Book-Entry Deposit Procedures for Certain Offerings by Non-U.S. Issuers under Section 3(c)(7) of the Investment Company Act

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Issuers relying on Section 3(c)(7) ("Section 3(c)(7)") of the Investment Company Act of 1940, as amended (the "Investment Company Act"), are frequently confronted with the question of how to ensure that they can establish the "reasonable belief"[2] that their investors are "qualified purchasers"[3] ("QPs"), as required under the Investment Company Act. U.S. issuers have to ensure that both their U.S. and non-U.S. investors are QPs, while non-U.S. issuers have to ensure that only their U.S. investors are QPs. The inquiry does not stop at the initial investor level, however, as the QP requirement extends to subsequent transferees in most circumstances. Ensuring that transferees are QPs becomes difficult for issuers when the securities issued are in book-entry form and the book-entry facilities do not monitor the qualifications of investors to ensure QP status.[4] Because issuers cannot rely on the services provided by the book-entry facilities in order to ensure that their investors are all QPs, issuers must utilize additional procedures to ensure that they have the requisite reasonable belief regarding the QP status of their investors.

An article published in 2003, "New Developments in Procedures for Book-Entry Deposit of Rule 144A Securities by 3(c)(7) Issuers[5]" (the "2003 Article"), addressed this question for both U.S. and non-U.S. issuers that are not classic investment companies ("non-fund issuers") and that issue debt securities placed in book-entry facilities (*e.g.*, The Depository Trust Company ("DTC") in the United States, or Euroclear Bank S.A./N.V. ("Euroclear") and Clearstream Banking Luxembourg ("Clearstream") in Europe). The 2003 Article described procedures (the "2003 Procedures") that provide a method for complying with the QP requirements imposed by Section 3(c)(7). The 2003

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[2] Rule 2a51-1(h) under the Investment Company Act.

[3] Section 2(a)(51)(A) of the Investment Company Act.

[4] We note that the National Securities Clearing Corporation, a subsidiary of The Depository Trust & Clearing Corporation, is proposing to establish a new "Alternative Investment Products" service as a processing platform for products offered by hedge funds, funds of hedge funds, commodity pools, managed futures and real estate investment trusts, which should provide a book-entry system for establishing the QP status of investors in these products that is not possible under existing DTC book-entry facilities. *See* SEC Release No. 34-57461 (March 10, 2008). *See* also n. 9 below.

[5] *See* "New Developments in Procedures for Book-Entry Deposit of Rule 144A Securities by 3(c)(7) Issuers," *The Investment Lawyer*, Vol. 10, No. 3, March 2003.

Article is premised on the theory that, because of the nature of the securities covered by the 2003 Procedures, there is little or no retail interest in such securities, and virtually all secondary trading in the United States in such securities will occur through broker-dealers that consult front-office systems such as Bloomberg, through which they can be alerted to the applicable trading restrictions. Since those broker-dealers will be knowledgeable about QIB[6]/QP status, once placed on notice, they can be expected to limit resales to QIB/QPs.

As mentioned above, the 2003 Procedures cover only certain types of issuers and generally apply only to debt securities. For example, classic investment companies ("fund issuers") should not rely on the 2003 Procedures. In this article, we introduce an alternative set of procedures (the "2008 Procedures") to be used for certain types of non-U.S. issuers that the 2003 Procedures did not cover, such as non-U.S. non-fund issuers of equity and non-U.S. fund issuers of debt and equity. The table below sets forth the procedures that we believe should be followed by issuers, based on the type of issuer and type of securities offered.

		Type of issuer			
		Non-fund		**Fund**	
		U.S.	**Non-U.S.**	**U.S.**	**Non-U.S.**
Type of securities offered	**Debt**	2003 Procedures[7]	2003 Procedures	N/A	2008 Procedures
	Equity	N/A[8]	2008 Procedures	N/A	2008 Procedures

The Alternative Procedures

The 2003 Procedures are not intended to be used by issuers of equity or by fund issuers. The 2003 Article explains that establishing the issuer's requisite reasonable belief for equity offerings is more difficult because equity securities are likely to have greater retail appeal and numerous pricing information sources are available to non-professional investors in equity securities. In addition, the typical pricing sources for equity securities do not include or reference the carefully articulated cautionary legends and deemed representations included in the 2003 Procedures. Also, since equity securities are often traded on a securities exchange (rather than in the inter-dealer market),

[6] "Qualified institutional buyer" ("QIB") is defined in Rule 144A under the Securities Act (as defined below).

[7] As set forth in the 2003 Procedures, we recommend that U.S. issuers not use the 2003 Procedures for offerings to non-U.S. persons absent special circumstances, such as the use of gatekeepers and purchaser letters for non-U.S. purchasers. Under the Investment Company Act, U.S. issuers are required to monitor the QP status of all their investors worldwide, and we are concerned that non-U.S. persons would generally not understand the need to comply with the deemed representations and covenants relating to the Investment Company Act.

[8] The 2003 Article indicates that the 2003 Procedures may be appropriate for equity offerings where (1) the equity securities are traded exclusively through the proprietary system of a broker-dealer that agrees to sell only to QPs, or (2) in the case of complex equity securities with limited sources of pricing information, for which traders in the secondary market would consult Bloomberg (or any other service that has 3(c)(7) legends available). *See supra* n. 5 at 5.

financial intermediaries do not directly intermediate most resales of equity securities, making it more difficult for issuers to establish the reasonable belief that transferees will be limited to QPs. Similarly, the 2003 Article carves out fund issuers on the basis that, because of regular publicity about funds (particularly hedge funds) and the potential retail appeal of funds, the risk that fund securities, if held though a book-entry depositary, would end up in the hands of a non-QP is too high and therefore the requisite reasonable belief may not be able to be established based solely on the 2003 Procedures, if at all.

Therefore, many issuers that desire to use a book-entry depositary but do not fit within the types of issuers covered by the 2003 Procedures have been left struggling to find a way to ensure that they can establish the requisite reasonable belief that all applicable investors meet the requirements of Section 3(c)(7). The 2008 Procedures are tailored to help a subset of these issuers, *but not all*. While we continue to believe that neither the 2003 Procedures nor the 2008 Procedures are suitable for U.S. fund issuers seeking to issue securities in book-entry form, non-U.S. fund issuers whose securities have their primary trading market offshore should be able to use the 2008 Procedures, so long as they follow the procedures set forth herein.[9] The 2008 Procedures likewise should be available to non-U.S. issuers of equity, again assuming that they follow the procedures set out below.

The table below outlines the 2008 Procedures. These procedures are designed for non-U.S. issuers in global offerings where securities are offered both in the United States, through private placements under Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"), and offshore, in placements under Regulation S under the Securities Act ("Regulation S"). Because the issuer is a non-U.S. entity and because a significant portion of the global offering is sold offshore under Regulation S, these securities are normally issued in book-entry form and settled through offshore book-entry facilities, such as Euroclear or Clearstream. The 2008 Procedures outlined below allow non-U.S. issuers to issue securities in book-entry form and, if desired, list them on an offshore stock exchange, while being able to comply with the exception provided under Section 3(c)(7).

[9] U.S. fund issuers could satisfy the reasonable belief standard by, for example, using a private book-entry depositary that functions as a closed system and allows only participants that meet the necessary qualifications (such as QP status). The Goldman Sachs Tradable Unregistered Equity system ("GS TrUE") and the proposed new system being developed by the National Securities Clearing Corporation (*see* note 4 above) are examples of such private closed systems that should be able to help issuers ensure that they can establish the requisite reasonable belief.

The 2008 Procedures are for use by non-U.S. issuers. Non-fund (non-U.S.) issuers of debt securities may continue to use the 2003 Procedures. Items in bold are requirements that are not present in the 2003 Procedures.

	The 2008 Procedures
Type of issuer	**The Issuer represents in the Purchase Agreement that it is a "foreign private issuer" (as defined in Rule 405 under the Securities Act). If the Issuer is a fund, it must also represent that its management team and principal operations are based outside the United States.**
Minimum amounts	The securities are either (i) denominated in amounts of at least **US$250,000** or (ii) sold to U.S. persons in minimum amounts of at least **US$250,000** per account.
Mechanics of issuance	a. Securities issued in global form to a common depositary for Euroclear / Clearstream and settled through Euroclear / Clearstream **(DTC not permitted)**. **b. A Custodian is appointed to act as gatekeeper with respect to the U.S. portion of the offering; the Custodian keeps the entire Euroclear / Clearstream position with regard to the U.S. purchasers in its name and will effect transfers of beneficial interests on its books only upon receipt of the requisite certifications.** **c. Custody Agreement:** (i) **Entered into at the closing of the offering.** (ii) **Between the Issuer and the Custodian, for the benefit of U.S. purchasers of securities held in custody.** (iii) **The Custodian passes through all rights and benefits of ownership of the securities (subject to the limitations on transfers described below).**
Initial distribution	**a. Each initial U.S. purchaser signs a representation letter.** **b. Securities sold to U.S. purchasers are held by, and registered in the name, or credited to the account of, the Custodian.**
Representation letter	The U.S. purchaser representation letter contains: a. Representation as to QIB/QP status; b. Agreement to resell only: (i) in an "offshore transaction"[(a)] under Regulation S; or (ii) to a U.S. person who is a QIB/QP; **c. Agreement to deliver to the Custodian prior to settlement of any transfer of securities, either:** (i) **if the resale is an offshore transaction, an exit letter signed by the transferor stating that the security was sold in an offshore transaction, or** (ii) **if the resale is not an offshore transaction, a representation letter signed by the transferee that is**

	The 2008 Procedures
	similar to the representation letter from the initial purchaser; **d. Agreement to notify on any resale the executing broker (and any other agent of the transferor involved in selling the securities) of the restrictions that are applicable to securities being sold and to require the broker (and such other agent) to abide by such restrictions;** e. Acknowledgement of Issuer's right to force resale or redemption of the securities if a purchaser or transferee violates these representations; and f. Agreement to transfer in amounts of at least US$250,000 when transferring to a known U.S. person (see "Subsequent transfers" below).
Percentage of offering in the United States	**Generally, less than 45% of the offering may be sold to U.S. purchasers (although a higher percentage may be feasible in certain circumstances[(b)]).**
Underwriters' certificate	The underwriters[(c)] sign a certificate addressed to the Issuer (and authorizing Issuer's counsel and underwriters' counsel to rely) stating that: a. **With respect to any sales to U.S. persons in the initial placement (and for 40 days following the closing), the underwriters will:** **(i) sell only to QIB/QPs that sign a representation letter, and** **(ii) deliver such representation letters to the Issuer at the closing of the offering (and at the expiration of the 40-day period);** **b. The principal trading market[(d)] for the Issuer's securities will be offshore, the percentage limitation on sales to U.S. purchasers has been complied with, and the underwriters expect that a significant amount of the trading activity on the primary secondary market will involve non-U.S. persons (and the underwriters may base such expectation on the percentage of the offering in the United States discussed above).[(e)]** **c. The underwriters have instituted, and have notified the dealers participating in the offering to institute, procedures to prevent themselves from being involved at the time of the initial placement and at any time during the 40-day period following the closing in purchases of the securities by U.S. persons that are not QPs (including purchases through the non-U.S. stock exchange); and** d. Securities will be sold to U.S. purchasers in minimum amounts of at least US$250,000.

	The 2008 Procedures
Subsequent transfers	Subsequent transfer by a U.S. person: a. Sale to a known U.S. person (through a non-U.S. stock exchange or elsewhere): (i) **The transferee delivers a representation letter (similar to the representation letter from the initial purchaser) to the Custodian.** (ii) **The securities sold to the transferee continue to be held by the Custodian, who records the transfer on its books.** (iii) Minimum sale amount of US$250,000 per account. b. Sale to a non-U.S. person or an "unknown person": (i) Sale must be an offshore transaction under Regulation S, not pre-arranged with a U.S. person (*e.g.*, regular way sale through the non-U.S. stock exchange, not involving underwritten offering or block trade). (ii) **The transferor delivers an exit letter to the Custodian that states that it is selling in an offshore transaction.** (iii) The transfer of securities is settled through Euroclear/ Clearstream.(f) c. No other transfers permitted.
Transfer restrictions	The offering memorandum contains a description of the transfer restrictions.
Information sources (Bloomberg, Reuters, Telekurs)	The Issuer and the underwriters have to ensure that the screens of *each* service that is expected to be an important source contains all the Section 3(c)(7) legends that are available for such service.
Tax considerations	Potential disadvantageous treatment for U.S. persons on the sale or disposition of equity securities of a non-U.S. issuer that is a PFIC for U.S. federal income tax purposes. U.S. persons should consult their tax advisors.

(a) "Offshore transaction" is defined in Rule 902(h) under the Securities Act as an offer or sale of securities where the offer is not made to a person in the United States and either (i) at the time of the buy order the buyer is outside the United States (or the seller reasonably believes that the buyer is outside the United States) or (ii) the transaction is executed through either (a) for purposes of Rule 903, a physical trading floor of an established foreign securities exchange located outside the United States or (b) for purposes of Rule 904, the facilities of a designated offshore securities market (as defined in Rule 902(b) under the Securities Act) and neither the seller nor anyone acting on its behalf knows that the sale has been pre-arranged with a buyer in the United States.

(b) This may be the case, for example, where the primary trading market is offshore, a significant amount of the secondary trading is expected to involve non-U.S. persons (*see* note (e) below) and, due to prior offerings, upon completion of the offering, the amount of the issuer's securities held by U.S. persons will be significantly lower than 45% of the aggregate number of outstanding securities of the issuer.

(c) The term generally used in private offerings under Rule 144A is "initial purchasers," however, in order to avoid any confusion, in this article we will refer to these parties as the "underwriters."

(d) "Primary trading market" is defined in Rule 12h-6 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). For purposes of the 2008 Procedures, this requirement is satisfied whether the "market" includes one or multiple non-U.S. jurisdictions.

(e) Note that if the securities are listed on an offshore exchange, the underwriters should be able to represent that the primary trading market is offshore.

The requirement that there be an expectation that a "significant" amount of secondary trading involve non-U.S. persons is intended to permit the issuer to rely on the *Goodwin Procter* no-action letter which states that a U.S. person that purchases securities in an offshore secondary market transaction not "involving" the issuer (or its agents, affiliates or intermediaries) need not be a QP. *See Goodwin Procter & Hoar*, SEC No-Action Letter (Feb. 28, 1997) *("Goodwin Procter")* (citing *Investment Funds Institute of Canada*, SEC No-Action Letter (Mar. 4, 1996) *("IFIC")*). Unless, at the time of issuance, an issuer reasonably expects that a "significant" amount of secondary trading will involve non-U.S. persons, we think it may be difficult to conclude that (i) secondary market purchases by U.S. purchasers occurred without the direct or indirect involvement of the issuer, as required by the *IFIC* and *Goodwin Procter* no-action letters, or (ii) in light of the substantial likelihood that a significant percentage of the purchasers in the secondary market would be U.S. persons, such sales would constitute legitimate offshore transactions of the type contemplated by the *IFIC* no-action letter. If the requirements of the *Goodwin Procter* or *IFIC* no-action letters are not met, the issuer will need to police every secondary transaction to ensure that unqualified U.S. persons are not acquiring its securities.

The definition of "significant" may depend on the particular transaction and issuer. Relevant factors may include, for example, prior offshore offerings listed offshore, where the size of such prior offerings in the aggregate, is substantially larger than the size of the current offering; the amount of U.S. ownership of the issuer that exists before the offering; the percentage of the issuer's securities that are part of the current offering; U.S. interest in the issuer generally; the number of U.S. purchasers and the percentage of the offering sold into the United States. Because Regulation S under the Securities Act, like the "significant" requirement described above, uses the locus of trading activity to determine the extent of U.S. regulation, it is worth noting that Rule 902(j)(1) of Regulation S states that "substantial U.S. market interest" in a security exists (and the offering of the security is then subject to heightened regulation) when 20% or more of the trading in such security takes place in the United States and less than 55% of the trading takes place in a single country other than the United States. For similar purposes, Rule 12h-6 under the Exchange Act describes the "primary trading market" of a security to be the jurisdiction in which 55% or more of the trading in such security takes place.

(f) The Custodian delivers the securities through Euroclear/ Clearstream.

In designing actual procedures to establish the requisite reasonable belief, circumstances may permit variations from the 2008 Procedures. These variations, and particularly the removal of the gatekeeper requirement, might be based on an extremely limited number of investors in the United States and/or both a robust trading market outside the United States and the placement of only a limited portion of the offering within the United States.[10] Other circumstances may require more strict limitations on placements in the United States and transfers by US holders.[11]

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[10] In certain instances, it may be appropriate to consider the offshore public float of the issuer's securities and, therefore, to require that the number of securities sold in the United States (including any prior offerings by the issuer to U.S. purchasers) represent a very limited portion of the sum of the current global offering and any prior offerings by such issuer (excluding any purchases by principals of the issuer who may be deemed to be non-U.S. purchasers). *See also* note (b) to the table above. Other factors that may be relevant where an issuer is using a variation of the 2008 Procedures are discussed in note (e) to the table above.

[11] A variation of the 2008 Procedures was used, for example, in an offering of common units and restricted depositary units, where initial U.S. investors purchasing securities in the 144A tranche of the offering were issued certificated securities in the form of restricted depositary receipts. The offering imposed an additional requirement that no U.S. person other than a QP could acquire securities of the issuer at any time (including in secondary offshore transactions). These additional precautions may be more appropriate where the business operations of the non-U.S. fund's manager are located in the United States or the majority of the issuer's securities are sold to U.S. persons. The 2008 Procedures present the advantage that no certificated securities are required to be issued, but the custodian, in its role as gatekeeper, keeps track of all purchases and transfers by U.S. investors on its books, while simultaneously keeping the securities beneficially owned by such U.S. investors in its name with the applicable offshore book-entry depositary (*See* (…continued)

Conclusion

The 2008 Procedures are designed to help certain non-U.S. issuers relying on the Section 3(c)(7) exception, for whom the 2003 Procedures are not available, to access the U.S. capital markets. We believe that, by using these alternative procedures in offerings of securities that have their primary trading market offshore and where the securities are held through non-U.S. book-entry depositaries, non-U.S. issuers can establish the reasonable belief that their U.S. investors meet the QP requirements of Section 3(c)(7) of the Investment Company Act.

(continued…)

"Subsequent transfers" in the table above). Also, so long as U.S. persons holding securities through the custodian do not transfer such securities in secondary market transactions that are pre-arranged with another U.S. person (as such term is used in Regulation S), the 2008 Procedures do not require the imposition of restrictions on U.S. persons in secondary market transactions (not involving the issuer, its affiliates or agents) in reliance on the *Goodwin Procter* no-action letter (as discussed in the notes to the table above).