SEC Clarifies "Voting Equity Securities" for Purposes of the Bad Actor Rules

The Securities and Exchange Commission (the "SEC") recently released additional guidance on the definition of "voting equity securities" as applied to the bad actor disqualification rules under Rule 506(d) of the Securities Act of 1933, as amended (the "Securities Act").[1] Private fund and hedge fund offerings to U.S. investors typically rely on Rule 506 under Regulation D as the basis for their exemption from registration under the Securities Act. Rule 506(d) disqualifies a securities offering from relying on a Rule 506 exemption if a covered person with respect to the issuer, which includes "any beneficial owner of 20% or more of the issuer's outstanding voting equity securities," has had a "disqualifying event." In the Rule 506(d) adopting release, the SEC defined the term "voting equity securities" as securities that confer to securityholders the ability to "control or significantly influence the management and policies of the issuer through the exercise of a voting right." This subjective definition has led many private fund sponsors to conclude that fund interests held by their investors may be deemed to constitute "voting equity securities" for purposes of Rule 506(d), and that, as a result, fund sponsors needed to identify and track whether investors had been subject to any "disqualifying events" in order to ensure that the fund itself did not inadvertently run afoul of Rule 506(d).

In its new guidance, the SEC states that it has reconsidered its initial views on the definition of "voting equity securities," and has now adopted a bright-line standard under which "voting equity securities" are defined as securities that, by their terms, provide the securityholders with a presently exercisable right to vote for the election of directors. For the avoidance of doubt, the SEC notes that the definition of "voting equity security" should be interpreted irrespective of the existence of control or significant influence. Therefore, even if a beneficial owner has control or significant influence over an issuer, the beneficial owner will not qualify as a covered person under the bad actor disqualification rules so long as it holds less than 20% of the issuer's outstanding securities that are currently entitled to vote for the election of directors.

The new guidance does not directly address the application of the bright-line standard to issuers organized as limited partnerships or limited liability companies. However, in view of this new guidance, we recommend that fund sponsors consider whether the interests held by investors in their funds give them a voting right equivalent to a presently exercisable right to vote for directors (e.g., determine whether a right to vote for the no-fault removal of a general partner is an equivalent right). If investors do not hold such voting rights, firms should no longer be required to question or track such investors for purposes of compliance with the bad actor disqualification rules.

[1] See "Amendments for Small and Additional Issues Exemptions under the Securities Act," Securities Act Release No. 9741 (March 25, 2015) (pp. 203-204). This guidance was issued in connection with amendments to Regulation A under the Securities Act, but the SEC explicitly noted that its guidance with respect to "voting equity securities" extended to Rule 506 under Regulation D.