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## SEC Proposes Bad Actor Disqualification to Popular Private Placement Safe Harbor

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On May 25, 2011, the Securities and Exchange Commission ("SEC" or "Commission") issued proposed amendments to Rule 506 of Regulation D implementing a "bad actor" disqualification for issuers from participating in exempt private placement securities offerings under Rule 506 (the "Proposed Rule") as required by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").<sup>1</sup> Rule 506 is the most widely used exemptive rule for limited and private offerings under Regulation D, accounting for an estimated 90-95 percent of all Regulation D offerings and the vast majority of capital raised in transactions under Regulation D.<sup>2</sup>

In its current form, Rule 506 does not impose any bad actor disqualification on issuers from participating in exempt securities offerings and, indeed, preempts any disqualifications arising under state law. Under the Proposed Rule, a disqualification under Rule 506 would arise upon specified disciplinary events involving an issuer, its affiliated persons or entities, or certain service providers such as promoters, underwriters, or other compensated participants in the offering. Disqualifying events would include significant disciplinary events such as criminal convictions, court injunctions, and most types of suspensions and bars from securities self-regulatory organizations ("SROs"). The Proposed Rule's disqualification provisions would also be triggered by less severe disciplinary events, such as certain SEC administrative enforcement orders and certain types of orders issued by state and federal securities and banking regulators.

Perhaps the most controversial aspect of the Proposed Rule is its "retroactive" application to prior disciplinary events, including settlements. Rule 506 offerings made after the effective date would be subject to any disqualifying events that had occurred within the relevant look-back periods,<sup>3</sup> regardless of whether the events occurred before enactment of the Dodd-Frank Act or the effectiveness of the Proposed Rule. Absent relief, issuers with relevant disciplinary history would be unable to raise capital through Rule 506 offerings – even if those same issuers (or their promoters, underwriters, executive officers, or affiliates) had previously sought and received relief from disqualifications that arose at the time.

This aspect of the Proposed Rule would present substantial challenges for any party involved in a

private placement under Rule 506 of Regulation D that had previously negotiated settlements with the Commission or other regulators. Even those settlements that were accompanied by customary orders granting relief from various disqualifications under the federal securities laws – including the similar disqualification arising under Rule 505 of Regulation D – would not be "grandfathered" from triggering the disqualification provisions of Rule 506 under the terms of the Proposed Rule. This retroactive application is a marked departure from the Commission's past treatment of settlements falling within the look-back periods of other disqualifications, such as the "ineligible issuer" provision for well-known seasoned issuers ("WKSIs") under Securities Act Rule 405.<sup>4</sup> Unless mitigating guidance is issued, those issuers involved in Rule 506 offerings – and those performing specified functions related to Rule 506 offerings – will need to evaluate the need to seek relief for long-settled or resolved disciplinary events.

The SEC has asked for comment on numerous issues, including whether it should "extend the benefit of waivers previously granted in respect of disqualification from Regulation A, Rule 505 of Regulation D or Regulation E, so that such waivers would cover the new disqualification provisions applicable to Rule 506." Comments on the Proposed Rule are due by July 14, 2011.

### **Summary of the Proposed Rule**

The Proposed Rule derives from Section 926 of the Dodd-Frank Act and Rule 262 of Regulation A. Under the Proposed Rule, Rule 506 would be amended to eliminate the exemption for an offering of securities that involves any of the following Covered Persons with respect to whom a Disqualifying Event has occurred:

**Covered Persons** include: issuers, any predecessor of the issuer, any affiliated issuer, and any director, officer, general partner or managing member of the issuer; any beneficial owner of 10 percent or more of any class of the issuers' 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 (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale of securities of the offering; or any director, officer, general partner, or managing member of any such compensated solicitor.<sup>5</sup>

**Disqualifying Events** include:

- **Criminal Convictions:** A conviction, within ten years before such sale (or five years, in the case of the issuer, the predecessor, and affiliated issuers), of any felony or misdemeanor, in connection with any purchase or sale of any security; involving the making of any false filing with the Commission; or arising out of conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.<sup>6</sup>
- **Court Injunctions and Restraining Orders:** Any order, judgment or decree of any court of competent jurisdiction, that, entered within five years before the relevant sale, restrains or enjoins such person from engaging or continuing to engage in

any conduct in connection with the purchase or sale of any 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.<sup>7</sup>

- **Final Orders:** A final order, judgment or decree of various regulators, such as state securities and insurance commissions and state and federal banking agencies, that at the time of such sale, bars a person from association with an entity regulated by such commission, authority, agency or officer; engaging in the business of securities, insurance or banking; or engaging in savings association or credit union activities. In addition, a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before the relevant sale.<sup>8</sup> A bar under the Proposed Rule would have no limit to the look-back period, and is disqualifying so long as the bar has a continuing effect.
- **Commission Disciplinary Orders:** An order of the Commission entered pursuant to Section 15(b) or 15B(c) of the Securities Exchange Act of 1934 or Section 203(e) or (f) of the Investment Advisers Act of 1940, that, at the time of such sale, suspends or revokes registration as a broker, dealer, municipal securities dealer or investment adviser; places limitation on the activities, functions or operations of such person; or bars such person from association with any entity or from participating in the offering of any penny stock.<sup>9</sup> The Commission has not proposed any look-back period for this disqualification event.<sup>10</sup>
- **Suspension or Expulsion from SRO Membership:** Suspension or expulsion from membership in, or 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 that is conduct inconsistent with just and equitable principles of trade.<sup>11</sup> The Commission has not proposed any look-back period for this disqualification event.
- **Stop Orders and Orders Suspending the Regulation A Exemption:** Within five years before such sale, subject to a refusal order, stop order, or order suspending the Regulation A exemption (or is the subject of an investigation or proceeding to determine such event) after filing (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the Commission.<sup>12</sup>
- **U.S. Postal Service False Representation Orders:** A U.S. Postal Service false representation order entered within five years of the proposed sale of securities or a temporary restraining order or preliminary injunction with respect to conduct alleged to have violated the false representation statute that applies to U.S. mail.<sup>13</sup>

**Reasonable Care Exception.** Recognizing the difficulty in determining whether disqualifications would apply to Rule 506 sales, the Commission is proposing a reasonable care exception that would apply if an issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a Covered Person.<sup>14</sup> The exercise of reasonable care would entail a factual inquiry by the issuer that

would take into account such factors as the risk of presence of bad actors, the presence of other compliance mechanisms, and the cost and burden of the inquiry. With this exception, the Commission aims to satisfy legislative intent and avoid placing an undue burden on capital-raising activity.

**Waiver.** In keeping with the Congressional mandate to adopt rules substantially similar to Regulation A, the Commission proposes to carry over the waiver provisions of Regulation A by permitting issuers to seek waivers from disqualification upon a showing of good cause and without prejudice to any other Commission action.<sup>15</sup>

**Retroactive Application.** As discussed above, past disqualifying events that occurred within the relevant look-back period (if one applies) would be subject to the proposed disqualification rules. The proposed disqualification rules would apply to all offerings made under Rule 506 after the effective date of the new provisions, but would not apply to sales made before the effective date, even if such sales were part of an offering that continues after such date. Similarly, sales made prior to the occurrence of a disqualification event would not be affected, but subsequent sales would be denied the exemption absent a waiver.

**Implementation.** The Commission has not proposed a phase-in period, but seeks input on the timing of implementation.

**Other Considerations.** In addition to the Proposed Rule, the Commission is considering certain unifying changes that go beyond the explicit scope of the Dodd-Frank Act, such as imposing uniform disqualification standards for all exemptions under Regulations A, D, and E without proposing rule text for the specific regulations. Similarly, the Commission is also considering a uniform ten-year look-back period for all disqualifying events with stated look-back periods.

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<sup>1</sup> Pub. L. No. 111-203, Section 926, 124 Stat. 1376, 1851 (July 21, 2010) (to be codified at 15 U.S.C. 77d note). Section 926 of the Dodd-Frank Act instructs the Commission to adopt rules disqualifying certain offerings from reliance on the safe harbor provided from Rule 506 for exemption from registration under Section 4(2) of the Securities Act of 1933. Section 926 mandates the adoption of rules that are "substantially similar" to Rule 262 of Regulation A.

<sup>2</sup> See Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Exchange Act Release No. 9211 (May 25, 2011) ("Proposing

Release"). Rules 504, 505, and 506 of Regulation D provide three distinct exemptions from the registration provisions of the federal securities laws.

<sup>3</sup> Certain disqualifying events are subject to ten-year look-back periods (e.g., convictions), others to five-year look-back periods (e.g., court injunctions, stop orders and orders suspending the Regulation A exemption, USPS orders), and others are not subject to any time limitation whatsoever (e.g., relevant state securities commission orders, NCUA or federal banking orders, SEC administrative enforcement orders, and SRO bar orders).

<sup>4</sup> Securities Act Rule 405 excluded settlements occurring prior to December 1, 2005 from the relevant disqualification trigger in the definition of "ineligible issuer."

<sup>5</sup> Proposed Rule 506(c)(1).

<sup>6</sup> Proposed Rule 506(c)(1)(i).

<sup>7</sup> Proposed Rule 506(c)(1)(ii).

<sup>8</sup> Proposed Rule 506(c)(1)(iii).

<sup>9</sup> Proposed Rule 506(c)(1)(iv).

<sup>10</sup> The Proposing Release expressed the view that a disqualification arises only for an order that prohibits or requires a specific act to be performed. As such, an SEC order of censures would not be a disqualifying event. The Commission also noted that the Division of Corporation Finance has taken the informal view that orders to pay civil money penalties would not be disqualifying events.

<sup>11</sup> Proposed Rule 506(c)(1)(v).

<sup>12</sup> Proposed Rule 506(c)(1)(vi).

<sup>13</sup> Proposed Rule 506(c)(1)(vii).

<sup>14</sup> Proposed Rule 506(c)(2)(ii).

<sup>15</sup> Proposed Rule 506(c)(2)(i).

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