ALERTS AND UPDATES

SEC Proposes Disqualifying "Bad Actors" from Rule 506 Offerings

June 6, 2011

Proposed "bad actor" rules are likely to increase the risks and costs associated with Rule 506 offerings.

The U.S. Securities and Exchange Commission (SEC) has announced proposed rules[1] that would deny the safe-harbor exemption provided by Rule 506 of Regulation D to securities for any offering involving certain "felons and other 'bad actors'" under the Securities Act of 1933 (the "Securities Act"). The period for comments on the proposed rules expires on July 14, 2011.

Disqualifying Events

The proposed rules include the following disqualifying events[2] that, in most instances, contain look-back provisions of between five and 10 years:

- criminal convictions regarding certain securities-related matters;
- court injunctions and restraining orders regarding certain securities-related matters;
- 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 advisors 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 or orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

As proposed, the new rules would apply to all sales of securities made in reliance on Rule 506 after the effective date of the final rules. An event that occurred before enactment of the Dodd-Frank Act or the effectiveness of the new rules would still be a disqualifying event if it occurred during the applicable look-back period. In addition, if a disqualification should arise during an offering, any sale made while the disqualification exists would not be entitled to the safe-harbor exemption provided by Rule 506.

Covered Persons

The proposed rules would be applicable to the following 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 percent 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 remuneration (directly or indirectly) 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.

"Reasonable Care" Exception

Under a proposed "reasonable care" exception, if there is a disqualifying event at the time of a sale, the issuer may still rely on the safe harbor provided by Rule 506 if it can establish that it did not know, and in the exercise of reasonable care, could not have known of the disqualifying event at the time of the sale. However, an issuer would not be able to rely on the "reasonable care" exception unless it could demonstrate that it made a factual inquiry into whether any disqualifications existed at the time of sale.

Other Proposed Amendments

In addition, the SEC seeks comment on whether it would be beneficial to implement uniform disqualifying rules applicable to Regulation A, Regulation E and other sections of Regulation D.

What This Means for Issuers

An issuer that complies with all of the provisions of Rule 506 other than the bad actor provisions might be entitled to rely on the statutory exemption provided by Section 4(2) of the Securities Act. However, an offering made in reliance on the statutory exemption provided by Section 4(2) would not constitute an offering of a "covered security" under the Securities Act; thus, state registration and review requirements would not be preempted by federal securities laws and would apply to the offering. Furthermore, issuers would then be subject to, and would still have to address, any state-level bad actor disqualifications.

Issuers that choose to rely on revised Rule 506 will need to implement processes and procedures that would exhibit that they exercised reasonable care in conducting their offerings. In this regard, such processes and procedures would have to take into account the risk that bad actors could be present; the availability of other screening and compliance mechanisms; and the cost and burden of the inquiry. At a minimum, issuers would need to consider updating the questionnaires typically used in connection with private placements to address the new bad actor disqualifications and should consider searching publically available databases and other sources for relevant information regarding a covered person's status as a bad actor. In a continuous offering, an issuer will need to take reasonable steps before subsequent sales to ensure that circumstances have not changed regarding a covered person's status as a bad actor.[3]

The proposed rules, if adopted in their present form, are likely to increase the risks associated with Rule 506 offerings and the costs of such offerings. However, it is likely that, over time, standard practices and procedures as to what constitutes reasonable care will be developed that should reduce the risks and costs posed to issuers by the bad actor disqualifications.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes the firm's comprehensive series of *Alerts* analyzing the provisions of the Dodd-Frank Act and emerging policies, as well as videos and links to relevant government websites. Duane Morris' attorneys are monitoring the rules and regulations released under the Dodd-Frank Act, as well as the regulatory agencies' interpretive guidance, to continuously update the Financial Services Reform Center.

For Further Information

If you have any questions regarding the proposed rules discussed in this *Alert*, including how they may affect your company, please contact Robert P. Bramnik, Laurence S. Lese, Howell J. Reeves, Heather Carmody, Kathleen A. Roth, Chad J. Rubin, any member of the Securities Law practice, any member of the Mergers and Acquisitions practice or the lawyer in the firm with whom you are regularly in contact.

Notes

1. *See* SEC Release No. 33-9211, available at www.sec.gov/rules/proposed/2011/33-9211.pdf. The promulgation of these proposed rules is required by Section 926 ("Section 926") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 926 requires, among other matters, that the disqualifying provisions implemented by the SEC be "substantially similar" to the disqualification provisions of Rule 262 of Regulation A under the Securities Act ("Rule 262"). Regulation A permits public offerings of securities not exceeding $5 million in any 12-month period by issuers that are not required to file periodic reports with the SEC.
2. Derived from the disqualifying events provided in Rule 262 and Section 926.
3. It is important to note that issuers may regain eligibility to rely on Rule 506 if they are able to terminate their relationship with the "bad actor" whose involvement triggered the disqualifying event.