



Investment Management Update

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SEC Issues Guidance on Bad Actor Rules

On December 4, 2013, the staff of the SEC's Division of Corporation Finance (the "Division") issued new Compliance and Disclosure Interpretations ("CDIs") concerning recently adopted Rule 506(d) of the Securities Act of 1933, the so-called "bad actor" rules. As background, Rule 506(d), which took effect on September 23, 2013, disqualifies securities offerings from reliance on a Rule 506 exemption from Securities Act registration if bad actors are involved in the offering. There is a "reasonable care" exception to Rule 506(d), whereby an issuer will not lose its Rule 506 exemption if it can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. However, Rule 506(d) does not specify the type or frequency of due diligence required to satisfy this standard. In fact, the final text of the rule and the adopting release raised numerous questions for investment advisers to hedge funds, private equity funds and other private funds about how to interpret many provisions of the rule. The Division's new CDIs address some of these areas of confusion, as summarized below.

GUIDANCE ON THE REASONABLE CARE EXCEPTION

The Division provided some guidance on the type and frequency of due diligence required to satisfy the reasonable care standard, stating that funds that continuously offer securities (such as hedge funds and

private equity funds) must conduct and update their due diligence efforts on potential bad actors "periodically," through the use of "bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances." (Question 260.14.) This guidance seems to confirm what most in the industry assumed: that bad actor due diligence requires some combination of database checking (and rechecking) and the use of questionnaires or certifications on at least an annual basis. Additionally, the Division clarified that the reasonable care exception covers circumstances where an issuer was unable to determine that a particular person was covered by the bad actor rule, or where an issuer incorrectly determines that a person is not covered by the rule. (Question 260.23.) As a result, advisers should carefully document their due diligence efforts with respect to both identifying persons covered by the rule and such persons' bad acts.

GUIDANCE ON AFFILIATED ISSUERS

Under Rule 506(d), an issuer is disqualified from relying on a Rule 506 exemption if an "affiliated issuer" is a bad actor. However, "affiliated issuer" is not defined under the rule, which created concerns in the industry that this term was meant to include an adviser's separate private funds, private funds advised by an affiliated adviser, or

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remote affiliates of a parent organization. As explained in Question 260.16, the term “affiliated issuer” is only meant to capture affiliates that are issuing securities in the same offering (e.g., funds in a master-feeder or parallel fund structure), which should be of comfort to most advisers.

GUIDANCE ON CURING BAD ACTOR DISQUALIFICATIONS

According to the Division, an issuer can cure a bad actor disqualification with respect to a placement agent by: (1) terminating the relationship; and (2) ceasing payments to the placement agent. (Question 260.15.) Based on this guidance, as well as other reasons, it is important for investment advisers to understand the termination provisions in their agreements with placement agents and ensure that placement agents are not contractually entitled to trailing fees in the event of a disqualification.

GUIDANCE ON FOREIGN BAD ACTS

Question 260.20 provides confirmation that a bad actor disqualification will not result from actions taken in foreign jurisdictions, such as convictions, court orders, injunctions in a foreign court, or regulatory orders issued by foreign regulatory authorities. (Question 260.20.)

The December 4 CDIs are available on the Commission’s website at: <http://www.sec.gov/divisions/corpfin/guidance/securities-actrules-interps.htm#260-14>. Please feel free to contact us if you have any questions regarding the bad actor rules or any other SEC-related matter.

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