public records and implement additional screening and compliance procedures.

³ Rules 504 and 505 of Regulation D permit unregistered sales of securities by an issuer of (a) less than \$1 million in any 12-month period to an unlimited number of purchasers (in the case of Rule 504) and (b) less than \$5 million in any 12-month period to an unlimited number of accredited investors and no more than 35 non-accredited investors (in the case of Rule 505), in each case so long as the other conditions of the rule are met. Regulation A exempts from registration sales of securities by both issuers and security holders that aggregate less than \$5 million in any 12-month period, including no more than \$1.5 million of securities offered by all selling security holders, again, as long as the other conditions of the rule are satisfied.

If you have any questions regarding the SEC's proposed rules, please contact Elizabeth C. Southern, <http://www.wcsr.com/elizabethsouthern>, the principal drafter of this alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: <http://www.wcsr.com/profSearch?team=corporateandsecurities>.

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