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Alert

SEC Releases a Second Installment of "Bad Actor" Rule Guidance

January 22, 2014

Earlier this month, the Division of Corporate Finance ("CorpFin") of the U.S. Securities and Exchange Commission supplemented — for the second time[1] — its Compliance and Disclosure Interpretations ("C&DIs")[2] to address some of the questions raised by private fund managers (and others) regarding the "bad actor" disqualification provisions of Rule 506(d).[3]

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 Rule 506 of Regulation D. However, the final text of the rule and the adopting release[4] raised a number of questions on how certain provisions of the bad actor rule would be interpreted in the context of private funds.

Details of the New SEC Staff Guidance

By issuing these new C&DIs, CorpFin has taken another substantial step toward resolving the points of confusion and uncertainty that continue to surround Rule 506(d). These new interpretations address the following points:

- **Defining "beneficial owner" for purposes of Rule 506(d)**
  Under Rule 506(d), an issuer is disqualified from relying on Regulation D if "any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power" is a bad actor (as described in the rule). However, neither the text of the rule nor the adopting release contained a definition of "beneficial owner" or "beneficial ownership,"[5] which resulted in some confusion in the marketplace.

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[1] We addressed the first (Dec. 3, 2013) round of bad actor C&DIs in an earlier *Alert* titled *SEC Releases Additional "Bad Actor" Rule Guidance*.

[2] 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.

[3] The new C&DIs are Questions 260.28 through 260.32 and can be found on the SEC website. This *Alert* provides a short summary of these C&DIs and, in addition, we have appended them, in full text, to this *Alert* as Appendix 1. We also append the full text of the December 2013 C&DIs (Questions 260.14 through 260.27) to this *Alert* as Appendix 2.

[4] Release No. 33-9414, *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings* (July 10, 2013).

[5] Footnote 280 to the adopting release, which spoke about "beneficial ownership reports," implied that a Rule 13d-3 definition would apply, which the new C&DIs have now confirmed and clarified.

Question 260.29 asks whether the term "beneficial owner," as used in Rule 506(d), is to be interpreted the same way as that term is used under Exchange Act Rule 13d-3. The answer is an unambiguous "Yes," and the C&DI goes on to expressly state that:

> "beneficial owner" under Rule 506(d) means any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, under Exchange Act Rule 13d-3 has or shares, or is deemed to have or share: (1) voting power, which includes the power to vote, or to direct the voting of, such security; and/or (2) investment power, which includes the power to dispose, or to direct the disposition of, such security.

- **Addressing the "look through" issue for beneficial owner determinations under Rule 506(d)**
  Question 260.30 follows with guidance on whether a "look through" to "controlling persons" is required, and it states that "[b]eneficial ownership includes both direct and indirect interests, determined as under Exchange Act Rule 13d-3."

- **Applying the Section 13(d) "group" theory to Rule 506(d) beneficial owners**
  CorpFin continued its application of the Rule 13d-3 definition of beneficial owner to Rule 506(d) in Question 260.31, providing guidance that the interests held by beneficial owners of voting securities who comprise a "group" are to be aggregated. Using the example of a voting agreement among shareholders, the staff demonstrated how the application of Section 13(d) and Rule 13d can result in the group itself having the status of a single beneficial owner that is deemed to beneficially own all of the securities owned by the group members, while the group members are only deemed to beneficially own those securities over which each actually has voting or investment power.

- **Clarifying the *post hoc* timing of the Rule 506(d) beneficial owner test**
  In Question 260.28, CorpFin clarified that a shareholder or investor is not covered by 506(d) as a 20% beneficial owner until after the transaction that makes it a 20% beneficial owner closes. In other words, a bad actor can complete a purchase that brings its interest in the issuer's outstanding voting securities over 20% and that transaction can be in compliance with Rule 506 of Regulation D, but the issuer will be disqualified from conducting subsequent placements under Rule 506 while that bad actor is a 20% or greater beneficial owner of the issuer's outstanding voting securities.

Specific C&DI Guidance on Rule 506(e)

In addition to the beneficial owner guidance discussed above, one C&DI, Question 260.32, focuses on whether a court or regulator determination that would otherwise, pursuant to Rule 506(d)(2)(iii), negate an issuer's Rule 506 ineligibility can also nullify the disclosure obligation set forth in Rule 506(e).[6]

The new C&DI clarifies that — with respect to pre-Sept. 23, 2013 acts or events of the kind enumerated in Rule 506(d) — an order of a court or regulator, even if it satisfies Rule 506(d)(2)(iii), cannot eliminate the Rule 506(e) notice obligation. CorpFin, however, did clarify that a regulatory authority could determine that an order entered before Sept. 23, 2013 would not have triggered disqualification

[6] Rule 506(d)(2)(iii) permits issuers to rely on a written determination from a disciplining court or regulatory authority that a relevant sanction resulting from a disqualifying event that occurred *on or after Sept. 23, 2013* should not result in a Rule 506 disqualification. Rule 506(e), on the other hand, requires issuer disclosure of disqualifying events that would have triggered disqualification, except that these events occurred *before Sept. 23, 2013*.

because it was not covered by Rule 506(d)(1) (i.e., "because the violation was *not* a final order *based on a* violation of any *law or regulation that prohibits fraudulent, manipulative, or deceptive conduct* entered within ten years before such sale" (emphasis added)).

Certain Implications of the Beneficial Owner Guidance

The C&DIs on the beneficial owner issue effectively require that private fund managers become intimately familiar with Section 13(d) and Rule 13d-3. By definitionally linking to Rule 13d-3, the CorpFin guidance provides a construct for determining the proper Rule 506(d) treatment of several common situations faced by private fund managers, including the following:

- **Advisers to multiple investors**
  Managers who have or share "voting power" or "investment power" over an investing entity (e.g., an investment adviser to a fund of funds) may be deemed under Rule 13d-3 to be the beneficial owner of that investing entity's positions. While every situation is different and a careful examination of the particular facts is required, if a manager has voting or investment power over two or more entities or accounts, then the manager should consider whether it would be deemed to be the beneficial owner of all of the various investments. This kind of conclusion could result, for example, in an adviser to two separate 12% holders of record being deemed, under Rule 13d-3, to have beneficial ownership of an aggregate 24% position.

- **Corporate entity investors**
  Beneficial ownership of the holdings of a corporation (or a similar structure for other forms of organization) can sometimes be deemed to be held solely by the corporation itself. The shareholders of a corporation generally are not deemed to be the beneficial owners of the securities held by the corporation because they typically do not have voting or investment power over the securities held by the corporation, although there are some exceptions to this general rule (such as in the case of a corporation's controlling shareholder(s)). Where a board of directors or other group of persons has voting or investment power over the securities held by the corporation, depending on the facts, the individual members of the board or other group may be deemed not to have voting or investment power over the securities and therefore not be deemed to be beneficial owners.[7] Accordingly, there may often be no need to look-through to individual directors or to shareholders of a corporation.

- **Investing partnerships**
  Many partnerships that make investments deem the general partner to have the Section 13(d) beneficial ownership of the partnership's positions; *provided* that the limited partners have no voting or investment power over the partnership's positions.

- **Trusts and endowments**
  Trusts and endowments must also be analyzed on a case-by-case basis. Some trusts and endowments will more closely resemble partnerships, while others will have a structure akin to

[7] See, for example, the so-called "rule of three" no-action letter (which concluded that where voting and investment decisions regarding a trust's portfolio securities are made by three or more trustees, and voting or investment decisions require the approval of a majority of those trustees, none of the individual trustees are deemed a beneficial owner of the trust's portfolio securities) (Southland Corp. (July 8, 1987)). Similar concepts may apply in other contexts.

a corporation; this structural distinction can result in very different outcomes in terms of Rule 13d-3 beneficial ownership.

Broader Guidance on the "Group" Concept under Section 13(d) and 13(g)

As noted above, the new bad actor C&DIs expressly apply the Section 13(d) "group" concept to Rule 506(d). Question 260.31 makes clear that an issuer can be disqualified from reliance on Rule 506 if: (i) a group beneficially owning a 20% or greater position is itself a bad actor or (ii) a member of a 20% group who is a bad actor is deemed to beneficially own the securities held by the other group members such that the member is itself a 20% or greater beneficial owner.

CorpFin provided, through the combination of Question 260.31 and a concurrent update to another set of C&DIs on "Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting," new guidance clarifying when an individual group member's bad actor status will be deemed to be a disqualifying condition. In Question 105.06 of the Section 13(d) C&DIs, CorpFin stated that an individual group member would be deemed to have beneficial ownership of the securities held by the other group members in situations where the agreement among them gives that individual member voting or investment power over the securities held by the other group members, such as where a member holds a *bona fide* irrevocable proxy or the right to designate a director for whom the other group members must vote (and not merely because it is a member of the group). If such a group agreement gives a bad actor beneficial ownership over 20% or more of an issuer's outstanding voting securities, the group agreement will result in a disqualifying condition.

Certain Considerations for Private Fund Managers

CorpFin's strong and unambiguous application of the Rule 13d-3 "group" concept does not necessarily mean that a manager needs to obtain bad actor representations from every single investor. It may, however, be useful to obtain representations from (or perform some other kind of "reasonable care" diligence on) groups of investors (e.g., private banking "platform" clients, managed accounts, or funds of funds) that share a common adviser *and* that collectively hold a position that approaches (or exceeds) 20% of a fund's equity voting securities. If a decision is made to obtain a representation, it should cover the investor of record as well as any other person that, through the investor of record, would be deemed a Rule 13d-3 beneficial owner of 20% or more of the issuer's outstanding voting securities.

In addition, given the clarification in Question 260.32, private fund managers should confirm with their placement agents (potentially among others) that there are no additional pre-Sept. 23 events that should be disclosed. Given the guidance provided in Question 260.23 (discussed in our earlier alert),[8] issuers may need to provide supplementary disclosure to investors or consider taking other steps to satisfy "reasonable care" if a placement agent (or other covered person) previously was taking a position regarding a prior sanction or order that is not consistent with new C&DI Question 260.32.

Remaining Open Issues

The two rounds of C&DIs have addressed many, but not all, of the uncertainty surrounding Rule 506(d). We are working with many market participants in seeking additional guidance and will keep our clients informed of any new developments.

[8] Question 260.23 states that "the reasonable care exception applies whenever … despite the exercise of reasonable care, [the issuer] could not have known that a disqualification existed under Rule 506(d)(1) … Issuers will still need to consider what steps are appropriate upon discovery of Rule 506(d) disqualifying events … throughout the course of an ongoing Rule 506 offering. An issuer may need to … provide Rule 506(e) disclosure, or take such other remedial steps to address the Rule 506(d) disqualification."

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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Appendix 1

January 3, 2014 Compliance and Disclosure Interpretations Regarding Rule 506(d)
Source: Division of Corporate Finance of the U.S. Securities and Exchange Commission

Question 260.28 Is a shareholder that becomes a 20% beneficial owner by purchasing securities in an offering a covered person with respect to that offering?

> *Answer*: Rule 506(d) looks to the time of each sale of securities, and provides that no exemption will be available for the sale if any covered person is subject to a bad actor triggering event at that time. A shareholder that becomes a 20% beneficial owner upon completion of a sale of securities is not a 20% beneficial owner at the time of the sale. However, it would be a covered person with respect to any sales of securities in the offering that were made while it was a 20% beneficial owner.

Question 260.29 Is the term "beneficial owner" in Rule 506(d) interpreted the same way as under Exchange Act Rule 13d-3?

> *Answer*: Yes, "beneficial owner" under Rule 506(d) means any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, under Exchange Act Rule 13d-3 has or shares, or is deemed to have or share: (1) voting power, which includes the power to vote, or to direct the voting of, such security; and/or (2) investment power, which includes the power to dispose, or to direct the disposition of, such security.

Question 260.30 For purposes of determining 20% beneficial owners under Rule 506(d), is it necessary to "look through" entities to their controlling persons?

> *Answer*: Beneficial ownership includes both direct and indirect interests, determined as under Exchange Act Rule 13d-3.

Question 260.31 Some of the shareholders of a Rule 506 issuer have entered into a voting agreement under which each shareholder agrees to vote its shares of voting equity securities in favor of director candidates designated by one or more of the other parties. Are the parties to the agreement required to aggregate their holdings for purposes of determining whether they as a group are, or any single party is, a 20% beneficial owner of the issuer and, therefore, a covered person under Rule 506(d)?

> *Answer*: Beneficial ownership of group members and groups should be analyzed the same as under Exchange Act Rules 13d-3 and 13d-5(b). Under that analysis, the shareholders have formed a group, and the group beneficially owns the shares beneficially owned by its members. In addition, the parties to the voting agreement that have or share the power to vote or direct the vote of shares beneficially owned by other parties to the agreement (through, for example, the receipt of an irrevocable proxy or the right to designate director nominees for whom the other parties have agreed to vote) will beneficially own such shares. Parties that do not have or share the power to vote or direct the vote of other parties' shares would not beneficially own such shares solely as a result of entering into the voting agreement. See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting CDI 105.06. If the group is a 20% beneficial owner, then disqualification or disclosure obligations would arise from court orders, injunctions, regulatory orders or other triggering events against the group itself. If a party to the voting agreement becomes a 20% beneficial owner because shares of other parties are added to its beneficial

ownership, disqualification or disclosure obligations would arise from triggering events against that party.

Question 260.32 Does an order issued by a court or regulator, in accordance with Rule 506(d)(2)(iii), waive the disclosure obligation set forth in Rule 506(e)?

Answer: No. The disclosure obligation in Rule 506(e) pertains to an issuer's obligation to provide investors disclosure of disqualifying events that would have triggered disqualification, except that these events occurred before September 23, 2013. Rule 506(d)(2)(iii) permits issuers to rely on the self-executing statement of a regulatory authority to avoid Rule 506 disqualification when that regulatory authority advises the Commission in writing or in its order, decree or judgment, that Rule 506 disqualification should not arise a consequence of a disqualifying event that occurred on or after September 23, 2013.

A regulatory authority such as a state securities commission may, however, determine that an order entered before September 23, 2013 would not have triggered disqualification under Rule 506(d)(1) because the violation was not a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale.

Appendix 2

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.