

## CLIENT MEMORANDUM

# SEC Provides Guidance on “Bad Actor” Disqualifications in Rule 506 Regulation D Offerings

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## AUTHORS

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On December 4, 2013, the staff of the Securities and Exchange Commission (the “SEC”) Division of Corporation Finance published additional guidance (the “Guidance”) on certain key issues with respect to the new “bad actor” provisions recently added to Regulation D Rule 506 under the Securities Act of 1933 (the “Securities Act”).<sup>1</sup> The Guidance defines “affiliated issuer” and “participation in the offering” for purposes of the provisions, and addresses questions concerning solicitors and the reasonable care exception, among others.

### **Background**

The Rule 506 private placement safe harbor is the most widely used exemption from registration under the Securities Act and is relied upon by numerous issuers, including many private investment funds. The SEC adopted new requirements for

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<sup>1</sup> See SEC Security Act Rules Compliance and Disclosure Interpretations (“C&DIs”), Questions 260.14- 260.27 (Dec. 4, 2013), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

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Rule 506 private offerings, effective September 23, 2013, requiring specified past “disqualifying events”<sup>2</sup> of certain “covered persons”<sup>3</sup> involved in a Rule 506 private placement to be disclosed in writing to potential investors a reasonable time prior to their purchase of securities.<sup>4</sup> More importantly, new Rule 506(d) provides that such events that occur on or after September 23, 2013 with respect to covered persons will disqualify an offering from relying on Rule 506.

### ***New SEC Staff Guidance***

Some key issues covered by the Guidance include the following:

#### Affiliated Issuer

Any “affiliated issuer” of an issuer in a Rule 506 offering is included in the list of covered persons for purposes of the disqualification provisions of Rule 506. The Guidance provides that an “affiliated issuer” of the issuer for purposes of the disqualifications only includes 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.

#### Solicitors

Rule 506(d) of Regulation D provides that a solicitor or placement agent that is engaged by an issuer conducting a Rule 506 offering could disqualify the offering if it or its covered persons are the subject of a disqualifying event.

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<sup>2</sup> Disqualifying events include: (i) certain criminal convictions, court injunctions and restraining orders; (ii) final orders of certain state and federal regulators; (iii) certain SEC orders; (iv) suspension or expulsion from membership in a self-regulatory organization (“SRO”), such as FINRA, or from association with an SRO member; and (v) U.S. Postal Service false representation orders. See Rule 506 (d) (1) (i) through (viii) adopted under the Securities Act.

<sup>3</sup> Covered persons include: (i) the issuer, including its predecessors and any affiliated issuers; (ii) directors, executive officers, other officers participating in the securities offering, general partners and managing members of the issuer; (iii) beneficial owners of 20% or more of the issuer’s total voting equity securities calculated based on voting power; (iv) promoters connected with the issuer at the time of sale; (v) persons that have been or will be paid remuneration (directly or indirectly) for soliciting investors; (vi) investment managers of issuers that are pooled investment funds; (vii) the general partners and managing members of such solicitors or investment managers; and (viii) the directors, executive officers, other officers participating in the offering of such solicitors or investment managers or of the managing members or general partners of any such solicitors or investment managers. See Rule 506 (d) (1).

<sup>4</sup> See Rules 506 (d) and (e). SEC Release 33-9414 (July 10, 2013), <http://www.sec.gov/rules/final/2013/33-9414.pdf> (disqualifying of Felons and Other “Bad Actors” from Rule 506 offerings). See Willkie Farr & Gallagher LLP, “SEC Lifts Ban On General Solicitation For Certain Private Offerings, Disqualifies ‘Bad Actors’ From Participating In Regulation D Private Offerings and Proposes Rules to Assist in Monitoring Market Practices” (July 18, 2013), [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/4427/SEC\\_Lifts\\_Ban\\_On\\_General\\_Solicitation.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/4427/SEC_Lifts_Ban_On_General_Solicitation.pdf).

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The Guidance confirms that an issuer could still rely on Rule 506 for future sales if the issuer terminates the engagement with the placement agent and the placement agent did not receive compensation for the future sales. Additionally, if the triggering disqualifying event involves 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). The Guidance confirms that disclosure of past disqualifying events of a solicitor are not required if the solicitor is no longer involved with the Rule 506 offering.

The Guidance also makes clear that issuers are required to provide disclosure of past disqualifying events of any solicitor or its covered control persons currently involved in the offering to all potential investors, and not just to the investors solicited by the particular solicitor or covered control person.

### Participation in the Offering

The Guidance explains that “participation in the offering” with respect to a solicitor is not just limited to the act of soliciting investors, but also includes 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. Additionally, participation in the offering would not include persons whose sole involvement is as members of a solicitor’s deal or transaction committee that is responsible for approving the solicitor’s participation in the offering.

### Foreign Disqualifying Events

The Guidance confirms that disqualification or disclosure under Rule 506(d) is not 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.

### Reasonable Care Exception

Rule 506 provides a reasonable care exception 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.<sup>5</sup> The Guidance explains that the exception would still apply when, despite the exercise of reasonable care, the issuer was unable to determine the existence of a disqualifying event, that a particular person was a covered person, or initially reasonably determined that

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<sup>5</sup> See Rule 506 (d) (2) (iv).

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the person was not a covered person but subsequently learned that determination was incorrect. The Guidance points out that issuers will still need to consider what steps are appropriate upon discovery of disqualifying events and covered persons throughout the course of an ongoing Rule 506 offering. In such cases, an issuer may need to seek waivers of disqualification, terminate the relationship with covered persons, provide disclosure of past disqualifying events, or take other remedial steps to address the disqualification.

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If you have any questions concerning the matters described in this memorandum, please contact Martin R. Miller (212-728-8690, [mmiller@willkie.com](mailto:mmiller@willkie.com)), Marc J. Lederer (212-728-8624, [mlederer@willkie.com](mailto:mlederer@willkie.com)) or the Willkie attorney with whom you regularly work.

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