

SEC Proposes “Bad Actor” Exclusion to Reliance on Rule 506

On May 25, 2011, the Securities and Exchange Commission (“SEC” or “Commission”) announced a proposed rule that would disqualify securities offerings involving certain “felons and other ‘bad actors’” from relying on the “safe harbor” from registration under the Securities Act of 1933, as amended (the “Securities Act”) created by Rule 506 of Regulation D.¹ The proposed rule seeks to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires the SEC to enact a rule creating “bad actor” exemptions to Rule 506 that are “substantially similar” to those under Rule 262 of Regulation A.²

The SEC will be accepting comments on the proposed rule until July 14, 2011.

I. Rule 506, the “Safe Harbor”

Rule 506 of Regulation D creates a “safe harbor” from the registration requirements of the Securities Act, by permitting issuers to initiate “sales of an unlimited dollar amount ... without registration, to an unlimited number of accredited investors and up to 35 non-accredited investors,” subject to compliance with the other provisions of the rule.³ Although two other rules under Regulation D also create exemptions to Securities Act registration requirements, Rule 506 accounts for 90-95% of the offerings that rely on a Regulation D exception.⁴

II. Persons Covered by the Proposed Rule

The proposed rule specifies the following classes of covered persons that would be prohibited from making a securities offering under Rule 506 if a disqualifying event has occurred:⁵

- 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;

¹ *Disqualification of Felons and Other “Bad Actors” from Rule 506 Offerings*, Release No. 33-9211; File No. S7-21-11 (May 25, 2011) (the “*Proposing Release*”) at 1, available at <http://www.sec.gov/rules/proposed/2011/33-9211.pdf>.

² See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 926, 124 Stat. 1851 (2010); Rule 262 of Regulation A at 17 CFR § 230.262 (2010) (which created bad actor exemptions to reliance on Regulation A that are broadly similar to those in the proposed rule). See also *Proposing Release* at 8 (discussing similarities and differences between the proposed rule and Rule 262). Regulation A provides for an exemption from registration under the Securities Act for offerings that do not exceed \$5,000,000.

³ *Proposing Release* at 4. “Offerings under Rule 506 are subject to all the terms and conditions of Rules 501 and 502, including limitations on the manner of offering (no general solicitation), limitations on resale and, if securities are sold to any non-accredited investors, specified information requirements.... In addition, any non-accredited investors must satisfy the investor sophistication requirements of Rule 506(b)(2)(ii). Offerings under Rule 506 must also comply with the notice of sale requirements of Rule 503.” *Proposing Release* at 4-5 n.10.

⁴ *Proposing Release* at 4.

⁵ *Id.* at 9-10.

- 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 noted that the term “officer” could affect a large portion of the employees of financial companies and is requesting comments concerning whether the term should be more specifically defined to apply only to executive officers and/or those officers involved in the offering.⁶ Although the current rule does not consider investment advisers to be “covered persons,” the SEC is considering whether it should extend this recognition to “investment advisers and their directors, officers, general partners and managing members” in certain cases. Specifically, the SEC noted that it might consider declaring investment advisers to be “covered persons” with respect to work they undertake for certain specified varieties of funds because a significant percentage of funds use Rule 506, and “in many fund structures the investment adviser and the individuals that control it are the real decision-makers for the fund.”⁷

III. Disqualifying Events

The proposed rule includes the following types of disqualifying events:⁸

- Criminal convictions within five years of the sale for “issuers, their predecessors and affiliated issuers” and 10 years for all others.
- Being subject to a court-issued injunction or restraining order that was issued within five years of the sale.
- Being subject to a final order from the National Credit Union Association or certain state and federal regulators entered within the 10 years prior to the sale.
- Being subject to certain SEC orders that, at the time of the sale, have the effect of suspending or revoking the individual’s “registration as a broker, dealer, municipal securities dealer or investment adviser,” of placing limitations “on the activities, functions or operations of such person,” or of barring “such person from being associated with any entity or from participating in the offering of any penny stock.”
- Expulsion, suspension, or bar from association with a member of “a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade,” that is in effect at the time of a sale.
- Having filed or been named as an underwriter in, “any registration statement or Regulation A offering statement filed with the Commission that, within five years before such sale, was the

⁶ *Id.* at 12-13.

⁷ *Id.* at 13.

⁸ *Proposed Rules 506(c)(1)(i)(A)-(C).*

subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.”

- Being subject to a United States Postal Service false representation order within five years of the sale or being currently “subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representation.”

The SEC proposes that the criminal convictions exclusion would apply only to violations or injunctions “in connection with purchase or sale of a security,” “involving the making of any false filing with the Commission,” or “arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.”⁹

IV. Reasonable Care Exception and Waivers

The proposed rule contains a reasonable care exception so that an organization would not lose the ability to use the Rule 506 “safe harbor” exemption if it did not know that a covered person was subject to a disqualifying event and could not have discovered this fact through the exercise of reasonable care.¹⁰ The SEC noted that an issuer must make an inquiry to establish this exception, and that the degree of investigation required to constitute reasonable care “would vary according to the circumstances of the covered persons and the offering, taking into account such factors as the risk that bad actors could be present, the presence of other screening and compliance mechanisms and the cost and burden of the inquiry.”¹¹

The SEC also noted that the proposed rule would allow it to grant waivers from application of the “bad actor” exception “[u]pon a showing of good cause ... if the Commission determines that it is not necessary under the circumstances that an exemption be denied.”¹²

V. Transitional Issues

The SEC noted that the new rule would cover all sales made after its effective date.¹³ The rule would apply even when the disqualifying event occurred before its effective date.¹⁴ It would also apply to disqualifying events that occur while an offering is underway but before the sale itself had taken place.¹⁵

⁹ *Proposed Rule 506(c)(1)(i)-(vii)*.

¹⁰ *Proposing Release* at 39-42.

¹¹ *Id.* at 42. “In some circumstances, factual inquiry of the covered persons themselves (for example, by including additional questions in questionnaires issuers may already be using to support disclosures regarding directors, officers and significant shareholders of the issuer) may be adequate. Issuers should also consider whether investigating publicly available databases is reasonable. In some circumstances, further steps may be necessary.” *Id.*

¹² *Proposed Rule 506(c)(2)(i)*.

¹³ *Proposing Release* at 44-45.

¹⁴ *Id.* at 45.

¹⁵ *Id.* at 49.

VI. Uniformity of “Bad Actor Standards” and “Look-Back” Periods

The SEC has also asked for comments regarding the desirability of pursuing greater uniformity across Regulations A, D, and E¹⁶ regarding “bad actor” standards and look-back periods.¹⁷ Although the SEC did not make any specific proposal for a potential uniform “bad actor” standard, it did suggest that the standards in Rule 506 could be extended to apply uniformly across relevant rules in Regulations A, D, and E.¹⁸ In addition, the SEC solicited comments regarding the potential for applying a uniform 10-year look-back period to all disqualifying events with specified period lengths.¹⁹

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

¹⁶ Regulation E affords an exemption from the registration requirements of the Securities Act for offerings by any small business investment company registered under the Investment Company Act of 1940, or any closed-end investment company that elects to be regulated as a business development company under the Investment Company Act.

¹⁷ *Id.* at 51.

¹⁸ *Id.* at 51-52.

¹⁹ *Id.* at 61-62.