

## SEC Proposes 'Bad Actor' Bars to Certain Private Securities Offerings

On May 25, 2011, the Securities and Exchange Commission (the "SEC") proposed amendments to Rule 506 of Regulation D, under which a company can currently raise, in a private placement, unlimited capital from an unlimited number of "accredited investors" (those who meet certain tests for wealth and sophistication) and from 35 or fewer non-accredited investors.

Rule 506 is one of the most widely used exemptions from public offering registration requirements, accounting for more than 90 percent of private offerings made pursuant to the Regulation D safe harbor.

Under the proposed amendments, no company would be allowed to sell securities in reliance on Rule 506 of Regulation D if the company or any other person covered by the rule was subject to a "disqualifying event" related to their prior conduct.

"The Dodd-Frank Act requires the [SEC] to adopt rules that would make this safe harbor unavailable if a felon or other bad actor is involved in the offering," said SEC Chairman Mary L. Schapiro, who added that "our proposals would implement the Dodd-Frank requirement in a balanced and tailored way."

The entire Dodd-Frank Act was previously described in our July 2010 Securities Law Update entitled "Summary of Corporate Governance Changes in the Dodd-Frank U.S. Financial Regulatory Reform Act," which can be found on our Website at [http://www.burnslev.com/apps/uploads/publications/Securities\\_Update\\_Dodd-Frank\\_July2010.pdf](http://www.burnslev.com/apps/uploads/publications/Securities_Update_Dodd-Frank_July2010.pdf).

What follows is a summary of the proposed amendments, which generally define:

- Those entities and individuals who are "covered persons" for whom a "disqualifying event" can act as a bar to participation in a private offering under Rule 506 of Regulation D;
- The specific "disqualifying events" that

would prohibit a person from participating in a Rule 506 offering and prohibit an issuer from making such an offering;

- The exception from disqualification that could apply to an issuer when "reasonable care" has been exercised to avoid a prohibited association with a "covered person"; and
- The availability of "waivers" from disqualification in limited circumstances.

The SEC also announced that it is considering an extension of these proposed amendments to other private offerings, such that the amendments would provide the uniform "bad actor" disqualifications for all offerings under Regulation A, Regulation D and Regulation E.

For a full copy of the SEC's proposed amendments to Rule 506 of Regulation D, see SEC Release No. 33-9211 (the "Release") at <http://www.sec.gov/rules/proposed/2011/33-9211.pdf>. Certain limited but related changes to Rule 501 and Form D are proposed in the Release as well.

The SEC's deadline for public comments to these proposals is July 14, 2011.

### COVERED PERSONS

As proposed, the Rule 506 "safe harbor" from public registration requirements would not be available to an issuer if any of the following entities or individuals suffered a "disqualifying event" (as described below):

- The issuer, or any predecessor of the issuer, or any affiliated issuer;
- Any director, officer, general partner or managing partner of the issuer;
- Any beneficial owner of 10 percent 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 offering of securities for sale;

- 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; or
- Any director, officer, general partner, or managing member of any such compensated solicitor.

This generally corresponds to the definition of "covered persons" found in Rule 262 pertinent to Regulation A private offerings.

The SEC, anticipating that the term "officer" could excessively include many vice presidents who perform ordinary functions at large financial advisers or intermediaries, has requested public comment on whether disqualification provisions should only be applied to covered persons who are "executive officers" performing senior leadership or policy-making functions.

### DISQUALIFYING EVENTS

Rule 506 would not be available to issuers associated with "covered persons" who are the subject of the following types of "disqualifying events":

- Certain criminal convictions;
- Certain court injunctions and restraining orders;
- Final orders of certain state or federal regulators;
- Certain SEC disciplinary orders;
- Suspension or expulsion from membership in, or suspension or bar from associating with a member of a securities self-regulatory organization;
- SEC stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

#### 1. Criminal Convictions

Under the proposed rule, it would be a "disqualifying event" if any "covered person" associated with a Rule 506 offering has been

convicted, within 10 years before such sale (or 5 years, in the case of issuers, their predecessors and affiliated issuers) of any felony or misdemeanor:

- “In connection with the purchase or sale of any security;
- Involving the making of any false filing with the SEC; or
- Arising out of the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.”

### **2. Court Injunctions and Restraining Orders**

Under the proposed rule, it would also be a “disqualifying event” if any “covered person” associated with a Rule 506 offering “is subject to any order, judgment or decree of any court of competent jurisdiction, entered within 5 years before such sale, which at the time of such sale, restrains or enjoins [that] person from engaging or continuing to engage in any conduct or practice:

- In connection with the purchase or sale of any security;
- Involving the making of any false filing with the [SEC]; or
- Arising out of the conduct of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.”

### **3. Final Orders of Certain Regulators**

The proposed rule would additionally make it a “disqualifying event” for any “covered person” associated with a Rule 506 offering to be subject to a final order of a State securities commission (or of an agency or officer of a State performing like functions) or a final order of a State authority that supervises or examines banks, savings associations, or credit unions or a final order of a State insurance commission (or of an agency or officer of a State performing like functions) or a final order of the National Credit Union Administration which:

- “At the time of such sale, bars the person from: (i) association with an entity regulated by such authority; (ii) engaging in the business of securities, insurance or banking; or (iii) engaging in savings association or credit union activities; or

- Constitutes a final order, based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct, which was entered within 10 years prior to such sale.”

Because there could be confusion over what constitutes the “final order” of a regulator, the SEC has also proposed to amend Rule 501 of Regulation D to add a definition of “final order” for purposes of bad actor disqualification. The term, as defined, would mean: “a written directive or declaratory statement issued by an appropriate federal or state agency pursuant to applicable statutory authority and procedures that constitutes a final disposition or action by the federal or state agency.”

The SEC has also proposed to expand the list of regulators whose orders should be relevant for purposes of bad actor disqualification. Noting that the Commodities Future Trading Commission and the SEC were left off the list of regulators enumerated by the Dodd-Frank Act due to a “historical quirk,” the SEC has proposed to add those agencies to the list of agencies whose final orders are relevant to “disqualifying events.”

### **4. SEC Disciplinary Orders**

The proposed rule would also make it a “disqualifying event” for any “covered person” associated with a Rule 506 offering to be subject to an order of the SEC entered pursuant to certain rules pertinent to brokers, dealers and investment advisers (as codified in section 15(b) or 15B(c) of the Exchange Act, or section 203(e) or (f) of the Investment Advisers Act of 1940) which at the time of such sale:

- “Suspends or revokes such person’s registration as a broker, dealer, municipal securities dealer or investment adviser;
- Places limitations on the activities, functions or operations of such person; or
- Bars such person from being associated with any entity or from participating in the offering of any penny stock.”

### **5. Suspensions or Expulsions**

In addition, the proposed rule would impose disqualification on any offering involving a “covered person” that is “suspended or expelled from membership in, or suspended or barred from association with a member of

[either] a registered national securities exchange or an affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.”

### **6. Stop Orders and Orders Suspending Exemptions**

The proposed rule would impose disqualification as well on any offering involving a “covered person” that has filed (as a registrant or issuer) or was an underwriter or was named as an underwriter in any registration statement or Regulation A offering statement filed with the SEC that:

- “Within 5 years before such sale was the 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.”

### **7. U.S. Postal Service False Representation Orders**

Finally, the proposed rule would add a disqualification to any offering that involves a “covered person” who is:

- “Subject to a U.S. Postal Service false representation order entered within 5 years before such sale; or
- At the time of such sale subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the U.S. Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.”

### **“REASONABLE CARE” EXCEPTION**

The SEC acknowledged in the Release that there could be a large number of potential “covered persons” whose presence or participation in an offering could act to defeat an exemption from public registration requirements. The SEC also acknowledged that it is possible that issuers will fail to uncover certain “disqualifying events,” despite acting with due diligence and good faith in checking the backgrounds of “covered persons” involved in an offering.

Thus, the proposed rule sets forth a “reasonable care” exception to the general

rules of disqualification. This “reasonable care” exception would only apply “if the issuer establishes that it did not know, and in the exercise of reasonable care could not have known, that a disqualification existed under [the proposed rule].”

In order to establish the exercise of “reasonable care” an issuer would have to demonstrate a reasonable factual inquiry into whether any disqualifications exist. Furthermore, the nature and scope of the required inquiry would vary based on the circumstances of the issuer and the other offering participants. In some cases, said the SEC, issuers should consider investigating backgrounds of “covered persons” through publicly available databases.

## WAIVERS

The SEC has also proposed to allow issuers to seek waivers from disqualification under Rule 506 in a similar manner to that allowed under Regulation A. Therefore, the disqualification provisions of Rule 506 would not apply under the proposed rule if the SEC determines that it is not necessary to deny a Regulation D exemption “upon showing of good cause [by the issuer] and without prejudice to any other action by the SEC.”

## TRANSITION ISSUES

Under the proposed rule, the disqualification provisions would apply only to Rule 506 offerings made after the effective date of the new provisions. Such offerings would be subject to disqualification based on events that had occurred during the relevant look-back periods, regardless of whether those events occurred prior to enactment of the Dodd-Frank Act.

Adversely affected issuers may regain eligibility to rely upon Rule 506 if they are able to terminate their relationship with any and every bad actor whose involvement in an offering triggers disqualification.

## POSSIBLE AMENDMENTS FOR UNIFORMITY

The SEC is also soliciting public comment on whether to create a uniform set of bad actor disqualifications for all private offerings under Regulation A, Regulation D and Regulation E.

“We are concerned that there may be confusion, and that compliance costs could

be increased if different disqualification standards apply to these exemptions,” the SEC stated in the Release, adding that it is considering extension of the new bad actor provisions of the proposed rule to other private offerings.

The SEC is also considering the creation of a uniform look-back period that would apply to all disqualifying events for all private offerings. Rather than using a 10-year look-back period for some disqualifying events and a 5-year look-back period for others, the SEC is considering the uniform adoption of a 10-year look-back period.

### *Explanatory Notes:*

*This update is intended to call your attention to a number of proposed rule changes of possible interest and relevance to you, but it is not intended to constitute a legal opinion or definitive summary of all changes that could be material to you.*

*Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these rule changes or want to learn more about our expertise in this area.*

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In the securities compliance area, we advise our clients on corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance. Specifically, we assist our clients in fulfilling their ongoing SEC and stock exchange reporting obligations, managing sensitive disclosure issues internally and with industry analysts, preparing proxy statements and handling stockholder meetings, structuring employee benefit plans and executive compensation packages under the SEC's "short-swing profit" reporting and liability rules, effecting resales of securities in the public trading markets under

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