

SEC PROPOSES TO DISQUALIFY CERTAIN PERSONS FROM RELIANCE ON PRIVATE PLACEMENT SAFE HARBOR

The Securities and Exchange Commission has proposed for the first time to disqualify certain “bad actors” from reliance on the private placement safe harbor under Rule 506 of Regulation D.¹ The Rule 506 exemption is relied upon by a wide variety of issuers, including many private investment funds, and, if adopted, this proposed change could have a negative impact on how many such issuers offer their securities to investors.

Background

Rule 506 provides a safe harbor from securities registration under the Securities Act of 1933 (the “Securities Act”) for private placements under Section 4(2) of the Securities Act and permits sales of an unlimited dollar amount of securities to be made, without registration, 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, and the other conditions of the rule are met. Rule 506 in its current form does not impose any bad actor disqualification requirements.

In addition, because securities sold under Rule 506 are “covered securities” under Section 18(b)(4)(D) of the Securities Act, offerings pursuant to Rule 506 have the benefit of a preemption of substantive state securities law requirements.²

Scope of the Proposed Rule

The disqualification provisions would apply if any of the following persons are subject to a “disqualifying event”:

- The issuer, including its predecessors and any affiliated issuers.³

¹ SEC Release No. 33-9211 (May 25, 2011), 76 Fed. Reg. 31,518 (June 1, 2011). The SEC Release is available at: <http://www.sec.gov/rules/proposed/2011/33-9211fr.pdf>. Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the “Dodd-Frank Act”), requires the SEC to adopt rules that would deny the exemption in Rule 506 of Regulation D to any securities offering in which certain felons and other “bad actors” are involved, that are “substantially similar” to the bad actor disqualification provisions of another limited offering exemptive rule, Rule 262 of Regulation A, and that also include other events enumerated in Section 926 (including certain state regulatory orders and bars).

² Under sections 18(b) and (c) of the Securities Act, the state securities regulators may only require an issuer relying on Rule 506 to file a notice with the state consisting of a copy of Form D as filed with the SEC, a filing fee and a Consent to Service of Process Form. However, an issuer unable to rely on Rule 506 would be subject to varying state law provisions and may even be precluded from selling to investors in a state.

³ The proposal would not include disqualifying events of an affiliate under common control that occurred before it was affiliated with the issuer.

- Directors, officers, general partners and managing members of the issuer.
- Beneficial owners of 10% or more of any class of the issuer's equity securities.
- Promoters of the issuer.
- Persons that have been or will be compensated for soliciting investors, as well as the general partners, directors, officers and managing members of any such solicitor.

As proposed, a "disqualifying event" would include:

- Criminal convictions, court injunctions or restraining orders, in connection with (i) the purchase or sale of a security, (ii) the making of a false filing with the SEC or (iii) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.⁴
- Final orders of state securities, insurance, banking, savings association or credit union regulators, federal banking agencies or the National Credit Union Administration that either bar the person from: (i) associating with a regulated entity, (ii) engaging in the business of securities, insurance or banking or (iii) engaging in savings association or credit union activities or that are based on fraudulent, manipulative or deceptive conduct and are entered within 10 years before the proposed sale of securities.
- Certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, and investment advisers and their associated persons, which would be disqualifying for as long as the order is in effect.
- Suspension or expulsion from membership in a "self-regulatory organization" ("SRO") or from association with an SRO member, which would be disqualifying for the period of suspension or expulsion.
- SEC stop or refusal orders and orders suspending an issuer's Regulation A exemption, issued within five years before the proposed sale of securities, or at the time of sale being subject to an investigation or proceeding to determine whether such a stop order or suspension order should be issued.
- U.S. Postal Service false representation orders entered within five years before the proposed sale of securities.

⁴ A criminal conviction must have occurred within 10 years of the proposed sale of securities (or five years, in the case of the issuer and its predecessors and affiliated issuers), while an injunction or restraining order must have occurred within five years of the proposed sale of securities.

Application to Pre-Existing Disqualifying Events

As proposed, convictions, suspensions, injunctions and orders pre-existing the enactment of the Dodd-Frank Act would be disqualifying. SEC Commissioners Casey and Paredes strongly objected to this feature of the proposal and as a consequence voted against it.

Reasonable Care Exception

The proposed rule would provide an exception from disqualification when the issuer can show it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed.

Waivers

The proposal also includes a provision whereby issuers may seek waivers of the disqualification from the SEC.⁵

Practical Consequences

Because a new or past disciplinary event involving various offering participants can disqualify an offering, upon effectiveness of this proposal many offerings may lose the ability to rely on Rule 506. A number of registered broker-dealer firms and their employees are currently subject to disqualifying events and therefore will not be able to act as solicitors for Rule 506 offerings. Issuers will also need to inquire about the disciplinary history of other offering participants before relying on Rule 506, including any existing or potential ten percent equity owner of an issuer.

Any issuer unable to rely upon the Rule 506 safe harbor that seeks in the alternative to qualify under the statutory exemption for private offerings in Section 4(2) of the Securities Act will need to exercise extreme caution, since the scope of that exemption as interpreted by the courts and the SEC over the years is substantially more limited and its contours much less clearly defined than Rule 506.

Additionally, a private offering outside of Rule 506 would not have the benefit of the preemption of substantive state securities law requirements and thus be subject to applicable state-specific disclosure, filing and investor suitability standards. Such an offering would also be subject in many states to review on the merits by state regulators, which could result in state-mandated changes to the terms of the offering or in certain cases an inability to make the offering in one or more states.

⁵ Unlike waivers for Regulation A disqualifications, which may be granted by the SEC's Director of the Division of Corporation Finance, the waivers proposed for Rule 506 disqualifications would require a direct order from the Commission itself.

Comment Requested

The SEC has specifically requested comment on over 80 aspects of this proposal, including among others (i) whether to “grandfather” certain persons, (ii) whether only “executive” officers should be covered persons, (iii) whether investment advisers to private funds and their officers, directors and partners should be specifically included as covered persons, (iv) whether foreign court injunctions and orders or CFTC final orders should be included as disqualifying events, (v) whether the SEC should be able to waive disqualifications, and (vi) the period of time after the rule’s adoption before it becomes effective.

The comment period ends July 14, 2011. Section 926 of the Dodd-Frank Act requires the SEC to adopt disqualifications to Rule 506 by July 21, 2011. However, it is not clear at this time when the proposed amendments to Rule 506 will be adopted in final form or become effective.

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