



Who is a "Covered Person" for the SEC's Bad Actor Disqualifications?

On September 23, 2013 the SEC's "Bad Actor Rule" went into effect with respect to private offerings under Regulation D. This Rule disqualifies any issuer from selling securities to investors through the use of Rule 506(b) and Rule 506(c) of Regulation D if it or any of its control persons ("covered persons") have committed any of eight enumerated categories of bad acts. **If any of the covered persons is disqualified, the offering may violate securities laws.** The SEC requires any issuer selling securities to make a factual inquiry to determine whether any of the covered persons trigger disqualification. The "Bad Actor Report" that CrowdCheck produces meets the SEC's requirements.

SEC Definition of Covered Person and Whether to Look-Through Entities

The SEC offers guidance on who exactly is considered to be a "covered person". Under the Rule and the SEC interpretations, covered persons include:

- The **company issuing securities**, including its predecessor entities and affiliated entities issuing securities;
- **Directors, general partners, and managing members** of the company;
- **Executive officers** of the company, and **other officers** of the company that participate in the offering;
- **20% beneficial owners** of the company;
- **Promoters** connected to the company;
- Any **person compensated for soliciting investors**, including any directors, general partners and managing members of those solicitors; and
- For pooled investment funds, the fund's **investment manager** and its **principals**.

While many of the covered persons are self-explanatory, some of these categories require further explanation. For instance, "promoter" is not used in the colloquial sense of someone currently promoting the company; that person is more likely to be a compensated solicitor, who is still a covered person. The SEC definition of a promoter includes a founder of the company who is still with the company, or holds at least 10% of any class of its securities.

Issuers must also be aware that, according to the SEC, the factual inquiry must "look through" some entities to **the people that control them**. If a 20% beneficial owner of an issuer is a partnership, then each of the general partners is a covered person. Likewise, in the case of an LLC, if a managing member of the issuer is another LLC, the managing members of *that* LLC

would also be considered covered persons. In short, the SEC requires that issuers look through any intermediary entity that is considered a control person and conduct a factual inquiry on the natural person exercising control.

Common Examples of Covered Persons in Regulation D Offerings

To help identify who the covered persons are in a particular situation, we have identified some common scenarios below:

- Javier is the sole executive officer, director, and shareholder of NewCo:
 - Covered persons - NewCo and Javier.
- Alicia is the CEO and Steve is the CFO of NewCo; Alicia and Tom are directors of NewCo; Alicia is the sole shareholder:
 - Covered persons - NewCo, Alicia, Steve, and Tom.
- Stacy is the CEO, Beth is the CFO, and Paul is the COO of NewCo; Stacy, Anand, Henry, and Roger are directors; Stacy, Anand, and HRP Partners LP each hold at least 20 percent ownership; Henry, Roger, and Peter are general partners of HRP Partners LP:
 - Covered persons - NewCo, Stacy, Beth, Paul, Anand, Henry, Roger, and Peter.
- NewLLC is a manager managed LLC; ManagerGroup LLC is the managing member of NewLLC; ManagerGroup LLC is managed by Becky, Jane, and Doug; Jimmy and Val each own half the issued membership interests of NewLLC:
 - Covered persons - NewLLC, ManagerGroup LLC, Becky, Jane, Doug, Jimmy, and Val.
- NewCo reorganized after previously operating as OldCo; Alan is the CEO, Dara is the CFO, and Edward is a finance officer who prepared NewCo's offering materials; Alan, Fiona, and Heather are directors; NewCo is 100% owned by LMN Partners LP; Liam, Michael, Nathan, and Scott are the general partners of LMN Partners LP:
 - Covered persons - NewCo, OldCo, LMN Partners LP, Alan, Dara, Edward, Fiona, Heather, Liam, Michael, Nathan, and Scott.

As the examples indicate, complicated management and ownership structures can create situations where the SEC's rules result in a large number of individuals and entities being defined as covered persons.

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