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A legal update from Dechert's Corporate Finance Group

SEC Proposes Amendments to Disqualify "Bad Actors" from Rule 506 Private Placements

The Securities and Exchange Commission ("SEC") on May 25, 2011 proposed amendments to Rules 501 and 506 of Regulation D and to Form D in order to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Specifically, the proposed amendments disqualify securities offerings involving "felons and other 'bad actors'" from relying on the safe harbor from registration under Section 4(2) of the Securities Act of 1933, as amended (the "Securities Act"), provided by Rule 506 of Regulation D.

Rule 506 is the most widely used Regulation D exemption, accounting for approximately 90-95% of all Regulation D offerings.[1] Rule 506 allows an unlimited dollar amount of securities to be sold, without registration, to an unlimited number of accredited investors and up to 35 non-accredited investors, provided that there is no general solicitation, resale limitations are imposed, applicable information requirements are met and the other conditions set forth in the rule are satisfied.

Section 926 of the Dodd-Frank Act requires the SEC to adopt disqualification rules which must be "substantially similar" to the bad actor disqualification provisions relevant to offerings under Regulation A as set forth in Rule 262 of the Securities Act, and be triggered by events specified in Section 926. Such rules, often referred to as "bad boy" provisions, prohibit issuers and other parties, including underwriters, placement agents and directors, officers and significant shareholders of the issuer, from participating in exempt securities offerings if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud and other specified legal violations.

The SEC's proposed amendments, which would be set forth in a new paragraph (c) of Rule 506, incorporate the substance of Rule 262 but simplify its framework by including only one list of potentially disqualified persons and one list of disqualifying events.

"Covered persons" under the proposed amendments include: (1) the issuer and any of its predecessors or affiliated issuers, (2) any director, officer, general partner or managing member of the issuer, (3) any 10% beneficial owner of the issuer's equity securities, (4) any promoter connected with the issuer at the time of the sale, (5) any person that has received pay (directly or indirectly) for solicitation of purchasers in connection with sales of securities in the offering and (6) any director, officer, general partner or managing member of any such compensated solicitor. The SEC is soliciting comments on whether disqualification should be reserved for "executive officers" rather than "officers", as issuers could potentially devote substantial amounts of time and incur significant costs in making factual inquiries given the broad definition of "officer"

1 http://www.sec.gov/rules/proposed/2011/33-9211.pdf.

under the Securities Act (which includes "a president, vice president, secretary, treasurer...and any person routinely performing corresponding functions with respect to any organization").

Disqualifying events under the proposed amendments include: (1) criminal conviction, (2) court injunctions and restraining orders, (3) final orders of certain state and federal regulators (*e.g.* state securities, banking and insurance regulators), (4) SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associates persons, (5) suspension or expulsion from membership in, or suspension or bar from association with a member of, a securities self-regulatory organization, (6) SEC stop orders and orders suspending a Regulation A exemption and (7) U.S. Postal Service false representation.

Although not mandated by Section 926 of the Dodd-Frank Act, the SEC has included a "reasonable care" exception in its proposed amendments, which would allow an issuer to rely on 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, of the disqualification. To satisfy the exception, issuers must conduct a factual inquiry, the extent of which would depend on the circumstances in each particular case. By including an exception, the SEC hopes to preserve the intended benefits of Rule 506 and not impose an undue burden on capital-raising activities of small businesses.

The proposed amendment to Rule 506 would apply to all offerings seeking the benefit of the rule after the effective date of the new provisions and subject those offerings to disqualification for any disqualifying event that occurred within the relevant look-back periods, regardless of whether the events occurred before the enactment of the Dodd-Frank Act.

The SEC is also soliciting public comments on possible amendments that would make bad actor disqualification rules uniform across other exemptive rules, including: (1) offerings under Regulation A, Rule 505 of Regulation D and Regulation E, which are currently subject to disqualification rules under Rule 262 or similar provisions based on that rule and (2) offerings under Rule 504 of Regulation D, which are not subject to federal disqualification provisions. The SEC also requests comments on an amendment to establish a uniform ten-year look back period for all disqualifying events that are subject to an express look-back period under current law.

The SEC's proposed amendments do not contemplate a phase-in period before issuers must comply with the new rules. However, in light of the additional steps issuers must take to determine whether they are subject to disqualification under Rule 506, the SEC is requesting comments as to whether it may be appropriate to provide issuers additional time after adoption of the rules before compliance is required.

We anticipate there will be many comments received encouraging the SEC to include in the final amendments to the rules its proposed "reasonable care" exception to the disqualification rules in order to reduce the burden of the due diligence obligations imposed on companies by the proposed amendments to the rules and to preserve the intended benefits of Rule 506. We also believe that many commentators will encourage the SEC to take additional steps to alleviate the burden on companies imposed by the new rules by (1) delaying implementation until at least 90 days after adoption, (2) covering only "executive officers" rather than all "officers" and (3) exempting disqualifying events that occurred prior to the enactment of the Dodd-Frank Act or the effective date of the proposed amendments.

If you would like to discuss any of the issues discussed above, please contact any of your regular contacts at the firm. We will inform you regarding any further updates in connection with the proposed amendments.

Comments may be submitted to the SEC on or before July 14, 2011. SEC Release No. 33-9211 detailing these proposed amendments is available at http://www.sec.gov/rules/proposed/2011/33-9211.pdf.

Practice group contacts

For more information, please contact one of the lawyers listed, or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/corporate_finance.

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