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Dodd-Frank Update: SEC Proposes Bad Actor Disqualifications for Private Placements under Regulation D

On May 25, 2011, the Securities and Exchange Commission (the "SEC" or "Commission") proposed amendments to rules promulgated under Regulation D to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Section 926 of the Dodd-Frank Act, entitled "Disqualifying felons and other 'bad actors' from Regulation D offerings," requires the SEC to adopt rules to disqualify certain securities offerings from reliance on the private placement safe harbor provided by Rule 506 of Regulation D.

We discuss the background, the proposed amendments to Rule 506 of Regulation D, and possible future SEC rulemaking below.

Background

Rule 506 permits sales of an unlimited amount of securities, without registration, to any number of accredited investors[2] and up to 35 non-accredited investors, as long as there is no general solicitation, the 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 exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D.

Unlike Rule 505 of Regulation D, Regulation E and Regulation A, Rule 506 of Regulation D does not currently have any "bad actor" disqualification provisions. "Bad actor" disqualification requirements prohibit issuers and others such as underwriters, placement agents, directors, officers, and shareholders of the issuer from participating in exempt securities offerings, if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. The SEC proposed similar amendments in 2007, but did not take final action on that proposal.[3]

Section 926 of the Dodd-Frank Act requires the SEC to adopt rules that would make the exemption available under Rule 506 unavailable for any securities offering in which certain "felons" or other "bad actors" are involved. Section 926 also requires the new rules to be substantially similar to the bad actor disqualification provisions of another limited offering exemptive rule, Rule 262, the bad actor disqualification provisions specified in Regulation A.

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[1] Release No. 33-9211 (May 25, 2011) (the "Proposing Release"). The Proposing Release is available at http://www.sec.gov/rules/proposed/2011/33-9211.pdf.
[2] In a separate rulemaking required under Section 413(a) of the Dodd-Frank Act, the SEC proposed amendments to the accredited investor standards in the rules promulgated under the Securities Act of 1933. Our news bulletin on those amendments is available at http://www.mofo.com/files/Uploads/Images/110125-Net-Worth-Standard-for-Accredited-Investors.pdf.
[3] Release No. 33-8828 (August 3, 2007). That Release is available at http://www.sec.gov/rules/proposed/2007/33-8828.pdf.

Proposed Amendments

Covered Persons

Section 926(1) of the Dodd-Frank Act requires the SEC to adopt disqualification rules that are substantially similar to those of Rule 262, the bad actor disqualification provisions applicable to offerings under Regulation A. The proposed amendments would add a new Section 506(c) to Regulation D. That new section would encompass disqualification provisions that are currently codified in Rule 262 of Regulation A and in Section 926(1) of the Dodd-Frank Act. The disqualification provisions in proposed Rule 506(c) generally correspond to the persons currently covered under Rule 262 and would thus apply to the following "covered persons":

- the issuer and any predecessor of the issuer or affiliated issuer, any director, or any officer;
- 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 a securities offering; or
- any director, officer, general partner, or managing member of any compensated solicitor.

The SEC has sought to clarify in the proposed rule that for entities organized as limited liability companies, managing members would be covered expressly, as are general partners of partnerships. In the case of financial intermediaries likely to be involved in a private placement under Rule 506, the SEC proposed to look to the current standards in Rule 505. Because Rule 505 transactions do not involve underwritten public offerings but rather the use of compensated placement agents and finders, the term "underwriters" in Rule 262 is replaced with "any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers." This Rule 505 standard would apply to transactions under Rule 506, as such transactions would also typically involve placement agents and finders.

The proposed rule also clarifies that the disqualification provisions do not apply to certain events prior to an offering. Under existing Rule 262(a)(5), orders, judgments, and decrees entered against affiliated issuers before the affiliation arose do not disqualify an offering, if the affiliated issuer is not in control of the issuer or under common control, together with the issuer, of a third party that controlled the issuer at the time that the order, decree, or judgment was entered. The proposed rule would clarify that this exclusion applies to all potentially disqualifying events that predate the affiliation.

The SEC is seeking comments on whether other categories of persons should be included in Rule 506(c), whether the term "officer" as it applies to financial intermediaries in private offerings should be reserved for "executive officers" only (i.e., those performing policy-making functions), whether the proposed coverage of 10 percent shareholders is appropriate, whether any exceptions need to apply for actions entered into prior to affiliation, and whether it would be appropriate to extend coverage to investment advisers and their directors, officers, general partners and managing members.

Disqualifying Events

The proposed rule includes seven categories of disqualifying events. They are:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state regulators (such as securities, banking, and insurance) and federal regulators;
- Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization ("SRO");
- Commission stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

A discussion of each of these categories appears below.

Criminal Convictions

Section 926(2)(B) of the Dodd-Frank Act provides for disqualification if any covered person "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 Commission," similar to the current language of Rule 262(a)(3) (with respect to criminal convictions of issuers) and Rule 262(b)(1) (with respect to criminal convictions of other covered persons). Unlike Rule 262(b)(1), however, Section 926(2)(B) of the Dodd-Frank Act does not address criminal convictions "arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer or investment adviser." Given that these convictions are covered in existing Rule 262, the proposed revision to Rule 506 would cover such convictions, and includes a reference to convictions arising out of the conduct of the business of a person compensated for soliciting purchasers, as is presently provided in Rule 505(b)(2)(iii).

Proposed Rule 506 also includes a five-year look-back period for criminal convictions of issuers and a ten-year look-back period for other covered persons. Rule 262 has similar look-back periods, but Section 922(2)(B) of the Dodd-Frank Act does not include any look-back period for convictions. The SEC is seeking comments on whether a longer look-back period is appropriate. The SEC is also seeking comments on whether the inquiry should focus on the beneficial ownership structure of an entity at the time of the disqualifying event, on the application of the rule to the date of the relevant sale, on the scope of the application, and whether corresponding convictions in foreign courts should trigger disqualification.

Court Injunctions and Restraining Orders

Currently under Rule 262, issuers and other covered persons are disqualified from reliance on Regulation A if the issuer or such covered person is subject to a court injunction or restraining order against engaging in or continuing any conduct or practice in connection with the purchase or sale of securities or involving the making of a false filing with the SEC. Proposed Rule 506(c)(1)(ii) reflects the substance of Rule 262, but also includes in its application orders arising out of the conduct of business of paid solicitors of purchasers of securities.

The SEC is seeking comments on whether a look-back period of five years for injunctions and restraining orders is appropriate, and whether foreign court orders and injunctions should have any consequences when subject to disqualification.

Final Orders of Certain Regulators

Section 926(2)(A) of the Dodd-Frank Act provides that the SEC disqualification rules must apply to offerings by any covered person who is subject to a final order of a state securities commission; a state agency that regulates banks, savings associations, credit unions and insurance companies; a federal agency, or the National Credit Union Administration. The order must be final, based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct and must bar the person from association with such entity and from engaging in the business of securities, insurance, banking, savings association or credit union activities. That section also contains a ten-year look-back period. Section 926(2)(A) is identical to existing provisions in the Securities Exchange Act ("Exchange Act") and the Investment Advisers Act of 1940 ("Advisers Act")[4] that grant the Commission authority to censure, suspend or revoke the registration of brokers, dealers and investment advisers based on financial industry bars and final regulatory orders issued against them by specified regulators.

Proposed Rule 506(c)(1)(iii) codifies Section 926(2)(A) of the Dodd-Frank Act and seeks to eliminate ambiguities, as the proposed rule provides that the order must bar the person "at the time of [the] sale" from one or more of the activities, the bar must be disqualifying only for as long as it has continuing effect, and that the ten-year look-back period applies from the date of the order and not the date of the underlying conduct. The SEC is seeking comments on whether the rule should clarify what constitutes a "bar" and whether a cut-off date for permanent bars is appropriate.

The proposing release discusses each of "Final Orders," "Fraudulent, Manipulative or Deceptive Conduct," and "Orders of Other Regulators" under this subsection. A discussion of each of these subcategories appears below:

- <u>Final Orders</u>

Proposed Rule 501 defines "final order" to mean the final steps taken by a regulator. The proposed definition is based on the Financial Industry Regulatory Authority ("FINRA") definition. FINRA collects information regarding disciplinary actions, including relevant final orders, through its uniform registration Forms BD, U4, U5, and U6 for the purpose of registration of broker-dealers and associated persons. In that context, FINRA defines "final order" to mean "a written directive or declaratory statement issued by an appropriate federal or state agency . . . pursuant to applicable statutory authority and procedures, that constitute a final disposition or action by that federal or state agency."[5]

The SEC is seeking comments on whether the proposed definition is appropriate and whether the definition should mean an order for which all rights of appeal have been exhausted.

- <u>Fraudulent, Manipulative, or Deceptive Conduct</u>

Section 926(A)(ii) of the Dodd-Frank Act provides that disqualification must result from final orders of the relevant regulators that are "based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct." Proposed Rule 501 does not differentiate between technical violations, and intentional or other more egregious conduct. The SEC is seeking comments on whether to provide guidance on what constitutes fraudulent, manipulative, or deceptive conduct, and whether to distinguish between technical violations and intentional or egregious conduct for the purposes of the disqualification.

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[4] See Section 15(b)(4)(H) of the Exchange Act and Section 203(e)(9) of the Advisers Act.
[5] See "Explanation of Terms" applicable to FINRA Forms U4, U5, and U6 (available at http://www.finra.org/web/groups/industry/@ip/@comp/@regi/documents/appsupportdocs/p116979.pdf).

- Orders of Other Regulators

Under Section 926 of the Dodd-Frank Act, bad actor disqualification would result from final orders issued by state and federal regulators enumerated in that section. That list does not currently include the Commission or the Commodity Futures Trading Commission ("CFTC"). Currently, some types of Commission orders are covered by bad actor disqualification rules such as Regulation A, Rule 505, and Regulation E. However, Commission orders in cease-and-desist proceedings are not disqualifying under current rules.[6] This distinction has the effect of subjecting individuals outside the securities industry to bad actor disqualification rules only if those persons are subject to court orders.

The SEC is seeking comment on whether CFTC orders are relevant for disqualification purposes, if cease-and-desist orders may be an appropriate basis for disqualification, and, if so, whether the rules should differentiate among different types of orders.

Commission Disciplinary Orders

Currently under Rule 262(b)(3), issuers and other covered persons that are subject to an SEC order entered pursuant to Section 15(b), 15B(a), or 15B(c) of the Exchange Act, or Section 203(e) or (f) of the Advisers Act, are disqualified from relying on the exemption available under Regulation A. Under the cited provisions of the Exchange Act and the Advisers Act, the SEC has the authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers, and investment advisers, including the suspension or revocation of registration, censure, placing limits on their activities, imposing civil money penalties and barring individuals from being associated with specified entities and from participating in the offering of any penny stock.

The SEC and its staff have historically required disqualification periods to run only for as long as some act is prohibited or required to be performed pursuant to an order. Therefore, censures are not disqualifying and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires. The SEC is seeking comments on whether this position should be codified, whether a look-back period should be required, and whether the reference to Section 15B(a) of the Exchange Act should be eliminated in the proposed rule. Orders issued under Section 15B(a) of the Exchange Act (the basic registration requirements for municipal securities dealers) are treated as disqualifying and the SEC believes that it is not appropriate to refer to it in the context of bad actor disqualification.

Suspension or Expulsion from SRO Membership or Association with an SRO Member

Rules 262(b)(4) imposes disqualification on an offering if any covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade. The proposed rule covers expulsion from FINRA and seeks comment on whether the rule should cover expulsion from any other organization, including foreign exchanges, and whether a look-back period is appropriate.

Stop Orders and Orders Suspending the Regulation A Exemption

Rule 262(a)(1) and (a)(2) impose disqualification on an offering if the issuer or any predecessor or affiliated issuer filed a registration statement or other Regulation A offering statement that is subject to a Commission refusal order, stop order, or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine if such an order should be issued. Paragraphs (c)(1) and (c)(2) extend disqualification to an underwriter under similar circumstances. Proposed Rule 506(c)(1)(vi) incorporates the substance of paragraphs (a)(1), (a)(2), (c)(1), and (c)(2) of Rule 262, thereby imposing disqualification on an

[6] In addition, investment company bars, civil penalties, and disgorgement under Sections 9(d) and (e) of the Investment Company Act, and censures of persons under Rule 102(e) of the Commission's Rules of Practice, are also not currently disqualifying.

offering pursuant to Regulation A under the circumstances discussed above on both issuers and underwriters. The SEC seeks comments on whether the look-back period is appropriate, and whether this provision should cover action by other regulators, including commodities and foreign regulators.

U.S. Postal Service False Representation Orders

Paragraphs (a)(5) and (b)(5) of Rule 262 impose disqualification on an offering if the issuer or another covered person is subject to a U.S. Postal Service false representation order entered within the preceding five years, or to a temporary restraining order or preliminary injunction with respect to conduct alleged to have violated the false representation statute that applies to U.S. mail. Proposed Rule 506(c)(1)(vii) incorporates the substance of these paragraphs and mirrors the current five-year look-back period.

The SEC seeks comments on whether the five-year look-back period is appropriate.

Reasonable Care Exception

Proposed Rule 506 incorporates a reasonable care exception that would apply if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person. The reasonable care exception would help preserve the intended benefits of Rule 506 and avoid creating an undue burden on capital-raising activities, while giving effect to the legislative intent to screen out felons and bad actors.[7]

In order to rely on the reasonable care exception, the issuer would need to conduct a factual inquiry, the nature of which would depend on the facts and circumstances of the issuer and the other offering participants. In such an inquiry, an issuer would need to consider various factors, such as the risk that bad actors present, the presence of screening and other compliance mechanisms, the cost and burden of the inquiry, whether other means used to obtain information about the covered persons is adequate, and whether investigating publicly available information is reasonable.

The SEC is seeking comments on whether the reasonable care exception is consistent with its goals of investor protection, how the factual inquiry differs from current practice, and whether specific steps for broker-dealers are required.

Waivers

Currently, issuers may seek waivers of disqualification under Regulation A if the issuer shows good cause. Proposed Rule 506(c)(2)(i) carries over the current waiver provisions of Regulation A. Waivers under the new rule will be issued by the Commission.

The SEC is seeking comments on whether it is appropriate for the Commission to have the authority to waive disqualification and whether such authority can be exercised in cases involving orders by state regulators.

[7] Regulation D already has a provision, Rule 508, under which “insignificant deviations” from the terms, conditions, and requirements of Regulation D will not result in the loss of the exemption if the person relying on the exemption can show that: (i) the failure to comply did not pertain to a term, condition or requirement directly intended to protect that individual or entity; (ii) the failure to comply was insignificant with respect to the offering as a whole; and (iii) a good faith and reasonable attempt was made to comply. The Commission does not believe that Rule 508 would cover circumstances in which an offering was disqualified under proposed Rule 506(c).

Transition Issues

Disqualifying Events that Predate the Rule

Under the proposal, the disqualification provisions would apply to all sales under Rule 506 after the effective date of the new provisions. 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 the enactment of the Dodd-Frank Act. This retroactive application of the disqualification provisions is the most controversial and elicited statements at the open meeting by Commissioners Kathleen Casey[8] and Troy Paredes.[9] The SEC justifies the retroactive application by referencing the language in Section 926 of the Dodd-Frank Act and by relying on the legislative history and intent of that provision.[10]

The SEC is seeking comments on whether grandfathering or other accommodations such as waivers are appropriate for events that predate the enactment of the Dodd-Frank Act. The SEC is also seeking comments on whether the retroactive application of the proposed disqualification provisions will operate in an unfair manner. For example, individuals who negotiated settlements prior to the enactment of the Dodd-Frank Act may have negotiated a different settlement had they known that it would result in disqualification from future Rule 506 offerings.

Effect on Ongoing Offerings and Timing of Implementation

The proposed bad actor disqualification provisions would apply only to sales of securities made in reliance on Rule 506 after the rule amendments go into effect. If disqualifying events occur while an offering is underway, only sales made after the event will be impacted.

The proposal does not contemplate any phase-in period or delay before issuers would be required to comply with the new disqualification rules.

The SEC is seeking comments on whether the disqualification provisions should apply after the effective date of the new rules, and whether it is appropriate to apply them to each sale of securities.

Amendment to Form D

The signature block of current Form D contains a certification that applies to transactions under Rule 505, confirming that the offering is not disqualified from reliance on Rule 505. Under the proposal, this certification would be broadened, so that issuers claiming a Rule 506 exemption would also be required to confirm that the offering is not disqualified from reliance on the Rule 506 exemption.

Possible Amendments to Increase Uniformity

Uniform Application of Bad Actor Disqualification to Regulations A, D, and E

The SEC is requesting comments on whether the bad actor disqualification standards proposed under Rule 506 should be applied uniformly to each of the other Regulation D exemptions, as well as to the exemptions under Regulations A and E. Currently, all bad actor disqualification provisions are substantially similar in language and

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[8] Commissioner Kathleen Casey's speech is available at http://www.sec.gov/news/speech/2011/spch052511tap-item1.htm.
[9] Commissioner Troy A. Paredes's speech is available at http://www.sec.gov/news/speech/2011/spch052511tap-item1.htm.
[10] The SEC reached the opposite result with respect to eligibility for being a "well known seasoned issuer." For the purposes of defining "ineligible issuer" (i.e., an issuer that is not eligible to be a "well known seasoned issuer"), ineligibility based on settlements applies only to judicial or administrative decrees or orders entered into after the effective date of the rule. See Release No. 33-8591 (July 19, 2005); available at http://www.sec.gov/rules/final/33-8591.pdf.

effect to those in Rule 262. The proposal seeks to preserve this uniformity by conforming all existing bad actor disqualification requirements to the standards proposed in Rule 506 offerings.

In order to adopt a uniform approach, the SEC will need to amend its rules to add a new paragraph (e) to Rule 502 and conform the current disqualification provisions in Regulations A and E to the new Rule 502(e), add underwriters and their directors, officers, general partners, and managing members to the categories of covered persons, add as covered persons investment advisers and the general partners, managing members, directors, and officers of investment managers of private funds and business development companies ("BDCs"); use the date of the relevant sale as the measurement date for the look-back period under Regulations A and E; and amend the certification requirements in Form D to apply to all Regulation D offerings.

The SEC is soliciting comments on possible approaches to uniformity, including whether to apply the proposed disqualification provisions uniformly to offerings under Regulations A, D, and E; whether to extend the application to Rule 504 offerings; whether to conform existing disqualification provisions of Regulations A and E to proposed Rule 506(c), and whether investment advisers of private fund issuers and BDCs should be included as covered persons.

Uniform Look-Back Periods

Currently, the Dodd-Frank Act provides for a ten-year look-back period for final orders of federal and state regulators, and for criminal convictions of covered persons other than the issuer (as provided under Rule 262), and a five year period for all other events.

The SEC is proposing to add a uniform ten-year look-back period for all disqualifying events and is soliciting comments on whether this is appropriate.

Request for Comments and Future Rulemaking

The SEC is soliciting comments, both specific and general, on each component of the proposal. Comments are due on July 14, 2011.