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More Flexible Approach Announced for Non-U.S. Issuers Seeking to Rely on the Section 3(c)(7) Exception Under the 1940 Act

New commentary recognizes more flexibility on the procedures that non-U.S. issuers of equity securities should implement when seeking to rely on the Section 3(c)(7) exception under the 1940 Act.

The authors of benchmark procedures related to an exemption under Section 3(c)(7) for offerings of equity or hybrid securities, frequently referred to as the 2008 Procedures , have published a new commentary to these procedures. The new commentary affirms the current market practice of selectively implementing elements of the 2008 Procedures for offerings by non-U.S. issuers depending on the particular facts of the issuer and the offering.

Key issues

Ten factors to consider in determining degree of flexibility from 2008 Procedures available to non-U.S. issuers in offerings of equity and hybrid securities:

More flexibility for *lower* levels of:

- inherent U.S. interest
- U.S. presence of the issuer
- offering activity directed at the United States
- structural or tax characteristics designed to encourage U.S. investor interest
- mass / retail appeal
- "fund-like" characteristics of the issuer

More flexibility for *higher* levels of:

- offering activity directed outside the United States
- depth of the trading market for the offered securities outside the United States
- structural or tax characteristics unfavorable to U.S. investors
- debt-like characteristics of hybrid securities

Background

The U.S. Investment Company Act of 1940 (as amended, the "1940 Act"), which was intended to primarily govern investment funds, has a broad scope that can also cover companies which are operating businesses due to issues within their corporate structure, often referred to as "inadvertent investment companies". A company may be an inadvertent investment company and have potential 1940 Act issues if, for example, it has a significant amount of investment securities on its balance sheet, conducts significant operations through subsidiaries that are not majority-owned, or has recently sold assets resulting in significantly increased liquidity.

A non-U.S. company which is an inadvertent investment company may nevertheless access the U.S. market if it complies with the exception provided in Section 3(c)(7) of the 1940 Act (as well as the Rule 144A safe harbor from the registration requirements of the U.S. Securities Act of 1933). To be eligible for the Section 3(c)(7)

exception, a non-U.S. issuer must establish a "reasonable belief" that the U.S. investors in their securities are exclusively "qualified purchasers" at the time they acquire the securities. Accordingly, non-U.S. issuers seeking to take advantage of this exception must implement procedures designed to provide them a basis for the requisite reasonable belief.

Section 3(c)(7) was added to the 1940 Act in 1996 through the National Securities Markets Improvement Act. After its adoption, a set of procedures was circulated, frequently referred to as the 2003 Procedures , which only covered certain types of issuers and generally applied only to debt securities. The 2003 Procedures have been generally accepted in the market and have been used on many transactions since their creation. In 2008, the 2008

Procedures were published and provided a set of procedures for offerings of equity and hybrid securities. Unfortunately, many non-U.S. issuers have found the 2008 Procedures difficult or impractical to implement, in part, due to relevant trading and clearing arrangements in non-U.S. markets. As a result, non-U.S. issuers which are inadvertent investment companies have not implemented the 2008 Procedures in full and instead have implemented "bespoke" procedures based on the advice of the relevant US counsel on the transaction.

New Commentary

The new commentary to the 2008 Procedures lends enhanced legitimacy to non-U.S. issuers requiring flexibility in the procedures. It identifies ten factors to consider in developing appropriate procedures that do not strictly follow all facets of the 2008 Procedures (see caption on previous page). For example, non-U.S. issuers have more flexibility to implement alternative procedures when there is little inherent U.S. interest in the offering or when the offered securities have structural or tax characteristics that are unfavorable to U.S. investors.

The new commentary addresses two important elements of the 2008 Procedures: (1) restrictions during the 40-day period following closing; and (2) the gatekeeper requirement.

40-Day Restriction Period

The 2008 Procedures require that underwriters track secondary market sales to U.S. persons within the 40-day period following the date of closing to ensure that all US investors are "qualified purchasers". The new commentary acknowledges that practices in certain non-U.S. markets may make it "impracticable to effectively monitor secondary market transactions during the 40-day period", and in these circumstances, the new commentary provides that issuers can consider alternative procedures. In addition, the new commentary confirms that transferees purchasing in the secondary market on a non-U.S. exchange generally need not be qualified purchasers as long as (1) the transactions are bona fide secondary sales that do not involve the issuer or its agents, affiliates or intermediaries and (2) a significant amount of the secondary trading on the non-U.S. exchange involves non-U.S. persons.

In lieu of a 40-day tracking period, the new commentary comments positively on an alternative procedure which would restrict the U.S. affiliate of each underwriter from engaging in secondary market transactions, directly or on behalf of a customer, that involves purchases by U.S. investors of the relevant securities during the 40-day period. This approach is consistent with the procedures implemented by non-U.S. issuers that were inadvertent investment companies in several recently completed equity offerings where the primary trading market and listing were outside the United States, including several on which Clifford Chance has advised.

Gatekeeper Requirement

In connection with secondary market transactions, the 2008 Procedures require a custodian to be appointed to act as a gatekeeper for securities transfers with respect to the securities purchased by U.S. investors in the offering. This custodian would be charged with holding the securities purchased by U.S. investors in its name via the relevant clearing system and would affect transfers of beneficial interests on its books only upon receipt of certifications as to qualified purchaser status. The new commentary reiterates that a gatekeeper may not be required in all cases. Specifically, it cites procedures in past transactions that did not implement a gatekeeper structure in circumstances where the issuer was offering less than 25% of the securities to U.S. persons. The new commentary further suggests that this 25% threshold may be exceeded in "special circumstances". Additionally, in the absence of a gatekeeper, the new commentary comments positively on the procedures implemented in several recent transactions which required U.S. investors to agree to limit resale's exclusively to offshore transactions (i.e. outside the U.S.) over the relevant offshore securities exchange.

Conclusion

The new commentary supports the existing market practice for offerings of equity or hybrid securities by non-U.S. issuers that are inadvertent investment companies seeking to rely on the Section 3(c)(7) exception under the 1940 Act. It recognizes that, depending on the characteristics of the issuer and the offering, modified procedures that are less stringent than the 2008 Procedures may be appropriate. While the new commentary identifies ten factors to consider when determining the amount of flexibility available from the 2008 Procedures, in each offering of equity and hybrid securities, non-U.S. issuers will be required to continue to assess on an ad hoc basis the appropriate procedures to implement to ensure they satisfy the "reasonable belief" requirements under Section 3(c)(7).

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