SEWARD & KISSEL LLP

THE PRIVATE FUNDS REPORT

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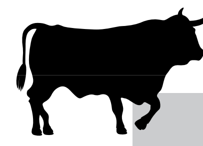

Proposed Hedge Fund Legislation Introduced

In the wake of Long-Term Capital, various industry groups (including the President's Working Group on Financial Markets) have issued recommendations on how to prevent such a situation from happening again. Essentially, the recommendations call for both U.S. and foreign regulators to encourage: (i) an increase in the level of disclosure by unregistered funds to both investors and lenders and (ii) the adoption of stronger risk management guidelines by lenders to such funds.

Responding to these various recommendations, on September 23, 1999, Representative Richard H. Baker, Chairman of the House Subcommittee on Capital Markets, introduced proposed legislation known as the "Hedge Fund Disclosure Act" (the "Act"). The Act requires any "unregulated hedge fund" with at least $3 billion in capital and any hedge fund group with at least $20 billion in total assets to comply with certain reporting requirements. *Under the reporting requirements, each affected hedge fund/hedge fund group must file a report with the Federal Reserve Board on a quarterly basis stating (i) total assets, (ii) total derivatives positions, (iii) the balance sheet leverage ratio of assets to liabilities, (iv) a meaningful and comprehensive measure of market risk (such as value-at-risk or stress test results), and (v) such other information as the Federal Reserve in consultation with the SEC, CFTC, Treasury Department and banking agencies may require.* Upon receipt of such a report, the Federal Reserve will transmit copies to the abovementioned regulators and, subject to the protection of certain proprietary information, make the report publicly available. In order to ensure compliance, the Act permits the Federal Reserve to seek enforcement in the U.S. District Court where the hedge fund is located and, in the case of any offshore fund that borrows from, accepts investments by or is a counterparty to a U.S. person, in the U.S. District Court for the District of Columbia. Finally, the Act

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U.S. Regulatory Snapshots

NASD Proposes Revamped Hot Issue Rule. On October 7, 1999, the NASD proposed a new rule related to trading in hot equity offerings ("hot issues"). The proposed rule contains several significant changes, including (i) the establishment of a requirement that a public offering rise by at least 5% within its first five minutes of trading to be considered "hot", (ii) limiting the rule's application to equity offerings and offerings with an equity component, and (iii) the elimination of the "conditionally restricted" category and the reclassification of many of those persons (e.g., hedge fund managers, investment advisors and other investment managers) as "absolutely restricted". While items (i) and (ii) will be beneficial changes for private funds generally, item (iii) will have an adverse effect on many funds that currently allocate hot issues to conditionally restricted persons (including the fund's general partner or investment manager). The proposed rule is being released for public comment. We will be monitoring it closely and may be commenting on it on behalf of various clients — if you are interested, please contact us.

Investment Company Act-Section 3(c)(1)/3(c)(7) Interpretations. On April 22, 1999, the SEC issued a no action interpretive letter to the American Bar Association clarifying its position on various issues relating to funds relying upon Section 3(c)(1) (i.e., funds with not more than 100 beneficial owners) or Section 3(c)(7) (i.e., funds consisting solely of "qualified purchasers", who are essentially individuals with $5 million in investments and entities with $25 million in investments) of the Investment Company Act of 1940. The issue of whether both a Section 3(c)(1) entity and a Section 3(c)(7) entity can be included in a single "master-feeder" structure if the master fund is relying upon Section 3(c)(7) was addressed in the interpretive letter. The interpretive letter stated that

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Industry Trends and Happenings

Increased Level of Transparency. A recent development apparently prompted by the near collapse of Long-Term Capital is that investors in private funds are demanding a higher level of portfolio transparency. As such, more managers are now providing a greater degree of portfolio information to their investors through mailings, password-protected web sites and other avenues. Often this information is provided on a regular basis (typically monthly).

Private Equity Fund of Funds. As some of the big names in the private equity sector surpass the $1 billion mark, funds of funds that are designed to invest in a diverse group of large private equity funds are becoming more prevalent.

Nasdaq Antitrust Class Action Settlement. On November 9, 1998, the Southern District of New York approved a $1.027 billion settlement relating to price fixing of 1,659 Nasdaq stocks traded between May 1, 1989 and July 17, 1996. Generally, anyone who traded in any of the 1,659 stocks is eligible to be in the class. The proceeds are to be distributed to all class members filing a proof of claim before the December 8, 1999 deadline. Priority weightings will be given to individual investors over certain institutional investors (e.g., investment advisers registered with the SEC or a state, as well as other entities with assets of at least $50 million). *Information about this settlement may be obtained via the Internet at **www.nasdaqlitigation.com** or by telephone at 1-800 933-6363.*

Web CRD Takes Effect. Private investment funds affiliated with broker-dealers should be aware that, effective as of August 16, 1999, broker-dealer filings (i.e, Forms BD, BDW, U-4 and U-5) are to be submitted to the NASD's Central Registration Depository via the web, except for the initial Form BD filing which is to be mailed.

Offshore Developments

Cross-liability between Separate Portfolios. Cross-liability is sometimes an issue for a fund with multiple portfolio classes, because if there are insufficient assets in one portfolio to cover that portfolio's debts and liabilities (e.g., margin calls), a creditor of that portfolio may seek to reach the assets in the other portfolios of the fund to make up the difference. While Delaware has adopted favorable legislation on this matter, offshore jurisdictions have not yet followed. Under Delaware law, a limited partnership or limited liability company may be established with multiple portfolios or series in which the debts and liabilities of one portfolio or series may only be enforced against the assets of such portfolio or series. This type of legislation has been adopted for Cayman Islands insurance companies, but has not yet been adopted for offshore investment funds. We understand that a renewed lobbying effort is now under way in the Cayman Islands regarding this issue.

Hot Issues. Since August 18, 1998, when various changes to the NASD's hot issue rules became effective, certain large offshore funds have been able to take advantage of one of the new provisions. That provision essentially allows offshore funds to allocate hot issues to all of their investors (without requiring a carve-out mechanism or separate classes of shares for restricted and non-restricted persons), provided the fund (i) has 100 or more investors, (ii) is listed on a foreign exchange, (iii) invests no more than 5% of its assets in any particular hot issue, and (iv) has no 5% or more owners that are restricted persons under the hot issue rule.

Around the Firm

John E. Tavss will be speaking at the Foundation of Accounting Education's 9th Investment Partnership Conference about *Issues Concerning Offshore Funds* on **November 4, 1999** in New York City. Mr. Tavss also recently spoke at the 1999 Conference of The International Bar Association in Barcelona on September 29, 1999, regarding European Hedge Funds.

John E. Tavss and **Peter E. Pront** will be speaking at The Institute for International Research's *Mastering Effective Tax, Accounting and Documentation Requirements for Private Investment Partnerships* on **November 10-11, 1999** at the Marriott East Side Hotel in New York City.

Steven B. Nadel will be speaking at the 3rd Annual Prime Brokerage Caucus about *Considerations Relating to U.S. and Offshore Hedge Funds* on **January 24-25, 2000** at the Marriott East Side Hotel in New York City.

John J. Cleary spoke at the MeesPierson Fund Services Seminar *How to Set Up a Hedge Fund* on October 7, 1999, at The Grand Hyatt Hotel in New York City.

Snapshots

(from front page)

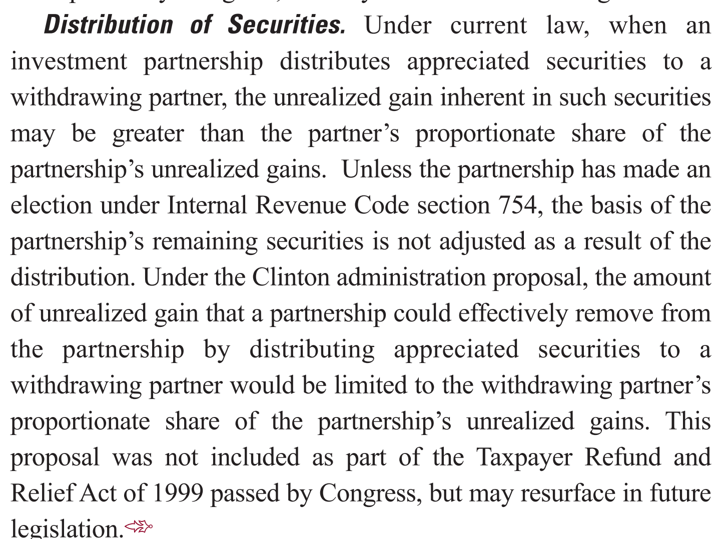
"any entity whose investors consist of non-qualified purchasers, that was formed or operated for the purpose of investing in a Section 3(c)(7) fund, and that subsequently invests in such a fund may result in a violation of the Investment Company Act". In our view, this language clearly indicates that, in a master-feeder structure, in order for the master fund to rely upon Section 3(c)(7), each feeder fund must be a Section 3(c)(7) fund and that, therefore, 3(c)(1) and 3(c)(7) entities cannot be combined in one master-feeder structure. In addition, a number of diverse issues were covered in the letter, including "knowledgeable employees", IRAs, trusts and involuntary transfers.

Proposed Pay-to-Play Ban for Investment Managers. On August 4, 1999, the SEC proposed a rule that would prohibit a registered investment adviser from providing advisory services for compensation to public funds for a period of two years following the date of its political contribution (and those of certain related persons) to certain elected officials and political candidates. For purposes of the proposed rule, an investment by a government entity in a hedge fund would be treated the same as if the government entity had entered into an advisory contract directly with the adviser. The SEC is currently seeking comments on the proposed rule.

NFA Plain English Rule Becomes Effective. On October 26, 1998, the CFTC approved National Futures Association Rule 2-35. Among other things, the Rule requires commodity pool operators who are required to file disclosure documents with the CFTC (including funds that invest less than 10% of their assets in futures and operate in reliance on Regulation 4.12(b)) to prepare disclosure documents in a "plain English" format utilizing principles outlined in the Rule's Interpretive Notice. The filing requirements do not apply to funds open solely to "qualified eligible participants" relying on Regulation 4.7. The Rule became effective on *April 30, 1999 for new commodity pools* and becomes effective on *December 31, 1999 for existing commodity pools*.

Constructive Ownership Transactions. In recent years, some taxpayers have attempted to convert short-term capital gain derived through actual ownership of a limited partnership interest in a hedge fund into long-term capital gain by making an indirect investment in the hedge fund by means of a derivative such as an equity swap or put-call option arrangement. The Taxpayer Refund and Relief Act of 1999, which was passed by Congress on August 5, contains a provision that would limit the ability of taxpayers to engage in such "constructive ownership transactions" by: (i) limiting the amount of long-term capital gain that a taxpayer recognizes with respect to such a transaction to the amount of long-term capital gain that the taxpayer would have recognized had the taxpayer held the hedge fund interest directly and treating any gain in excess of such amount as ordinary income, and (ii) imposing an interest charge on the amount of gain that is treated as ordinary income. The bill was recently vetoed in its entirety by President Clinton, but it is likely that this provision will be reintroduced in future legislation.

Taxation of Partial Withdrawals from Limited Partnerships. Under current law, a partner generally does not recognize gain upon the receipt of a cash distribution from a partnership unless the amount of cash exceeds the partner's tax basis of its partnership interest. The Clinton administration proposed to treat a partial liquidation of a partner's interest in a partnership (i.e., a reduction in the partner's percentage share of capital) as a complete liquidation of that portion of the partner's interest (i.e., a partner would recognize gain upon the receipt of cash in excess of the partner's basis for the redeemed interest even if his basis for the overall interest exceeds the amount of the cash distribution). This proposal was not included as part of the Taxpayer Refund and Relief Act of 1999 passed by Congress, but may resurface in future legislation.



Distribution of Securities. Under current law, when an investment partnership distributes appreciated securities to a withdrawing partner, the unrealized gain inherent in such securities may be greater than the partner's proportionate share of the partnership's unrealized gains. Unless the partnership has made an election under Internal Revenue Code section 754, the basis of the partnership's remaining securities is not adjusted as a result of the distribution. Under the Clinton administration proposal, the amount of unrealized gain that a partnership could effectively remove from the partnership by distributing appreciated securities to a withdrawing partner would be limited to the withdrawing partner's proportionate share of the partnership's unrealized gains. This proposal was not included as part of the Taxpayer Refund and Relief Act of 1999 passed by Congress, but may resurface in future legislation.

HEDGE FUND

(from front page)

calls on the SEC, CFTC and federal banking agencies to promulgate rules requiring public companies, including financial institutions, to publicly disclose their direct material exposures to significantly leveraged financial institutions, including hedge funds covered by the Act.

Conclusion: As of the publication of this newsletter, the future of the Act remains uncertain. First, bipartisan Congressional support for the Act has not yet been determined. Second, while the Act currently affects only the largest of hedge funds, many industry participants are concerned that the Act's scope may be broadened to affect a broader class of hedge funds, including those who do not employ significant financial leverage. Lastly, there are many areas of the Act that require further clarification, including what constitutes "capital" for purposes of determining whether an investment vehicle is an "unregulated hedge fund" and the detail of information to be reported pursuant to the Act (and a fund's ability to protect proprietary information).

Important Reminder

As year-end approaches, investment managers should bear in mind that they may have a filing obligation under Section 13(f) of the Securities Exchange Act of 1934. *Section 13(f) requires that an initial Form 13F be filed* ***within 45 days after the end of the calendar year*** *in which a manager, as of the end of any month during such year, exercised investment discretion over $100 million or more in Section 13(f) securities.* "Section 13(f) securities" include U.S. exchange-traded (e.g., NYSE or AMEX) or NASDAQ-quoted stocks, equity options and warrants, shares of closed-end investment companies and certain convertible debt securities. Section 13(f) generally requires disclosure of all such Section 13(f) securities positions. It does not, however, require the disclosure of short positions, nor does it permit the netting of short positions from long positions in determining the $100 million threshold. Furthermore, managers subject to Section 13(f) will have an ongoing quarterly filing obligation.

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