Private Offerings to U.S. Investors by Non-U.S. Investment Funds: A Post Dodd-Frank Update

As globalization of the private equity and hedge fund marketplace continues, more and more non-U.S. fund managers look to the U.S. markets for investors. But the U.S. regulatory landscape surrounding investment funds is evolving rapidly, including as a result of implementation of the Dodd-Frank Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). This alert outlines what we see as some of the principal regulatory considerations for a non-U.S. fund sponsor assessing the merits of conducting a private offering of interests in a non-U.S. fund to investors in the United States (a “U.S. Offering”).

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Securities Law Compliance

Any U.S. Offering must be conducted in compliance with applicable U.S. securities laws, including the U.S. Securities Act of 1933, as amended (the “Securities Act”), the U.S. Securities Exchange Act of 1934, as amended (the “Exchange Act”), the U.S. Investment Company Act of 1940, as amended (the “Investment Company Act”), and the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”). As will be described below, certain of these statutes and the rules under them were changed dramatically by the Dodd-Frank Act.

U.S. Securities Act

As a general rule, an issuer that offers or sells its securities in the United States must register the offering of those securities under Section 5 of the Securities Act or must qualify for an exemption from such requirement. The registration exemptions potentially available to an issuer include the exemption for non-public offerings made pursuant to Section 4(2) of the Securities Act. Investment funds seeking to rely on this exemption typically will seek to ensure that they have complied with the non-public offering requirement by satisfying the conditions of a “safe harbor” contained in Rule 506 of Regulation D under the Securities Act (“Regulation D”). If an issuer satisfies the conditions of the Rule 506 safe harbor, its offering will be deemed non-public and exempt from the Securities Act’s registration requirements.

The Rule 506 safe harbor permits an issuer to sell its securities only to persons who are “accredited investors”.1 “Accredited investors” are defined in Rule 501(a) of Regulation D, and generally include among others:

- Natural persons who, either individually or jointly with their spouse, have a net worth, exclusive of their primary residence, in excess of $1 million,2 or who have had an annual income in excess of $200,000 (or $300,000 when combined with their spouse’s income) in each of the last two years and have a reasonable expectation of reaching the same income level in the current year; and
- Entities that have total assets in excess of $5 million.

In addition to its investor-qualification criteria, Rule 506 limits the manner in which an issuer can offer its securities to potential investors (prohibiting any form of “general solicitation or general advertising”). We further discuss limits on publicity later in this alert.

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1 Technically, Rule 506 also permits sales to a small number of non-accredited investors. But most investment funds forego any sales to non-accredited investors, as those sales can trigger onerous disclosure requirements under Regulation D.

2 Prior to the Dodd-Frank Act, the value of the primary residence was not excluded. SEC rules regarding, for example, the treatment of mortgage debt when calculating net worth are also under consideration. See Private Placement Update: SEC Proposes Changes to the Net Worth Standard for Determining Accredited Investor Status, Feb. 10, 2011, available at http://www.shearman.com/private-placement-update--see-proposes-changes-to-the-net-worth-standard-for-determining-accredited-investor-status-02-10-2011/.
The rules that govern Regulation D offerings also require that an issuer file with the U.S. Securities and Exchange Commission (“SEC”) an online, publicly available notice on Form D no later than 15 days after the date of the first sale of securities in the applicable offering. Filing a copy of Form D, together with any applicable (i) consent to service, (ii) fee, and/or (iii) other form prescribed by the U.S. states into which fund interests are sold, also has the effect of preempting applicable state securities registration laws.

U.S. Exchange Act

Pursuant to Section 12(g)(1) of and Rule 12g-1 under the Exchange Act, an issuer generally must register a class of its equity securities with the SEC if the issuer had total assets in excess of $10 million at the end of its most recent fiscal year and such class of securities is held of record by 500 or more persons. Rule 12g3-2(a) provides an exemption from such registration requirement for a class of securities issued by certain non-U.S. issuers if the securities are held of record by fewer than 300 persons resident in the United States (subject to certain counting “look-throughs” where an intermediary may be acting as a record holder on behalf of one or more U.S.-resident beneficial owners). Many—though not all—non-U.S. private funds are eligible to rely on this exemption.

The anti-fraud and market manipulation provisions of the Exchange Act apply to issuers regardless of whether their securities are exempt from registration under the Exchange Act.

U.S. Investment Company Act

Under the Investment Company Act, an “investment company” includes, among others, any issuer that is, or holds itself out as being, engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities. On its face, most investment funds fall within this definition and, as such, could be subject to registration with the SEC as an investment company under the Investment Company Act. There are, however, a number of statutory exclusions from this definition, two of which are particularly relevant to investment funds and are known as the “private investment company” exclusions.

The first of the “private investment company” exclusions is set forth in Section 3(c)(1) of the Investment Company Act, which generally excludes from the definition of “investment company” any issuer that has no more than 100 beneficial owners of its

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3 Form D provides the SEC and the public with certain basic information relating to the issuer and the applicable offering. The Form must be amended from time to time in accordance with its instructions. The U.S. Financial Industry Regulatory Authority (FINRA, previously known as the National Association of Securities Dealers or NASD) also proposes to require a separate filing to be made with FINRA disclosing certain information about the offering and use of proceeds in the case of private placements sold other than to institutional investors. The filing would be required only when a FINRA member broker-dealer participates in the offering and would be made by the FINRA member. See Private Placement Update: Electronic Filing of Form D, Jan. 26, 2009, available at http://www.shearman.com/cm012609/.

securities and that is not making, or proposing to make, any public offering of its securities. Under this exclusion, beneficial ownership is broadly defined and various counting “look-throughs” may apply, including in respect of certain types of investors that own 10 percent or more of the issuer’s outstanding voting securities. Notably for non-U.S. funds, the SEC staff historically has taken the view that non-U.S. funds seeking to rely on Section 3(c)(1) need not count non-U.S.-resident beneficial owners of their securities toward Section 3(c)(1)’s beneficial-ownership limitation. The SEC staff historically has also taken the view that Section 3(c)(1)’s prohibition against public offerings within the United States (and, thus, a non-U.S. fund seeking to rely on Section 3(c)(1) might simultaneously conduct a public offering of its securities outside the United States).

A fund alternatively may qualify for the other “private investment company” exclusion, namely Section 3(c)(7) of the Investment Company Act. Section 3(c)(7) of the Investment Company Act generally excludes from the definition of “investment company” any issuer whose securities are beneficially owned solely by persons that, at the time of acquiring such securities, are “qualified purchasers”, and that is not making, or proposing to make, any public offering of its securities. “Qualified purchasers” are defined in Section 2(a)(51) of the Investment Company Act, and generally include among others:

- Natural persons who own not less than $5 million in “investments” (as defined in the rules under the Investment Company Act);
- Entities that own not less than $25 million in investments; and
- Persons investing solely on behalf of qualified purchasers.

As with Section 3(c)(1), the SEC staff historically has taken the views the (i) non-U.S. funds seeking to rely on Section 3(c)(7) need not qualify non-U.S.-resident beneficial owners of their securities as qualified purchasers, and (ii) Section 3(c)(7)’s prohibition against public offerings of securities applies only in respect of public offerings within the United States (and, thus, a non-U.S. fund seeking to rely on Section 3(c)(7) might simultaneously conduct a public offering of its securities outside the United States).

U.S. Advisers Act

An “investment adviser”, for U.S. law purposes, is a person who is engaged in the business of providing advice, making recommendations, issuing reports or furnishing analyses of securities either directly or through publications for compensation. Absent an exemption, this would require nearly all investment fund advisers with U.S. investors to register as investment advisers under the Advisers Act.

Although now substantially revoked by the Dodd-Frank Act, for many years fund sponsors sought to qualify for the “private investment adviser” or “14-or-fewer clients” exemption from registration under the Advisers Act, which was available to advisers who during the preceding 12 months: (i) had fewer than 15 clients; (ii) did not hold themselves out to the public as an investment adviser; and (iii) did not advise any U.S. registered investment companies.5 That exemption was especially

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5 Investment Advisers Act of 1940 § 203(b)(3) (pre Dodd-Frank Act).
attractive to non-U.S. fund sponsors because non-U.S. clients typically were not counted and an investment fund typically
was counted as a single client for these purposes (even though a particular fund might have hundreds of investors). With the
passage of the Dodd-Frank Act, this exemption is slated to expire in July 2011, although the SEC in its final rules released on
June 22, 2011 provided that any adviser operating in reliance on the counting-clients exemption may delay registering with
the SEC until March 30, 2012.6 Because the SEC is entitled to a 45-day period to review an adviser’s registration filing before
acting on it, firms registering with March 30 in mind effectively will need to submit their filings by February 14, 2012.

The general thrust of the Dodd-Frank Act’s investment adviser reforms was to tighten oversight of investment fund
managers. But Congress also established limited new investment adviser exemptions for so-called “foreign private advisers”
and for two group of firms that the SEC plans to collectively call “exempt reporting advisers” – these latter two groups being
firms that manage either (i) solely “private funds” subject to an assets under management (AUM) ceiling7 or (ii) solely
venture capital funds. On June 22, 2011, the SEC released final rules to give shape to the new exemptions.8

“Foreign private adviser” exemption

The Dodd-Frank Act provides for a narrow exemption for what it calls “foreign private advisers”. If a non-U.S. fund manager
qualifies, then it will be fully exempt from registration with the SEC (and unlike the “exempt reporting advisers” discussed
below, it will have no record-keeping or reporting requirements under the Advisers Act).

In order to qualify for this exemption, an investment adviser must satisfy all of the following criteria:

- Have no place of business in the United States;
- Have in total fewer than 15 U.S. clients and U.S. investors in private funds advised by the investment adviser;

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6 The reprieve represented by this March 2012 date was not a surprise, as it had been signaled for some time. See, e.g., letter from SEC official, available at
http://www.sec.gov/rules/proposed/2010/ia-3110-letter-to-nasaa.pdf. For a public policy rationale for the extension, you may wish to refer to Shearman & Sterling’s letter to

7 For purposes of the Dodd-Frank Act’s references to “private funds”, a private fund is understood to be any investment fund relying on one of
two exemptions from regulation under the Investment Company Act – those being the Sections 3(c)(1) and 3(c)(7) exemptions described
above. A non-U.S. fund with no U.S. investors and that has not made a U.S. offering typically would not be considered to be operating in
reliance on Sections 3(c)(1) or 3(c)(7) and would not be a “private fund” under the provisions of the Dodd-Frank Act. This is an important
definition to bear in mind for purposes of both the new investment adviser registration and reporting rules and the Volcker Rule. The SEC
further clarified that an adviser to a fund that is exempt from registration as an investment company pursuant to Section 3(c)(1) or 3(c)(7) of
the Investment Company Act would not lose the right to rely on the private fund adviser exemption just because the fund also qualifies for
another exclusion from investment company registration. For example, a fund that as a precaution relies on Sections 3(c)(1) or 3(c)(7), but in
fact also qualifies as an exempt real estate fund under Section 3(c)(5)(C) of the Investment Company Act, could still be a “private fund” for
purposes of the private adviser exemption. The adviser must, however, treat the fund as a private fund for all purposes, including Form ADV
reporting.

Office Release) Shearman & Sterling also prepared a detailed summary of these final rules, available at http://www.shearman.com/dodd-
frank-act-rulemaking-sec-finalizes-exemptions-and-disclosure-requirements-for-investment-advisers-and-sets-compliance-for-early-2012-
07-12-2011/
• Have aggregate AUM attributable to these U.S. clients and U.S. investors in private funds advised by the adviser of less than $25 million⁹;

• Not hold itself out generally to the public in the United States as an investment adviser; and

• Not act as an investment adviser to any U.S. registered investment companies or U.S. business development company.

The new “foreign private adviser” exemption is much more limited than the existing “14-or-fewer clients” exemption. Notably, it requires that a fund manager look through its funds and count the U.S. investors in those funds when determining whether the threshold of “15 clients and investors” has been reached. Even very limited U.S. connections – such as advising a non-U.S. fund with either 15 or more U.S. investors or $25 million or more in U.S. client investments – therefore will be enough to render the exemption unavailable. By contrast, under the “14-or-fewer clients” exemption, “look-throughs” were not required.

Advisers that wish to rely on the “foreign private adviser” exemption also must take caution with respect to the requirement that the firm not “hold itself out” generally to the investment public in the United States. The SEC has interpreted the term “holding out” to include:

• Listing in a directory as an investment adviser;

• Including references to investment advisory services in stationery or business cards;

• Providing information about advisory services on unrestricted websites; and

• Letting it be known generally that the adviser will provide investment services or will accept new advisory clients.

“Exempt reporting advisers” – solely managing private funds (and a broad “out” for non-U.S. firms)

One of the two new categories of “exempt reporting advisers” covers any investment adviser that both (i) advises solely private funds; and (ii) in the aggregate, manages less than $150 million in private fund assets at a place of business in the United States. Such an adviser will be able to take advantage of this AUM-based exemption regardless of the number of funds that it manages. The other side of this coin, at least for U.S. firms, is that if an adviser has even a single client that is not a private fund (such as a “separate account”), the exemption will be suddenly unavailable. The $150 million threshold is to be calculated annually and would take account of both contributions and redemptions of investor capital, as well as appreciation and depreciation in value of fund investments.

There are significant differences with respect to how U.S. and non-U.S. advisers are treated, to the benefit of non-U.S. firms. When calculating whether the $150 million threshold has been reached, a U.S. adviser must include all assets of all private funds that it manages. By contrast, a non-U.S. adviser may omit from the calculation any accounts and investment funds managed at a place outside of the United States, irrespective of the amount of fund investments by U.S. persons. As such, for non-U.S. advisers, it is the location where the adviser’s investment decisions are made, and not where the fund is organized.

⁹ The rules provide for no buffer or cure period, so that if, for example, a $20 million investment with a firm that is attributable to a U.S. person were to grow to more than $25 million as a result of capital appreciation, currency exchange rate fluctuations or other reasons, the firm could – quite suddenly – lose its eligibility to remain exempt as a foreign private adviser.
or its source of investment, that is central to the $150 million threshold. Also to the benefit of non-U.S. advisers, while a single non-fund client (e.g., a single “separate account” client) will disqualify a U.S. firm from this exemption, a non-U.S. adviser may continue to advise non-U.S., non-fund clients. Therefore, many non-U.S. fund managers with no management activities in the United States and no U.S. “separate account” clients ultimately will find that they are exempt from registration (albeit subject to reporting and recordkeeping requirements, as described below).

“Exempt reporting advisers” – solely managing venture capital funds

The second category of “exempt reporting advisers” relates to managers solely of venture capital funds. Under the proposed rules for this exemption, a “venture capital fund” would be defined as a private fund that satisfies all of the following requirements:

- Holds no more than 20% of the fund’s capital commitments in “non-qualifying investments” (other than short-term holdings), with “qualifying investments” generally consisting of equity securities of “qualifying portfolio companies” that are generally directly acquired by the fund (and not on the secondary market);
- Is generally not leveraged (other than limited short-term borrowing), excluding certain guarantees of qualifying portfolio company obligations by the fund;10
- Does not offer investors redemption or other similar liquidity rights except in extraordinary circumstances;
- Represents to its investors and prospective investors that it carries out a venture capital strategy and
- Is not registered under the Investment Company Act and has not elected to be treated as a business development company.

This definition can be limiting relative to a number of common venture capital fund structures so that some venture capital firms could find themselves outside of the definition of a term they have long used to describe their business. It is also clear that traditional private equity funds should not expect to be able to rely upon this exemption. Moreover, no beneficial interpretation of this exemption has been offered by the SEC for non-U.S. firms, unlike the private fund manager exemption just discussed.

A venture capital fund manager relying on this exemption still will be subject to reporting and recordkeeping requirements, as discussed below.

“Exempt reporting advisers” – exempt yes, but still reporting

Assuming qualification under one of the two exemptions just described, an “exempt reporting adviser” will not be required to register with the SEC, but would file a short-form version of the same registration form used by SEC-registered advisers (Form ADV) and would do so in the same public format, with all filed information to be available online. Information to be filed with the SEC about the exempt reporting adviser and its advisory business would include the following: (i) basic

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10 A venture capital fund would not be permitted to “borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the private fund’s aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days.”
identifying information about the adviser, (ii) the identity of the adviser’s direct and indirect owners and its control persons (for this purpose, directors, certain officers, and similar personnel), (iii) financial industry affiliations, (iv) other business activities in which the adviser and its affiliates engage, and (v) disciplinary history of the adviser and its employees that may reflect on the firm’s integrity.

An “exempt reporting adviser” will also be subject to the new fund-by-fund Form ADV disclosures described below. Finally, an “exempt reporting adviser” will be subject to as yet unspecified recordkeeping requirements.

New Reporting Rules for Investment Advisers

Fund-by-fund reporting on Form ADV

All advisers to private funds that use Form ADV (that is, fully registered advisers and exempt reporting advisers) will be subject to new fund-by-fund public reporting. The following non-exhaustive list provides a sense of the breadth of the disclosures that the SEC decided to include on Form ADV regarding each private fund that an adviser manages:

- Name and place of formation of the fund;
- Name of the directors, general partner, or managing member of the fund;
- Details about master funds and feeder funds (whether or not the feeder is affiliated);
- Whether the fund invests more than 10% of its assets in other funds;
- The exclusion from the Investment Company Act on which the fund relies;
- Whether the fund invests at all in funds registered under the Investment Company Act;
- Type of fund,11 (which the SEC’s Implementing Release refers to as “investment strategy”);
- The gross asset value;
- Minimum subscription amount required for non-affiliated entities;
- Number of beneficial owners and the percentage of the fund owned by non-U.S. persons, funds-of-funds, the adviser and its related persons;
- Identities of any other investment advisers or sub-advisers to the fund;
- The fund’s Form D file number (for any fund relying on Regulation D under the Securities Act);
- Auditor information and whether the fund’s financial statements are audited and prepared in accordance with U.S. GAAP;

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11 The adviser would indicate whether the fund is a hedge fund, liquidity fund, private equity fund, real estate fund, securitized asset fund, venture capital fund, or “other” (with a description of such “other” type of fund).
• Identifying information about the fund’s prime broker, custodian and administrator, and whether any of these service providers are related to the adviser; and

• Percentage of the private fund’s assets that were valued by a non-affiliate during the last fiscal year.12

An investment adviser having its principal office and place of business outside the United States would not be required to report with respect to a private fund that is not a “U.S. person” (as defined in Regulation S) and that is not offered to, or beneficially owned by, U.S. persons. Moreover, a non-U.S. fund that has not utilized U.S. jurisdictional means while offering its securities would not be a “private fund”, at least for these reporting purposes. As such, for purposes of the private fund disclosure requirements, it would seem that a fund that makes a valid offering pursuant to Regulation S of the Securities Act and no corresponding U.S. offering would not be considered a private fund, regardless of whether it comes to have U.S. persons as its beneficial owners. For some non-U.S. firms, the new reporting requirements therefore may operate as an incentive to closely control which of their sponsored funds are marketed to U.S. persons.

Form PF

The Dodd-Frank Act directed the SEC to require that SEC-registered investment advisers to private funds maintain records, and file reports, containing information “necessary and appropriate for the assessment of systemic risk” by the newly-organized Financial Stability Oversight Council (FSOC). The FSOC is a joint body of the primary U.S. financial services regulators.

On January 26, 2011, the SEC and the U.S. Commodity Futures Trading Commission unveiled a package of proposed rules in response to that Congressional systemic risk mandate.13 If adopted as is, the two regulators would require SEC-registered advisers to file reports on a new Form PF that are:

• Broad-based in scope, providing for over 60 different high-level categories of reported information and literally hundreds of sub-categories of information – with the most detailed reporting proposed for fund managers with more than $1 billion in AUM;

• Intrusive, in that the reports will collect information that firms view as highly sensitive and proprietary (listing, for example, a fund’s lenders and derivative counterparties by name and exposure); and

• Administratively demanding, in that the reports will be both complex and prepared on an essentially “real-time” basis, quarterly with only a 15-day lag (or annually for smaller managers).

Importantly, Form PF will not be required of any firm falling within one of the new categories of exempt reporting advisers discussed above. A non-U.S. fund manager, even if registered with the SEC and so nominally subject to Form PF, also need

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12 For purposes of this disclosure requirement, an entity should be viewed as valuing an asset if the valuation procedure was carried out for purposes of subscriptions, redemptions, distributions or fee calculations.

not report on any private fund it manages that during the last fiscal year was itself not a U.S. person and that was neither offered to, nor beneficially owned by, any U.S. persons. As with new Form ADV reporting, this carve-out could result in a non-U.S. manager choosing to limit the availability of some of its funds to U.S. investors.

**Bank-Related Fund Sponsors and the Volcker Rule**

Among the more publicized provisions of the Dodd-Frank Act is the so-called Volcker Rule, which generally prohibits covered “banking entities” from engaging in proprietary trading and from investing in or sponsoring hedge funds or private equity funds. The Volcker Rule has been criticized as both over-reaching in curbing legitimate financial industry activities and not going far enough in its prescriptions.14

Although a detailed analysis of the Volcker Rule is outside the scope of this alert, it is worth noting the following basic areas of interest to bank-related fund sponsors:

- The Volcker Rule generally applies to banking groups (including any bank or non-bank subsidiary in the group) operating through a branch or bank subsidiary in the United States. In practice, it captures virtually every major commercial and investment bank worldwide;
- The Volcker Rule’s prohibitions affect every office and affiliate of U.S.-based institutions, so there is no possibility for a U.S. institution to shift business abroad to avoid the prohibitions;
- The prohibitions on sponsoring and investing in hedge funds and private equity funds are subject to a number of exceptions and technical fine points. For example, a banking entity is not prevented from “advising” a fund that it does not “sponsor”; and
- The Volcker Rule restricts many transactions and relationships between a banking entity and any hedge fund or private equity fund with respect to which the entity serves as fund manager, adviser, and/or sponsor.

The non-U.S. banking community is closely watching an exemption granted by Congress for non-U.S. bank involvement in non-U.S. hedge and private equity funds that are not offered for sale or sold to a U.S. resident. But nothing has been published by federal regulators at the date of writing that further clarifies how this exemption will operate. The treatment of non-U.S. bank activities that relate to funds marketed solely outside the United States, when operated along side funds marketed into the United States, is especially ambiguous.

The Volcker Rule is to be implemented over a multi-year period so as to allow banks to conform or divest existing activities that it makes impermissible. That said, it generally appears that organizing new bank-sponsored funds that would be prohibited by the Volcker Rule will not be an option after July 2012.

State Securities Laws

In addition to the U.S. federal securities laws listed above, a fund may have to comply with selected state securities laws (or “Blue Sky” laws) which could require notice filings and corresponding filing fees with state authorities depending on the jurisdictions in which the sales of interests are made (usually the states of the U.S. investors’ principal place of business or residence).

Publicity

Under the U.S. securities laws, if a non-U.S. investment fund expects to have any U.S. investors, it is important to avoid engaging in a “general solicitation” or “general advertising” in the United States prior to and during fundraising. This means that a fund and its agents (which includes all management, personnel, placement agents, attorneys, accountants and other representatives) should be careful during this period not to make statements to the general public (individually or taken as a whole) with regard to an investment in a fund. If a fund or its agents make statements that could be viewed as a “general advertising” or “general solicitation”, the SEC could impose a “cooling-off period” with respect to U.S. investors (typically a cessation of all fundraising and a moratorium on fund closings for a period of up to 30 days or more, depending on the nature and extent of the publicity). Such a “general solicitation” could also trigger registration of the fund sponsor or the fund under the Advisers Act or the Investment Company Act, respectively, and limit a law firm’s ability to issue a “clean” private placement opinion were such an opinion to be requested by a U.S. investor or placement agent.

Examples of publicity that is prohibited in a private placement include:

- Advertisements, articles, notices or other communications published in any newspaper, magazine, publicly available website, or similar media or broadcast over television or radio; and
- Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

Therefore, it is important that the fund and its agents strictly avoid statements: (i) to reporters (including for trade journals serving the investment fund industry); (ii) on the sponsor’s website (unless access is restricted to only accredited investors, and including any articles about the fund written by others); and (iii) at investor or industry conferences, regarding the following:

- The fund (either by name or otherwise), the fact that the sponsor is raising a fund, any of the terms of the fund or securities (including target size, target investments, or capital needs), or any other sources of capital;
- Any placement agent for the fund or the types of investors being targeted; and
- The sponsor’s “track record” (investment returns, IRRs, percentage of returned capital, profits, etc.).

Note, however, that the following kinds of statements are generally permissible by SEC-registered investment advisers (unregistered investment advisers, including exempt reporting advisers, should refrain from making any public statements):

- Statements regarding the sponsor generally, including its investment program, philosophy, investment strategy, etc.;
- Discussions of individual investments sold, owned or being pursued by the sponsor (subject to the restrictions on discussing “track records” above); and
- Descriptions of the investment team, including references to specific individuals and their experience (but not “track record”).

Similar restrictions on general solicitations may be imposed by individual U.S. states and non-U.S. jurisdictions. Therefore, a fund sponsor should always consult local counsel prior to making any public statements or preparing written marketing
materials in connection with fundraising. It is important that all members of a fund sponsor’s organization be similarly sensitized to these issues.

**Disclosure**

Regulation D exempts an offering only from the registration requirements of the Securities Act. If a non-U.S. fund markets its interests to U.S. investors, the fund and its sponsors and marketers will still be subject to the anti-fraud provisions of the various U.S. securities laws. These anti-fraud provisions seek to promote full disclosure in connection with offers and sales of securities by prohibiting both the making of any untrue statement of a material fact and the omission of any material fact necessary in order to make the statements made not misleading.

Any marketing materials that a fund distributes in connection with a U.S. Offering (e.g., a private placement memorandum or flip-book) should take into consideration the following:

- **Appropriate Risk Factors.** Any marketing materials should address any risks, potential conflicts of interest, and charges that investors face should they choose to invest in the fund. These risk factors should be thoroughly reviewed by fund management and be expansive in scope.

- **Offering/Securities Legends.** Any private placement memorandum should contain appropriate securities legends, including any that are required by state securities (or “Blue Sky”) laws.

- **Track Records.** Any disclosure that details the investment history or track record of fund management should be presented consistently and in enough detail to allow investors to determine the basis upon which returns are calculated (e.g., gross versus net calculations). Any calculations should be made using consistent methodology, and all investments (with both positive and negative returns) should be included in these calculations.

- **Anti-Fraud Liability.** The fund and its sponsors and marketers will still be liable for any anti-fraud violations under the Securities Act or the Advisers Act.

Investment advisers and broker-dealers are both also subject to rules on the content (and in the case of FINRA member broker-dealers, the use and filing) of marketing materials relating to investment funds. As already suggested, these rules are especially stringent in regard to the presentation of performance returns.

Finally, any inaccuracies or new material developments that occur with respect to the fund must be disclosed in a supplement to the marketing materials that are used in connection with a U.S. Offering prior to any interests in the fund being sold to U.S. investors.

**ERISA Considerations**

An investment fund offering interests to U.S. investors should take care to avoid having its assets characterized as “plan assets” for purposes of the U.S. Employee Retirement Income Security Act of 1974, as amended (“ERISA”), which would subject the fund’s adviser and the activities of the fund to various fiduciary and “prohibited transaction” rules, including
strict prohibitions on many related-party transactions. An investment fund will avoid characterization of fund assets as “plan assets” for the purposes of ERISA if: (i) equity participation in the fund by “benefit plan investors” is not “significant”; or (ii) the investment fund qualifies as an “operating company” (including a “venture capital operating company” or a “real estate operating company”).

**Significant Equity Participation**

The “25 percent limit” is a structure commonly relied upon by investment funds to prevent their assets from being characterized as plan assets. Equity participation will not be significant if benefit plan investors, in the aggregate, hold less than 25 percent of the value of each class of equity interests issued by the fund (excluding interests held by the fund’s adviser and its affiliates).

To avoid ERISA’s complex and broad fiduciary and prohibited transaction rules by complying with the “25 percent limit”, an investment fund should develop processes to elicit whether a prospective investor is a benefit plan investor and to verify continued compliance with the “25 percent limit”.

**Operating Company**

Alternatively, an investment fund can avoid ERISA “plan asset” treatment by qualifying the fund as an “operating company”. Private equity investment funds often qualify by meeting the definition of a “venture capital operating company” (a “VCOC”). An investment fund is a VCOC, for purposes of ERISA, if it: (i) invests primarily in entities engaged in the production or sale of a product or service other than the investment of capital; and (ii) obtains certain contractual management rights with respect to the entities in which it invests.

**Anti-Money Laundering Law Considerations**

An unregistered investment fund is not currently subject to U.S. anti-money laundering (“AML”) restrictions. The U.S. Treasury Department, through its agency FinCEN, has recently withdrawn a proposed rule that would have required unregistered investment companies with a U.S. nexus to develop AML programs. Nonetheless, most investment funds offering in the United States continue to comply with internal “know your customer” policies and procedures.

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15 Section 2510.3-101 of the U.S. Department of Labor Regulations, as modified by Section 3(42) of ERISA, defines “plan assets”.
16 “Benefit plan investors” are defined as (i) any employee benefit plan that is subject to the provisions of ERISA (this does not include U.S. federal, state and local governmental plans and most non-U.S. plans); (ii) any plan described in Section 4975(e)(1) of the U.S. Internal Revenue Code of 1986, as amended, including individual retirement accounts and Keogh plans; and (iii) an entity whose underlying assets include “plan assets” by reason of such an employee benefit plan’s or plans’ investment in the entity. This definition includes insurance company general or separate accounts, as well as collective investment vehicles (such as hedge funds), that are considered to hold plan assets.
Freedom of Information Act and State Disclosure Law Considerations

In recent years, certain U.S. investors – most notably state pension funds – have received requests for disclosure of their investments pursuant to the U.S. Freedom of Information Act and other state disclosure laws (collectively, “FOIA”). Various courts have sided with plaintiffs seeking disclosure of the pension funds’ investments under FOIA. The requests have been for, among other information, portfolio company financial statements, portfolio company valuations, and terms and conditions of limited partnership agreements.

An investment fund whose information is made public may be at a competitive disadvantage to other investment funds not subject to disclosure. An investment fund can guard against this risk in a number of ways, including:

- Restricting the information that it provides its investors, and in particular the information that it provides U.S. pension funds and other state entities;
- Developing procedures to establish the information it discloses as “confidential” under the state statutes that exempt certain confidential information; and
- Limiting or prohibiting investments by U.S. investors that may be subject to FOIA.

Broker-Dealer Law Considerations

Any person engaged in the business of effecting transactions in securities in the United States for the account of others will likely meet the definition of “broker” under the Exchange Act, and will be required to register as a broker-dealer with the SEC and to be admitted as a member of the U.S. Financial Industry Regulatory Authority, unless an exemption from this requirement is available.

Under the “issuer’s exemption” from broker-dealer registration, an issuer and its officers and directors, or its managing member (or similar entity), are generally not considered to be acting as a broker in respect of the sale or redemption of the issuer’s securities. Three principal factors must be considered in respect of the application of this exemption to fund personnel:

- Whether the personnel of the fund are limited to marketing the issuer’s (i.e., the fund’s) own securities;
- Whether the applicable personnel have substantial responsibilities other than marketing securities; and
- Whether the personnel receive compensation specifically for marketing activities (i.e., compensation that varies with the size or occurrence of a securities transaction).

One additional aspect of broker-dealer registration under U.S. law is that both U.S. state and federal governments regulate those persons who sell securities under their laws. Therefore, it is important to consider the treatment of a fund’s personnel under state law once specific jurisdictions for sale have been identified.

Commodity Exchange Act Considerations

Investment fund sponsors that manage or advise funds that trade in commodity futures contracts and/or exchange-traded commodity option contracts (including options on futures), and/or that invest in other funds that trade in such instruments, may be subject to regulation under the U.S. Commodity Exchange Act, as amended, as commodity pool operators (“CPOs”) (in their capacity as the operator of such a fund) and/or commodity trading advisors (“CTAs”) (in their capacity as an adviser to such a fund in respect of such trading or investment activity).
The U.S. Commodity Futures Trading Commission (“CFTC”) is generally responsible for the registration and regulation of CPOs and CTAs. Many fund sponsors presently rely on one or more exemptions from CPO and/or CTA registration, however, and, thus, can be subject to little (if any) active CFTC regulatory oversight.

CPO Registration Exemptions
One of the more commonly claimed CPO registration exemptions (on which non-U.S. fund sponsors frequently rely) is CFTC Rule 4.13(a)(4). Rule 4.13(a)(4) generally provides that a fund operator is exempt from registration as a CPO with respect to a given fund if (among other things):

- The fund interests being offered are exempt from registration under the Securities Act, and are offered and sold without marketing to the public in the United States; and
- Each natural person investor is a “qualified eligible person” (as defined in CFTC Rule 4.7(a)(2)) and all other investors are either qualified eligible persons (as defined in CFTC Rule 4.7) or accredited investors defined in Regulation D.

A fund sponsor relying on this exemption must provide certain mandated disclosures to investors and file a notice with the U.S. National Futures Association (“NFA”) claiming its exemption no later than the time it delivers a subscription agreement to a prospective investor.

The CFTC has, however, proposed revoking Rule 4.13(a)(4), as well as another commonly relied-upon CPO registration exemption—Rule 4.13(a)(3) (the so-called “de minimis” exemption). If these exemptions are indeed revoked or significantly limited, fund sponsors in many cases can be expected to revert to registering with the CFTC as CPOs and claiming regulatory relief under CFTC Rule 4.7, which provides broad relief from a number of the disclosure, reporting, and recordkeeping requirements otherwise applicable to a registered CPO. Reliance on Rule 4.7 is conditioned on, among other things, the CPO having a reasonable belief that investors in the applicable fund meet certain suitability requirements (namely, status as “qualified eligible persons”).

CTA Registration Exemptions
CFTC Rule 4.14 provides three CTA registration exemptions on which non-U.S. fund sponsors and/or their third-party CTAs frequently rely:

- Pursuant to CFTC Rules 4.14(a)(4) and (a)(5), a CTA is exempt from registering as a CTA if it is registered with the CFTC as a CPO, or exempt from such registration, and its commodity trading advice is directed solely to, and for the sole use of, the investment funds for which it is so registered or exempt.
- Pursuant to CFTC Rule 4.14(a)(10), a CTA is exempt from registering as a CTA if it has provided commodity trading advice to fewer than 16 clients with the last 12 months and does not hold itself out generally to the public as a CTA. For purposes of this exemption, (i) a CTA generally may regard a fund as a single client, (ii) the prohibition against “holding out” is broadly construed, but a CTA will not be deemed to have held itself out generally as a CTA solely by participating in a non-public offering of interests in the fund, and (iii) CTAs that have their principal place of business outside of the United States need only count their clients that are residents of the United States (which may exclude, for example, non-U.S. funds to which they act as CTAs).

Additional CFTC Considerations Post-Dodd-Frank
The Dodd-Frank Act has extended to the CFTC jurisdiction over many types of over-the-counter swap transactions. As a result, an investment fund’s use of such swaps shortly will require consideration as to whether the fund sponsor is a CPO and/or CTA and whether any related exemptions are available. In addition, a variety of substantive new rules governing
participation in over-the-counter derivatives transactions are under consideration. These rules address central clearing mechanisms, conduct and reporting rules for larger swap participants, and other requirements.18

Tax Considerations

Tax efficient structuring is critical to a successful fund offering, so fund sponsors should consult their tax advisors early in the process of planning a U.S. Offering. As different types of U.S. investors can have different tax profiles, it is important to assess the types of investors that will be targeted and to develop a fund structure specific to the target audience. U.S. taxable investors, for example, generally prefer partnership or “pass-through” tax treatment in which investors can benefit from the potentially favorable tax character of the underlying investment income and gain. U.S. tax-exempt investors (generally pension funds, universities, private foundations and certain retirement accounts) generally prefer to invest in an entity treated as a corporation for U.S. tax purposes and organized in a jurisdiction that does not impose local tax.

As a related matter, the U.S. Foreign Account Tax Compliance Act of 2009 (FATCA) requires any entity in the broadly defined class of “foreign financial institutions” (“FFIs”) – including private investment funds – to comply with an expansive reporting regime. If an FFI does not comply, it will be subject to a 30% withholding tax on (1) most U.S. source payments made to the FFI and (2) proceeds from the disposition by the FFI of investments generating such U.S. source income. These requirements will generally apply to non-U.S. investment funds, including non-U.S. private equity and hedge funds, and will be effective for payments to, or dispositions by, such funds after December 31, 2012.

The reporting requirements imposed under the bill require such a fund to enter into an agreement with the U.S. Treasury Department to obtain information about its investors and to disclose information about certain U.S. investors (as well as certain non-U.S. investors with substantial U.S. owners) to the Secretary of the Treasury (an “FFI Agreement”). If a fund does not enter into an FFI Agreement, the withholding tax imposed on certain U.S. source income and related disposition proceeds realized by the fund may not be refundable to the fund or creditable to its investors. We understand that, to the extent reasonably practicable, most covered investment funds intend to enter into an FFI Agreement and to comply with the current FATCA reporting requirements to avoid the imposition of the withholding tax.

A fund generally will be required to enter into an FFI Agreement to avoid withholding under FATCA regardless of whether it has any U.S. investors. However, a fund generally will not be required to report to the U.S. Department of Treasury information relating to non-U.S. investors with no substantial U.S. owners and to certain classes of U.S. investors, such as U.S. public companies or tax-exempt entities.

Conclusion

This alert provides an overview of the current regulatory regime that a non-U.S. fund sponsor faces when it conducts a private offering of investment fund interests to U.S. investors. However, many of these requirements are fluid – and

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trending stricter – in light of far-reaching U.S. regulatory reforms. Fund sponsors considering marketing or operations in the United States should be prepared for continuing changes to this framework.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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