

SEC Update

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Bad Actors: Snubbed at Golden Globes, But Awarded Guidance from SEC

AUTHORS

Michael J. Rivera
Parker B. Morrill

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Bad actors received no accolades at last night's Golden Globe Awards. However, persons designated as "bad actors" under the federal securities laws are very much in the SEC's limelight. On December 4, 2013 and January 3, 2014, the SEC issued **guidance** on the provisions that disqualify "bad actors" from participating in private securities offerings conducted under new Rule 506 of Regulation D of the Securities Act of 1933 (Rule 506). The guidance appeared in the form of 19 new Compliance and Disclosure Interpretations (CDIs) posted on the SEC website by its Division of Corporation Finance. The CDIs answer some of the many questions that have arisen about the proper application and interpretation of the bad actor disqualification provisions since their implementation on September 23, 2013.

As we **previously reported**, Rule 506 allows issuers to offer and sell securities using general solicitation provided the specific requirements of the rule are satisfied. A chief requirement for an offering to qualify for the Rule 506 registration exemption is compliance with the so-called "bad actor" disqualification provisions, which state that specified persons involved in the offering (referred to as "covered persons") must not have been subject to certain criminal convictions or judicial or administrative disciplinary orders (referred to as "disqualifying events"). Covered persons include, among others, the issuer, placement agents/underwriters, promoters, investment managers, and certain of their executives, directors, and owners.

Understanding the bad actor disqualification provisions is critical for issuers and firms seeking to assist with offerings under Rule 506, as the rule is the most widely used registration exemption under Regulation D. Issuers (and their management) could be subject to SEC sanctions and liability to investors for conducting offerings that fail to comply with the bad actor disqualification provisions. In addition, when a covered person is negotiating a settlement of a government investigation, that person should carefully analyze whether the settlement terms would cause them to be disqualified from participation in future Rule 506 offerings.

We recommend that issuers and all other covered persons carefully review Rule 506 and all 19 new CDIs (which are **CDI question numbers 260.14 to 260.32**). Listed below are ten key pieces of guidance found in the CDIs.

1. Issuers may reasonably rely on a covered person's agreement to provide notice of a disqualifying event, but in a continuous, delayed, or long-lived offering, the issuer must periodically update the factual inquiry through bring-down representations or other steps.
2. An issuer could continue to rely on Rule 506 if a placement agent or one of its control persons becomes subject to a disqualifying event while the offering is ongoing. However, the issuer will need to terminate the placement agent and not pay compensation for any future sales. Alternatively, if only a control person of the placement agent becomes disqualified, the issuer could continue to rely on Rule 506 if such person was terminated or ceased serving in a "covered person" role.
3. All solicitors who receive compensation for soliciting purchases in a Rule 506 offering are considered covered persons, regardless of whether they are deemed a "broker" under the federal securities laws.
4. Officers of a compensated solicitor are considered covered persons to the extent they solicit investors or otherwise "participate" in the offering. Such participation includes preparing offering materials, undertaking due diligence efforts and other offering activities.
5. Actions taken by foreign courts or regulators with respect to a covered person do not trigger the disqualification provisions.

6. Covered persons are not subject to disqualification for events occurring before the effective date of new Rule 506 (September 23, 2013). However, issuers must disclose such disqualifying events (even where a court or regulator advises the SEC that no disqualification should arise as a result of the event) and are not permitted to seek from the SEC a waiver of this disclosure obligation.
7. Only SEC cease-and-desist orders that arise from scienter-based violations of the federal securities laws constitute disqualifying events.
8. The designation of "affiliated issuers" as covered persons is not meant to include every entity affiliated with a Rule 506 issuer. Rather, the disqualification provisions apply to any affiliate of the issuer that itself is also issuing securities in the same offering.
9. Covered persons include beneficial owners of 20% or more of the issuer's outstanding voting equity securities. A person that becomes a 20% beneficial owner through purchases completed in a Rule 506 offering is not considered a covered person for purposes of the offering. In addition, practitioners should look to Rules 13d-3 and 13d-5(b) of the Securities Exchange Act of 1934 to interpret whether individual shareholders, shareholder groups, and members of shareholder groups constitute "beneficial owners" of an issuer's securities. For example, parties to a voting agreement that empowers the parties to vote or direct the vote of shares held by other parties to the agreement will be deemed beneficial owners of such shares.
10. The CDIs also address the reasonable care exception, disqualification waivers, disclosure of bad acts by placement agents, additional beneficial owner issues, and the timing of when an issuer needs to determine whether it is disqualified.

For more information about complying with new Rule 506, as well as about the process for "bad actors" requesting from the SEC a waiver from the disqualification provisions of Rule 506, please contact **Michael J. Rivera** or **Parker B. Morrill**. Mr. Rivera is Chair of Venable's **Securities Enforcement and Compliance Practice Group**.