Schulte Roth&Zabel

Alert

SEC Releases "Bad Actor" Rule Guidance

December 11, 2013

On Dec. 4, 2013, the Division of Corporate Finance of the U.S. Securities and Exchange Commission supplemented its Compliance and Disclosure Interpretations ("C&DIs")[1] to address some of the questions raised by private fund managers (and others) regarding the recently promulgated "bad actor" rules contained in new Rule 506(d).[2]

New Rule 506(d), which became effective on Sept. 23, 2013, disqualifies issuers that have committed or experienced (or who have a relationship with certain categories of persons who have committed or experienced) one or more of an enumerated list of bad acts and actions from relying on the exemption from registration under the Securities Act of 1933 provided by Regulation D. However, the final text of the rule raised a number of questions on how certain provisions of the bad actor rule would be interpreted in the context of private funds.

While the December 4 C&DIs do not answer all of the questions that private fund managers have about Rule 506(d), they resolve several points of confusion, including the following:

- **Resolving the "Affiliated Issuer" Question**
  Under Rule 506(d), an issuer is disqualified from relying on Regulation D if an "affiliated issuer" is a bad actor. There was considerable confusion and concern about whether the "affiliated issuer" concept captured situations such as separate private funds with a common adviser, private funds advised by another manager under a shared corporate parent or a portfolio company in which a private fund holds an interest.[3]

  Question 260.16 provides a resolution that private fund managers will generally welcome, stating that under Rule 506(d), "affiliated issuer" is limited to an entity that is an affiliate (as defined in Rule 501(b) of Regulation D) of the issuer that is issuing securities *in the same offering*. Therefore, this C&DI, among other things, makes clear that portfolio companies are not "affiliated issuers." (Managers were also reminded that "in the same offering" picks up the integration concept in Rule 502(a) of Regulation D and that they should, therefore, analyze that point in appropriate situations.)

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[1] The C&DIs, generally presented in a question-and-answer format, comprise a publicly available source of Division guidance on certain issues raised by the rules promulgated by the SEC under the Securities Act of 1933. They are subject to revision from time to time and will often also contain an indicator of the latest date of publication or revision.

[2] The relevant C&DIs are Questions 260.14 through 260.27 and can be found on the SEC website. This *Alert* provides a short summary of some of these C&DIs and, in addition, we have appended the full text of Questions 260.14 through 260.27 hereto.

[3] While this has been referred to as a "private equity issue," it also was a concern for hedge funds that take concentrated positions in public companies, private equity funds and all managers with multiple product offerings.

- **The Division's Interpretation of "Participation in an Offering"**
  Covered persons under Rule 506(d) include officers of — among others — compensated solicitors and private fund managers who are "participating in the offering" of privately placed securities. One C&DI, Question 260.19, seeks to resolve confusion over the applicability of "participation in an offering" to non-soliciting officers of a placement agent. The Division's response confirms that it does not intend to employ a narrow construction of the scope of "participation" in an offering: it states that participation "is not limited to solicitation of investors . . . [it includes] participation or involvement in due diligence activities or the preparation of offering materials . . . providing structuring or other advice to the issuer in connection with the offering, and communicating with the issuer, prospective investors or other offering participants about the offering." It does, however, provide a list of some activities that "would generally not be deemed to be participating in the offering" (e.g., opening brokerage accounts, wiring funds and bookkeeping activities).

- **Limited Guidance on "Reasonable Care"**
  Rule 506(d) introduced a "reasonable care" standard into an issuer-directed savings provision. In Question 260.23, the Division clarified that the following actions, if reasonable under the surrounding circumstances, would not necessarily constitute Rule 506(d) violations:

  (i) An inability to determine the existence of a disqualifying event;

  (ii) An inability to determine that a particular person was a covered person; and

  (iii) An initial (but ultimately incorrect) determination that a particular person was not a covered person.

  However, no express guidance was provided in this C&DI on appropriate subsequent steps once the applicable error was discovered, although a non-exclusive list of options was included (e.g., obtaining waivers of disqualification, terminating the relationship with such a covered person, providing Rule 506(e) disclosures or other remedial steps).

- **Obtaining Bringdowns and Updating Disclosures**
  Question 260.14 confirms that "if an offering is continuous, delayed or long-lived, the issuer must update its [Rule 506(d)] factual inquiry periodically through bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances." The C&DI does not provide any further guidance or any safe harbor on frequency or extent.

- **Universal Placement Agent Disclosures**
  Question 260.26 makes it clear that the Division expects issuers to send Rule 506(e) disclosures on placement agent prior bad acts to all investors — not just to those introduced by the placement agent making the bad act disclosure.

- **The "Termination" Solution**
  Another C&DI confirms that timely termination of a disqualifying solicitation arrangement or termination or modification of an employment relationship can preserve an issuer's prospective ability to rely on Regulation D. With respect to the termination of a placement agent, Question 260.15 also states that the terminated solicitor may "not receive compensation for the future sales." In a related C&DI, Question 260.27, the Division makes clear that an issuer conducting a continuous offering is not required to provide Rule 506(e) disclosures with respect to compensated solicitors who are no longer involved with the offering.

- **No Foreign Bad Acts**
  Some of the "bad acts" listed in Rule 506(d) do not specifically identify geographic restrictions (e.g., the disqualification for a person "subject to any order, judgment or decree of any court of competent jurisdiction . . . [that] restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any security . . ."). Question 260.20 provides confirmation that a Regulation D disqualification will not result from convictions, court orders,

injunctions in a foreign court or regulatory orders issued by foreign regulatory authorities. (Note that this determination accords with pre-existing language in the SEC's releases.)

- **Rule 105 Orders**
  Rule 105 is a non-scienter-based rule and Question 260.21 confirms that a cease and desist order under Rule 105 will not trigger a Regulation D disqualification, even though Rule 105 is itself promulgated under a scienter-based provision of law (i.e., Section 10(b) of the Securities Exchange Act).

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Appendix
December 4, 2013 Compliance and Disclosure Interpretations Regarding Rule 506(d)

Source: Division of Corporate Finance of the U.S. Securities and Exchange Commission

Question 260.14 When is an issuer required to determine whether bad actor disqualification under Rule 506(d) applies?

Answer: Rule 506(d) disqualifies an offering of securities from reliance on a Rule 506 exemption from Securities Act registration. Issuers must therefore determine if they are subject to bad actor disqualification any time they are offering or selling securities in reliance on Rule 506. An issuer that is not offering securities, such as a fund that is winding down and is closed to investment, need not determine whether Rule 506(d) applies unless and until it commences a Rule 506 offering. An issuer may reasonably rely on a covered person's agreement to provide notice of a potential or actual bad actor triggering event pursuant to, for example, contractual covenants, bylaw requirements, or an undertaking in a questionnaire or certification. However, if an offering is continuous, delayed or long-lived, the issuer must update its factual inquiry periodically through bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances.

Question 260.15 If a placement agent or one of its covered control persons, such as an executive officer or managing member, becomes subject to a disqualifying event while an offering is still ongoing, could the issuer continue to rely on Rule 506 for that offering?

Answer: Yes, the issuer could rely on Rule 506 for future sales in that offering if the engagement with the placement agent was terminated and the placement agent did not receive compensation for the future sales. Alternatively, if the triggering disqualifying event affected only the covered control persons of the placement agent, the issuer could continue to rely on Rule 506 for that offering if such persons were terminated or no longer performed roles with respect to the placement agent that would cause them to be covered persons for purposes of Rule 506(d).

Question 260.16 For purposes of Rule 506(d), does an "affiliated issuer" mean every affiliate of the issuer that has issued securities?

Answer: No. Under Rule 506(d), an "affiliated issuer" of the issuer is an affiliate (as defined in Rule 501(b) of Regulation D) of the issuer that is issuing securities in the same offering, including offerings subject to integration pursuant to Rule 502(a) of Regulation D. Securities Act Forms C&DIs 130.01 and 130.02 provide examples of co-issuer or multiple issuer offerings.

Question 260.17 Are compensated solicitors limited to brokers, as defined in Exchange Act Section 3(a)(4), who are subject to registration pursuant to Exchange Act Section 15(a)(1), and their associated persons?

Answer: No. All persons who have been or will be paid, directly or indirectly, remuneration for solicitation of purchasers are covered by Rule 506(d), regardless of whether they are, or are required to be, registered under Exchange Act Section 15(a)(1) or are associated persons of registered broker-dealers. The disclosure required in Item 12 of Form D expressly contemplates that compensated solicitors may not appear in FINRA's Central Registration Depository (CRD) of brokers and brokerage firms.

Question 260.18 Does the term "participating" include persons whose sole involvement with a Rule 506 offering is as members of a compensated solicitor's deal or transaction committee that is responsible for approving such compensated solicitor's participation in the offering?

Answer: No.

Question 260.19 Are officers of a compensated solicitor deemed to be "participating" in a Rule 506 offering only if they are involved with the solicitation of investors for that offering?

Answer: No. Participation in an offering is not limited to solicitation of investors. Examples of participation in an offering include participation or involvement in due diligence activities or the preparation of offering materials (including analyst reports used to solicit investors), providing structuring or other advice to the issuer in connection with the offering, and communicating with the issuer, prospective investors or other offering participants about the offering. To constitute participation for purposes of the rule, such activities must be more than transitory or incidental. Administrative functions, such as opening brokerage accounts, wiring funds, and bookkeeping activities, would generally not be deemed to be participating in the offering.

Question 260.20 Is disqualification under Rule 506(d) triggered by actions taken in jurisdictions other than the United States, such as convictions, court orders, or injunctions in a foreign court, or regulatory orders issued by foreign regulatory authorities?

Answer: No.

Question 260.21 Is disqualification under Rule 506(d)(1)(v) triggered by all Commission orders to cease and desist from violations of Commission rules promulgated under Exchange Act Section 10(b)?

Answer: No. Disqualification is triggered only by orders to cease and desist from violations of scienter-based provisions of the federal securities laws, including scienter-based rules. An order to cease and desist from violations of a non-scienter based rule would not trigger disqualification, even if the rule is promulgated under a scienter-based provision of law. For example, an order to cease and desist from violations of Exchange Act Rule 105 would not trigger disqualification, even though Rule 105 is promulgated under Exchange Act Section 10(b).

Question 260.22 If an order issued by a court or regulator provides, in accordance with Rule 506(d)(2)(iii), that disqualification from Rule 506 should not arise as a result of the order, is it necessary to seek a waiver from the Commission or to take any other action to confirm that bad actor disqualification will not apply as a result of the order?

Answer: No. The provisions of Rule 506(d)(2)(iii) are self-executing.

Question 260.23 Does the reasonable care exception only cover circumstances where the issuer has identified all covered persons but, despite the exercise of reasonable care, was unable to discover the existence of a disqualifying event? Or could it also apply where, despite the exercise of reasonable care, the issuer (i) was unable to determine that a particular person was a covered person (for example, an officer of a financial intermediary that the issuer did not know was participating in the offering, despite the exercise of reasonable care) or (ii) initially determined that the person was not a covered person but subsequently determined that the person should have been deemed a covered person?

Answer: The reasonable care exception applies whenever the issuer can establish that it did not know and, despite the exercise of reasonable care, could not have known that a disqualification existed under Rule 506(d)(1). This may occur when, despite the exercise of reasonable care, the issuer was unable to determine the existence of a disqualifying event, was unable to determine that a particular person was a covered person, or initially reasonably determined that the person was not a covered person but subsequently learned that determination was incorrect. Issuers will still need to consider what steps are appropriate upon discovery of Rule 506(d) disqualifying events and covered persons throughout the course of an ongoing Rule 506 offering. An issuer may need to seek waivers of disqualification, terminate the relationship with covered persons, provide Rule 506(e) disclosure, or take such other remedial steps to address the Rule 506(d) disqualification.

Question 260.24 Is there a procedure provided in Rule 506(e) for issuers to seek a waiver of the obligation to disclose past events that would have been disqualifying, except that they occurred before September 23, 2013 (the effective date of Rule 506(d))?

Answer: No. The disclosure obligation is not subject to waiver.

Question 260.25 Does Rule 506(e) require disclosure of past events that would no longer trigger disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years before the offering or an order or bar that is no longer in effect at the time of the offering?

Answer: No. Rule 506(e) requires only disclosure of events that would have triggered disqualification at the time of the offering had Rule 506(d) been applicable. Because events outside the applicable look-back period and orders that do not have continuing effect would not trigger disqualification, Rule 506(e) does not mandate disclosure of such matters in order for the issuer to be able to rely on Rule 506.

Question 260.26 In an offering in which the issuer uses multiple placement agents or other compensated solicitors, is the issuer required to provide investors with disclosure under Rule 506(e) only with respect to the particular compensated solicitor or placement agent that solicited those investors and its covered control persons (i.e., general partners, managing members, directors, executive officers, and other officers participating in the offering)?

Answer: No. Issuers are required to provide all investors with the Rule 506(e) disclosure for all compensated solicitors who are involved with the offering at the time of sale and their covered control persons.

Question 260.27 In a continuous offering, is the issuer required to provide disclosure under Rule 506(e) for all solicitors that were ever involved during the course of the offering?

Answer: No. A reasonable time prior to the sale of securities in reliance on Rule 506, the issuer must provide the required disclosure with respect to all compensated solicitors that are involved at the time of sale. Disclosure with respect to compensated solicitors who are no longer involved with the offering need not be provided under Rule 506(e) in order for the issuer to be able to rely on Rule 506.