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The US Investment Company Act

A legal minefield for non-US issuers

Illustration: Getty Images

Jonathan Baird of **Freshfields Bruckhaus Deringer** and **Eric Stuart** of **Jones Day** consider the main issues that arise for non-US listed issuers seeking to rely on the exemption from registration under section 3(c)(7) of the US Investment Company Act.

The US Investment Company Act of 1940, as amended (ICA), is a complex piece of legislation designed to protect investors in US investment funds, and has long been a thorn in the side of non-US companies seeking to raise capital in the US or which have security holders in the US.

In addition to imposing a number of onerous requirements and restrictions on the companies that are subject to it, any contract of a company that sells se-

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curities in violation of the ICA is void and unenforceable under US law. This is not just a problem for classic investment funds: the extremely broad and complicated definition of investment company in the ICA means that even companies which are not structured or operated as funds (that is, inadvertent investment companies) must also be aware of its implications (*see box "Inadvertent investment companies"*).

As registration under, and compliance with, the ICA is not practical or advisable for non-US issuers, they must seek to qualify for an exemption from registration (*see box "Commonly used exemptions for non-US issuers"*). The exemption most commonly used by non-US listed issuers, contained in section 3(c)(7) of the ICA (section 3(c)(7)), has recently been the subject of considerable discussion. Efforts made to establish a recognised market standard approach to section 3(c)(7) have proved challenging because effective reliance on section 3(c)(7) is highly dependent on the surrounding facts and circumstances.

Inadvertent investment companies

The definition of investment company in the US Investment Company Act of 1940 (ICA) is so complex that it is beyond the scope of this article. However, besides including companies that hold themselves out as engaging primarily in the business of investing or trading in securities, the definition captures companies (commonly referred to as inadvertent investment companies) that have more than 40% of their assets (excluding certain cash items and US government securities) in the form of "investment securities".

The ICA's definition of investment securities is very broad and includes virtually all instruments that could be thought of as a security, as well as some that might not, such as certain notice accounts. Securities issued by certain majority-owned subsidiaries are, however, excluded from the definition.

Companies involved in finance and asset management are at particular risk of being inadvertent investment companies, but the issue also often crops up for:

- Development stage companies that raise capital pending investment in expanding operations.
- Holding companies with minority stakes in other entities.
- Companies with complicated financing or treasury operations.

Other area where ICA problems tend to appear include the real estate, oil and gas, metals and mining, biotechnology, and technology sectors.

Adding to the complexity, the section 3(c)(7) exemption is no longer in itself an end for non-US issuers. While registration under the ICA may have been avoided, recent US regulatory reforms after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank) have led to a number of new consequences for issuers that rely on section 3(c)(7). Some of these may prove particularly problematic for non-US issuers, especially those that are publicly traded.

This article focuses on the main issues that arise for non-US listed issuers seeking to rely on the section 3(c)(7) exemption, including:

- The development of market practice and recommended procedures for ICA compliance.
- The effect of Dodd-Frank, including the US Investment Advisers Act of 1940 (IAA), the US Commodities Exchange Act (CEA) and the prohibition on bank proprietary trading and hedge and private equity fund ownership under Dodd-Frank's "Volcker Rule".
- Complications resulting from the relaxation of private offering publicity restrictions under the US Jumpstart Our Business Start-ups Act of 2012 (JOBS Act).
- Practical steps and considerations.

MARKET PRACTICE

Traditionally, the two exemptions to registration under the ICA most readily available to non-US issuers are found in section 3(c)(7) and section 3(c)(1) of the ICA (the private fund exemptions).

Unlike other ICA exemptions, most of which require an issuer to satisfy substantive criteria regarding its activities or assets, the private fund exemptions focus on the number and nature of an issuer's US security holders. Accordingly, they have generally been the most attractive options for non-US issuers, including for inadvertent investment companies relying on the exemptions on a prudential basis in cases where the risk of falling foul of the ICA is fairly remote.

Application of exemptions

In order to qualify for the section 3(c)(1) exemption, a non-US issuer must have fewer than 100 US residents as its security holders (there are also certain related attribution rules, aimed at attempts to circumvent the relevant limitation).

In order to qualify for the section 3(c)(7) exemption, a non-US issuer may have an unlimited number of security holders who are US residents, provided that (subject to certain exceptions) all such US residents are "qualified purchasers" (*see box "Definition of qualified purchaser"*). Importantly, it can be sufficient for the issuer or certain persons acting on its behalf to have a reasonable belief that such US residents are qualified purchasers.

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On their face, neither private fund exemption makes any specific provision for non-US issuers. However, section 7(d) of the ICA (section 7(d)) prohibits a non-US investment company from making a public offering of its securities in the US in the absence of an order of the US Securities and Exchange Commission (SEC). In a series of no-action letters, the SEC's Division of Investment Management (the Division) has taken the position that a non-US issuer does not breach section 7(d) if it privately places securities with US residents in conformity with either private fund exemption (*Touche Remnant & Co, 27 August 1984; Goodwin, Procter & Hoar No 1, 28 February 1997; Goodwin, Procter & Hoar No 2, 5 October 1998; Wilmer, Cutler & Pickering and Davis Polk & Wardwell, 5 October 1998*).

Whereas a US issuer wishing to rely on either private fund exemption must ensure that all of its security holders (whether US or non-US persons) are taken into account for the relevant exemption, a non-US issuer need only take into account (subject to certain qualifications) its security holders who are US residents.

A non-US issuer which has not used US jurisdictional means (for example, the US postal service, or using the telephone or internet to contact potential US investors) to offer or sell its securities does not infringe section 7(d), whether or not the sales are to US or non-US investors (*Global Mutual Fund Survey, 14 July 1992*). Accordingly, an issuer which has never offered its securities in the US (whether publicly or privately) need not be concerned initially about infringing the ICA. But if US persons acquire the issuer's securities in the secondary market, and the issuer then wishes to include those persons in a subsequent securities offering (for example, in a rights issue), or if it otherwise decides to offer its securities in the US, then it must consider the application of the ICA.

Compliance with the private fund exemptions must be achieved both on the initial sale of an issuer's securities and on an ongoing basis. This is relatively straightforward for privately-held issuers, where transfers of securities can easily be monitored and restricted.

However, it is more complicated for publicly traded issuers. Following the initial issue of securities, they will usually be held in electronic book entry form through a clearing system, and the identity of purchasers may not be easy to monitor. It may be difficult (or even impossible or unlawful) to place meaningful restrictions on market transfers of the securities.

The Division permits a non-US issuer to ignore US persons who acquire its securities in the secondary market, provided that the acquisition takes place without the direct or indirect involvement of the non-US issuer, its affiliates, agents or intermediaries (*Investment Funds Institute of Canada, 4 March 1996*).

The positions taken by the Division also require that, if the issuer has sold securities to US persons and is relying on section 3(c)(7), any transferees of the relevant securities must also be either qualified purchasers or non-US persons. Subsequent transferees of non-US persons are not required to be qualified purchasers (even if those subsequent transferees are US persons), provided that the non-US issuer, its affiliates, agents and intermediaries have not been involved in the relevant transfer (*Investment Funds Institute of Canada, 4 March 1996; Goodwin, Proctor & Hoare No 1, 28 February 1997*).

Commonly used exemptions for non-US issuers

Exemption	Description
Section 3(b)(1)	Issuers primarily engaged in a business other than investing in securities.
Section 3(c)(1)	Private investment companies, for an issuer with no more than 100 beneficial owners of its securities who are US persons.
Section 3(c)(5)	Commercial financing and mortgage banking businesses, for issuers involved in commercial and real estate financing operations.
Section 3(c)(7)	Qualified purchaser funds, for an issuer with an unlimited number of US security holders that are "qualified purchasers" (*see box "Definition of qualified purchaser"*).
Section 3(c)(9)	Oil and gas funds.
Rule 3a-1	Issuers with no more than 45% of their assets invested in, and no more than 45% of their income derived from, investment securities.
Rule 3a-2	Transient investment companies.
Rule 3a-8	Research and development companies.

Development of market procedures

The challenge for publicly traded non-US issuers of meeting the requirements of section 3(c)(7) has led to the development of a number of different approaches tailored to specific markets.

The Division's *ABA Section of Business Law* no-action letter (*22 April 1999*) states that a reasonable belief that a security holder is a qualified purchaser must be formed by the relevant issuer itself, or a person acting on its behalf, and not (unlike Rule 144A resales under the US Securities Act of 1933, as amended (Securities Act)) by the transferor security holder. The letter further states that:

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- Procedures for resales could be developed to allow an issuer to form the requisite reasonable belief.

- Whether a particular set of procedures would be sufficient for this purpose depends on the facts of the case (so the Division would not respond to requests to assess whether any particular set of procedures is adequate).

Following publication of the *ABA* no-action letter, a group of prominent New York law firms (originally referred to as the "five firms", and now consisting of Cleary Gottlieb, Davis Polk, Shearman & Sterling, Sidley Austin, Sullivan & Cromwell and Willkie Farr) together developed a set of procedures, first published in 1999, designed to achieve section 3(c)(7) compliance for securities held in electronic book entry form through being deposited in the Depositary Trust Company (DTC) (the 1999 procedures). The 1999 procedures were updated in 2003 (the 2003 procedures) to cover securities held through Euroclear and Clearstream.

The 1999 procedures were initially developed to facilitate electronic settlement of the securities of structured finance issuers and were specifically noted not to be applicable to "classic" or "true" investment companies.

Although the 2003 procedures also claimed to be available to non-US inadvertent investment companies, as a practical matter, the equity securities of such issuers rarely settle through Euroclear or Clearstream initially but rather through the national system of the issuer's place of organisation and/or stock exchange listing. As these systems are not usually able to implement procedures for section 3(c)(7) securities similar to those of DTC, Euroclear or Clearstream, in practice, the 2003 procedures were only implemented in the debt markets (generally for structured finance issuers).

Nevertheless, elements of the 2003 procedures began to be applied by non-US investment companies with European stock exchange listings and shares held electronically through local clearing systems. These non-US issuers adopted some of the 2003 procedures in order to attract investment from a limited number of US institutional investors without requiring those persons to hold their securities in physical or other relatively illiquid forms.

Compliance with the 2003 procedures in full proved unrealistic in the equity markets, especially London, leading issuers to adopt a range of approaches which varied depending on a number of factors, including:

- The features of the relevant market on which the securities were traded.

- Other local law concerns.

- The connection of the relevant issuer to the US.

- The level of US interest in the relevant securities.

- The extent to which the issuer and its advisers could conclude that the relevant measures could satisfy the requisite reasonable belief standard.

The period from 2004 to 2007 saw a significant increase in European equity listings by investment companies (often referred to as permanent capital vehicles), many with a focus on alternative asset classes or investment strategies.

Some of these vehicles had significant US interest and connections, particularly the listing on Euronext Amsterdam of KKR Private Equity LP, AP Alternative Assets, LP, Conversus Capital, LP and NB Private Equity Partners Limited in 2006-2007 (the Amsterdam listings). The level of US interest led these issuers to adopt particularly sophisticated arrangements so that they could satisfy the section 3(c)(7) requirements as to a reasonable belief that relevant security holders were qualified purchasers.

2008 procedures/market concerns

The experience of non-US equity issuers and their advisers in attempting to find an appropriate means of implementing section 3(c)(7) procedures led to the five firms publishing a further revised set of procedures in 2008 (the 2008 procedures). These were designed specifically to apply to "true", rather than inadvertent, investment companies.

The 2008 procedures drew on the experiences of, and techniques used, in the Amsterdam listings, but did not differentiate between markets or local legal or regulatory requirements. Key elements of the 2008 procedures included:

Definition of qualified purchaser

The definition of qualified purchaser in section 2(a)(51) of the US Investment Companies Act includes four broad categories:

- Natural persons with at least $5 million in investments.

- Family companies with at least $5 million in investments.

- Trusts with trustees and settlors who are qualified purchasers.

- Companies owning and investing on a discretionary basis at least $25 million in investments.

In addition, most qualified institutional buyers are treated as qualified purchasers, as are "knowledgeable employees" who, broadly speaking, are the senior management of the relevant issuer.

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- Offering securities to US persons in minimum amounts.

- Using a gatekeeper to monitor sales by, and among, US security holders.

- Requiring US purchasers to sign a representation letter, which included their status as qualified purchasers, and covenants regarding the terms on which they may resell their securities.

- Requiring certain representations or certifications from the underwriters of the offering.

- Requiring the underwriters to institute procedures regarding their involvement in immediate secondary market trades in the issuer's securities with US persons.

- Using cautionary legends on information sources (such as Reuters or Bloomberg) which refer to the issuer.

While a useful step forward as an effort to codify best practice in evolving market techniques, the 2008 procedures also created some confusion in the market because their strict application was not possible in certain jurisdictions, and they arguably cast doubt on previous market practices regarding section 3(c)(7).

Most of the confusion and concern arose as a result of the numerous variables to be considered in determining precisely which measures may be appropriate for a particular issuer, which essentially turn on the amount of interest in the issuer in the US. Issuers with a direct connection to the US (for example, an investment company with a high profile US-based investment manager) or which are specifically structured to appeal to US investors (for example, by being structured as a partnership for US tax purposes) may require more robust procedures than an issuer without broader US market appeal, but which happens to have a limited number of US institutional investors.

In order to better understand the variables and their impact, the Association for Financial Markets in Europe (AFME) conducted a survey to ascertain the procedures put in place for compliance with section 3(c)(7) in equity offerings, covering European offerings by 25 funds and involving $27.2 billion in securities, during the period from 2005 through 2008 (*AFME Equity Capital Markets Division: Considerations for Compliance by Foreign Funds with Section 3(c)(7) of the US Investment Company Act of 1940", www.afme.eu/WorkArea/DownloadAsset.aspx?id=6984*).

2012 update

Discussions between the authors of the 2008 procedures and market participants led to the publication in 2012 of an updated commentary to address the confusion and concern in the market (the 2012 update).

While not specifically setting out new procedures, the 2012 update stressed that the market benefits of a consistent approach to the implementation of section 3(c)(7) procedures should be balanced with sufficient flexibility to tailor specific aspects of the procedures to the legal risks presented by an issuer's particular circumstances.

The 2012 update includes a non-exclusive list of the factors to be considered in determining which elements of the 2008 procedures may be appropriate. The factors identified include:

- The inherent US interest in the offering.

- The presence of the issuer (or any investment adviser) in the US.

- The proportion of offering activity directed at, and outside, the US.

- The depth of the non-US trading market for the securities.

- Structural or tax characteristics designed to encourage US investor interest.

- The level of mass or retail appeal and the availability of information beyond financial intermediaries when securities have both debt and equity characteristics.

- Whether the issuer is a "true" investment company or an inadvertent investment company.

The 2012 update also highlights the following three areas in the 2008 procedures that are most subject to debate in terms of their appropriateness for any particular transaction:

Using a gatekeeper to control transfers of securities among US persons. Using a gatekeeper is intended to assist in policing transfers of uncertificated securities through settlement systems such as Euroclear or CREST. However, it creates cost and complexity for an issuer, may cause regulatory concerns in certain markets (for example, a gatekeeper has not been used on any London listing and the regulatory implications of doing so are unclear). The use of a gatekeeper has, in the past, been limited to the Amsterdam listings.

Using an underwriters' certificate or representation to support the issuer's assessment of the likely US interest in the offering. Numerous underwriters have expressed concern about the breadth and nature of representations that have been requested. It is predominantly a fact-specific assessment and, in any transaction, the parties will need to consider who is best placed to determine likely US interest in the offering: whether it is the issuer, its investment adviser or the underwriters, and how that determination is best recorded.

Restrictions on the participation by US persons in the immediate secondary market in the issuer's securities. (Or, at least, restricting US persons who have been approached by the issuer or persons on its behalf from buying in the secondary market without adequate precautions being taken.)

Certain restrictions on secondary market trading are necessary in light of the requirement that US purchasers who have been procured by the issuer or its agents may only sell their securities to

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another known US person if that person is also a qualified purchaser. This is ordinarily dealt with by the US purchaser providing a representation letter to the issuer in which they promise to sell their securities either offshore (other than to known US persons) or to US persons who are qualified purchasers.

Difficulties arise, however, where US persons are approached as part of an offering (for instance during a roadshow) but do not buy securities directly from the issuer or the underwriters and therefore do not provide a representation letter. The secondary market restrictions are designed either to stop these persons from dealing in the shares or to require that, if they do, they provide the relevant representations. However, underwriters are concerned that such arrangements are very difficult (if not impossible) to implement without having a serious impact on the secondary market.

This requirement has usually been addressed by the issuer and the underwriters agreeing on a case-by-case basis on precautionary procedures which address the concern but can be implemented without hindering secondary market trading more generally. These have included agreeing to notify the underwriters' sales and trading desks of the relevant section 3(c)(7) restrictions or to preclude the underwriters' US broker-dealer affiliates from marketing or trading the securities to, or with, US persons for an agreed period.

Each of these areas continue to be addressed on a case-by-case basis (which is appropriate, given the importance of the surrounding facts and circumstances), although it is generally accepted that gatekeepers will not be used on London listings.

POST DODD-FRANK IMPLICATIONS

Since the publication of the 2008 procedures, the US regulatory landscape has changed considerably, particularly with the enactment of Dodd-Frank in 2010. An issuer contemplating using the section 3(c)(7) exemption must now consider a number of other consequences of doing so.

Investment Advisers Act

Dodd-Frank considerably tightened the basis on which investment advisers to private funds (defined for this purpose as investment funds which rely on the private fund exemptions) can escape registration under the IAA. Registration requires an investment adviser to be subject to SEC supervision and to comply with the substantive requirements imposed on registered advisers. This will be a concern for non-US issuers that have external advisers, including many publicly traded investment funds.

Previously, private fund advisers with fewer than 15 clients were exempt from registration. The Dodd-Frank amendments to the IAA removed this exemption and also required that, in order to determine whether registration is needed, the adviser must look to the number of underlying investors in the relevant private fund and determine whether any of those investors are US persons.

The options for non-US advisers to private funds which include US investors are now quite limited. There are two specific exemptions:

The foreign private adviser exemption. The threshold criteria for this exemption are restrictive. In order to qualify, a non-US adviser must have:

- No place of business in the US.
- Fewer than 15 clients and investors in private funds advised by the adviser resident in the US.
- Less than $25 million of assets under management attributable to such US clients and investors.

This exemption will probably not be available to a private fund unless it has a very limited number of US investors or other connections to the US.

The private fund adviser exemption for "exempt reporting advisers". To qualify, a non-US investment adviser may not:

- Have any US person as a client other than a qualifying private fund.
- Manage from a place of business in the US more than $150 million of assets, all of which must be attributable to private funds.

However, although this exemption relieves an adviser from having to register under the IAA, it must still make various filings with, and reports to, the SEC and may be subject to SEC examinations. Unless they are actively seeking to do business in the US, many non-US advisers will want to avoid this, both from a cost and a compliance perspective. It may be preferable for these advisers to attempt to ensure that the funds which they advise or manage do not rely on section 3(c)(7) and that those funds do not actively seek (or even seek to prohibit) US investors.

It is not yet entirely clear how the revised IAA regime will be applied to non-US advisers which advise publicly traded non-US issuers that rely on section 3(c)(7) or that otherwise have US investors. SEC releases indicate that, in determining who will count as a US investor for these purposes, similar considerations to the no-action positions on the private fund exemptions will apply so that US persons who have acquired securities without the involvement of the issuer or its agents need not be counted as US clients or investors in determining whether the adviser itself has a registration or reporting requirement under the IAA (*for example, SEC Final Rule: Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, 21 July 2011, www.sec.gov/rules/final/2011/ia-3222.pdf*).

Commodities Exchange Act

While not directly linked to an issuer's reliance on the private fund exemptions, changes made to the CEA by Dodd-Frank and ancillary amendments made by the US Commodities Futures Trading Commission (CFTC) to its rules may lead non-US issuers and their advisers to seek to avoid having US security holders. The changes fall into two categories:

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- A broadening of what constitutes a commodity interest (thereby triggering the application of the CEA) to include numerous types of swaps as well as futures and options.

- Limiting the availability of the exemptions available to non-US issuers and their advisers to registration with the CFTC so that registration with the CFTC and compliance with certain of its reporting requirements may be necessary.

The Volcker Rule

The Volcker Rule generally prohibits any banking entity both from proprietary trading and from owning an interest in, sponsoring, or having certain relationships with, "hedge funds" or "private equity funds", which are broadly defined as any issuer relying on one of the private fund exemptions (*section 619, Dodd-Frank*).

The US Treasury, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the SEC have proposed a joint rule (the proposed rule) to implement the Volcker Rule, which would have a broad impact beyond traditional hedge and private equity funds in that "covered funds" will include all entities relying on the private fund exemptions and not just hedge funds and private equity funds (*Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds", www.sec.gov/rules/proposed/2011/34-65545.pdf*). The proposed rule has been subject to extensive comment and may be amended before it is final.

Although a full discussion of the Volcker Rule and the proposed rule is beyond the scope of this article, issuers that seek to rely on section 3(c)(7) should be aware of the proposed rule, as it might affect their relationships with the "covered banking entities" that are subject to the Volcker Rule (regulated entities). Regulated entities will be subject to a number of restrictions under the proposed rule in relation to "covered funds". As currently drafted, a non-US issuer that would need to rely on section 3(c)(1) or section 3(c)(7) had it been organised in, or offered its securities to residents of, the US would also be considered a covered fund under the proposed rule.

Practical considerations

Issuers which are, or may be, investment companies for the purposes of the US Investment Companies Act (ICA) should consider the following:

Transfer/repurchase rights. To the extent that it is lawful and compliant with regulatory requirements, the issuer's constitutional documents should provide the ability to repurchase or force transfers of securities held by persons who may compromise the issuer's exemption from registration under the ICA or the US Commodities Exchange Act (CEA) or any external investment adviser's exemption from registration under the Investment Advisers Act (IAA) or CEA.

However, it should be noted that such rights are not alone sufficient either to prove or achieve compliance with section 3(c)(7) of the ICA. Further, London-listed issuers should note that the UK Listing Authority will only permit restrictions on the transfer or holding of listed securities where there is a clear and compelling legal or regulatory reason for doing so.

Continuing obligations. It is important to remember that compliance with the private fund exemptions is a continuing requirement and does not just apply when an issuer is raising capital. So far as possible, issuers should consider undertaking regular analysis of their security holder registers to identify possible US owners. This may be as (if not more) relevant for the purposes of the US Foreign Account Tax Compliance Act as well.

The no-action letters from the US Securities and Exchange Commission's Division of Investment Managers take some nuanced approaches as to which US investors must be taken into account for the purposes of the private fund exemptions, which rely on distinctions that can be difficult to make in practice. Further, it is not necessarily the case that the approach taken in these no-action letters will be applied consistently in respect of the other US legislation described in this article.

US marketing activity. Notwithstanding the recent changes as a result of the US Jumpstart Our Business Startups Act, issuers should take great care in undertaking any activity that may be regarded as promoting the issuer's securities to potential US investors (whether in connection with a primary issuance or through the encouragement of secondary market activity) and, as far as is possible, ensure that no-one conducts any such activity on their behalf without adequate restrictions put in place to ensure compliance with all of the relevant US legislation.

This includes US advertising, press coverage, investor (or potential investor) roadshows, and can even include limiting access to the issuer's website for US persons. Indeed, issuers may choose actively to discourage US persons from investing in their securities, for example, by specific warnings on the issuer's investor documentation, annual reports, website and/or other investor communications (*see feature article "Pre-marketing: threading the needle", this issue*).

Other exceptions to registration. Issuers that are not true investment companies should analyse whether they can structure their affairs so that they do not fall within the ICA's definition of investment company or whether they can qualify for an exemption from registration other than section 3(c)(7) or section 3(c)(1).

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The proposed rule prohibits regulated entities from owning interests in covered funds, subject to limited exemptions. Although it only limits the activities of a regulated entity and not those of an issuer relying on section 3(c)(7), it could have negative implications for section 3(c)(7) issuers, including both true investment funds and inadvertent investment companies.

For example, as drafted, the prohibition on regulated entities owning the securities of covered funds could hinder the underwriting of, and market making in, the securities of issuers relying on section 3(c)(7). Although the proposed rule excludes these activities from its proprietary trading ban, it does not extend this exclusion to the ban on ownership of covered fund shares. This could adversely affect section 3(c)(7) issuers' ability to raise capital or the liquidity of their securities. Similarly, insurance companies that are regulated entities would not be able to hold the securities of covered funds in a general account, which could limit demand for the securities of issuers relying on section 3(c)(7).

Non-US banking entities with no US operations, subsidiaries or affiliates would not be subject to the proposed rule, and its prohibitions would also not apply to certain non-US regulated entities in respect of covered funds, provided that the relevant covered fund's securities have not been offered or sold to US residents.

Section 3(c)(7) issuers may need to develop relationships with these entities for some of their capital markets requirements and may want to avoid offering their securities to US investors in order to preserve flexibility for transactions involving eligible non-US regulated entities.

THE JOBS ACT

The JOBS Act directed the SEC to amend its private offering rules under the Securities Act to permit certain publicity in private offerings made under Rule 506 of Regulation D (Rule 506) or Rule 144A under the Securities Act (Rule 144A), which provide exemptions from registration under the Securities Act in various circumstances.

The SEC proposes to amend Rule 506 to remove the prohibition on general solicitation and general advertising for Rule 506 offers and sales (provided that all purchasers are accredited investors) and amend Rule 144A to permit securities to be offered to persons other than qualified institutional buyers (provided that all purchasers are, or are reasonably believed to be, qualified institutional buyers).

These proposed amendments represent a significant change to the US private offering regulatory framework by allowing offering documents to reach the general public and not just reach the limited investor class permitted by Rule 506 or Rule 144A. Unintentional publicity will also no longer risk loss of the exemption.

However, issuers relying on section 3(c)(7) must also comply with restrictions imposed by the ICA, including those against offering securities to the public (*see "Application of exemptions" above*).

In response to concerns expressed by the private funds industry and its supporters, in the proposing release for the JOBS Act amendments, the SEC stated that it has historically treated Rule 506 transactions as non-public offerings for the purposes of section 3(c)(7) and that it believed private funds, such as hedge funds, venture capital funds and private equity funds, could continue to rely on section 3(c)(7) while engaging in general solicitation and advertising under the amended Rule 506 (*SEC proposed rule: Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 And Rule 144A Offerings, www.sec.gov/rules/proposed/2012/33-9354.pdf*).

Non-US issuers listed on non-US exchanges are, however, different from the privately offered funds that the SEC referred to in stating this belief (and often conduct offerings using exemptions other than Rule 506, such as Rule 144A). Marketing activity in the US could conceivably lead to investment activity outside the US by US persons without appropriate procedures to ensure their eligible status to invest. In light of the special concerns highlighted for these section 3(c)(7) issuers in the Division no-action letters regarding the private fund exemptions (*see "Development of market procedures" above*), publicly-listed section 3(c)(7) issuers should consider carefully whether they may take advantage of the increased flexibility offered by the proposed amendments in the absence of any further statements by the SEC.

OTHER US CONCERNS

It is worth bearing in mind that, besides the changes introduced by Dodd-Frank, non-US issuers that are investment companies must continue to monitor their status under the US Employee Retirement Income Security Act of 1974 if they have US investors.

Also, irrespective of whether or not they have US investors, non-US investment companies will need to consider their position in relation to the US Foreign Account Tax Compliance Act if they receive US source income or "pass-thru payments" from other entities, and may need to analyse their security holders to identify any US holders, irrespective of whether such persons have invested with the knowledge of the issuer (*see feature article "FATCA: sweeping international tax obligations", www.practicallaw.com/6-518-7061*).

Practical steps

In light of legal and regulatory developments in the US after Dodd-Frank, non-US issuers which are either true investment companies or inadvertent investment companies for the purposes of the ICA should think carefully before offering securities to US persons and will need to consider in detail all of the potential consequences before relying on either private fund exemption (*see box "Practical considerations"*).

If a non-US investment company determines that section 3(c)(7) provides it with the most satisfactory means of securing an exemption from ICA registra-

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ABA Section of Business Law

no-action letter, 22 April 1999	www.sec.gov/divisions/investment/noaction/1999/aba042299.pdf
2003 procedures, including 1999 procedures at Attachment L	www.shearman.com/files/Publication/3545d4bb-6f38-4bf3-9639-03759cff5fe7/Presentation/PublicationAttachment/d7f6e3ea-2a36-424f-a57e-117a0aca1eba/144A-3c7.pdf
2008 procedures	www.shearman.com/files/upload/AM_062608.pdf
2012 update	www.shearman.com/files/upload/Investment-Company-Act-Status-of-Non-US-Issuers_IF_032312.pdf

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tion, the 2008 procedures, as clarified by the 2012 update, provide a detailed description of the types of procedures currently seen in the market, as well as a discussion of the factors to consider in determining the appropriate level of procedures, so that an issuer may develop the requisite belief regarding the status of its US security holders.

However, those procedures are not exclusive, and an issuer which does not follow them precisely (or at least certain elements of them) is not otherwise prevented from establishing the requisite reasonable belief. Both the issuer's links to, and connections with (or lack thereof), the US and the nature and requirements of the market(s) in which the issuer's securities are traded will be important considerations. To date, there has been little US regulatory or judicial focus on the use of section 3(c)(7) by non-US issuers, but it is possible that this could change following the Dodd-Frank reforms, given the increased focus on, and importance of, the private fund exemptions for purposes other than the ICA.

If a non-US issuer risks falling within the definition of investment company for the purposes of the ICA, it may be prudent (especially in the case of inadvertent investment companies) to seek another exemption from registration rather than to rely on section 3(c)(7) and thereby become a covered fund for the purposes of the Volcker Rule. That said, although there are a range of other exemptions available, many are very fact-specific and do not provide the versatility and ease of use offered by section 3(c)(7).

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