SEC Issues Guidance on Bad Actor Rules

On December 4, 2013, the Division of Corporation Finance (the "Division") of the U.S. Securities and Exchange Commission (the "SEC") issued new Compliance and Disclosure Interpretations ("CDIs") concerning the recently adopted "bad actor" rules. These rules, including new Rules 506(d) and 506(e) under the Securities Act of 1933 (the "Securities Act"), became effective on September 23, 2013, and codified certain rulemaking mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The new guidance will be of interest to any issuer, including private funds, offering interests in reliance on the safe harbors provided by Rule 506 of Regulation D (these issuers will include most hedge funds, private equity funds, and other private funds offered to U.S. investors).

New Rule 506(d) disqualifies securities offerings involving certain covered persons who are "bad actors" from reliance on Rule 506, but provides an exception from disqualification when an issuer can show it did not know and, in the exercise of reasonable care, could not have known that a covered person participating in the offering was a bad actor. Rule 506(d) only applies to covered persons who were the subject of a bad actor event on or after September 23, 2013. New Rule 506(e), however, requires disclosure to investors of certain bad actor events that occurred prior to September 23, 2013. For our prior client alert addressing the bad actor rules (as well as the general solicitation rules released the same day), please click here. The new CDIs pertaining to Rules 506(d) and (e) include the following clarifications:

With respect to "affiliated issuers":

- The Division has clarified that for purposes of Rule 506(d), an "affiliated issuer" is an affiliate of the issuer where such affiliate is itself issuing securities in the same offering. Rule 506(d) includes "affiliated issuer" in its list of potential bad actors; however, "affiliated issuer" is not defined in the rule. There was widespread concern that this term could capture, amongst other things, controlled portfolio companies of private equity funds or remote affiliates of large, diverse financial services firms, requiring private funds relying on Regulation D to inquire as to the "bad actor" status of a potentially vast number of affiliated entities. The new CDI gives comfort that an issuer is not required to diligence the bad actor status of affiliates other than those issuing securities in the same offering as the issuer (e.g., funds in a master-feeder structure and parallel funds) or falling within one of the other enumerated categories of potential bad actors in Rule 506(d).

With respect to due diligence and reasonable care:

- Rule 506(d) does not specify the frequency with which issuers have to verify their bad actor due diligence in order to be able to rely on the reasonable care exception found in the rule. The Division has provided some limited relief by clarifying that if an issuer is not actively offering securities (e.g., the fund is in wind down or closed to new investment), then such issuer can rely on covered persons' agreement to provide notice of bad actor events. However, an issuer engaged in continuous offerings (e.g., a hedge fund) must update its factual inquiry periodically through the use of bring-downs, questionnaires and certifications, negative consent letters, and periodic re-checking of public databases, among other things. The Division failed to clarify how frequently such issuers must update their inquiries.
- Rule 506(d) provides that issuers will not be subject to disqualification in the event they can establish that they did not know, and in the exercise of reasonable care, could not have known that a bad actor disqualification existed. The Division has clarified that the reasonable care exception can apply even

in situations where an issuer was unable to determine that a particular person was a covered person or where an issuer initially determined that a person was not a covered person, but subsequently learned the determination was incorrect. In light of this guidance, having a reasonable basis and taking a consistent approach with respect to determining which persons are covered persons seems particularly important. Furthermore, the CDIs imply that if a determination is made post-sale that a certain person was a covered person and the subject of a bad actor event at the time of the sale, even where the issuer was not aware of such facts, having exercised reasonable care, in the period preceding such sale, the issuer may still need to "cure" such disqualification or otherwise seek a waiver from the SEC following such post-sale determination.

With respect to curing bad actor disqualifications:

- The Division has provided comfort that an issuer can cure a bad actor event with respect to a placement agent by (i) terminating the issuer's engagement with the placement agent and (ii) ceasing future payments to the placement agent.
- The Division also clarified that a bad actor event with respect to a placement agent's covered control person could be cured simply by having the placement agent remove the covered control person from the offering, either by terminating them or otherwise modifying their role such that they would no longer be deemed to be a covered control person of the placement agent at the time of a sale under Regulation D.

With respect to disclosure under Rule 506(e):

- The Division has stated that issuers cannot seek a waiver of the obligation to disclose bad actor events occurring prior to September 23, 2013.
- The Division has clarified that pursuant to Rule 506(e), issuers are not required to disclose to investors the bad acts of compensated solicitors no longer involved in the offering. This provides considerable, although not unexpected, relief to issuers of continuous offerings who may have engaged and terminated numerous placement agents over an extended period. However, in certain circumstances it remains unclear whether a solicitor would still be regarded as "involved in the offering", for example, where the solicitor is no longer providing services with respect to an offering, but is still receiving legacy compensation and/or is still the beneficiary of an indemnity with respect to prior sales under the same offering.
- The Division has reaffirmed that disclosure pursuant to Rule 506(e) is only required with respect to events that would have triggered disqualification under Rule 506(d) had they occurred on or after September 23, 2013. In other words, events occurring outside the look-back periods in the relevant Rule 506(d) disqualification provisions do not need to be disclosed to investors because they would not have otherwise triggered disqualification.

With respect to compensated solicitors:

- The Division has stated that an issuer must provide to *all* investors required disclosure under Rule 506(e) relating to a solicitor and not merely the investors who were placed by the placement agent to which the disclosure relates.
- Rule 506(d) defines solicitors as any persons paid or being paid remuneration for solicitation of purchasers in connection with the relevant sale of securities. Solicitors constitute one category of potential bad actors under the rule. The Division clarified that such category is not limited to

registered broker-dealers (*i.e.*, broker-dealers registered under Section 15(a)(1) of the Securities Exchange Act of 1934), but instead captures any person who is paid, directly or indirectly, for the solicitation of purchasers in the sale.

- A solicitor's directors and officers who participate in a Regulation D offering are included as covered persons under Rule 506(d). There has been some question regarding what constitutes "participating" in an offering. The Division has confirmed, consistent with the final release but providing further detail, that for officers of solicitors, the concept of participating in an offering is broader than merely soliciting investors. The Division specifically points to involvement in due diligence activities, preparing offering materials, providing structuring advice to the issuer, and communicating with the issuer and investors in connection with the offering as activities that would constitute "participating in the offering"; however, consistent with the final release, they added that such activities must rise above the level of being transitory or incidental. The Division also specifically excepted administrative functions such as opening accounts, wiring funds, and bookkeeping. Notably, the Division only provided this guidance with respect to the directors and officers of *solicitors* – they did not address the meaning of "participating in the offering" for other categories of covered persons to whom such phrase is relevant (*e.g.*, directors and officers of an issuer, general partner, and investment manager).
- Members of a solicitor's deal or transaction committee responsible for approving engagements with issuers are not deemed to be "participating" in an offering merely by virtue of being a member of such committee.

With respect to bad actor events generally:

- The Division has made clear that actions taken in jurisdictions other than the U.S. (e.g., convictions, court orders, or injunctions in a foreign court, or regulatory orders issued by foreign regulatory authorities) are outside the scope of the disqualification events captured by Rule 506(d).
- The Division has clarified that SEC cease and desist orders based on violations of SEC rules promulgated under Exchange Act Section 10(b) are only deemed to be disqualification events if the order is based on a violation of scienter-based provisions of the federal securities laws, including scienter-based rules. The CDI provides the example of an order to cease and desist from violations of Exchange Act Rule 105 would not trigger disqualification, even though Rule 105 is promulgated under Section 10(b).
- The Division has stated in the CDI that if an order issued by a court or regulator provides that disqualification from Rule 506 will not arise as a result of such order, then it is unnecessary to seek a waiver or take further action with the SEC in order to confirm such bad actor disqualification will not apply as the result of such order.

The new CDIs pertaining to Rules 506(d) and (e) are available here. Please contact your usual Ropes & Gray advisor with any questions about these CDIs.