

Investment Management Alert

December 6, 2013

SEC Staff Provides Clarification of Scope of Bad Actor Disqualification

The staff of the Securities and Exchange Commission's Division of Corporation Finance published "Compliance and Disclosure Interpretations" (CDIs) on Wednesday, December 4, 2013, that provide important clarification regarding the scope of the "bad actor" disqualification in Rule 506(d) under the Securities Act of 1933 for certain convictions, cease and desist orders, suspensions and bars ("disqualifying events") that occur on or after September 23, 2013, and the disclosure obligation in Rule 506(e) for disqualifying events that occurred prior to September 23, 2013.

Rule 506 provides that disqualifying events committed by a list of specified "covered persons" affiliated with the issuer or the offering¹ would result in disqualification from using Rule 506 or require disclosure to investors prior to their purchasing securities. However, Rule 506 also provides a defense for issuers that did not know and, in the exercise of reasonable care, could not have known of that disqualifying event. Prior to the issuance of the CDIs, private funds and other issuers offering and selling securities in reliance on Rule 506 were forced to broadly interpret the covered persons with which an issuer would have to inquire of any disqualifying events and the consequences of a disqualifying event.

The most significant of the CDIs is that the definition of "affiliated issuer" for purposes of the bad actor disqualification is an affiliate of the issuer that is "issuing securities in the same offering, including offerings subject to integration. . ." with the offering for which Rule 506 is being used.² Consequently, fund issuers will no longer need to inquire of controlled portfolio companies whether they have any disqualifying events.

Other interpretations of interest include:

- An issuer may reasonably rely on a covered person's covenant (or a bylaw or similar undertaking) to provide notice of a potential or actual disqualifying event. For a continuous or long-lived offering, the issuer would be required to update its factual inquiry through reasonable steps such as

¹ The persons specified in Rule 506(d) include (i) the issuer, (ii) any predecessor of the issuer, (iii) any affiliated issuer, (iv) any director, (v) any executive officer, (vi) any other officer participating in the offering, (vii) a general partner or managing member of the issuer, (viii) any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, (ix) any promoter connected with the issuer at the time of the sale, (x) any investment manager of an issuer that is a pooled investment fund, (xi) any person that is paid remuneration for solicitation of purchasers in connection with the sale of securities in the offering (a "compensated solicitor"), and (xii) any general partner, managing member, director, executive officer or other officer participating in the offering of the investment manager or compensated solicitor.

² See CDI 260.16

questionnaires, certifications, negative consent letters or database searches. The CDI does not specify a recommended frequency for such updates. [CDI 260.14]

- If a placement agent becomes subject to a disqualifying event while an offering is ongoing, the issuer could continue to 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 future sales.” [CDI 260.15]
- If a placement agent’s “covered persons,” such as its executive officers, directors and officers participating in the offering, are subject to a disqualifying event, the placement agent could continue its role in the offering if the problematic covered persons are terminated or are no longer performing roles within the placement agent that would make them covered persons. [CDI 260.15]
- Convictions, orders, bars and suspensions in jurisdictions other than the United States do not trigger disqualification. [CDI 260.20]
- Actions based on non-scienter-based rules, such as Rule 105 of Regulation M, would not trigger disqualification even if such non-scienter-based rules were promulgated under Section 10(b) of the Securities Exchange Act of 1934. [CDI 260.21]
- Examples of participating in an offering include (i) participation or involvement in due diligence activities, (ii) participation or involvement in preparation of the offering document, (iii) provision of structuring or other advice to the issuer in connection with the offering, or (iv) communication with the issuer, prospective investors or other offering participants about the offering; but administrative functions, such as opening brokerage accounts, wiring funds and bookkeeping functions, would not generally be deemed to be “participation” in the offering. [CDI 260.19]
- The reasonable care exception could apply when, despite the exercise of reasonable care, the issuer (i) is unable to determine the existence of a disqualifying event, (ii) is unable to determine if a person is a covered person, or (iii) erroneously determined that a person was not a covered person. Upon discovering such error or disqualifying event, the issuer would need to consider what steps are appropriate and may terminate the relationship with the covered person, obtain a waiver from the SEC staff or take other remedial steps. [CDI 260.23]
- It is not necessary to seek a waiver of Rule 506(d) from the SEC staff if the relevant court or administrative order includes language stating that disqualification under Rule 506(d) should not occur. [CDI 260.22]
- No waiver may be granted for the disclosure of bad acts under Rule 506(e) (as opposed to their disqualifying effect under 506(d) if the disqualifying event occurs after September 23, 2013). [CDI 260.24]

- Disclosure under 506(e) must be made to all investors regarding all “bad acts” by all compensated solicitors involved in the offering at the time of sale and their respective covered persons, irrespective of which compensated solicitor actually solicited the investor. [CDI 260.26]
- Rule 506(d) disqualification does not apply if the issuer is not offering securities at the time, and no disclosure need be made relating to compensated solicitors who are no longer involved in the offering at the time of sale. [CDI 260.14 and 260.27]

The interpretations are available here starting at 260.14. Our previous alert summarizing “bad actor” disqualification or disclosure is available here.

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