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Private Offerings to U.S. Investors by Non-U.S. Investment Funds

As private equity and hedge fund sponsors seek out new sources of capital during these challenging economic times, many non-U.S. fund managers are looking to the U.S. markets for investors. This alert provides a general overview of certain issues that a non-U.S. fund sponsor should consider before conducting a private offering of interests in a non-U.S. fund to investors in the United States (a “U.S. Offering”). While the U.S. regulatory landscape surrounding investment funds is undergoing increasing scrutiny and there is an expectation of enhanced regulatory oversight on the horizon, this alert summarizes U.S. laws as they currently stand. We will provide updates as any new regulatory proposals come to light.¹

Securities Law Compliance

Any U.S. Offering must be done 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”).

Securities Act

As a general rule, an issuer that offers or sells its securities in the United States must register those securities under Section 5 of the Securities Act or must qualify for an available exemption therefrom. Among other exemptions, a U.S. offering of an investment fund may be exempt from the registration requirements of the Securities Act pursuant to Regulation D promulgated thereunder (“Regulation D”). Most non-U.S. investment funds selling securities under Regulation D rely on the regulation’s Rule 506, which requires an issuer to have a reasonable belief that all of the U.S. investors in the offering are “accredited investors.” “Accredited investors” are defined in Rule 501(a) of Regulation D, and include:

- Investors who with their spouse have a net worth of \$1 million, or have an annual income of \$200,000 (\$300,000 when combined with the spouse’s income); and
- Businesses and other entity investors having total assets of \$5 million.²

In addition to the accredited investor requirements, there are additional requirements for a valid Regulation D offering, including providing adequate disclosure for anti-fraud liability (as discussed below), and manner of offering limitations (which prohibit “general solicitation” of the public, also discussed below). The rules that govern Regulation D offerings also require the fund to publicly file an online notice on Form D with the U.S. Securities and

¹ See “Oversight of Private Pools of Capital” Is Firmly on the Reform Agenda – What It Might Mean for U.S. Fund Managers, Jan. 30, 2009, available at http://www.shearman.com/am_013009/.

² The SEC has proposed changes to the definition of “accredited investor,” which have yet to be acted on. See SEC Release No. 33-8766 (Dec. 27, 2006), available at <http://www.sec.gov/rules/proposed/2006/33-8766.pdf>; SEC Proposes Rules Prohibiting Fraud by Investment Advisers and Creating a New Category of Accredited Investor, Jan. 22, 2007, available at http://www.shearman.com/am_012207/.

Exchange Commission (“SEC”) no later than 15 days after the sale of securities to U.S. investors.³

Exchange Act

Under Section 12(g)(1) of and Rule 12g-1 under the Exchange Act, an issuer with total assets of \$10 million at the end of its fiscal year and a class of equity securities held by 500 or more persons must register its securities under the Exchange Act. Rule 12g3-2 provides an exemption for foreign issuers from the registration requirements of Section 12(g) if no class of securities has 300 or more holders resident in the United States. The anti-fraud and other market manipulation provisions of the Exchange Act apply even to issuers that are exempt from registration under the Exchange Act.

Investment Company Act

Under the Investment Company Act, an “investment company” is 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 securities. On its face, most investment funds fall within this definition. There are exceptions to the definition of “investment company,” however, that most investment funds seek to fall within. The two most widely used definitional exceptions from the Investment Company Act are known as the “private investment company” exceptions.

The 100-Person Exception

The first of the “private investment company” exceptions is set forth in Section 3(c)(1) of the Investment Company Act, which excludes from the definition of “investment company” any non-U.S. investment vehicle with no more than 100 U.S. beneficial owners of its securities that does not make, or propose to make, any public offering of its securities in the United States. Under this exception, beneficial ownership is broadly defined and provides for look-through for certain U.S. investors that own 10 percent or more of the issuer’s outstanding voting securities.

The Qualified Purchaser Exception

A fund may alternatively qualify for an exception from registration under the Investment Company Act as set forth in Section 3(c)(7) thereof, which excludes from the definition of “investment company” any non-U.S. issuer whose securities are purchased only by U.S. persons that are “qualified purchasers,” and that does not make, or propose to make, a public offering of its securities in the United States. “Qualified purchasers” are defined in Section 2(a)(51) of the Investment Company Act, and include as a general matter:

- Natural persons who own not less than \$5 million in investments;
- Companies or other institutional investors that own not less than \$25 million in investments; and
- Persons investing solely on behalf of qualified purchasers.

The implications of complying with the offering restrictions under the Investment Company Act are similar to those presented by the Securities Act and are discussed below.

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. Among other exemptions, a fund sponsor may qualify for the “private investment adviser” exemption from registration under the Advisers Act, which is available to advisers who during the preceding 12 months: (i) have fewer than 15 clients; (ii) do not hold themselves out to the public as an investment adviser; and (iii) do not advise any registered investment companies.⁴ Most investment fund advisers qualify for this exemption by counting each investment fund as a single client for the purposes of this rule (even though a particular fund might have hundreds of investors). A fund is counted as a single client when it receives investment advice based on its investment

³ See *Private Placement Update: Electronic Filing of Form D*, Jan. 26, 2009, available at <http://www.shearman.com/cm012609/>.

⁴ Investment Advisers Act of 1940 § 203(b)(3).

objectives rather than the investment objectives of the fund's individual investors. An adviser with principal offices and principal places of business outside the United States may count only those clients that are U.S. citizens or U.S. residents. Subject to limited exceptions, this means, significantly, that funds that are not domiciled in the United States need not be counted as clients of non-U.S. advisers for purposes of the Advisers Act's "client counting" rules.

An adviser that has 14 or fewer clients must also not "hold itself out" generally to the investment public to qualify for this exemption. 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.

To qualify for the private investment adviser exemption, an adviser should establish compliance procedures to assure continuing satisfaction of the number of clients and holding out criteria.

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 several months 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, 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* (in particular 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" (IRRs, percentage of returned capital, profits, etc.).

Note, however, that the following kinds of statements are generally permissible by registered investment advisers (unregistered investment 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 prior to or during 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.

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 must 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.⁵ 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

⁵ Section 2510.3-101 of the U.S. Department of Labor Regulations, as modified by Section 3(42) of ERISA, defines “plan assets.”

“benefit plan investors”⁶ 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.

⁶ “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.

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 rule⁷ 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.⁸

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.

⁷ 67 Fed. Reg. 60,617.

⁸ For a summary of recently proposed changes to the AML laws, see *U.S. Treasury Proposes Changes to Anti-Money Laundering Regulations*, Dec. 2, 2008, available at http://www.shearman.com/lt_120208/.

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, Inc., 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 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 invest in exchange-traded futures and options on futures may be subject to regulation under the U.S. Commodity Exchange Act, as amended, as commodity trading advisors (“CTAs”) or commodity pool operators (“CPOs”). The U.S. Commodity Futures Trading Commission (“CFTC”) regulates the activities of CTAs and CPOs. Most fund sponsors claim exemption from registration under the CFTC rules.

The most common exemption a non-U.S. fund sponsor uses to avoid the CPO registration requirements is CFTC Rule 4.13, which provides that a sponsor is exempt from registration as a CPO if (among other reasons):

- 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 U.S. natural person investor is a “qualified eligible person” (as defined in CFTC Rule 4.7(a)(2)) and all other U.S. investors are either qualified eligible persons (as defined in CFTC Rule 4.7) or accredited investors under the Securities Act.

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

CFTC Rule 4.14 provides two commonly relied-upon CTA exemptions:

- A CTA that is registered as an investment adviser with the SEC (or applicable state securities regulatory authority), or is exempt from such registration, is exempt from registration as a CTA if it provides commodity trading advice solely to investment funds organized and operated outside the United States and:
 - The CPO of such fund has not organized it and is not operating it in such fashion to avoid registration;
 - Other than the fund sponsor and its principals, solely “non-United States persons” invest in the fund, subject to a 10 percent limit on investors that do not meet this qualification;
 - There is no marketing activity that could have the effect of soliciting investors other than non-United States persons; and

- No marketing activity is conducted from within the United States.

CTAs relying on this exemption must file a notice with the NFA claiming such exemption no later than the time it delivers an advisory agreement to a prospective U.S. investor, and must maintain certain books and records for five years and submit to special calls of the CFTC.

- 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.

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, in light of the expectation of enhanced U.S. regulatory oversight of investment funds following recent economic, market and financial institution events, fund sponsors considering marketing or operations in the United States should be prepared for changes to this framework in the near future.

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.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Jeffrey P. Crandall
New York
+1.212.848.7540
jcrandall@shearman.com

Laura S. Friedrich
New York
+1.212.848.7411
laura.friedrich@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

M. Holland West
New York
+1.212.848.4579
hwest@shearman.com

Lorna X. Chen
Hong Kong
+852.2978.8001
lorna.chen@shearman.com

Richard H. Metsch
New York
+1.212.848.7518
rmetsch@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
rsacks@shearman.com

Steven A. Homan
New York
+1.212.848.4548
steve.homan@shearman.com

Claudio M. Oksenberg
São Paulo
+55.11.3702.2204
claudio.oksenberg@shearman.com