

## SEC Issues New CD+Is Regarding Rule 506 “Bad Actor” Disqualifications

On January 3, 2014, the SEC’s Division of Corporation Finance updated its Compliance and Disclosure Interpretations (CDIs) to add five additional CDIs regarding, among other things, how beneficial ownership under the “bad actor” disqualifications in Rule 506 private placements is determined, as well as one CDI regarding the beneficial ownership of group members under Rule 13d-3.

Under Rule 506(d), the exemption from registration provided by Rule 506 of Regulation D is not available for a sale of securities if the issuer or other specified persons, including any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, are covered by specified “bad actor” disqualifications (subject to exception under limited circumstances). Last week, several new CDIs were issued by the SEC clarifying, among other things, how beneficial ownership under Rule 506(d) is to be determined. The CDIs are set forth here: [Question 260.28](#); [Question 260.29](#); [Question 260.30](#); [Question 260.31](#) (and in a related CDI about the determination of the beneficial ownership of group members under Rule 13d-3, [Question 105.06](#)); and [Question 260.32](#).

The new CDIs are summarized below:

- For purposes of Rule 506(d), a shareholder that becomes a 20 percent beneficial owner upon completion of a sale of securities is not a 20 percent beneficial owner (and therefore not a “covered person”) at the time of the sale.
- For purposes of Rule 506(d), the term “beneficial owner” is interpreted the same way as under Exchange Act Rule 13d-3, and “beneficial ownership” includes both direct and indirect interests, determined as under Exchange Act Rule 13d-3.
- Beneficial ownership of group members and groups should be analyzed as it is under Exchange Act Rules 13d-3 and 13d-5(b) (see bullet immediately below). As a result, shareholders of a Rule 506 issuer that 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 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 will beneficially own such shares. If the group is a 20 percent beneficial owner, then disqualification or disclosure obligations under Rule 506 would arise from triggering events against the group itself. If a party to the voting agreement becomes a 20 percent 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.
- With respect to Rule 13d, the formation of a group under Rule 13d-5(b), without more, does not result in the attribution of beneficial ownership to each group member of the securities beneficially owned by other members. Under Section 13(d)(3) of the Exchange Act, the group is treated as a new “person” for purposes of Section 13(d)(1), and the group is deemed to have acquired, by operation of

Rule 13d-5(b), beneficial ownership of the shares beneficially owned by its members. For example, if a party to the voting agreement has the right to designate one or more director nominees for whom the other parties have agreed to vote, the party with that designation right becomes a beneficial owner of the securities beneficially owned by the other parties under Rule 13d-3(a). Conversely, 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. The CDI does note that a contract, arrangement, understanding or relationship concerning voting or investment power among parties to the agreement, other than the voting agreement itself, may result in a party to the voting agreement having or sharing beneficial ownership of securities held by other parties to the voting agreement under Rule 13d-3.

- An order issued by a court or regulator in accordance with Rule 506(d)(2)(iii) does not waive the disclosure obligation set forth in Rule 506(e). The CDI notes, however, that a regulatory authority may 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.

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