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SEC Issues New Guidance on “Bad Actor” Disqualification from Rule 506 Offerings

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On December 4, 2013, the staff of the Securities and Exchange Commission (SEC) Division of Corporation Finance issued new guidance regarding the “bad actor” disqualification provisions of Rule 506(d) of Regulation D under the Securities Act of 1933 (Securities Act) and the related disclosure requirements of Rule 506(e) through an update to its [Securities Act Rules Compliance and Disclosure Interpretations](#) (C&DIs). The 14 new CD&Is provide important clarification to the final rules approved by the SEC earlier this year and additional guidance to issuers seeking to comply with the new requirements of Rules 506(d) and 506(e) of Regulation D under the Securities Act. This advisory summarizes some of the more significant of these new CD&Is.

Background

An issuer that seeks to offer and sell securities in the United States must either register the offering under the Securities Act by filing a registration statement with the SEC or rely on an exemption from the registration requirements of the Securities Act. 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 private funds.

On July 10, 2013, the SEC adopted Rules 506(d) and 506(e), which became effective

on September 23, 2013. Under Rule 506(d), an issuer of securities seeking to rely on the exemption from registration set forth in Rule 506 of Regulation D under the Securities Act generally may *not* rely on that exemption if the issuer or any related “covered person” (including placement agents and certain controlling persons, officers, and affiliates of the issuer) has been subject to any “disqualifying event” specified in that rule. “Disqualifying events” under Rule 506(d) generally include securities-related bad acts, such as criminal convictions in connection with the sale or purchase of any security; bars by certain federal or state regulators from engaging in the business of securities, insurance, or banking or from savings association or credit union activities; certain cease-and-desist and other orders by the SEC; and certain suspensions, expulsions, or bars from association with a registered national securities exchange. If any “[disqualifying event](#)” existed before September 23, 2013, then Rule 506(e) requires the issuer offering securities under Rule 506 to disclose the “disqualifying event” to prospective investors within a reasonable time prior to any sale of securities to such persons.

New SEC Guidance

Some of the more significant CD&Is related to Rules 506(d) and 506(e) include the following:

Reliance on Rule 506 After a Placement Agent’s Disqualifying Event

If a placement agent or one of its covered control persons becomes subject to a disqualifying event while an offering is ongoing, the issuer may continue to rely on Rule 506 going forward in respect of that offering if the issuer terminates its engagement with the placement agent and the placement agent does not receive compensation for any future sales in that offering or, if the disqualifying event affects only a covered control person of the placement agent, if that person is terminated or ceases to perform a role with respect to the placement agent that would cause him or her to be a covered person with respect to the issuer for purposes of Rule 506(d). (CD&I 260.15.)

Compensated Solicitors

All persons who have been or will be paid, directly or indirectly, remuneration for solicitation of investors are covered by Rule 506(d). Such persons may include persons other than brokers registered pursuant to the Securities Exchange Act of 1934 or their associated persons. (CD&I 260.17.)

This CD&I suggests that marketing personnel of the general partner, managing member, or investment manager of a private fund may be “covered persons” for purposes of Rule 506(d).

Disclosure of Past Disqualifying Events of Solicitor

Issuers must provide all prospective investors with the disclosure required under Rule 506(e) (typically, disclosure of “bad acts” occurring prior to September 23, 2013) for all placement agents and other compensated solicitors (and their respective covered control persons) who are involved with the offering at the time of any sale to such persons, regardless of whether or not such placement agents and other compensated solicitors actually sold interests to the prospective investors to whom disclosure is required to be made. In an offering in which the issuer uses multiple placement agents or other compensated solicitors, if disclosure under Rule 506(e) is required with respect to one or more of those agents or solicitors (or their respective covered control persons), the issuer may not selectively provide Rule 506(e) disclosure only to those investors who were solicited by the specific agents or solicitors that triggered the disclosure requirement. (CD&I 260.26.)

It would seem that one could plausibly read Rules 506(d) and 506(e) as only requiring disclosure of any disqualifying event with respect to a placement agent or other compensated solicitor and its covered control persons only to the investors actually solicited by such agent or solicitor in light of: (1) the language of Rule 506(d), which mandates the loss of the exemption from the registration requirements of Securities Act under Rule 506 for a “sale” of securities if any solicitor has been or will be paid in connection “with such sale of securities” (rather than “with the offering of such securities”) and (2) the potential that disclosure regarding all compensated solicitors in an offering could confuse and mislead investors who have only been solicited by specific solicitors. However, the staff of the SEC’s Division of Corporation Finance has taken a different interpretive position in this CD&I.

Affiliated Issuer

“Affiliated issuer” does not include every affiliate of the issuer that has issued securi-

ties. Instead, for purposes of Rule 506(d), an “affiliated issuer” of the issuer is 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. (CD&I 260.16.)

Foreign Disqualifying Events

Disqualification under Rule 506(d) would not be triggered by actions taken in jurisdictions other than the United States. This includes convictions, court orders or injunctions in a non-U.S. court, or regulatory orders issued by non-U.S. regulatory authorities. (CD&I 260.20.)

Reasonable Care Exception

Rule 506(d)(2)(iv) provides a reasonable care exception if the issuer can establish that it did not know and, despite the exercise of reasonable care, could not have known that a disqualification existed under Rule 506(d)(1). The SEC’s guidance explains that this may occur when, despite the exercise of reasonable care, (1) the issuer was unable to determine the existence of a disqualifying event; (2) was unable to determine that a particular person was a covered person; or (3) initially reasonably determined that the person was not a covered person, but subsequently learned that determination was incorrect. If an issuer discovers a Rule 506(d) disqualifying event or covered person during the course of an ongoing offering of securities in reliance on the safe harbor provided under Rule 506, it must then consider what steps would be appropriate to continue permissibly relying on Rule 506. An issuer may need to seek waivers of disqualification from the SEC, terminate the relationship with the applicable covered persons, provide disclosure to investors in accordance with Rule 506(e), or take other remedial steps to address such Rule 506(d) disqualification. (CD&I 260.23.)

Waiver of Obligation to Disclose Past Events

The Rule 506(e) disclosure obligation for past events that would have been disquali-

fying, except that they occurred before September 23, 2013 (the effective date of Rule 506(d)), is not subject to waiver by the SEC. (CD&I 260.24.)

Accordingly, issuers should not attempt to seek such waiver of disclosure from the SEC.

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This article summarizes only some of the more significant CD&Is. We encourage you to read the full text of the SEC’s CD&Is regarding the “bad actor” disqualification provisions of Rule 506(d) and the related disclosure requirements of Rule 506(e), which is available at www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

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