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SEC Proposes "Bad Actor" Disqualifications for Rule 506 Private Placements

On May 25, 2011, the Securities and Exchange Commission (SEC) proposed rules to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). Section 926 requires the SEC to adopt rules that disqualify securities offerings that involve certain "felons and other 'bad actors'" from reliance on the safe harbor exemption from registration under the Securities Act of 1933 (Securities Act) provided by Rule 506 of Regulation D under the Securities Act.

Briefly, any offer or sale of a security must be registered under the Securities Act or qualify for an exemption from registration. Rule 506 provides a "safe harbor" for private securities offerings in any amount in which securities are sold only to investors that are "accredited" or that meet the sophistication requirements as set forth in Regulation D, and that otherwise comply with the provisions of the Rule. Rule 505 under Regulation D, which provides a safe harbor for private offerings up to $5 million, already includes such "bad actor" disqualifications. The vast majority of private offerings are, however, conducted under Rule 506. In its proposing release, the SEC requests comment on whether to extend the proposed rules to all other safe harbor registration exemptions, including the Rule 504 exemption for offerings of up to $1 million that is not currently subject to federal disqualification provisions.

The proposed rules set forth certain "covered persons" whose prior conduct could disqualify an issuer from relying on Rule 506. Covered persons would include: (i) the issuer and any predecessor or affiliated issuer; (ii) any director, officer, general partner or managing member of the issuer; (iii) any beneficial owner of 10% or more of any class of the issuer's equity securities; (iv) promoters; (v) any person that has or will be paid for soliciting purchasers in the offering; and (vi) any general partner, director, officer or managing member of any such solicitor. In general, the disqualifying events would include: (i) criminal convictions and court injunctions and restraining orders relating to certain securities-related conduct or the making of any false filing with the SEC; (ii) final orders issued by state securities commissions, banking regulators or insurance commissions or federal banking agencies; (iii) SEC orders that suspend registration as a broker, dealer, municipal securities dealer or investment adviser or places limits on such activities, or bars participation in penny stock offerings; (iv) suspensions or expulsions from membership in a national securities exchange or association; (v) filing or being named underwriter in a registration statement or Regulation A offering statement filed with the SEC subject to a stop order or related pending proceeding; and (vi) U.S. Postal Service false representation orders. The look-back period would be ten years for criminal convictions and five years for other actions, except for bars and orders, which would be disqualifying as long as they had a continuing effect.

Under the proposed rules, all securities sales under Rule 506 after the rules' effective date would be covered, even if the disqualifying event occurred prior to enactment of the final rules or, for that matter, Dodd-Frank. Further, the proposed rules would apply to all sales under Rule 506 as opposed to all offerings. As a result, disqualifying events that occur during an offering would disqualify any sales made after such event, even though sales in the same offering prior to the event would not be disqualified. The proposed rules would, however, provide that issuers could seek a waiver from the disqualification provisions from the SEC if "it is not necessary under the circumstances that an exemption be denied."

The proposed rules also provide that the disqualifications will not apply to an offering if the issuer can show that it did not know, and could not have known in the exercise of reasonable care, that a disqualification existed. This will require a factual inquiry on the part of the issuer to ensure that there is no such disqualification.

The SEC has asked for comment on a number of facets of the proposed rules (available at www.sec.gov/rules/proposed/2011/33-9211fr.pdf). Therefore, we expect some modifications but that overall the final rules, governed largely by Dodd-Frank, will be generally consistent with the proposed rules.

Reminder: XBRL Compliance Deadline Fast Approaching

In May 2009 the SEC adopted rules requiring all domestic issuers who file financial statements using U.S. Generally Accepted Accounting Principles (U.S. GAAP) and foreign issuers that use International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS/IASB) to file their financial statements in interactive data format using eXtensible Business Reporting Language, or XBRL. The XBRL requirements were phased in so that smaller reporting companies and non-accelerated filers would not be subject to the requirements until June 15, 2011. For such companies that report on a calendar-year basis, the first report that must include financial statements tagged in XBRL will be the quarterly report for the quarter ending June 30, 2011, which must be filed by August 15, 2011. The Staff of the SEC has issued a Summary of XBRL Information to assist these so-called "phrase 3" filers that will be filing in XBRL for the first time (available at www.sec.gov/spotlight/xbrl/xbrlsummaryinfophase3-051011.shtml). The Summary provides general guidance with respect to the XBRL requirements and links to additional resources. We suggest that companies filing in XBRL for the first time review this summary and the related guidance in connection with the preparation of their upcoming quarterly reports on Form 10-Q.

About Ober Kaler

Ober|Kaler is a national law firm that provides integrated regulatory, transaction and litigation services to financial, health care, construction and other business organizations. The firm has more than 130 attorneys in offices in Baltimore, MD, Washington, DC and Falls Church, VA. For more information, visit www.ober.com

About Me

I am a former SEC attorney who also has prior "big firm" experience. I assist public as well as private companies with compliance with federal and state securities laws, including assisting public companies with their reporting obligations under the Securities Exchange Act of 1934, at competitive billing rates. Please contact me if you would like more information about my practice or to discuss how I can be of assistance to you. Visit my bio at www.ober.com/attorneys/penny-somer-greif.

This Bulletin contains only a general overview of the matters discussed herein and should not be construed as providing legal advice. If you have any questions about the information in this Bulletin or would like additional information with respect to these matters, please contact me at 410.347.7341 or via e-mail at psomergreif@ober.com.

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