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Market Solutions

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Market Solutions

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Market Solutions is a quarterly newsletter about the activities of the Financial Markets Association as well as legislative/regulatory developments of interest to FMA members. The opinions expressed in this publication are those of the authors, not necessarily those of the Association and are not meant to constitute legal advice. *Market Solutions* is provided as a membership service of the **Financial Markets Association**, 333 2nd Street, NE - #104, Washington, DC 20002, *dp-fma@starpower.net*, 202/544-6327, *www.fmaweb.org*. Please let us have your suggestions on topics you would like to see addressed in future issues.

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Weeding Out Bad Actors: The Rule 506 Bad Actor Provisions and Capital Markets Practice–One Year Later

By Bradley Berman
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As we approach the anniversary of the effectiveness of the Rule 506 bad actor provisions (if you don't happen to have it marked on your calendar, the new rules went into effect on September 23, 2013), it is a good time to survey how issuers and placement agents have adapted in response to the new rules.

Since the new rules became effective, the Securities and Exchange Commission Division of Corporation Finance has issued several sets of Compliance and Disclosure Interpretations (C&DI 260.14 –260.32).[1] Some of the C&DIs are applicable to Rule 506 continuous offering programs.

The Compliance and Disclosure Interpretations

For example, C&DI 260.14 states, in part:

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 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.
[Emphasis added.]

A placement agent in a continuous offering program should consider including an issuer covenant in the placement agent agreement to the effect that the issuer has exercised reasonable care to determine whether any covered person is subject to a bad actor disqualification, and that the issuer will notify the placement agent in writing of any bad actor disqualification relating to any covered person, or any event that would, with the passage of time, become such a disqualification event. The placement agent may wish to include in the placement agent agreement an issuer covenant

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LAST CHANCE TO REGISTER for FMA's LEGAL AND LEGISLATIVE ISSUES CONFERENCE
October 23–24, 2014 ■ Hyatt Regency Washington (on Capitol Hill) ■ Washington, DC

Legislative/Regulatory Actions

This column was written by lawyers from Morrison & Foerster LLP to update selected key legislative and regulatory developments affecting financial services and capital markets activities. Because of the generality of this column, the information provided herein may not be applicable in all situations, and should not be acted upon without specific legal advice based on particular situations.

In this issue, we address various selected developments from the **Banking Regulators**, the Dodd-Frank Act's **Title VII**, and the **Consumer Financial Protection Bureau (CFPB)**.

BANKING REGULATORS

U.S. Banking Regulators Issue Finalized Liquidity Coverage Ratio

On September 3, 2014, the Federal Reserve Board, FDIC, and the OCC (the "Agencies") issued the final Liquidity Coverage Ratio (LCR) rule to strengthen the liquidity positions of large financial institutions. The rule requires banking organizations subject to the rule to maintain high quality, liquid assets (HQLA), such as central bank reserves and government and corporate debt, that can be converted easily and quickly into cash in an amount equal to or greater than its projected cash outflows minus its projected cash inflows during a 30-day stress period. Similar to the proposal, the final rule sets forth three categories of eligible HQLA, the lower two of which would be assigned haircuts. The rule also restricts the amounts of the lower two HQLA that comprise the total HQLA amount, and specifies methods for calculating net cash outflows.

The rule applies to banking organizations having total consolidated assets of $250 billion or more or total consolidated on-balance sheet foreign exposure of $10 billion or more, and any subsidiary depository institutions with $10 billion or more of total consolidated assets ("covered companies"). The rule will also apply a less stringent, modified LCR to bank holding companies and savings and loan holding companies without significant insurance operations that, in each case, have $50 billion or more in total assets but do not meet the above thresholds ("modified companies"). The final rule does not apply to foreign banking organizations or U.S. intermediate holding companies that are required to be established under the Board's Regulation YY, other than those companies that are otherwise considered to be covered companies.

The final rule also establishes a framework for a flexible supervisory response when a covered company's LCR falls below 100 percent. Under the final rule, a covered company must notify the appropriate Agency on any business day that its LCR is less than 100 percent. In addition, if a covered company's LCR is below 100 percent for three consecutive business days, the covered company must submit a plan for remediation of the shortfall. The LCR will complement existing supervisory guidance and the more qualitative and internal stress test requirements in the Board's Regulation YY.

Covered companies with $700 billion or more in consolidated assets or $10 trillion or more in custodied assets must begin daily LCR calculations on July 1, 2015. Other covered companies have until July 1, 2016 to comply with the daily calculation requirement. All covered companies must calculate their LCR at the end of each month starting on January 1, 2015, the effective date of the final rule. Modified companies are only required to calculate their LCR at the end of each month, beginning on January 1, 2016.

For more information, please read our client alert at ***http://www.mofo.com/~/media/Files/ClientAlert/2014/09/140904FinalizedLiquidityCoverageRatio.pdf.***

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FMA Welcomes New Members!

Jarryd Anderson	The Clearing House Association
Alma Angotti	Navigant
Robert Anzenberger	U.S. Dept of the Treasury
Emma Bailey	Barclays
Gail Bernstein	WilmerHale
Steven Church	Cleary Gottlieb Steen & Hamilton LLP
Jordan Costa	JPMorgan Chase & Co.
Kurt Eidemiller	U.S. Dept of the Treasury

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to periodically update its factual inquiries of any covered persons. Similarly, the issuer may want to include a mirror representation from the placement agent regarding periodic inquiries of any of the placement agent's covered persons.

The timing of periodic updates by an issuer or a placement agent in a continuous offering program remains open; the SEC has not, and probably will not, identify a specific timeline. The SEC previously stated that "[t]he timeframe for inquiry should also be reasonable in relation to the circumstances of the offering and the participants."[2]

"A placement agent in a continuous offering program should consider including an issuer covenant in the placement agent agreement to the effect that the issuer has exercised reasonable care to determine whether any covered person is subject to a bad actor disqualification…."

Despite careful diligence by an issuer of its covered persons, there may be times during a continuous offering program when the issuer discovers that a covered person is subject to a disqualification. If, despite the exercise of reasonable care, the issuer was unable to determine the existence of a disqualifying event or that a particular person was a covered person, or initially reasonably determined that the person was not a covered person but subsequently learned that that determination was incorrect, then the reasonable care exception of Rule 506(d)(2)(iv) will be available for the issuer. The issuer must then consider what steps are appropriate upon discovery of the Rule 506 disqualifying event. The SEC suggested that those steps might include seeking waivers of disqualification, termination of the relationship with the covered person or persons, providing Rule 506(e) disclosure, or taking other remedial steps to address the disqualification to ensure that the Rule 506 exemption will remain available.[3,4]

Many continuous offering programs have multiple placement agents. Any of those agents may have agreements with other registered dealers to place the securities. Not all of these agents and dealers may be involved with a particular placement of the issuer's securities. At a reasonable time prior to the sale of the securities, the issuer must determine which agents and dealers will be involved in the sale. If any of these agents and dealers were the subject of any matters that would have disqualified them from using Rule 506 prior to the effectiveness of Rule 506(d) (i.e., prior to September 23, 2013), then Rule 506(e) disclosure must be made to all investors in the offering – whether or not they purchased the securities from the issuer through the particular agent or dealer that is the subject of the disclosure. No disclosure of such pre-effective bad actor events relating to a placement agent on the program that is not involved in the offering need be made to investors in that offering.[5]

Other valuable guidance was provided by the new C&DIs, some of which is summarized below:

- An "affiliated issuer," for purposes of Rule 506(d), is an affiliate (as defined in Rule 501(b)) of the issuer that is issuing securities in the same offering, including offerings subject to integration pursuant to Rule 502(a).[6]
- 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 are not "participating" in a Rule 506 offering, for purposes of Rule 506(d)(1).[7]
- Actions taken in jurisdictions other than the United States, such as convictions, court orders, injunctions in a foreign court, or regulatory orders issued by foreign regulatory authorities will not trigger a disqualification under Rule 506(d).[8]
- Rule 506(e) does not mandate disclosure of past events that would no longer trigger a disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years prior to an offering or a bar that is no longer in effect at the time of the offering.[9]
- A shareholder that becomes a 20% beneficial owner of the issuer's voting equity securities upon completion of the sale of securities in a Rule 506

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offering is not a 20% beneficial owner at the time of the sale, for purposes of determining who is a covered person with respect to that offering.[10]

- The term "beneficial owner," as used in Rule 506(d), is interpreted the same way as under Rule 13d-3 under the Securities Exchange Act of 1934; beneficial ownership includes both direct and indirect interests, determined as under Rule 13d-3. Consequently, one must look through entities to their controlling persons.[11]
- If there is 20% beneficial ownership of the issuer's voting equity securities by shareholders that have formed a group, the disqualification or disclosure obligations will apply to triggering events that apply only to the group itself, assuming that no member of the group is a 20% beneficial owner. Here, the SEC used the example of a group being formed by means of a voting agreement. If any party to the voting agreement has or shares power to vote or direct the vote of shares beneficially owned by other parties to the agreement, then beneficial ownership of such shares will be attributed to that party.[12] In those circumstances, one would look not only at the group itself, but also through the group to the parties to the voting agreement and determine whether any such party is a 20% beneficial owner due to such aggregated voting power and whether that party is subject to a disqualification event.[13]

There are still some open issues relating to Rule 506(d) offerings that have not been addressed by the new C&DIs. For example:

Matchmaking portals. Are operators of matchmaking portals compensated solicitors subject to the disqualification provisions?

- Most likely not, if they are not receiving transaction-based compensation. Section 4(b)(1) of the Securities Act of 1933 provides an exemption from broker-dealer registration for persons operating what is commonly known as a matchmaking portal for Rule 506 offerings of securities to accredited investors, provided, among other requirements, that those persons receive no compensation in connection with the purchase or sale of such securities. In C&DI 260.17, the SEC noted that compensated solicitors are not limited to brokers who are subject to registration under Section 15(a)(1) of the Exchange Act. The SEC stated that "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 ... Section 15(a)(1) ...."14 Although not directly addressed by the SEC, it appears that a matchmaking portal that satisfies the exemption from broker or dealer registration provided by Section 4(b)(1) of the Securities Act could not be operated by a compensated solicitor.

> *"The timing of periodic updates by an issuer or a placement agent in a continuous offering program remains open; the SEC has not, and probably will not, identify a specific timeline."*

Diligence by placement agents. Most of what the SEC has said about diligence procedures is in the context of a reasonable investigation by the issuer. In the Adopting Release, the SEC stated that they anticipated that "financial intermediaries and other market participants will develop procedures for assisting issuers in gathering the information necessary to satisfy the issuer's factual inquiry requirement."[15]

- It seems reasonable that placement agents and other compensated solicitors in a Rule 506 offering should be able to rely on the same sources of information used by the issuer in making its factual inquiry. The SEC's advice in C&DI 260.14 (discussed above), that an issuer's reliance on a certification is reasonable, should also cut in favor of a placement agent or other compensated solicitor relying on a periodic certification by any of its directors, executive officers or other officers participating in the offering, its general partner or managing member (if so structured), or any director, executive officer, or other officer participating in the offering of such general partner or managing member.

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Rule 506(d)(2)(ii) Waiver of Disqualification

Since September 23, 2013, the SEC has granted a number of waivers from the disqualification provisions of Rule 506(d) upon a showing of good cause.[16] The issuers and placement agents receiving waivers were subject to various SEC orders or judgments described in Rule 506(d)(1)(ii) or (iv), or, in one case, plead guilty to a felony or misdemeanor described in Rule 506(d)(1)(i). Each of those actions constituted a disqualifying event under Rule 506(d)(1). Waivers are granted under Rule 506(d)(2)(ii).

"Despite careful diligence by an issuer of its covered persons, there may be times during a continuous offering program when the issuer discovers that a covered person is subject to a disqualification."

The arguments presented in the waiver requests have common themes:

- None of the disqualifying events had to do with a Regulation D offering;
- The applicants had already paid fines to the SEC in connection with the disqualifying events pursuant to the relevant order or judgment;
- Some of the applicants had neither admitted nor denied the allegations in the order or judgment, or stipulated to some, but not all, of the facts therein;
- Most of the applicants took remedial action to address the alleged behavior;
- Disqualification from the use of Rule 506 would adversely and disproportionately affect the applicant and third parties, such as affiliates of an issuer for which Rule 506 would be unavailable and, for placement agents, potential clients/issuers contemplating Rule 506 offerings; and
- For a period of five years from the date of the judgment or order, the applicants agreed to furnish to potential investors a written description of the judgment or order a reasonable time prior to any sale.[17]

In each case, the Commission granted the waiver request and did not disqualify the applicant from the use of the Rule 506 exemption. Some large financial institutions that service hedge funds have made the argument in their waiver applications that a disqualification from future Rule 506 offerings would disproportionately harm them and their clients. Absent a waiver, these institutions would be shut out from acting as placement agents for hedge funds for which they act as placement agents. For example, one large financial institution had launched over 20 hedge funds that rely on Rule 506 for continuous offerings through that institution.[18]

Another large financial institution was recently barred from offering private equity and hedge fund investments to its clients. There, the bank was the victim of bad timing that caused the result of the original conduct to be bounced from what would have been just a disclosure obligation of past acts under Rule 506(e) to an outright disqualification event. The original "bad acts" occurred in 2006-2007 and had to do with selling collateralized debt obligations. The bank had reached a settlement with the SEC in 2011, which was rejected by the Southern District of New York. The Second Circuit overturned the district court in August 2014, resulting in the SEC disqualifying the bank from using Rule 506. If the district court had accepted the original settlement in 2011, which was prior to the effectiveness of the bad actor amendments, the bank would not have been disqualified and would have had to disclose the pre-effective bad acts to investors. This run of circumstances may be a factor in favor of the bank if the SEC grants a waiver from disqualification.[19]

At the present time, the SEC has not issued any written standards regarding waivers or what constitutes a showing of good cause. In the adopting release for the Rule 506 amendments, the SEC stated that "it would be premature to attempt to articulate standards for granting waivers, although we may consider doing so …."[20] The SEC put forth a non-exhaustive list of circumstances that could be relevant to a waiver request: "a change of control, change of supervisory personnel, absence of notice and opportunity for hearing, and relief from a permanent bar for a person who does not intend to apply to reassociate with a regulated entity …."[21]

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In a recent letter to The Honorable Sherrod Brown, SEC Chair Mary Jo White stated that a written policy statement regarding waivers under Rule 506 is currently under consideration by the staff, and that the staff is also completing a formal written policy setting forth the factors that it considers in determining whether good cause has been shown to grant relief from disqualifications that may arise under Regulation A, Rule 505 or 506.[22]

Other Regulatory Schemes—Overlap, Harmony and Dissonance

Placement agents and other compensated solicitors will have on file various forms, such as FINRA Form U4 and Form ADV, which require disclosure by their employees and others of "bad acts" similar to those that may constitute a disqualification event under Rule 506(d). As discussed in our Client Alert cited above, a review of those forms will be helpful in identifying any covered person that may be subject to a disqualification event.[23] Some of the responses required by those forms, however, may sweep in past acts that would not constitute a disqualification event under Rule 506(d).[24] Consequently, a respondent who provides a "yes" answer to the disclosure questions of Form U4 or Form ADV will not necessarily be disqualified from participating in a Rule 506 offering. There are also some Rule 506(d) disqualification events that are not contemplated by Form U4 or Form ADV. These differences are due to the varying regulatory objectives of the Exchange Act, the Investment Advisers Act of 1940, and the Securities Act.

"There are still some open issues relating to Rule 506(d) offerings that have not been addressed by the new C&DIs."

In this regard, a covered person would be disqualified under Rule 506(d)(1)(i) if that person has:
been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor:

- In connection with the purchase or sale of any security;
- Involving the making of any false filing with the Commission; or
- Arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities.

A review of responses to Items 11A or 11B of Form ADV, or Questions 14A or 14B of Form U4, which require disclosure of criminal events, would be helpful in determining whether a covered person is subject to a disqualifying event under Rule 506(d)(1)(i). However, the disclosure items in those two forms cast a much wider net than does Rule 506(d)(1). Items 14A and 14B of Form U4 have no time limit on the requested criminal disclosure and cover, in addition to convictions, guilty pleas and pleas of no contest to any type of felony. Those items also cover felony and misdemeanor convictions, and pleas in foreign and military courts (foreign courts are specifically excluded from the scope of Rule 506(d)(1) under C&DI 260.20, as discussed above), and misdemeanors involving investments or investment-related business, or any fraud, false statements, or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or conspiracy to commit any of those offenses. Item 11 of Form ADV covers the same events, but has a ten-year look-back period. Both Form U4 and Form ADV also cover being charged with any of the felonies or misdemeanors described in those items.

Item 14D(2) of Form U4, which has no counterpart in Form ADV, requests disclosure of final orders issued by various regulatory authorities. This item differs from Rule 506(d)(1)(iii) only in that a final order of the U.S. Commodity Futures Trading Commission ("CFTC") is not covered in Item 14D(2) of Form U4 and that item is open-ended in terms of past violations. Rule 506(d)(1)(iii) is limited to a ten-year look-back period. Consequently, a "yes" answer to Item 14D(2) might not constitute a disqualification event under Rule 506(d)(1)(iii), and a "no" answer might not capture a CFTC violation that would be a disqualification event. Also, a "final order" is defined somewhat differently by FINRA

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than in Rule 501(g).[25] The SEC definition requires that the statutory authority that issued the final order provided for notice and an opportunity for a hearing.

Further, a review of responses to Form U4 and Form ADV would not pick up disqualification events covered by Rule 506(d)(1)(vii) or (viii), which cover stop orders and orders suspending the Regulation A exemption, and U.S. Postal Service false representation orders, respectively.

> *"Most of what the SEC has said about diligence procedures is in the context of a reasonable investigation by the issuer."*

Rule 506 Compliance Guide

The SEC posted a small entity compliance guide that summarizes the Rule 506 disqualification rules. The guide can be found at: **http://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide.htm.** ■

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[1] *The Compliance and Disclosure Interpretations can be found at: http://www.mofo.com/~/media/Files/Articles/140915CDI2601432Rule506BadActor.pdf.*

[2] *Release 33-9414 (July 10, 2013) (the "Adopting Release") at 67. The Adopting Release is available at: http://www.sec.gov/rules/final/2013/33-9414.pdf.*

[3] *See C&DI 260.23*

[4] *A detailed discussion of the types of provisions that should be added to placement agent agreements for Rule 506 offerings, and other suggested diligence actions to be conducted as part of a program to ensure compliance with Rule 506, can be found in our Client Alert at: http://media.mofo.com/files/Uploads/Images/130715-Bad-Actor-Disqualifications.pdf under "Action Items for Issuers and Placement Agents."*

[5] *See C&DIs 260.26-27*

[6] *See C&DI 260.16*

[7] *See C&DI 260.18*

[8] *See C&DI 260.20*

[9] *See C&DI 260.25*

[10] *See C&DI 260.28*

[11] *See C&DIs 260.29 and 260.30*

[12] *The SEC stated, in another C&DI, that "in order for one party to the voting agreement to be treated as having or sharing beneficial ownership of securities held by any other party to the voting agreement, evidence beyond formation of the group under [Exchange Act] Rule 13d-5(b) would need to exist." See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting C&DI 105.06.*

[13] *See CD&I 260.31. The beneficial ownership rules should be carefully analyzed in more complicated situations, such as determining whether investment advisers to multiple funds or to a fund of funds, or certain trusts, depending on their structure, are subject to a disqualification event.*

[14] *See C&DI 260.17*

[15] *Adopting Release at 68.*

[16] *The waivers can be found at http://www.sec.gov/divisions/corpfin/cf-noaction.shtml#3b under "Section 3(b) – Rules 262 and 505 Disqualification" commencing on November 25, 2013. These waivers also covered disqualifications under Regulation A and Rule 505.*

[17] *This disclosure is required under Rule 506(e) for bad acts that would have been disqualifications under Rule 506(d), but occurred prior to September 23, 2013. Rule 506(e) does not have a look-back limitation. Rule 262 of Regulation A and Rule 505 do not have an analogous provision.*

[18] *See Credit Suisse AG (Feb. 21, 2014) at http://www.sec.gov/divisions/corpfin/cf-noaction/2014/credit-suisse-group-ag-022114.pdf.*

[19] *See "Bad actor rule is a 'big deal' for hedge funds," Risk.net (Sept. 9, 2014).*

[20] *Adopting Release at 71.*

[21] *Id. at 72.*

[22] *Letter from Mary Jo White, Chair of the Securities and Exchange Commission, to The Honorable Sherrod Brown (Sept. 8, 2014), available at: http://www.mofo.com/~/media/Files/Articles/140908BrownSECPolicyReWaivers.pdf.*

[23] *The SEC pointed to these types of forms as a source of information for financial intermediaries and other market participants when assisting an issuer in satisfying its factual inquiry requirement. See the Adopting Release at 68.*

[24] *Many of the disclosure items in Form U4 and Form ADV are identical, or substantially identical.*

[25] *The FINRA definition of "final order" can be found at: http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p468051.pdf.*