SEC Proposes Rule to Disqualify "Bad Actors" from Certain Regulation D Offerings

The Securities and Exchange Commission ("SEC") recently proposed amendments to Securities Act Rules 501 and 506 under Regulation D, as well as to Form D, to disqualify certain felons and other "bad actors" from participating in Rule 506 securities offerings. This proposal will impact private offerings by certain corporate issuers as well as most offerings by hedge funds, private equity funds, and other alternative investment funds. The proposed amendments implement Section 926 of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act. The SEC proposal is available at: http://www.sec.gov/rules/proposed/2011/33-9211.pdf.

Dodd-Frank Act Requirement

The Dodd-Frank Act requires the SEC to adopt rules that provide for the disqualification of offerings and sales of securities made under Rule 506 of Regulation D for certain "bad actors". In particular, the SEC must adopt disqualifications that:

- are substantially similar to the provisions of Rule 262 under the Securities Act (which provides certain disqualifications for Regulation A securities offerings for persons subject to certain orders, convictions, judgments, suspensions, or expulsions); and
- disqualify any offering or sale of securities by a person that:
  - is subject to a final order of any state securities, bank or insurance regulatory authority, an appropriate federal banking agency, or the National Credit Union Administration, that (1) bars the person from (a) association with an entity regulated by such authority; (b) engaging in the business of securities, insurance, or banking; or (c) engaging in savings association or credit union activities; or (2) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the preceding 10-year period; or
  - has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

The Dodd-Frank Act requires the SEC to adopt these new rules by July 21, 2011. It would appear unlikely that the SEC will meet this deadline considering that the comment period for the current proposal does not end until July 14, 2011.

Rule 506 provides a safe harbor for the registration exemption under Section 4(2) of the Securities Act of 1933. Section 4(2) provides an exemption from Securities Act registration for transactions by an issuer not involving any public offering (*i.e.*, private offerings). Rule 506 permits sales of an unlimited dollar amount of securities to be made to an unlimited number of "accredited investors" and up to 35 non-accredited investors, so long as there is no general solicitation, appropriate resale limitations are imposed, any applicable information requirements are satisfied, and the other conditions of the rule are met. Rule 506 is the most widely used Regulation D exemption and is generally relied upon by hedge funds, private equity funds and other privately offered investment funds as well as various other issuers.

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Proposed Disqualifications

Under the proposed amendments, no exemption under Rule 506 would be available for a sale of securities if a covered person:

- has been convicted within ten years (or five years, in the case of issuers, their predecessors, and affiliated issuers) of certain felonies or misdemeanors involving SEC filings or securities transactions businesses;
- is subject to any court order, judgment, or decree entered within five years that restrains or enjoins the person from engaging or continuing to engage in any conduct or practice involving SEC filings or securities transactions businesses;
- is subject to a final order of a state securities, banking, or insurance authority; a federal banking agency; or the National Credit Union Administration that (a) bars the person from association with certain regulated entities or from engaging in certain securities, banking, insurance, and similar activities or (b) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years;
- is subject to an order of the SEC entered pursuant to Section 15(b) or 15B(c) of the Exchange Act or Section 203(e) or (f) of the Advisers Act that (a) suspends or revokes the person's registration as a broker-dealer, municipal securities dealer, or investment adviser, (b) places limitations on the activities, functions or operations of the person, or (c) bars the person from being associated with any entity or from participating in the offering of any penny stock;
- is suspended or expelled from membership in, or 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 constituting conduct inconsistent with just and equitable principles of trade;
- has filed (as a registrant or issuer) a registration statement or Regulation A offering statement filed with the SEC (or was an underwriter in such an offering) that, within five years, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued; or
- is subject to a US Postal Service false representation order entered within five years or is subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the US Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.

Covered Persons

The proposed disqualification provisions would generally correspond to the persons covered by Rule 262. This would include the following persons:

- The issuer and any predecessor of the issuer or affiliated issuer;
- Any director, officer, general partner, or managing member 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 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; and
- Any director, officer, general partner, or managing member of any such compensated solicitor.

Officers—The SEC is not proposing to make other changes in the classes of persons that would be covered by the new disqualification rules. All the officers of issuers and compensated solicitors of investors would be covered as provided in current rules, rather than only executive officers as provided in earlier proposals. The SEC is concerned that, with the extension of bad actor disqualifications to Rule 506 offerings, continued use of the term "officer" may present significant challenges, particularly as applied to financial intermediaries. The term "officer" is defined under Securities Act 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."

Financial institutions that are acting as placement agents may have large numbers of employees that would come within this definition, many of whom would not have any involvement with any particular offering, but all of whom would be covered persons for purposes of disqualification. Issuers could potentially devote substantial amounts of time and incur significant costs in making factual inquiries. Accordingly, the SEC seeks comment on whether disqualification should be reserved for executive officers, officers actually involved with the offering or limited in some other way, or whether using the same broad category employed in the existing rules would be justified because it would provide a greater degree of investor protection.

Advisers and Related Persons—The proposal does not cover the investment advisers of issuers, or the directors, officers, general partners, or managing members of such investment advisers. These persons are not currently covered under Rule 262 of Regulation A. However, a significant percentage of issuers in Rule 506 offerings are investment funds, and in many fund structures, the investment adviser and the individuals that control it are the real decision-makers for the fund. For that reason, the SEC notes that it may be appropriate for investment advisers and their directors, officers, general partners and managing members to be covered by the bad actor disqualification provisions of Rule 506, at least for issuers that identify themselves as "pooled investment funds" on Form D, or that are registered as investment companies under the Investment Company Act of 1940, are "private funds" as defined in Section 202(a)(29) of the Investment Advisers Act of 1940 or that elect to be regulated as "business development companies," and perhaps for other types of issuers.

Beneficial Owners and Management—The SEC also seeks comment on whether there are circumstances in which the rules for disqualification of entities should focus on the beneficial owners and management of such entities at the time of the disqualifying event, rather than the legal entities themselves, and provide for different treatment of entities that have undergone a change of control since the occurrence of the disqualifying event. This would be a broader application of the principle underlying existing Rule 262(a)(5), under which events relating to certain affiliates are not disqualifying if they pre-date the affiliate relationship.

Look-Back Periods and Other Measurements

For purposes of establishing the relevant look-back periods, the proposal would measure from the date of the sale for which exemption is sought. Rule 262 of Regulation A currently measures from the date of the requisite filing with the SEC, which occurs before any offer of securities can be made under that exemption. The SEC believes this approach is not appropriate for Rule 506 offerings because no filing is required to be made with the SEC before an offer or sale is made in reliance on Regulation D. Current Rule 505, which effectively applies Rule 262 in a Regulation D context, addresses this issue by substituting "the first sale of securities under this section" for the Rule 262 reference to filing a document with the SEC. For purposes of Rule 506, the proposal would refer to the date of each relevant sale, rather than the date of first sale, because the SEC believes it creates a more appropriate look-back period for offerings that may continue for more than one year (for example, this is the case for most hedge funds and many other privately-offered investment funds).

The proposal would also provide that certain disqualifications relate to convictions, bars, orders, judgments, decrees and suspensions in existence "at the time of [the] sale". This would clarify that a bar is disqualifying only for as long as it has continuing effect. The proposal would clarify that the related orders, judgments or decrees must have been "entered" within the relevant ten-year period, so it is clear that the SEC is measuring from the date of the order and not the date of the underlying conduct.

SEC and CFTC Orders

The disqualifications required by the Dodd-Frank Act do not include all types of SEC orders and do not include orders of the Commodities Futures Trading Commission. The SEC is considering and soliciting comment on whether orders of the SEC and the CFTC should have the same effect for disqualification purposes as the orders of the other regulators designated by the Dodd-Frank Act.

Some types of orders issued by the SEC are covered by current bad actor disqualification rules, and some are not. Most significantly, orders issued in stand-alone SEC cease-and-desist proceedings are not disqualifying under current rules. The reason for this omission appears to be largely historical. The SEC seeks comment as to whether SEC cease-and-desist orders may be an appropriate basis

for disqualification and, if so, whether the rules should differentiate among different types of orders. Unless the disqualification rules cover SEC cease-and-desist orders, entities and individuals outside the securities industry would be subject to bad actor disqualification for SEC actions only if those persons are subject to a court order.

The SEC is also considering whether orders of the CFTC are relevant for disqualification purposes. The SEC believes that were it to include SEC and CFTC orders in the bad actor disqualification rules, it would do so by adding references to the SEC, the CFTC and the commodities business in the paragraph of the rules that addresses “final orders” of certain regulators. Any requirements the rule may impose on such orders and any interpretive positions that may apply would apply to orders of the SEC and the CFTC on the same basis as it did to orders of state and other federal regulators covered by the rule. The SEC would exclude from this provision SEC disciplinary orders that are already covered under current rules, and continue to treat them separately.

Reasonable Care Exception

To clarify the issuer’s obligations under the new rules, the proposal would create a “reasonable care” exception. Under this exception an issuer would not lose the benefit of the Rule 506 safe harbor, despite the existence of a disqualifying event, if it can show that it did not know and, in the exercise of reasonable care, could not have known of the disqualification. Under the proposal, the burden would be on the issuer to establish that it had exercised reasonable care. This would most likely occur in the context of an enforcement proceeding brought by a regulator or a private action brought by investors. To establish reasonable care, the issuer would be expected to conduct a factual inquiry, the nature and extent of which would depend on the facts and circumstances of the situation.

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 the 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, this might include additional questions in questionnaires issuers may already be using to support disclosures regarding directors, officers and significant shareholders of the issuer. Issuers should also consider whether investigating publicly available databases is reasonable. In some circumstances, further steps may be necessary.

Waivers

Issuers may currently seek waivers from disqualification from the SEC under Regulation A and the SEC may grant a waiver if it determines that the issuer has shown good cause that it is not necessary under the circumstances that the registration exemption be denied. The proposal would carry over the current waiver provisions of Rule 262 to the new rule.

Disqualifying Events that Pre-Date the Rule

The proposed disqualification provisions would apply to all sales made under Rule 506 after the effective date of the new provisions. The provisions would not affect any transaction that was completed before the effective date. Offerings made after the effective date would be subject to disqualification for all disqualifying events that had occurred within the relevant look-back periods, regardless of whether the events occurred before enactment of the Dodd-Frank Act, or the proposal or effectiveness of the amendments to Rule 506.

The SEC believes that past disqualifying events should be taken into account under new disqualification rules. In addition, the SEC is mindful that Section 926 replaced a provision in an earlier bill that would have eliminated federal pre-emption of Rule 506 offerings, thus subjecting such offerings to state “blue sky” regulation. Without pre-emption, existing convictions, disciplinary orders and other disqualifying events would have operated to disqualify offerings in the states that have bad actor disqualification rules. Replacing this provision with Section 926 was not seen as decreasing investor protection in this regard, suggesting that Section 926 was intended to take into account pre-existing disqualifying events.

The proposal does not attempt to exempt, “grandfather” or otherwise make special provision for events that occurred before enactment of the Dodd-Frank Act or the effective date of the proposed amendments. The SEC seeks comment, however, about whether the new disqualification provisions required under the Dodd-Frank Act would operate in an unfair manner in particular respects and whether it should provide grandfathering or other accommodation for some or all events that predate enactment of the Dodd-Frank Act, the proposal or the effective date of the rules, provided such grandfathering or

other accommodation would be consistent with the requirements of Section 926.

Effect on Ongoing Offerings

The proposed bad actor disqualification provisions would apply to each sale of securities made in reliance on Rule 506 after the rule amendments go into effect. Disqualifying events that occur while an offering is underway would be analyzed in a similar fashion. Sales made before the occurrence of the disqualification would not be affected by it, but sales thereafter would be disqualified unless and until the disqualification is waived or removed. The SEC believes this approach is consistent with other rules and provides appropriate incentives to issuers and other covered persons, but seeks comment on other possible approaches.

Timing of Implementation

The proposal does not contemplate any phase-in period or delay before issuers would be required to comply with the new disqualification rules. However, given that the new rules may require issuers to take a number of actions before they could confirm that they were not disqualified from relying on Rule 506, it may be appropriate to provide additional time after the rules are adopted but before compliance is required. For example, issuers might undertake an inquiry of covered persons, modify existing due diligence questionnaires, take steps to remove any existing disqualifications and seek waivers of disqualification, if necessary.

Amendment to Form D

The proposal includes a conforming amendment to Form D to reflect that bad actor disqualification would apply to Rule 506 transactions as well as Rule 505 transactions under Regulation D. The signature block of the current Form D contains a certification that applies only to transactions under Rule 505, confirming that the offering is not disqualified from reliance on Rule 505 for one of the reasons stated in current Rule 505(b)(2)(iii). Under the proposal, this certification would be broadened, so that issuers claiming a Rule 506 exemption would also confirm that the offering is not disqualified from reliance on Rule 506 for one of the reasons stated in Rule 506(c).

Uniform Application of Bad Actor Disqualification

Under the proposal, Rule 506 would be the only exemption subject to the disqualification rules mandated by the Dodd-Frank Act. The other Securities Act exemptions that currently provide for “bad actor” disqualification (Regulation A, Rule 505 of Regulation D, and Regulation E) would continue to follow the disqualification schemes currently in effect. Offerings under Rule 504, the remaining Regulation D exemption, would be the only Regulation D exemption not subject to any federal disqualification requirements. The SEC is concerned that there may be confusion, and that compliance costs could be increased, if different disqualification standards apply to these exemptions. The SEC is considering whether to preserve basic uniformity by conforming all existing bad actor disqualification requirements for exempt offerings to the standards proposed to be applied to Rule 506 offerings, and requests public comment on that approach. The SEC also seeks comment on whether broadening the impact of the rule changes by uniform application should affect the proposal to not provide for grandfathering of existing disqualifying events.

Uniform Look-Back Periods

The SEC is also considering making uniform all of the look-back periods that apply to disqualifying events that have an express look-back period. Rather than using a ten-year period for the final orders of certain state and federal regulators (as required under the Dodd-Frank Act), and for criminal convictions of covered persons other than the issuer, its predecessors and affiliated issuers (as provided under current Rule 262), and a five-year period for all other events subject to an express look-back period, a uniform ten-year look-back to all such events is being considered. The SEC seeks comment on this proposal.

Submitting Comments

You may submit comments on the proposed rules on or before July 14, 2011. You may submit comments to the SEC by submitting a hard copy, by sending an e-mail to rule-comments@sec.gov with “File Number S7-21-11” in the subject line, or at this link.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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