SEC Issues Guidance for Regulation D "Bad Actor" Disqualification

Background

Earlier this year, Rule 506, a part of Regulation D under the Securities Act,[1] was amended by adding a paragraph that prohibits issuers and others from participating in Rule 506 offerings if, among other things, they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.[2] The new provision became effective on September 23, 2013.[3] The new provision applies to the bad acts of the issuer and any of its predecessors and affiliated issuers, the issuer's participating directors and officers, beneficial owners of at least 20% of the issuer's outstanding voting equity, significant shareholders, promoters, investment managers, and compensated solicitors involved in the offering (each a "covered person"). Prior to the amendment, Rule 506 did not impose any bad actor disqualification requirements.

If a covered person engages in an event that triggers disqualification under the new Rule 506, the relevant securities offering will no longer have available Rule 506's protection. Rule 506 disqualifying events under the new rule include, among others, felony and misdemeanor criminal convictions in connection with the purchase or sale of securities or false SEC filings, court injunctions and restraining orders within the last five years related to the purchase or sale of securities or false SEC filings; final orders issued by state banking, credit union, and insurance regulators, Federal banking regulators and the National Credit Union Administration barring association with regulated entities of the type those regulators oversee and dealing with fraudulent, manipulative, or deceptive conduct; disciplinary or stop orders issued by the SEC; suspension or expulsion from membership in a Self-Regulatory Organization (such as FINRA or a stock exchange); stop orders applicable to a registration statement; and false representation orders by the U.S. Postal Service within the last five years.

The new disqualifications apply only to triggering events occurring after effectiveness of the new rules. For triggering events occurring prior to the effectiveness of the new rules, in lieu of disqualification, the issuer must provide written disclosure to each purchaser of its securities, at a reasonable time prior to sale, disclosing matters that would have triggered disqualification had they occurred before the effective date of the new disqualification provisions. The final rule includes a reasonable care exception from disqualification that will apply if an issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person. Issuers must also exercise reasonable care in determining whether a disqualification exists, however, the SEC did not specify what constitutes reasonable care, stating instead that the determination is a fact specific inquiry, dependent upon a number of circumstances, and requiring a factual inquiry into whether any disqualification exists. The nature and scope of the factual inquiry will depend on the facts and circumstances concerning the issuer and the participants involved. Issuers may also request waivers from disqualification, which may be granted by the SEC when good cause is shown. In addition, disqualification will not apply if an authority issuing the relevant judgment or order determines and advises the SEC that disqualification should not arise.

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[1] Securities offerings made in accordance with the conditions of Regulation D are afforded a safe harbor from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act").

[2] *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings*, Release No. 33-9414 (July 10, 2013), available at, http://www.sec.gov/rules/final/2013/33-9414.pdf.

[3] The so-called "bad actor" provision does not apply to offerings made in reliance on Rule 144A.

Recent SEC Guidance

On December 4, 2013, the SEC issued guidance for the application of the Regulation D "bad actor" provision. For ease of reference, the guidance issued has been excerpted from the SEC web site and is attached as Annex A hereto.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Mary Stokinger at 212.701.3430 or mstokinger@cahill.com.

ANNEX A

SEC Staff guidance regarding Securities Act Rule 506(d)[4]

Question 260.14

Question: When is an issuer required to determine whether bad actor disqualification under Rule 506(d) applies?

Answer: Rule 506(d) disqualifies an offering of securities from reliance on a Rule 506 exemption from Securities Act registration. Issuers must therefore determine if they are subject to bad actor disqualification any time they are offering or selling securities in reliance on Rule 506. An issuer that is not offering securities, such as a fund that is winding down and is closed to investment, need not determine whether Rule 506(d) applies unless and until it commences a Rule 506 offering. An issuer may reasonably rely on a covered person's agreement to provide notice of a potential or actual bad actor triggering event pursuant to, for example, contractual covenants, bylaw requirements, or an undertaking in a questionnaire or certification. However, if an offering is continuous, delayed or long-lived, the issuer must update its factual inquiry periodically through bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances. [Dec. 4, 2013]

Question 260.15

Question: If a placement agent or one of its covered control persons, such as an executive officer or managing member, becomes subject to a disqualifying event while an offering is still ongoing, could the issuer continue to rely on Rule 506 for that offering?

Answer: Yes, the issuer could rely on Rule 506 for future sales in that offering if the engagement with the placement agent was terminated and the placement agent did not receive compensation for the future sales. Alternatively, if the triggering disqualifying event affected 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). [Dec. 4, 2013]

Question 260.16

Question: For purposes of Rule 506(d), does an "affiliated issuer" mean every affiliate of the issuer that has issued securities?

Answer: No. Under 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. Securities Act Forms C&DIs 130.01 and 130.02 provide examples of co-issuer or multiple issuer offerings. [Dec. 4, 2013]

[4] Quoted from the SEC website, Securities Act Rules Compliance and Disclosure Interpretations, at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

Question 260.17

Question: Are compensated solicitors limited to brokers, as defined in Exchange Act Section 3(a)(4), who are subject to registration pursuant to Exchange Act Section 15(a)(1), and their associated persons?

Answer: No. All persons who have been or will be paid, directly or indirectly, remuneration for solicitation of purchasers are covered by Rule 506(d), regardless of whether they are, or are required to be, registered under Exchange Act Section 15(a)(1) or are associated persons of registered broker-dealers. The disclosure required in Item 12 of Form D expressly contemplates that compensated solicitors may not appear in FINRA's Central Registration Depository (CRD) of brokers and brokerage firms. [Dec. 4, 2013]

Question 260.18

Question: Does the term "participating" include persons whose sole involvement with a Rule 506 offering is as members of a compensated solicitor's deal or transaction committee that is responsible for approving such compensated solicitor's participation in the offering?
Answer: No. [Dec. 4, 2013]

Question 260.19

Question: Are officers of a compensated solicitor deemed to be "participating" in a Rule 506 offering only if they are involved with the solicitation of investors for that offering?

Answer: No. Participation in an offering is not limited to solicitation of investors. Examples of participation in an offering include 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. [Dec. 4, 2013]

Question 260.20

Question: Is disqualification under Rule 506(d) 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?

Answer: No. [Dec. 4, 2013]

Question 260.21

Question: Is disqualification under Rule 506(d)(1)(v) triggered by all Commission orders to cease and desist from violations of Commission rules promulgated under Exchange Act Section 10(b)?

Answer: No. Disqualification is triggered only by orders to cease and desist from violations of scienter-based provisions of the federal securities laws, including scienter-based rules. An order to cease and desist from violations of a non-scienter based rule would not trigger disqualification, even if the rule is promulgated under a scienter-based provision of law. For example, an order to cease and desist from violations of Exchange Act Rule

105 would not trigger disqualification, even though Rule 105 is promulgated under Exchange Act Section 10(b). [Dec. 4, 2013]

Question 260.22

Question: If an order issued by a court or regulator provides, in accordance with Rule 506(d)(2)(iii), that disqualification from Rule 506 should not arise as a result of the order, is it necessary to seek a waiver from the Commission or to take any other action to confirm that bad actor disqualification will not apply as a result of the order?

Answer: No. The provisions of Rule 506(d)(2)(iii) are self-executing. [Dec. 4, 2013]

Question 260.23

Question: Does the reasonable care exception only cover circumstances where the issuer has identified all covered persons but, despite the exercise of reasonable care, was unable to discover the existence of a disqualifying event? Or could it also apply where, despite the exercise of reasonable care, the issuer (i) was unable to determine that a particular person was a covered person (for example, an officer of a financial intermediary that the issuer did not know was participating in the offering, despite the exercise of reasonable care) or (ii) initially determined that the person was not a covered person but subsequently determined that the person should have been deemed a covered person?

Answer: The reasonable care exception applies 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 under Rule 506(d)(1). This may occur when, despite the exercise of reasonable care, the issuer was unable to determine the existence of a disqualifying event, was unable to determine that a particular person was a covered person, or initially reasonably determined that the person was not a covered person but subsequently learned that determination was incorrect. Issuers will still need to consider what steps are appropriate upon discovery of Rule 506(d) disqualifying events and covered persons throughout the course of an ongoing Rule 506 offering. An issuer may need to seek waivers of disqualification, terminate the relationship with covered persons, provide Rule 506(e) disclosure, or take such other remedial steps to address the Rule 506(d) disqualification. [Dec. 4, 2013]

Question 260.24

Question: Is there a procedure provided in Rule 506(e) for issuers to seek a waiver of the obligation to disclose past events that would have been disqualifying, except that they occurred before September 23, 2013 (the effective date of Rule 506(d))?

Answer: No. The disclosure obligation is not subject to waiver. [Dec. 4, 2013]

Question 260.25

Question: Does Rule 506(e) require disclosure of past events that would no longer trigger disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years before the offering or an order or bar that is no longer in effect at the time of the offering?

Answer: No. Rule 506(e) requires only disclosure of events that would have triggered disqualification at the time of the offering had Rule 506(d) been applicable. Because events outside the applicable look-back period and

orders that do not have continuing effect would not trigger disqualification, Rule 506(e) does not mandate disclosure of such matters in order for the issuer to
be able to rely on Rule 506. [Dec. 4, 2013]

Question 260.26

Question: In an offering in which the issuer uses multiple placement agents or other compensated solicitors, is the issuer required to provide investors with disclosure under Rule 506(e) only with respect to the particular compensated solicitor or placement agent that solicited those investors and its covered control persons (i.e., general partners, managing members, directors, executive officers, and other officers participating in the offering)?

Answer: No. Issuers are required to provide all investors with the Rule 506(e) disclosure for all compensated solicitors who are involved with the offering at the time of sale and their covered control persons. [Dec. 4, 2013]

Question 260.27

Question: In a continuous offering, is the issuer required to provide disclosure under Rule 506(e) for all solicitors that were ever involved during the course of the offering?

Answer: No. A reasonable time prior to the sale of securities in reliance on Rule 506, the issuer must provide the required disclosure with respect to all compensated solicitors that are involved at the time of sale. Disclosure with respect to compensated solicitors who are no longer involved with the offering need not be provided under Rule 506(e) in order for the issuer to be able to rely on Rule 506. [Dec. 4, 2013]