SEWARD & KISSEL LLP

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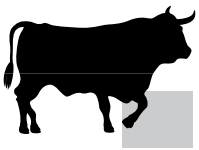

Establishing a Registered Private Investment Fund

In an effort to offer alternative investment opportunities to a broader client base, a number of private investment funds have been established that are registered under the Investment Company Act of 1940 (the 1940 Act) as closed-end investment companies (Registered Funds). While many of these vehicles are "funds-of-funds" investing in underlying unregistered private hedge funds, some of these funds may make direct investments. These Registered Funds are generating much interest and present a variety of issues.

Advantages. Registered Funds may be viewed as attractive because they: (i) allow for more investors than unregistered private investment funds (which generally can have no more than 100 investors or must otherwise be limited to "qualified purchasers"); (ii) are not subject to the NASD's "hot issue" rule; (iii) are not treated as "plan assets" under ERISA (i.e., the Registered Fund can have over 25% retirement plan assets); and (iv) may afford the manager an exclusion from CFTC registration.

Regulatory Issues. The investment manager of a Registered Fund must be registered with the SEC as an investment adviser. Registered Funds are typically offered pursuant to the private placement exemption under Regulation D of the Securities Act of 1933 (the 1933 Act). Accordingly, Registered Funds generally sell interests only through a private placement to "accredited investors" (i.e., generally, individuals with a net worth exceeding $1 million and entities with assets exceeding $5 million). The offering of some Registered Funds is also registered under the 1933 Act, thereby permitting them to be publicly offered (including to unaccredited investors). However, if a Registered Fund's manager receives incentive compensation or the Fund invests in an underlying private investment fund managed by a registered investment adviser charging such compensation, all

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Business Contingency Planning

Since September 11, 2001, authorities have articulated the need for investment managers to implement effectively tailored contingency plans to mitigate the effects of natural disasters, wide-scale emergencies and/or terrorist acts. In fact, *the National Futures Association has passed NFA Compliance Rule 2-38, which will require all commodity pool operators and commodity trading advisors to establish such a written plan and to provide the NFA with emergency contacts by July 1, 2003.* It is recommended that contingency plans address the loss of access to information, facilities and/or personnel.

Access to Information. Investment managers deal in enormous amounts of information about their clients, investments and employees. Assuring the integrity of this information is critical. Information redundancy can be obtained through a range of contractual and service arrangements with fund service providers such as prime brokers, attorneys, accountants and administrators, and/or with off-site document storage companies that specialize in document protection and retrieval. Moreover, computer files, e-mails, contact information and investment information can be stored through arrangements with outside storage companies, on- or off-site back-up services and/or disk or tape back-up systems. Finally, information storage at the personal residences of the key personnel of a manager provides a relatively inexpensive way to further insulate a manager from data loss.

Access to Facilities. Even if a manager succeeds in preserving its information, it can still find itself without access to its offices, vendors, computer systems, communications infrastructure, investment materials, internet and e-mail resources, and even basic water or sanitation services. Contingency plans may address this through the leasing of temporary space, extra analog and/or cellular communications avenues, supplemental dial-up modems, augmented messenger services and/or alternative sources of power and water.

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Registered Private Investment Fund

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investors must also be "qualified clients" (i.e., generally, a $1.5 million net worth test), regardless of whether the offering is registered under the 1933 Act.

Structural Issues. Registered Funds are typically formed as U.S. limited liability companies or limited partnerships. The manager receives an asset-based fee and/or incentive compensation for its services as investment adviser. Investors are usually admitted on a monthly or quarterly basis. Unlike mutual funds, Registered Funds are ordinarily structured as "closed-end" funds and, therefore, provide liquidity only through periodic discretionary issuer tender offers.

Pursuant to the 1940 Act, a Registered Fund's offering memorandum, other organizational documents (e.g., limited partnership or limited liability company agreement, advisory agreement, custody agreements and placement agreements) and all other material agreements must be filed with the SEC. Registered Funds must also file financial statements with the SEC (including audited annual financials), and provide investors with annual and semi-annual reports, in addition to disclosure documentation relating to any repurchase offers. Finally, Registered Funds must comply with 1940 Act requirements, including that the Fund have a Board of Directors responsible for, among other things, approving the investment advisory agreement, approving valuations, and authorizing the repurchase of interests.

Disadvantages. The disadvantages associated with Registered Funds include: (i) increased burdens associated with regulatory and administrative compliance; (ii) periodic filings with the SEC (which are publicly available); (iii) in the case of Registered Funds making direct portfolio investments, various limitations on investment activities such as leverage use, short sales, principal transactions with affiliates and the issuance of senior securities; (iv) a requirement that assets be maintained with a third-party custodian; and (v) record-keeping rules related to transactions involving the Registered Fund.

Business Contingency Planning

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Access to Personnel. Disaster planning must also contemplate the impact of the loss of human life on the manager's business. Contingency plans must preserve the decision-making processes of a working business, establish centralized procedures for communicating with employees, and preserve the disaster response functions called for by a contingency plan. The maintenance of accessible and up-to-date contact information for all employees and clients, orderly telephone trees, and clearly defined lines of authority are all central to having an office function without the benefit of firm decision-makers. Additional measures include business interruption and "key-man" insurance, coordinated travel policies and ensuring that multiple persons have access to all phases of the business. Finally, there should be a review of side-letters with "key-man" withdrawal terms.

On-Going Requirements. After establishing a contingency plan, every firm should periodically update, test and review it. "Fire drills" provide an effective avenue for giving employees practice at dealing with a disaster, identifying a plan's weaknesses and reinforcing its strengths, all without the pressures associated with an actual emergency situation.

Conclusion. The development of an effective contingency plan depends in large part on the individual circumstances of a given organization. For further information, including model plan guidelines, please contact any of the attorneys in Seward & Kissel's Investment Management Group.

New FTC Rule for Safeguarding Information. On a related note, *the Federal Trade Commission has adopted a Rule requiring financial institutions, including private investment funds, to adopt a written program containing administrative, technical and physical safeguards appropriate to their situation to protect the security, confidentiality and integrity of customer information from unauthorized disclosure, misuse, alteration or destruction. The program should, among other things, designate a coordinating employee and identify foreseeable risks. Moreover, service providers dealing with such information (e.g., administrators) will have to contractually agree to comply with the Rule.* A model program has been enclosed with this newsletter. This Rule supplements existing information privacy obligations.

Legislative and Regulatory Snapshots

New York Attorney General Speaks Out. On March 3, 2003, New York State Attorney General Eliot Spitzer spoke at the inaugural event of The Wall Street Hedge Fund Forum, a new industry group established to provide education about the industry. In Spitzer's view, the problems encountered in the investment banking industry were structural and systemic (e.g., the conflicts of interest between the activities of research analysts and investment bankers), thereby making them conducive to an industry-wide investigation and settlement. On the other hand, Spitzer noted that the private investment fund industry does not have similar conflicts of interest in that investors' interests were generally aligned with those of private fund managers. To the extent there are individualized problems with private investment funds, those may be best remedied through individual prosecution. However, Spitzer did indicate that, as the industry grows, a number of areas could eventually become possible areas of inquiry (but which he believed were not necessarily industry-wide problems), including:

(i) *Marketing to Unsophisticated Investors.* As managers seek to attract more investors, and begin to target less sophisticated investors through registered funds and other means, questions may arise concerning additional registrations by managers and whether more disclosure may be merited.

(ii) *Pressure to Maintain Performance.* If returns are affected by difficult market conditions, there may be increased pressure on managers to maintain performance, which may result in some managers engaging in improper or manipulative action.

(iii) *Short Selling.* While Spitzer made it clear that he is not against short selling generally, he noted that short sellers (as well as persons who have long positions) who engage in manipulative activities should be prosecuted.

(iv) *Excessive Use of Leverage.* Spitzer queried whether private investment funds use more leverage than other financial entities and, if so, whether the failure of a large private investment fund would have a collateral impact on the banking system.

(v) *Transparency.* Given the industry's growth, should additional portfolio transparency be provided to investors.

(vi) *Valuation of Less Liquid Positions.* Less liquid positions could be subject to mis-valuation.

Industry Investigation Continues. The SEC is continuing its investigation of the private investment fund industry. In this regard, on May 14–15, 2003, the SEC held roundtable discussions about the industry covering topics, including: structure, marketing, transparency and disclosure, valuation, allocation of trades, strategies, market participation, fraud and the current regulatory framework (for a synopsis of the roundtable, visit Publications & Speeches on our website at www.sewkis.com). A public report from the SEC is expected shortly. While the outcome is uncertain, possible results may include: (i) requiring managers to register as investment advisers with the SEC; (ii) requiring increased publicly available portfolio transparency; and (iii) changing the investor criteria necessary to invest in private investment funds. In addition, both Houses of Congress have held hearings about the industry.

Throughout the course of the SEC investigation, many government officials have expressed concern about the lack of accurate information available about private investment funds and their operations. In response to this, the Managed Funds Association, an industry lobby group, has drafted the MFA's Concise Guide to the Hedge Fund Industry. For further information, visit http://www.mfainfo.org/.

SEC Proposes Compliance Programs for Registered Investment Companies and Registered Investment Advisers. On February 6, 2003, the SEC released for public comment proposed rules that would require registered investment companies and registered investment advisers to: (i) implement programs designed to prevent the violation of federal securities laws, which should, at a minimum, address portfolio management processes, trading practices, proprietary and personal trading, disclosures to investors, safeguarding of client assets, creation and maintenance of records, valuation of securities, protection of client information and business continuity plans; (ii) review their programs annually to determine their effectiveness; and (iii) appoint a chief compliance officer.

SEC Establishes Web Pages about Private Investment Funds. The SEC has recently established a series of web pages designed to educate the public about private investment funds and funds-of-funds (visit www.sec.gov/answers/hedge.html). The SEC has also set up a link to the web site of a fictitious private investment fund to help demonstrate an example of fraud (visit http://www.growthventure.com/grdi/).

NASD Issues Notice to Brokers Selling Private Investment Funds. In February 2003, the NASD issued Notice 03-07 to its broker-dealer members, reminding them of their obligations when selling private investment funds, including: (i) providing balanced disclosure in promotional materials; (ii) having a reasonable belief that

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the fund is suitable for any investor; (iii) determining that their recommendations are suitable for a particular investor; (iv) supervising associated persons selling private investment funds; and (v) training associated persons regarding the features, risks and suitability of these products. The NASD issued this Notice in response to its concerns about the retailization of these funds.

On April 22, 2003, the NASD announced that it had censured and fined Altegris Investments, a registered broker-dealer, for failing to disclose the risks associated with the hedge funds it was marketing, even though the funds' underlying offering memoranda contained risk disclosures.

Update on the Patriot Act. On December 31, 2002, the U.S. Treasury, Federal Reserve and SEC issued a joint report to Congress pursuant to the Patriot Act with respect to private investment funds that recommends: (i) adoption of rules requiring the establishment of an anti-money laundering (AML) program for certain "unregistered investment companies" (these regulations are discussed in *The Private Funds Report, Vol. V*), and (ii) requiring unregistered investment companies to establish customer identification and verification programs.

In addition, on April 29, 2003, the U.S. Treasury issued proposed rules requiring all commodity trading advisors and investment advisers (registered or unregistered with $30 million or more under management) of separately managed accounts to adopt AML programs similar to those recommended previously for unregistered investment companies. In the case of unregistered advisers, the proposal also requires that a Notice be filed with the Financial Crimes Enforcement Network setting forth contact information, number of clients and assets under management.

CFTC Issues New Release on Registration Issues. On March 13, 2003, the CFTC issued a release (visit www.cftc.gov/files/opa/press03/opacposandctas.pdf) proposing various new registration exemptions for commodity pool operators (CPOs) and commodity trading advisors (CTAs), and expanding the temporary relief (the Relief) issued on November 6, 2002 (see *The Private Funds Report, Vol. V*). Essentially, the release:

(i) expands the Relief by exempting a manager from CPO registration, if the pool is open solely to "accredited investors" and the manager can demonstrate limited commodity interest trading by representing that the (a) aggregate initial margins and premiums required to establish commodity interest positions does not exceed 2% of the pool's liquidation value or (b) aggregate net notional value of the pool's commodity interest positions does not exceed 50% of the pool's liquidation value;

(ii) clarifies that a CPO of a fund-of-funds may rely on the Relief, if the underlying investee funds themselves are either registered with the CFTC or rely upon the Relief, and such investee funds represent that they are in compliance with the requirements of the Relief;

(iii) proposes Rule 4.13(a)(4), which would exempt a manager from CPO registration, if the pool is exempt from SEC registration, is sold privately in the U.S. and each investor that is an individual is a "qualified purchaser" or, in the case of an entity, an "accredited investor" or "qualified eligible person"; and

(iv) proposes Rule 4.14(a)(10), which would exempt from CTA registration any party who during the preceding 12 months has had fewer than 15 clients and does not hold itself out to the public as a CTA (for purposes hereof, the CFTC is proposing to treat most entities as single clients without looking through such entities to their owners).

SEC Adopts Proxy Rules for Registered Investment Advisers. On January 31, 2003, the SEC adopted a new rule and amendments (Proxy Voting Rules) to an existing rule under the Investment Advisers Act of 1940. The Proxy Voting Rules require SEC registered investment advisers with voting authority over client proxies to: (i) implement written proxy voting procedures to ensure that proxies are voted in the best interests of their clients; (ii) describe proxy voting procedures for clients and, upon request, provide a copy of the procedures to their clients; (iii) disclose to their clients, upon request, information about how proxies were voted; and (iv) retain certain records involved in the proxy voting process. *Registered investment advisers must be in compliance by August 6, 2003.* A more detailed memo on this matter is available upon request.

NASDAQ Launches Official Closing Price. On April 14, 2003, the NASDAQ announced that it had begun calculating the NASDAQ Official Closing Price (NOCP) for all National Market and SmallCap securities. Prior to the NOCP, NASDAQ did not designate an "official" closing price, and generally the last eligible trade report was used by many market participants.

A Look at Fee Deferrals. Over the past year, there have been a number of reports about a few private investment fund managers who are being investigated by the IRS in connection with their offshore fund fee deferral programs. In the typical offshore fee deferral program, the investment manager and the fund agree that

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fees will not be paid on a current basis and that such deferred amounts will be indexed to the performance of a particular investment (usually, the fund itself) and appreciate (assuming the fund has positive returns) on a tax-free basis as a liability owed by the fund to the manager until the specified deferral period ends. In light of the IRS' scrutiny of these programs, it is suggested that fee deferral programs be reviewed and that the following guidelines be satisfied:

- the investment manager must utilize the cash basis method of accounting;
- the investment manager should make its deferral election prior to the commencement of the fiscal year in which the fees that are sought to be deferred are actually earned;
- a majority of the offshore fund's board of directors should be independent (i.e., not comprised of persons associated with the investment manager or its affiliates);
- once a deferral election has been made, the investment manager should not: (i) seek to extend or renew the deferral period or (ii) attempt to withdraw any of the deferred amounts prior to the end of the deferral period;
- the investment manager should not be permitted to assign, transfer or pledge any portion of its interest in the deferred amounts; and
- the deferral election should be documented properly and on a timely basis and sent to the offshore fund's administrator.

We note that, in 2002 and 2003, several bills addressing the taxation of certain deferred compensation arrangements relating to employees were introduced in Congress to address certain perceived abuses concerning deferral arrangements by Enron and other multi-national corporations. The primary focus of these bills are: (i) the proposed elimination of the tax deferral benefits currently provided by many "rabbi trusts" established and maintained outside of the U.S. (i.e., irrevocable trusts formed by an employer, the assets of which are subject to the claims of the employer's judgment creditors) and other similar arrangements; (ii) to provide more explicit rules regarding the circumstances under which an employee's deferred compensation is treated as "funded" by the employer and therefore currently taxable to the employee; and (iii) specific legislative authorization permitting the IRS to promulgate new rules to prevent the improper deferral of the taxation of compensation income. While the IRS and Congress are aware of the deferred fee arrangements typically entered into by investment managers and offshore investment funds, the proposed legislation does not appear to be aimed directly at, or apply to, any deferred fee arrangements that do not involve the location offshore of the assets to be used by the offshore fund to satisfy the obligation to the investment manager. The bill signed into law by President Bush on May 30, 2003 does not contain any provisions relating to the taxation of deferred compensation. At the present time, it is unclear whether the proposals will be enacted and, if enacted, the effective dates of any such legislation. We will continue to apprise you of any new developments.

New Tax Shelter Regulations. In February 2003, the IRS released final regulations expanding previously existing information reporting, record maintenance and investor list maintenance requirements with respect to certain "tax shelter" transactions (the Regulations). *The Regulations may potentially apply to a broad range of investments not typically viewed as tax shelter transactions, including investments in private investment funds and investments by such funds.*

Under the Regulations, if a fund engages in a "reportable transaction", the fund and each investor who is treated as participating in such transaction would be required to retain all records material to such transaction, file IRS Form 8886 — Reportable Transaction Disclosure Statement as part of its federal income tax return for each year it participates in the transaction and send a copy of such form to the IRS at the time the first such tax return is filed. In addition, "material advisors" (e.g., possibly a private investment fund manager) with respect to a transaction that is known to be or reasonably expected to become a "reportable transaction" must maintain lists of persons who participate in such transactions and furnish these lists to the IRS within twenty days of a request.

In order for a private investment fund to avoid becoming subject to some requirements contained in the Regulations, it should provide written notification to its investors that they are authorized to disclose to others the tax treatment and structure of their investment in the fund. Furthermore, while many private investment funds generally will be exempt from the Regulations' requirements, ***funds that derive losses from certain transactions that exceed specified monetary thresholds (e.g., funds-of-funds, funds engaged in foreign currency transactions and funds, such as convertible arbitrage funds, that engage in "straddle transactions") will likely be subject to the information reporting requirements.***

The scope of the Regulations may be affected by further IRS guidance. Please contact Peter Pront or Dan Murphy in our Tax Group, if you wish to discuss the Regulations.

Investment Management Group News

Seward & Kissel LLP launched its new web site on June 3, 2003 (visit www.sewkis.com). Many Investment Management Group publications are posted on the site.

Seward & Kissel LLP was again ranked as the number one hedge fund law firm, this time according to a survey published by CogentHedge.com in December 2002.

Robert B. Van Grover will speak about Establishing the Right Criteria for Successful Manager Selection at the 10th Annual Hedge Fund Forum on June 25, 2003 at the Roosevelt Hotel in New York City. He also spoke about anti-money laundering at the Hedge Fund Regulation and Compliance seminar sponsored by Financial Research Associates on March 28, 2003 at the American Conference Centers in New York City.

John J. Cleary spoke at the Goldman Sachs Sixth Annual Hedge Fund CFO Forum on May 18–21, 2003 at The Ritz Carlton in Key Biscayne, Florida.

Maureen Hurley, an associate in the Investment Management Group, spoke about private placements at Hedge Funds: Hot Regulatory and Operational Issues at the Practicing Law Institute in New York City on March 12, 2003.

Prior editions of this newsletter and an Index to Covered Topics may be found on the web at www.sewkis.com under Publications & Speeches.

Seward & Kissel LLP

If you have any questions or comments about this newsletter, please feel free to contact any of the attorneys in our Investment Management Group specializing in private investment funds via telephone at (212) 574-1200 or e-mail generally by typing in the attorney's last name ***@sewkis.com***

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