WSGR ALERT

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SEC PROPOSES RULE TO DISQUALIFY FELONS AND OTHER BAD ACTORS FROM RULE 506 OFFERINGS

On May 25, 2011, the Securities and Exchange Commission (SEC) proposed a rule that would, among other things, prevent an issuer from using a Rule 506 exemption for any securities offerings in which "felons and other 'bad actors'" are involved. The current version of Rule 506 does not impose any bad-actor disqualification requirements.

Rule 506, which is the most widely used exemption from registration under the securities laws (accounting for an estimated 90-95 percent of the offerings made under Regulation D), allows an issuer to raise unlimited capital from an unlimited number of accredited investors, provided that certain conditions are met. The proposed rule implements the provisions of Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which is proposed to be codified in a new paragraph (c) of Rule 506. The Dodd-Frank Act requires the new rule to be "substantially similar" to the bad-actor disqualification provisions of Rule 262 of Regulation A, which is an exemption from registration for certain small offerings, and to include an expanded list of disqualifying events enumerated in the Dodd-Frank Act.

Once the SEC's proposed rule takes effect, an issuer hoping to rely on a Rule 506 exemption will need to conduct a factual inquiry with respect to potentially disqualifying events to establish its reasonable care exception.

The Proposed Rule Requirements

Under the proposed rule, an offering would be unable to rely on the Rule 506 exemption if the issuer (including its predecessors and affiliated issuers) or any other covered persons had a "disqualifying event."

Covered Persons

The proposed rule would cover the issuer, its predecessors, and affiliated issuers, as well as:

- directors, officers, general partners, and managing members of the issuer;
- 10 percent beneficial owners and promoters of the issuer; and
- persons compensated for soliciting investors, as well as the general partners, directors, officers, and managing members of any compensated solicitor.

The SEC currently is soliciting comments on whether or not the term "officers" should apply to executive officers (those performing policy-making decisions for a covered person as defined in Rule 501(f) of Regulation D), only to officers actually involved with the offering, or be limited in some other way or in the way employed in the existing rules.

The proposed rule does not currently include investment advisers or directors, officers, general partners, or managing members of investment advisers as covered persons. However, the SEC is considering adding these persons to the definition of covered persons for certain types of issuers, such as "pooled investment funds" in Item 4 of Form D, "business development companies," registered investment companies under the Investment Company Act of 1940, and "private funds" as defined in Section 202(a)(29) of the Investment Advisers Act of 1940.

Disqualifying Event

Under the proposed rule, a "disqualifying event" would include the following:

- ***Criminal convictions*** in connection with the purchase or sale of a security, making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries. The criminal conviction would have to have occurred within 10 years of the proposed sale of securities (or five years, in the case of the issuer and its predecessors and affiliated issuers).
- ***Court injunctions and restraining orders*** in connection with the purchase or sale of a security, making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries. The injunction or restraining order would have to have occurred within five years of the proposed sale of securities.
- ***Final orders*** from state securities, insurance, banking, savings association, or credit union regulators; federal banking agencies; or the National Credit Union Administration that:
  - bar the issuer from:
    - associating with a regulated entity;
    - engaging in the business of securities, insurance, or banking;

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  - engaging in savings association or credit union activities; or
  - are based on fraudulent, manipulative, or deceptive conduct, and are issued within 10 years before the proposed sale of securities.

In connection with this event, the SEC is considering amending Rule 501 of Regulation D to add a definition of "final order" for purposes of the bad-actor disqualification, which likely will be based on the FINRA definition.

- ***Certain SEC disciplinary orders*** relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons, which would be disqualifying for as long as the order is in effect.

- ***Suspension or expulsion*** from membership in a "self-regulatory organization" (SRO) or from association with an SRO member, which would be disqualifying for the period of suspension or expulsion.

- ***SEC stop orders*** and orders suspending the Regulation A exemption issued within five years before the proposed sale of securities.

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

Pre-existing convictions, suspensions, injunctions, and orders would constitute "disqualifying events." With respect to affiliated issuers, the exclusion applies to all potentially disqualifying events that pre-date the affiliation. For the purpose of establishing the start of the relevant look-back periods, the SEC is proposing to use the date of the sale for which the exemption is sought, rather than the date of the first sale.

Reasonable Care Exception and Waivers

Although some disqualifying events will be a matter of public record, there is no central repository that aggregates information from all federal and state courts and regulatory authorities that would be relevant in determining whether or not a covered person has a disqualifying event in his or her past. In order to ease the potential burden of the bad-actor disqualification, the proposed rule attempts to clarify the issuer's obligations through the "reasonable care exception."

The reasonable care exception would prevent an issuer from losing the benefits of the Rule 506 safe harbor despite the existence of a disqualifying event if the issuer can show that it "did not know and, in the exercise of reasonable care, could not have known" that a disqualification existed. To establish its reasonable care exception, the SEC believes that an issuer would be expected to conduct a "factual inquiry, the nature of which would depend on the facts and circumstances." Some of the factors to be taken into account may include 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 in some circumstances, factual inquiry of the covered persons themselves (for example, by including additional questions in questionnaires that issuers already may be using to support disclosures regarding directors, officers, and significant shareholders of the issuer) may be adequate. Issuers also should consider whether investigating publicly available databases is reasonable. In some circumstances, further steps may be necessary.

The proposed rule contemplates that the SEC may grant a waiver from disqualification if it determines that the issuer has shown good cause "that it is not necessary under the circumstances that the [registration] exemption . . . be denied."

Transition and Timing

The comment period for the proposed rule expires July 14, 2011. The proposed rule does not contemplate any phase-in period or delay before issuers would be required to comply.

Disqualifying Events that Pre-Date the Proposed Rule

Under the proposed rule, the new bad-actor disqualification provisions would apply to all sales made under Rule 506. The provisions would not affect any transaction that was completed before the effective date. Offerings made after the effective date would be subject to disqualification for all disqualifying events that had occurred within the relevant look-back periods, regardless of whether or not the events occurred before the enactment of the Dodd-Frank Act, or the proposal or effectiveness of the amendments to Rule 506. However, offerings that would be disqualified from reliance on Rule 506 under the proposed rule could potentially still be effected on a registered basis, pursuant to an available statutory exemption such as Section 4(2) or Section 4(5) of the Securities Act, or pursuant to another exemptive rule. Alternatively, the SEC has indicated that issuers may regain eligibility to rely on Rule 506 if they are able to terminate their relationships with the bad actors whose involvement triggers the disqualification.

Effect on Ongoing Offerings

As proposed, the bad-actor disqualification provisions would apply to each sale of securities made in reliance on Rule 506 after the rule amendments take effect. Sales of securities made before the effective date 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. Only sales made after the effective date of the amendments would be subject to disqualification.

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Under the proposed rule, disqualifying events that occur while an offering is underway would be analyzed in a similar fashion. Sales made before the occurrence of the disqualification would not be affected by it, but sales thereafter would be disqualified unless and until the disqualification is waived or removed.

Possible Amendments to Increase Uniformity

Uniform Application of Bad-Actor Disqualification to Regulations A, D, and E

The SEC is considering possible amendments with respect to uniformly applying the new bad-actor disqualification provisions proposed for Rule 506 offerings to offerings under Regulation A, Rule 505 of Regulation D, and Regulation E (all of which currently are subject to bad-actor disqualification under existing Rule 262 or under similar provisions based on that rule) and offerings under Rule 504 of Regulation D (which currently are not subject to federal disqualification provisions).

Uniform Look-Back Periods

The SEC also is considering possible amendments with respect to providing a uniform 10-year look-back period to align with the 10-year look-back period required under the Dodd-Frank Act for specified regulatory orders, and bars for all disqualifying events that are subject to an express look-back period under current law (e.g., criminal convictions within the last five or ten years, court orders within the last five years).

What You Should Do Now

There are steps companies can take now to prepare for the enactment of the proposed rule:

- Consider commenting on the proposed rule before the July 14, 2011, deadline.
- Undertake an inquiry of your covered persons regarding whether or not they have had a disqualifying event.
- Conduct targeted background checks on your covered persons to determine whether or not such persons have had a disqualifying event.
- Prepare to update your D&O questionnaires, investor qualifications questions, due diligence questionnaires, and standard investor representations following the adoption of the proposed rules.
- Take steps to remove any existing disqualifications, if necessary.

For any questions or more information on these or any related matters, please contact your regular Wilson Sonsini Goodrich & Rosati contact or any member of the firm's corporate and securities practice.

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