

## SEC's "Bad Actor" Proposal Poses Challenges for Rule 506 Issuers

The Securities and Exchange Commission (the "Commission") just released proposed rules that would disqualify securities issuers from utilizing the private placement safe harbor under Rule 506 if certain "covered persons" have committed certain specified "bad acts." This could have a significant impact on private placements because Rule 506 has become the preferred exemption for these, accounting for approximately 93% of private offerings under Regulation D. Rule 506 is the exemption of choice because it allows an unlimited amount of money to be raised from an unlimited number of accredited investors (subject to general solicitation limitations), has no explicit disclosure requirements when all investors are accredited and, under the National Securities Markets Improvement Act of 1996 (NSMIA), a Rule 506 offering preempts substantive review under state blue sky laws.

Until now, there has been no "issuer qualification" restricting use of the 506 exemption. This last aspect is about to change. As required by section 926 of the Dodd-Frank Act, on May 25, 2011, the Commission released proposed rules that would require companies seeking safe harbor under Rule 506 to take affirmative steps to ensure that none of the covered persons qualify as bad actors.

### Who is Covered?

The proposed revision to Rule 506 contains a long list of covered persons. The issuer is responsible for determining that these persons have not committed any bad acts that would lead to disqualification. These covered persons include:

- Issuers
- Issuer Predecessors
- Directors
- Officers
- General Partners
- Managing Members
- Beneficial Owners of 10% or more of any class of the issuer's equity securities
- Promoters
- Persons compensated for soliciting purchasers, such as placement agents
- Directors, Officers, and Managing Members of compensated solicitors

This is a broad list, as a large number of individuals involved in any one offering may be covered. Issuers will have to carefully interpret the regulation to determine who qualifies as a covered person.

One issue that should raise concern for issuers is which individuals in placement agents would qualify as covered persons. As currently written, the revised Rule 506 borrows language from Rule 505, covering individuals who will be paid for soliciting purchasers, as well as directors, officers, and managing members. At the same time, the Commission realizes that a large number of individuals at placement agents may qualify as officers, and thus be covered persons even if not directly involved in the placement at issue. The Commission is seeking comment on whether to restrict this definition to just “executive officers,” or only to officers involved in the offering.

Another possible area of concern is that, as currently written, the revised Rule 506 considers 10% shareholders of public and private companies to be covered persons. For public companies, such a rule could create a situation where a bad actor buys a 10%+ interest in a company and thus bars that company from relying on the safe harbor of Rule 506. Private companies may face a similar situation where, for example, a 10%+ interest in the company is transferred to a bad actor. The Commission is soliciting comments on whether the 10% level is an appropriate threshold, whether distinctions should be drawn between private and public companies, and whether the Commission should instead only consider individuals with actual control as covered persons.

### **What is a Bad Act?**

A “bad actor” is a covered person who has committed a “bad act.” The Commission has proposed a list of bad acts that is equally exhaustive. Bad acts include any action that has resulted in:

- Securities-related criminal convictions;
- Securities-related injunctions and court orders;
- Final orders from certain regulators, including federal banking agencies and state securities commissions, that bar the individual from association with a regulated entity, prohibit the individual from securities and banking-related business, or which are based on fraudulent conduct within the last 10 years;
- Commission disciplinary orders that revoke one’s registration or otherwise limit their activities;
- Suspension or expulsion from a self-regulatory organization;
- Commission Stop Orders and Orders suspending exemptions under Regulation A; and
- U.S. Postal Service False Representation Orders.

These bad acts are predicated on regulatory determinations by any one of numerous agencies. Records of these determinations are not aggregated in a single source, and, in fact, may not be publicly available. Thus, to the extent that issuers have to take affirmative steps to ensure that none of the covered persons has committed a bad act, such due diligence may be both time-consuming and costly.

As currently written, bad acts will only lead to disqualification where they have led to action by courts or regulatory agencies in the United States. However, the Commission is also concerned about whether bad acts committed by covered persons in foreign jurisdictions should affect the ability of issuers to rely on Rule 506. Thus, the Commission is seeking comment on whether foreign court convictions, injunctions, and orders of foreign securities regulators should lead to disqualification. If

the Commission decides to include such acts an issuer's efforts to ensure compliance could become even more difficult.

### Exceptions

Because ensuring full compliance with Rule 506 may be onerous the proposed rule has two built-in exceptions. Under the first exception, if the issuer can show good cause the Commission may determine that a Rule 506 exemption is still warranted. There is no guidance in the proposed rule release as to what constitutes "good cause."

Under the second exception, the issuer will still be entitled to a Rule 506 exemption on a showing that the issuer did not know, and despite the exercise of reasonable care, could not have known, about the existence of a qualifying bad act. To show reasonable care, the issuer will have to make a factual inquiry into whether any covered person has committed a bad act. While the scope and nature of such an investigation will depend upon the circumstances of each case, the Commission suggests that such an inquiry consist of questioning covered persons, investigating publicly accessible databases, and, in some cases, taking further steps. As currently written, the standard of reasonable care is vague. While such a reasonable care standard is necessarily determined by the facts of each situation, the current description of what constitutes reasonable care may present a challenge to issuers struggling to determine what steps are needed to show reasonable care. However, assuming reasonable care is taken, a Rule 506 exemption is still available despite covered persons having committed bad acts.

### Timing

As currently written, the new requirements to Rule 506 would apply to all sales of securities that occur after the Rule is amended. Thus, even if an offering commenced before the amended Rule 506 went into effect, any subsequent sale of securities would subject the issuer to the new requirements. Further, the Rule as amended would apply to bad acts committed both before and after the Rule went into effect. The Commission is soliciting comments on how best to implement the Rule, including whether there should be a phase-in period, and how prior bad acts should be treated under the Rule.

### Stay Tuned

The Commission is soliciting comments until July 14th and the final amendment to Rule 506 may be substantially different than this initial proposal. However, issuers of securities should take note of this possibly important change to Rule 506. Especially given the current lack of a phase-in period, it may be prudent for issuers contemplating a private offering to proactively evaluate who qualifies as a covered person, and begin researching possible bad acts. Potential issuers should also consider new compliance procedures, including more extensive questionnaires and searches into publicly accessible databases, to be conducted before a private placement takes place. Privately held companies may want to consider transfer restrictions that prevent transfers of shares to bad actors. Financing sources may want to ensure that issuer representations include representation as to qualification of the issuer to utilize the Rule 506 exemption after enactment of the final rules.

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