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SIFMA
Securities Industry and Financial Markets Association

The Bond Market Association, Recommended Policies and Procedures for Secondary Market Trading in Book-Entry Section 3(c)(7) Securities

I. INTRODUCTION

Section 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") excludes from regulation under the Investment Company Act entities whose outstanding securities are owned exclusively by persons who are, at the time they acquire the securities, "qualified purchasers" ("QPs") as defined in Section 2(a)(51)(A) of the Investment Company Act. When a Section 3(c)(7) issuer engages in a placement of its securities (usually in reliance on Rule 144A for 1933 Act purposes), the issuer and the other participants in the transaction will seek to ensure that all purchasers of the securities are persons that the issuer and other persons in the transaction "reasonably believe" to be QPs.

Section 3(c)(7) and Rule 2a51-1 under the Investment Company Act require, however, that the Section 3(c)(7) issuer (or a designated "Relying Person" acting on such issuer's behalf) reasonably believe ***at all times*** that the holders of the issuer's securities are persons who, at the time of their acquisition of the securities, are QPs. A U.S. issuer must have a "reasonable belief" that **all** of its investors are "qualified purchasers" ("QPs"), including initial purchasers and also subsequent transferees. A non-U.S. issuer is generally required to have this "reasonable belief" only about its U.S. investors.

After secondary trading commences in Section 3(c)(7) securities, and especially where the securities settle on a book-entry basis through various securities depositories, which include The Depository Trust Company ("DTC") in the United States, or Euroclear Bank S.A./N.V. ("Euroclear") and Clearstream Banking Luxembourg (a division of Clearstream International) ("Clearstream Banking") in Europe (DTC, Euroclear, and Clearstream Banking being referred to collectively hereinafter as "Securities Depositories"), it becomes more difficult for the issuer on an ongoing basis to acquire and maintain information about the holders of its securities.

Moreover, the SEC staff stated in an April 1999 letter to the American Bar Association that a Section 3(c)(7) issuer could not rely on another person's reasonable belief about the QP status of the holders of its securities (unless that other person were "acting on its behalf"); rather, the Section 3(c)(7) issuer must be able to make its own reasonable determination that all holders (or, in the case of non-U.S. issuers, each holder that is a U.S. person) of its securities are QPs at the time they acquire the securities. Any non–U.S. person that purchases a non–U.S. issuer's securities is not required to be a QP, nor is any

subsequent transferee, as long as neither the issuer nor its agents, affiliates or intermediaries are involved in any sales that are made to U.S. persons.

Market participants have developed procedures under which Securities Depositories act as custodians for Rule 144A securities. In the April 1999 letter, however, the SEC staff declined to confirm that the procedures developed for resales in the Rule 144A market were necessarily sufficient for Section 3(c)(7) purposes. The letter did state, however, that certain procedures (such as CUSIP indicators and dealer lists) "could be components of reasonable compliance procedures." Actual compliance with Section 3(c)(7) would depend on all facts and circumstances, and the staff stated that it would not respond to requests to assess any particular set of procedures.

A group of law firms, working originally with DTC and more recently in cooperation with the Securities Depositories, has developed a set of procedures (the "Recommended Procedures") designed to enable Section 3(c)(7) issuers to establish the requisite reasonable belief that all of the holders (or, in the case of non-U.S. issuers, each holder that is a U.S. person) of their securities are QPs notwithstanding the deposit of those securities in the Securities Depositories. A copy of those procedures and an explanatory memo are attached hereto as Exhibit 1. It should be noted that the Recommended Procedures state that they are recommended only for certain structured finance issuers, such as SPVs and CDOs. They are also appropriate for certain foreign issuers, for example, a foreign operating company that may not fully satisfy the Investment Company Act's asset and income tests. The Recommended Procedures are not appropriate for "classic" private investment companies or hedge funds. Finally, the Recommended Procedures are designed to be used only for Rule 144A offerings, and U.S. issuers relying on Section 3(c)(7) should not offer book-entry securities under Regulation S.

Members of The Bond Market Association (the "Association") have concluded that it would be helpful for the Association to provide its member firms with recommended policies and procedures in connection with *secondary market transactions* in Rule 144A securities of Section 3(c)(7) issuers held in a Securities Depository. The Association believes that, as a supplement to the Recommended Procedures, these additional recommendations serve to advance the common interests shared by Section 3(c)(7) issuers, dealers and purchasers in maintaining Section 3(c)(7) issuers' non-regulated status under the Investment Company Act.

While the Association recommends that its members and other market participants implement and observe the following policies and procedures for secondary market trading in book-entry Section 3(c)(7) securities, it does not intend to imply that these policies and procedures are the exclusive means by which dealers may facilitate compliance with Section 3(c)(7). Depending on a dealer's particular situation, other policies and procedures may be equally appropriate. Similarly, the Association does not intend to suggest, and makes no representation as to whether, the adoption of any or all of these policies and procedures constitutes a necessary or sufficient legal basis upon which to conclude that compliance with Section 3(c)(7) has been achieved in any particular circumstance.

The Association's recommendations are summarized in Section II below and are discussed in Section III.

II. SUMMARY OF RECOMMENDED POLICIES AND PROCEDURES

1. Establish internal policies, procedures and database/systems capabilities that facilitate the identification of securities of Section 3(c)(7) issuers.

2. Establish internal policies and procedures that result in the ongoing identification of purchasers as QIBs/QPs and maintenance of updated QIB/QP lists.

3. Consult individual transaction documents for particular restrictions applicable to securities of Section 3(c)(7) issuers.

4. Provide buyers with notification of Section 3(c)(7) restrictions.

5. Observe minimum denomination or purchase requirements, if any.

6. Disseminate and redistribute reminders and notices from 3(c)(7) issuers.

7. Provide assistance to issuers in respect of legends appearing on third-party vendor screens.

III. DETAILS OF RECOMMENDED POLICIES AND PROCEDURES

1. Establish internal policies, procedures and database/systems capabilities that facilitate the identification of securities of Section 3(c)(7) issuers.

Upon instruction received from an issuer, DTC's security descriptor identifies Section 3(c)(7) securities, and DTC's deliver order tickets sent to DTC participants carry a "3c7" indicator. At the issuer's request, DTC will send an "Important Notice" to all DTC participants in connection with the initial offering of a Section 3(c)(7) security, and will distribute periodically to all DTC participants a "Reference Directory" that includes a list of all issuers who have advised DTC that they are Section 3(c)(7) issuers as well as CUSIP numbers for these issuers' securities. The Reference Directory will be updated monthly. The CUSIP number for Section 3(c)(7) securities will have an attached field that will have "3c7" and "144A" indicators.

Euroclear and Clearstream Banking are now able to implement, upon issuer request, procedures that parallel those available at DTC. It is the issuer's responsibility to request the procedures at these service providers with respect to particular security. The Association recommends that member firms incorporate relevant information regarding securities of Section 3(c)(7) issuers, including but not necessarily limited to the information described above, into their firm-wide securities databases. Database systems should be designed to alert firm personnel responsible for settling transactions to the fact that the security is a Section 3(c)(7) security. In principle, these policies and procedures

are not different from those employed to identify Rule 144A and other restricted securities.

Information that is collected and maintained in this manner should distinguish between Section 3(c)(7) issuers that are U.S. persons and those that are non-U.S. persons. As noted above, in the case of non-U.S. issuers, a Section 3(c)(7) issuer's reasonable belief requirement applies only to holders of its securities who are U.S. persons.

2. Establish internal policies and procedures that result in the ongoing identification of purchasers as QIBs/QPs and maintenance of updated QIB/QP lists.

In principle, this is no different from being in a position to have a "reasonable belief" that a purchaser of a Rule 144A security is a QIB. The Association recommends that member firms who rely on a customer certificate of QIB status should expand the certificate to account for the fact that not all QIBs are QPs. (In particular, certain smaller securities dealers and certain participant-directed employee plans, e.g., 401(k) plans, are excluded from the definition of QP even though they may be QIBs). A sample certificate that the Association recommends for this purpose is attached as Exhibit 2.

Not all member firms rely exclusively on customer certificates of QIB status. For example, some firms regard customers as QIBs based on information provided by the customers or information that the firms obtain from third party sources. To the extent that these firms choose to continue to follow these procedures, those procedures should be modified to obtain the additional information necessary to establish QP status.

In either case, the Association recommends that member firms implement procedures that result in a periodic updating of information regarding the QIB and QP status of their customers. The Association recommends that this updating cycle be no less frequent than every sixteen (16) months, which is the general time frame prescribed under Rule 144A(d) for obtaining current financial and other information with respect to a QIB.

3. Consult individual transaction documents for particular restrictions applicable to securities of Section 3(c)(7) issuers.

There is no guarantee that all Section 3(c)(7) issuers will have adopted the Recommended Procedures. This means that resales may be subject to different substantive and/or procedural requirements from deal to deal. Such requirements may supersede the procedures discussed in these recommendations.

4. Provide buyers with notification of Section 3(c)(7) restrictions.

Member firms who sell securities in reliance on Rule 144A are already required to notify the purchaser that they (or a seller for whom they are acting as agent) may be relying on Rule 144A. The Association recommends that firms follow a parallel procedure to inform purchasers of the fact that a security is a Section 3(c)(7) security. Although a variety of methods may be used to effect such notification, the procedure should include the

addition of a trailer to the confirmation for a transaction in a Section 3(c)(7) security that calls attention to the fact that the security is a Section 3(c)(7) security. Firms should bear in mind that the Section 3(c)(7) restrictions continue to apply even after the securities are no longer subject to the conditions of Rule 144A.

5. Observe minimum denomination or purchase requirements, if any.

Where the underlying transaction documents call for minimum denominations or minimum purchase amounts, the Association recommends that firms avoid making sales of Section 3(c)(7) securities--even to QPs--in amounts less than those specified.

6. Disseminate and redistribute notices and reminders from 3(c)(7) issuers.

The Association understands that issuers using the Recommendation Procedures must send annual or other periodic reminders of the Section 3(c)(7) restrictions to the holders of their securities. Since member firms will be receiving these reminders in their capacity as participants in one or more Securities Depositories, the Association recommends that they follow their usual procedures for forwarding them to their customers.

7. Provide assistance to issuers in respect of legends appearing on third-party vendor screens.

Section 3(c)(7) issuers will generally arrange for third-party vendor screens (including those maintained by Bloomberg, L.P., Reuters Group plc and Telekurs Holding Ltd.) to include appropriate legends regarding Rule 144A and Section 3(c)(7) restrictions. Upon a determination that one or more of these vendor screens are important sources of information for the securities in question, member firms should communicate with issuers and the relevant information vendors if they discover that these legends are missing, inaccurate or incomplete.