Regulation D Rule 506 Proposal

SEC Proposes Rules Disqualifying Unregistered Securities Offerings Involving “Bad Actors” from Reliance on the Rule 506 Safe Harbor

SUMMARY

The Securities and Exchange Commission has proposed rules implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 926 requires the SEC to issue rules that disqualify securities offerings involving felons and other “bad actors” from reliance upon Rule 506 of Regulation D under the Securities Act of 1933, which provides a safe harbor from Securities Act registration requirements. The new rules are required to be “substantially similar” to the disqualification provisions of Rule 262 under the Securities Act, which apply to offerings under Regulation A and Rule 505 of Regulation D, and to expand the list of disqualifying events to include certain state regulatory and other actions specified in Section 926.

The proposed new rules would require an issuer to make a factual inquiry to determine whether any covered person is subject to a disqualifying event, which may be ongoing or may be as many as five or ten years old, depending on the nature of the event. Covered persons would include the issuer, any person paid to solicit purchasers in the offering and a broad range of related persons, such as officers, directors, general partners and 10% equity owners of the issuer or any paid solicitor.

The SEC would have the authority to grant waivers from disqualification upon a showing of good cause. However, the SEC does not propose to “grandfather” disqualifying events that have occurred before the new rules take effect, although it has asked for comment on several possible grandfathering approaches. Unless the SEC modifies the proposed rules to grandfather prior events, issuers and securities firms may need to seek waivers for events occurring before the effective date of the rules.
BACKGROUND AND OVERVIEW

Rule 506 of Regulation D provides a safe harbor from registration under the Securities Act for private securities offerings meeting the requirements of that rule. Among other things, the offerings must be conducted without general solicitation and any purchasers who are not “accredited investors” must not exceed 35 in number, must receive certain financial information about the issuer and must (alone or with a representative) be capable of evaluating the merits and risks of the proposed investment. Unlike Rules 504 and 505 of Regulation D, however, Rule 506 does not impose any limit on the size of the offering and, according to the SEC, appears to be by far the most frequently used exemption in Regulation D.2

The disqualification provisions in Rule 262 currently apply to the exemption provided by Rule 505 but not to the exemption provided by Rule 506. The proposed new rules would impose comparable disqualification provisions with regard to Rule 506, would expand the list of specific disqualifying events to include various state regulatory events and would lengthen the relevant look-back period from five to ten years for certain events. The proposal would also expand the scope of persons who, if subject to a disqualifying event, would render Rule 506 unavailable for an offering.

The new disqualification provisions would incorporate the substance of Rule 262 as expanded but simplify the framework to include one list of disqualifying events and one list of potentially disqualified persons. The SEC proposes to codify these provisions in new paragraph (c) of Rule 506. It also asks for comment on whether the proposed rules should apply to Rule 505 and Regulations A and E, which are currently subject to the disqualifying provisions in Rule 262, in order to harmonize the disqualifying provisions across these exemptions.

The proposing release confirms that the disqualification provisions applicable to Rule 506 will not apply with regard to the statutory exemption from registration provided by Section 4(2) of the Securities Act. Reliance on Section 4(2) rather than Rule 506, however, may have collateral consequences under state securities laws. Under Section 18 of the Securities Act, securities offered pursuant to Rule 506 are not subject to the registration requirements of state securities laws, a benefit that does not apply to securities offered in a Section 4(2) private placement (unless the securities are listed on a national securities exchange or rank senior to listed securities of the same issuer, for example).

COVERED PERSONS

Under the proposal, the Rule 506 safe harbor would not be available for an offering of securities if any of the following persons (which we refer to as “covered persons”) were subject to a disqualifying event described in the next section:

- the issuer of the securities;
- any predecessor of the issuer;
- any affiliated issuer;3

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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;
- any person that has been or will be paid (directly or indirectly) remuneration for soliciting purchasers in the offering; and
- any director, officer, general partner or managing member of any such paid solicitor.

The SEC notes that the term “officer” may present significant challenges, particularly as applied to large, multinational financial institutions that may participate in private offerings as placement agents, dealers, advisors or finders. “Officer” is defined under SEC Rule 405 to include “a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization.” Given the potential breadth of this term, the SEC asks whether it should be limited for the purpose of Rule 506, for example, to officers who qualify as “executive officers” as defined in Rule 405 or who are “actually involved with or devote time to the relevant offering.” Given the proposed requirement that an issuer intending to rely on Rule 506 must conduct a factual inquiry to determine whether any covered person is subject to a disqualification, as described below, the scope of this definition will have significant practical consequences for issuers and other offering participants.

The SEC also requests comment on whether the proposed coverage of 10% shareholders (which mirrors the current Rule 262 provision) is appropriate, or should be replaced with a higher threshold or a standard based on actual control.

In the proposal, covered persons would not include an investment advisor of an issuer or directors, officers, general partners or managing members of such an advisor. However, the SEC has asked for comment on whether the proposed rules should apply to these persons or at least to those advising certain types of issuers, such as “pooled investment funds” referenced in Form D, registered investment companies, private funds and business development companies.

DISQUALIFYING EVENTS

Section 926 of the Dodd-Frank Act requires that the disqualifying events for Rule 506 be substantially similar to those in Rule 262 under Regulation A with two main additions. In broad terms, the SEC’s proposed rules would include the following types of disqualifying events from Rule 262:

- criminal convictions in connection with the purchase or sale of a security, the making of a false filing with the SEC or the conduct of a securities business such as that of an underwriter, broker-dealer or investment adviser;
- court injunctions and restraining orders relating to the purchase or sale of a security, the making of a false filing with the SEC or the conduct of a securities business;
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons;
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- 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 suspension proceedings relating to Securities Act registration statements or Regulation A offerings; and
- U.S. Postal Service false representation orders.

Under Rule 262, some of the above disqualifications apply with regard to issuers while others apply with regard to underwriters and related persons, such as officers, directors, 10% beneficial owners and general partners. Under the proposed rules, the disqualifications would generally relate to all covered persons, subject to certain exceptions and qualifications.

As required by Section 926, the proposed disqualifying events would also include a new category relating to orders of state and certain other financial regulators. This category would include final orders issued by state securities, banking, credit union and insurance regulators, and by federal banking regulators and the National Credit Union Administration, that either:

- bar a person from association with an entity regulated by the regulator issuing the order, or from engaging in the business of securities, insurance or banking or in savings association or credit union activities, or
- are based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct within a ten-year period.

The SEC also proposes to expand the list of disqualifying criminal convictions in Rule 262 to provide a five-year look-back for criminal convictions of issuers and a ten-year look-back for criminal convictions of all other covered persons. The SEC asks whether the proposed look-back period for criminal convictions is appropriate and whether the rule should provide different disqualification periods for issuers and other entities compared to individuals or should make all look-back periods uniform. The SEC is also considering whether a disqualification should apply to an entity that has undergone a change of control after the disqualifying event.

The proposed list of disqualifying events does not include injunctions or orders of foreign courts, nor do the proposed events based on actions of federal regulators include any actions of the Commodity Futures Trading Commission. Orders issued by the SEC in stand-alone cease-and-desist proceedings also would not be included, as currently they are not under rule 262. The SEC asks for comment on whether these omissions are appropriate.

FACTUAL INQUIRY REQUIREMENT
The proposed rules contain an exception from disqualification if the issuer can show it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. This exception would include an instruction stating that an issuer could not establish that it has exercised reasonable care unless it has made a factual inquiry into whether any disqualifications exist and that the nature and
scope of the inquiry would vary based on the particular facts and circumstances. The proposing release provides the following guidance with regard to “reasonable care”:

“The steps an issuer should take to exercise reasonable care would vary according to the circumstances of the covered persons and the offering, taking into account such factors as risk that bad actors could be present, the presence of other screening and compliance mechanisms and the cost and burden of the inquiry. 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 publically available databases is reasonable. In some circumstances, further steps may be necessary.”

As noted above, the proposed list of covered persons, and particularly the inclusion of “officers”, could make it difficult for issuers and other offering participants to determine in a reliable way whether the Rule 506 safe harbor is available.

WAIVERS
The proposal would authorize the SEC to grant waivers from disqualification under Rule 506 on grounds similar to those on which waivers may be granted under Rule 262. The SEC could grant a waiver with regard to Rule 506 if the SEC determines, upon a showing of good cause, “that it is not necessary under the circumstances for the exemption provided by Rule 506 to be denied”. Currently the Office of Small Business Policy, Division of Corporation Finance at the SEC handles applications for waivers from disqualification under Rule 262. In contrast, the proposing release states that there would be no delegation of authority for Rule 506 waivers to the SEC staff and such waivers would have to be issued by a direct order of the Commission itself. A request for a waiver should discuss the background of the matter, including the facts and legal issues involved, and a rationale for granting the waiver. The SEC seeks comment on waiver procedures for Rule 506 offerings.

TRANSITION/PRIOR ACTS
The proposed rules would apply to all sales made in reliance upon Rule 506 after the effective date of the rules. Offerings made after that date would be subject to all disqualifying events that occurred within the relevant look-back periods, regardless of whether those events occurred before the rules took effect or before the Dodd-Frank Act was enacted. Although the proposing release states the SEC’s belief that including prior events carries out the mandate of Congress as reflected in Section 926, the SEC recognizes that this could affect a number of market participants and seeks comment on ways to alleviate concerns about possible unfairness. In particular, the SEC has asked whether it should adopt an approach (similar to that taken with regard to eligibility to be a “well known seasoned issuer” under the Securities Act) of grandfathering disqualifying orders arising from a negotiated settlement before the

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Dodd-Frank Act was enacted, on the theory that the parties might not have agreed to settle had they
known they would be subject to disqualification under Rule 506. The SEC has also asked whether
waivers granted under Rule 262 with regard to disqualifying events occurring prior to the enactment of the
Dodd-Frank Act should be extended to apply to Rule 506. Unless the SEC modifies the proposed rules to
grandfather prior events, issuers and market participants will need to consider whether they will be
subject to disqualification under Rule 506 when the rules take effect and, therefore, need to seek a waiver. While an extension of prior waivers under Rule 262 to Rule 506 may help limit the number of
disqualifications arising from prior acts, it may not eliminate them, because the disqualifying events under
Rule 506 as proposed would be broader in scope than those under Rule 262, and also because some
issuers or market participants may have decided not to seek waivers under Rule 262 due to the limited
utility of the exemptions afforded by that rule.

EFFECT ON ONGOING OFFERINGS
As proposed, the “bad actor” disqualification provisions would apply to each sale after the rule is adopted.
Sales made before the occurrence of a disqualifying event would not be affected.

The SEC has requested comment on how the disqualification provisions should apply to offerings that are
already underway at the time the new rules become effective.

POSSIBLE AMENDMENTS TO INCREASE UNIFORMITY
The SEC is considering, and solicits comment on, whether the new “bad actor” standards required by the
Dodd-Frank Act for Rule 506 offerings should be applied uniformly to offerings under Regulation A, Rule
505 of Regulation D and Regulation E. The SEC is also considering making uniform all the look-back
periods that apply to disqualifying events. The SEC requests comments on a possible uniform look-back
period of ten years for all disqualifying events. The SEC also seeks comment on whether there are
events that should trigger a permanent disqualification.

EFFECTIVE DATE AND COMMENTS
Section 926 of the Dodd-Frank Act requires the SEC to adopt rules by July 21, 2011. Comments are due
by July 14, 2011.

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ENDNOTES


2 Rule 504 and 505 offerings are limited in size to $1.0 million and $5.0 million, respectively. The SEC states that over 90% of the notice filings made under Regulation D during the 12 months ended September 30, 2010 related to offerings under Rule 506.

3 Disqualifying events relating to affiliated issuers that pre-date the affiliate relationship would be excluded under the proposed rules.

4 The proposed rules would amend Rule 501 of Regulation D to define “final order” based on the definition used by the Financial Industry Regulatory Authority in Forms U-4, U-5 and U-6: “a written directive or declaratory statement issued pursuant to applicable statutory authority and procedures by a Federal or state agency . . ., which constitutes a final disposition or action by that Federal or state agency”. The SEC has asked for comment on whether this (or some other) definition should be adopted.

5 See the definition of “ineligible issuer” in clause (1)(vi) of Rule 405 under the Securities Act. Two Commissioners raised strong objections to the proposal that negotiated settlements prior to enactment were not to be grandfathered.
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