

# Marketing Private Equity Funds to US Investors: US Securities and Other Regulatory Issues

An EVCA Special Paper

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EVCA's activities cover the whole range of private equity: venture capital (from seed and start-up to development capital), buyouts and buyins.

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## 1. Introduction

A panoply of regulation exists in the US to ensure the integrity of financial markets and protect US investors. Many of these statutes and regulations come into play for private equity funds located abroad but wishing to offer limited partner interests to US investors. A summary of some of the key legislation and issues such private equity funds will encounter is provided below.

## 2. US Securities Act of 1933

Offerings of securities to investors within the US are subject to the US Securities Act of 1933, as amended (the “Securities Act”). The Securities Act requires that sales of securities, including limited partner interests in private equity funds, be registered with the US Securities and Exchange Commission (the “SEC”), unless the offering qualifies for an exemption from such registration requirement. The primary exemptions private equity funds rely upon to avoid registration under the Securities Act are Section 4(2) and Regulation D.

### 2.1. Private placements under section 4(2) of the Securities Act

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Section 4(2) of the Securities Act provides that “transactions by an issuer not involving any public offering” (i.e., private placements) are not subject to the registration requirements of the Securities Act. Section 4(2) is in many respects a common law exemption – its meaning has been subject to judicial interpretation over several decades and its availability is fact-specific. Generally, the factors a court will consider when determining whether an offering may fall within the Section 4(2) exemption include (i) the sophistication of the prospective investors, (ii) the number of prospective investors, (iii) the relationship between the issuer and the prospective investors, and (iv) the nature, scope, manner and size of the offering. Because of the subjective nature of the Section 4(2) exemption, most US law firms would advise against relying solely on such exemption.

### 2.2. Regulation D Safe Harbor

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Regulation D under the Securities Act allows issuers to avoid both the costly and time-consuming securities registration process and the uncertainty related with Section 4(2) by providing a “safe harbor” for private placements. Regulation D contains several sets of rules that issuers of securities must follow to ensure that their offering falls within this safe harbor and therefore avoid registration under the Securities Act. The rules in Regulation D are of varying complexity depending on the dollar value of the offering and other factors, however, compliance with Rule 506 of Regulation D, the primary requirements of which are outlined below, ensures exemption from registration regardless of the dollar value of offering. Because this safe harbor is not exclusive, an offering which falls short of meeting all of the requirements of Rule 506 may still be exempt under Section 4(2) or Regulation S (which is more fully described overleaf).

### 2.2.1. Accredited investors

While Rule 506 allows for participation by up to 35 non-“accredited investors,” the additional disclosure requirements associated with the inclusion of these parties are burdensome and impractical for most issuers. Thus, in general, offerings should be limited to investors who are “accredited investors.” Broadly speaking, “accredited investors” are natural persons or entities who surpass certain thresholds with respect to income, net worth or total assets. Sponsors of private equity funds should require prospective investors to provide certain representations in their subscription documents to ensure that each investor qualifies as an “accredited investor” under the Securities Act.

### 2.2.2. No general solicitation or advertising

Rule 506 prohibits an issuer of securities from marketing such securities by using “general solicitation or general advertising,” which includes mass mailings, written or broadcast advertisements, press releases, and open informational seminars. Instead, issuers of securities, including issuers of limited partner interests, are expected to have knowledge of and consider the sophistication of the proposed investor before making contact. Thus, one-on-one marketing to a prospective investor that the issuer (or its agent) reasonably believes is an accredited investor and with whom the issuer (or its agent) has a pre-existing relationship is permitted. If the issuer uses a placement agent to solicit US investors, the engagement letter with such placement agent should clearly state the restrictions with respect to general solicitation and advertising.

While ordinary course news articles about fund investments that do not discuss fundraising or investment performance may be permissible, it is recommended that neither the issuer nor anyone acting on its behalf engage in discussions with reporters. Articles about the fund and its managers generally could be characterized by the SEC as promoting the offering by using a general solicitation or general advertising, whether these articles appear in publications of general circulation or more limited industry journals and in such an event the safe harbor provided by Regulation D may not be available to such offering.

It is generally acceptable to use password-protected websites and electronic mail to deliver offering materials once prospective investors have been identified without using general solicitation or advertising. After the final closing of an offering, issuers may publish “tombstone” ads in selected periodicals and interviews with the press are permissible. Issuers should be careful to ensure that the final closing is in fact final, as failure to comply with these general solicitation and advertising requirements could jeopardize the exemptions under both the Securities Act and the 1940 Act (as discussed below).

Note that issuers simultaneously offering securities outside of and in the US, may hold press conferences outside of the US in accordance with Rule 135e of the Securities Act, which provides a limited safe harbor for “foreign private issuers” (as defined in Rule 405 of the Securities Act) to hold such press conferences with respect to an offering. Rule 135e requires (i) an intent to make a bona fide offshore offering, (ii) that access be provided to both US and non-US journalists, and (iii) the inclusion of specific legends on any written material regarding an offering to be conducted in part in the US. If these requirements are met, the offshore press conference will not run afoul of the prohibition in Rule 506 against general solicitation and general advertising.

### 2.2.3. Resale limitations

Limited partner interests sold in reliance on the Section 4(2) exemption and the Regulation D safe harbor are considered “restricted securities” and issuers are required to exercise reasonable care to assure that the purchasers of the securities are not underwriters; that is, issuers must make reasonable inquiry of each investor to confirm that such investor is acquiring the securities for investment purposes rather than for resale. In addition, any offering documents should include a legend stating that the securities have not been registered and cannot be resold except pursuant to registration or an exemption therefrom and the operating agreement of the fund should contain restrictions on transfer.

### 2.2.4. Integration

In order to prevent issuers from circumventing the registration requirements of the Securities Act by separating a single non-exempt offering into several exempt offerings, the SEC requires the integration of certain related offerings by using a five factor test. To determine whether the SEC would be likely to integrate separate offerings, issuers should consider whether the separate offerings: (i) are part of a single plan of financing, (ii) involve the same class of security, (iii) are made at or about the same time, (iv) involve the same consideration, and (v) are made for the same general purpose. While this five factor test is subjective, Rule 502(a) of Regulation D provides that offerings commenced more than six months apart are deemed to be separate offerings under Regulation D.

### 2.2.5. Filing requirement

Rule 503 of Regulation D requires that issuers relying on this safe harbor file notice of their sale of securities with the SEC on Form D no later than fifteen days after the first sale of securities in such offering.

## 2.3. Regulation S

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Regulation S under the Securities Act allows certain non-US securities offerings to be deemed to occur outside of the US and therefore not be subject to the registration requirements under the Securities Act. In order to take advantage of this exemption, the offer or sale of the securities must be made in an “offshore transaction” and neither the issuer, an affiliate of the issuer, nor any person acting on their behalf may use “directed selling efforts” within the US. Generally, to be considered an “offshore transaction” the offer must be made to investors outside of the US and either the seller must reasonably believe that the buyer is offshore at the time of the sale or the sale must be executed on an “established foreign securities exchange.” “Directed selling efforts” are activities which would condition the market in the US for the securities being offered, with certain exceptions for notices required by US or non-US law and press conferences held by “foreign private issuers” pursuant to Rule 135e. The foregoing applies only to non-US issuers; US issuers must comply with additional conditions in order to rely on Regulation S.

## 3. Securities Exchange Act of 1934

While the Securities Act governs the **offering** of securities within the US, the US Securities Exchange Act of 1934, as amended (the “Exchange Act”), governs the **trading** of securities within the US, by regulating both securities trading markets and public trading of securities.

### 3.1. Section 12(g) registration

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Of primary concern to funds with US investors are the periodic public disclosure obligations that the Exchange Act imposes on “reporting companies.” Section 12(g) of the Exchange Act sets out the circumstances in which an issuer must register as a “reporting company.” In order to avoid Section 12(g) registration, and to avoid the ongoing reporting requirements of the Exchange Act, a non-US fund must have fewer than 300 US holders of record of each class of equity security.<sup>(1)</sup> A security is deemed to be held of record by each person who is identified as an owner of the security on the issuer’s books and records; therefore, each partner listed on a fund’s schedule of partners would generally count as one holder of record.

### 3.2. Rule 10b-5

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Regardless of whether an issuer of securities must register under the Exchange Act, it will still be subject to the antifraud provision contained in Rule 10b-5. A cornerstone of US securities regulation, this rule makes it unlawful, in connection with the purchase or sale of any security, to make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. This prohibition has been applied broadly to a range of situations including fraudulent securities trading by individuals and/or corporations and false or misleading corporate disclosures. The remedies available under Rule 10b-5 are also broad. To avoid running afoul of Rule 10b-5, issuers should work closely with their US legal counsel when preparing any offering materials and, especially during fundraising periods, when making decisions regarding the content, timing, scope and audience of any potential disclosures.

<sup>(1)</sup> US funds must have fewer than 500 holders of record of each class of equity security in order to avoid Section 12(g) registration.

## 4. Investment Company Act of 1940

The US Investment Company Act of 1940, as amended (the “1940 Act”), strives to protect US investors by imposing fiduciary duties and disclosure obligations on registered “investment companies.” Private equity funds seek to avoid this onerous oversight by relying on the exemptions from registration as an investment company provided in Sections 3(c)(1) and/or 3(c)(7) of the 1940 Act. Without the availability of such exemptions, funds would be required to register with the SEC as investment companies and would become subject to regulatory oversight which would severely curtail their ability to conduct business in the manner which most private equity funds contemplate. Section 3(c)(1) provides an exemption from registration as an investment company for funds with no more than 100 beneficial owners, while Section 3(c)(7) provides an exemption from registration as an investment company for funds whose ownership interests are held exclusively by “qualified purchasers,” without limitation on the number of beneficial owners. Both exemptions serve to prohibit the **public** offering of securities to US investors by an entity that is not registered under the 1940 Act.

### 4.1. Section 3(c)(1): 100 person exemption

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Section 3(c)(1) of the 1940 Act provides an exemption from registration for companies whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. In general, many investors will count as “one person” for the purposes of the beneficial owner count under Section 3(c)(1), even those that are partnerships, corporations or other entities. Moreover, certain “knowledgeable employees” (as defined in SEC rules) of the fund or its affiliates may be excluded from the count. However, a fund may be required to “look through” an investor and count each of the underlying beneficial owners of that investor toward the 100 beneficial owner limitation of the fund. For example, if an investor is an entity that holds 10% or more of the entity’s voting securities and such investor is itself an Investment Company (as described in the 1940 Act) or relies on the exemptions provided in Section (3)(c)(1) or Section 3(c)(7) of the 1940 Act (a “10% Holder”), that 10% Holder must be “looked through” and each beneficial owner of that 10% Holder must be counted as beneficial owners of the fund. There are a number of other situations which would require the fund to “look through” an investor and the rules for determining the number of beneficial owners are complex. For non-US funds, the determination of the number of beneficial owners only applies to investors who are US residents. In addition, because this 100-owner limit applies on an ongoing basis and not just at the time of sale, funds relying on this exemption must implement transfer restrictions and related procedures to ensure continued compliance.

### 4.2. Section 3(c)(7): qualified purchaser exemption

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Section 3(c)(7) provides an exemption from registration for entities whose ownership interests are held exclusively by “qualified purchasers,” without limitation on the number of beneficial owners (note, however, that the limits on number of holders of record imposed by the Exchange Act, as discussed above, apply regardless). The financial sophistication requirements to be considered a “qualified purchaser” under the 1940 Act are more stringent than the financial requirements to be considered an “accredited investor” for purposes of Regulation D of the Securities Act.

Generally, to be considered a qualified purchaser, one must be either (i) a natural person with at least \$5 million in investments, (ii) a company that is owned by family members and that owns at least \$5 million in investments, (iii) certain trusts with qualified purchasers as contributors and decision makers, (iv) any entity that owns and invests at least \$25 million in investments or (v) certain “knowledgeable employees” (as defined in SEC rules). Note that for purposes of determining qualified purchaser status, the term “investments” also has a specific definition found in the 1940 Act. Special “look through” rules apply if any investor is formed for the purpose of acquiring the securities being offered.

## 5. Investment Advisers Act of 1940

The US Investment Advisers Act of 1940, as amended (the “Advisers Act”), requires persons engaged in the business of providing investing advice or securities analysis and reports to US investors to register with the SEC and submit to regulatory oversight. Managers of private equity funds may avoid registration under the Advisers Act by having fewer than 15 “clients.” In most cases, each private equity fund managed by such manager – rather than each of the underlying investors – counts as a single client, provided that each such fund conforms to certain structural requirements. Generally, an investment adviser domiciled in the US must count all clients it advises while a non-US advisor may be required to count as clients only the US citizens or residents it advises.

Regardless of whether a manager is required to register under the Advisers Act, it will be subject to new antifraud rules contained in Rule 206(4)-8 of the Advisers Act. Similar to Rule 10b-5 discussed above, this rule prohibits advisers to private equity funds and other pooled investment vehicles from (i) making false or misleading statements to investors or prospective investors in those vehicles, or (ii) otherwise defrauding those investors or prospective investors through improper conduct. In light of the broad reach of the rule and the fact that an adviser can be liable for a violation of this rule for negligent acts, advisers should work closely with their US legal counsel to review all communications with investors and prospective investors to ensure that such communications do not contain untrue or misleading statements, as well as to review existing policies and procedures designed to prevent fraudulent conduct in its broadest sense.

## 6. Blue Sky Laws

In addition to the federal securities regulation regime discussed above, each state in the US has securities regulation and state investment adviser regulation, many of which have exemptions that are similar to the federal exemptions discussed herein. While offerings exempt under Rule 506 are not subject to state registration requirements, some states may require certain legends to be included in the fund’s governing documents and may impose post-sale notice filing requirements.

## 7. USA Patriot Act

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “Patriot Act”) established far-reaching regulations with the goal of improving the ability of the US government to counter terrorism. The Patriot Act requires certain entities to implement anti-money laundering compliance provisions and anti-terrorism financing detection procedures. While typical private equity funds are exempt from the formal requirements of the Patriot Act, it has become standard practice for private equity funds and their managers to require that each investor make certain representations and warranties with respect to these issues in the subscription documents.

## 8. Open Records Laws

Both the US federal government and individual state governments have open records laws, which generally require that a wide range of information held by public agencies be made available to the public upon request. Specifically, investors in private equity funds that are public entities (e.g., public pension plans, endowment funds of public universities and publicly traded funds-of-funds) are subject to such laws and the scope of information required to be disclosed – which varies from state to state – often includes a limited partnership’s organizational documents and the data set forth in a limited partnership’s periodic reports provided to these public entities in their capacities as limited partners. Most fund managers are concerned about allowing performance data and other sensitive information into the public domain, therefore private equity fund managers make significant efforts to avoid such disclosure through an extensive confidentiality provision in the fund’s governing agreement.

## 9. Employee Retirement Income Security Act of 1974

The US Employee Retirement Income Security Act of 1974, as amended (“ERISA”) was enacted to safeguard participants in US employee benefit plans by requiring certain disclosures and establishing standards of conduct for fiduciaries of such plans. Generally, when benefit plans subject to ERISA (“ERISA Plans”) invest in private equity funds, the fund and its managers may become subject to the various provisions of ERISA if the assets of the fund are deemed to be assets of a benefit plan. Among other things, the fund managers would be held to heightened fiduciary duties imposed by ERISA and the fund would be subject to ERISA’s prohibited transaction rules and other onerous fiduciary requirements. In order to accept ERISA Plan investors while not running afoul of ERISA regulations, fund managers generally use best efforts to cause their funds to qualify for an exemption from the plan asset regulation under ERISA. These exemptions and ERISA generally are discussed more fully in the companion publication entitled “*Marketing Private Equity Funds to US Investors: ERISA Issues*”.

## 10. Bank Holding Company Act of 1956

By and large, financial holding companies may invest in private equity funds. However, the US Bank Holding Company Act of 1956, as amended (the “BHCA”), prohibits a private equity fund that is “controlled” by a financial holding company from routinely managing or operating portfolio companies, except under very limited circumstances. To prevent this situation, the financial holding company must not (i) serve as a general partner, managing member or other similar role with respect to a fund, (ii) own or control 25% or more of any class of shares or similar interests in the fund, (iii) directly or indirectly select, control or constitute a majority of the management of the fund, or (iv) act as the investment adviser to the fund and own or control more than 5% of any class of voting shares or similar interest in the fund. Fund managers often include these limitations as provisions in the fund’s governing documents and such provisions apply only to investors that are subject to the BHCA.

## 11. FCC Ownership Limitations

The US Federal Communications Commission (the “FCC”) imposes limitations on ownership of media companies (e.g., newspaper, television, radio and cable companies). Consequently, fund managers typically include insulating language in the limited partnership agreement to preclude the fund’s ownership of media companies being attributed to the regulated limited partner. Such insulating language generally prohibits a limited partner from having an active role with the limited partnership or any media company in which it invests.

## 12. The Gramm-Leach-Bliley Act

The US Gramm-Leach-Bliley Act (the “GLB Act”) and the Privacy of Consumer Financial Information Rule promulgated by the US Federal Trade Commission (“FTC”) thereunder (the “Privacy Rule”) require “financial institutions”: (i) to provide an initial and annual notice to “customers” regarding privacy policies and practices, (ii) to describe the circumstances in which the financial institutions may disclose “nonpublic personal information” about customers to nonaffiliated third parties and (iii) to provide a means by which customers can “opt-out” of certain enumerated types of disclosures. The FTC has also issued a rule under the GLB Act entitled Standards for Safeguarding Customer Information, which requires “financial institutions” to develop and implement a written “information security program” appropriate to their operations.

## 13. Financial Industry Regulatory Authority

The Financial Industry Regulatory Authority (“FINRA,” formerly the National Association of Securities Dealers or “NASD”) is the self-regulatory body for the securities industry in the US. Among other things, FINRA regulates independent broker dealers, or “finders,” who offer or promote private equity funds in the US. Many states also require registration of broker-dealers or placement agents before permitting such persons to make offers to potential investors in their jurisdiction. Additionally, NASD Rule 2790 restricts the sale of “new issues” (equity securities sold in an initial public offering) to accounts in which “restricted persons” have a beneficial interest and NASD Rule 2710 imposes filing requirements on persons associated with an NASD member who intend to participate in any manner in certain public offerings of securities.



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