SEWARD & KISSEL LLP

THE PRIVATE FUNDS REPORT

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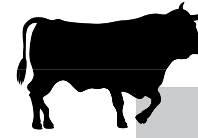

Private Investment Funds and the Internet

Many private investment funds and their investment advisers have begun to use the Internet either by participating in web site databases operated by third parties or by establishing web sites of their own.

However, there are a number of regulatory issues which must be considered in order for a private investment fund (including an offshore fund targeting U.S. investors) and/or its adviser to comply with the U.S. securities laws, such as the Investment Advisers Act of 1940, the Investment Company Act of 1940 and the Securities Act of 1933. Specifically, any private investment fund adviser relying on an exception provided in the Investment Advisers Act (which excepts an investment adviser from SEC registration if it has fewer than 15 clients and does not hold itself out publicly as an investment adviser) must consider whether its Internet activity would result in "holding itself out to the public." In addition, the Investment Company Act affords a private investment fund two exceptions from the definition of an investment company and thus having to register with the SEC, both of which exceptions (i.e., Sections 3(c)(1) and 3(c)(7)) are predicated on a private placement of the fund's securities under the Securities Act. Accordingly, a private investment fund's Internet activity must be conducted in a manner so as not to result in a public offering of its securities.

While a private investment fund or its non-SEC registered adviser is clearly prohibited from setting up a web site that is freely accessible to anyone with a computer terminal, there have been legal developments that nonetheless afford such funds and their advisers some degree of Internet access. The most direct SEC

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Choosing a Name

The growth of the private investment fund industry has made the issue of selecting names for the fund and its adviser increasingly problematic.

Advisers are becoming, by necessity, more expansive in their choices, given that such names must often overcome potential common law, state, federal trademark, and even Internet-related hurdles.

When selecting a company name, generally, it will first be checked for availability in the state of the company's formation, as well as the state of the company's principal office. Even if this check reveals no conflicts (with identical or substantially similar names), one must still be concerned with other areas of conflict.

Conflicts, for example, may exist with respect to trademarks, service marks and Internet domain names, all of which have become valuable commodities for advisers endeavoring to stand out from the crowd and avoid being confused with similarly named, but unrelated, entities. Trademarks and service marks are names that are used, respectively, in relation to specific goods or services. An Internet domain name, if used like a trademark (i.e., as an identifier of specific goods or services), may be a registrable trademark. A person's right to use a name, however, is different than one's right to register it as a trademark. The ability to trademark a name merely because no other entity has done so does not necessarily give someone the right to use that name if another entity has been using the name longer and one business is likely to be confused with another (i.e., if another entity has been using the name longer, they can challenge someone else's use of the name, even if that other person had the name registered).

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interpretation relating to private investment fund web sites is set forth in the no-action letters issued by the SEC to *Lamp Technologies, Inc.* in 1997 and 1998. These letters granted Lamp permission to establish a web site for listing information about third party private investment funds, provided that (1) the site was password protected, (2) the site was accessible only by accredited investors, and (3) site subscribers would not be permitted to invest in any posted fund for 30 days after their qualification to invest.

Lamp does not address the direct establishment of a web site by a private investment fund or its adviser. It is generally recommended that web sites operated by private investment funds or their advisers have password-protected access with the password being given solely to existing investors and prospective investors with whom the adviser has a substantive preexisting relationship. With respect to a web site involving the adviser itself, unless the adviser is a registered investment adviser, the site should similarly not be accessible by the general public. The web site should contain appropriate legends and the domain name should not give any indication that it relates to a private investment fund or an investment adviser. Finally, there may be applicable state law issues that need to be considered depending upon the jurisdiction involved.

Practical Considerations

State Level Investment Adviser Registration. While many advisers to private investment funds are not registered as investment advisers with the SEC on the basis that they have fewer than 15 clients (i.e., a private investment fund generally counts as only one client regardless of how many investors it has) and do not hold themselves out to the public as advisers, such advisers should bear in mind that many states have their own investment adviser registration requirements. The following is a synopsis of the registration requirements in certain key states assuming the adviser's principal office is located in that state:

California: registration is required.

Connecticut: registration is required if the adviser has less than $25 million in assets and fewer than 15 clients.

Florida: while the Florida statute provides that an adviser need not register if it does not hold itself out publicly as an investment adviser and has no more than 15 clients within 12 consecutive months in the state, state regulators take the position that having a place of business in the state is considered publicly "holding out".

Massachusetts: registration is not required if

(i) the adviser has no clients in the state, so long as such adviser is appropriately registered as an adviser in each jurisdiction where it does have clients, or

(ii) if the adviser's only clients in the state consist of investment entities made up solely of accredited investors.

New Jersey: registration is required if the adviser has more than 5 clients (excluding certain institutional clients) in the state.

New York: registration is required if the adviser has more than 40 clients in the state.

Texas: registration is not required if the adviser's sole clients in the state are accredited investors that are entities.

U.S. Legislative and Regulatory Snapshots

Comprehensive Banking Reform Legislation Enacted. The enactment of the Gramm-Leach-Bliley Act (the "GLBA") on November 12, 1999 should provide greater flexibility to bank-affiliated private investment funds. However, the GLBA's modification of the bank exemption from SEC investment adviser registration under the Investment Advisers Act of 1940 may cause some hesitation on the part of those banks that previously provided advisory services directly to both registered investment companies and private investment funds.

The GLBA repeals various sections of the Glass Steagall Act, which effectively barred affiliations and management interlocks between banks and entities "engaged principally" in the issuance, underwriting and distribution of securities (e.g., private investment funds). Under the GLBA, many of such activities may now be conducted through certain newly created bank affiliates, namely "financial holding companies" and "financial subsidiaries", provided that such entities first file certifications with the Federal Reserve Board or the Comptroller of the Currency demonstrating that they are well capitalized, well managed, and have at least a satisfactory rating under the Community Reinvestment Act.

Conversion to these new entities is not mandatory; existing bank holding companies and bank operating subsidiaries who desire to maintain their current regulatory status and activities will remain subject to the old bank affiliation rules. However, the powers and activities of such entities may not be expanded. As such, absent conversion, such entities may not operate open-end private investment funds, since the continuous offering and redemption of open-end interests by such a fund would be deemed to be the equivalent of being "principally engaged" in securities offerings and, therefore, prohibited, unless operated by a financial holding company or a financial subsidiary.

The GLBA has also modified the exemption for banks from SEC registration as an investment adviser under the Investment Advisers Act by repealing the exemption for any bank that acts as an adviser to a registered investment company. Since the exemption was not available previously to holding company or bank operating subsidiaries, its repeal should have minimal impact on banking institutions that were involved in fund management through such entities. However, for those banks that advised private investment funds directly and also advised one or more investment companies, elimination of the exemption has more significant consequences. These banks will either have to register as investment advisers or transfer their bank advisory activities to a registered affiliate.

Additional New Hedge Fund Legislation Proposed. The hedge fund legislation proposed by Representative Richard Baker on September 23, 1999 (see *The Private Funds Report,* Fall/Winter 1999 edition) was expanded by the Capital Markets Subcommittee of the House Banking Committee to include those funds or fund groups with $3 billion of total assets or $1 billion of net assets, but not certain commodity pools. In addition, an alternative proposal was introduced on November 18, 1999 as part of the proposed Derivatives Market Reform Act of 1999. The new legislation, which was introduced in the House by Representative Edward J. Markey of Massachusetts and in the Senate by Senator Byron Dorgan of North Dakota, is part of a comprehensive bill intended to address issues relating to the use of over-the-counter derivatives, as well as matters raised by the near collapse of Long-Term Capital Management.

With respect to hedge funds, Title III of the Markey/Dorgan bill, entitled "Hedge Fund Reporting", proposes certain amendments to the Investment Company Act of 1940 for every "unregistered hedge fund". The bill defines an "unregistered hedge fund" as any pooled investment vehicle or group of pooled investment vehicles that:

(i) has total assets under management of $1 billion and

(ii) relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act or is a foreign company that would be

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required to obtain an SEC order if it conducted a public offering of its securities.

Under the reporting requirements, each "unregistered hedge fund" would be required to file a quarterly report with the SEC prepared in accordance with generally accepted accounting principles that includes (A) a statement of financial condition, (B) a statement of income (loss), (C) a statement of cash flows, (D) a statement of changes in equity, (E) a description of the models and methodologies used to calculate, assess and evaluate market risk, and (F) such other information, and within such time period, as the SEC, in consultation with the Treasury Department, Federal Reserve, CFTC and other appropriate regulatory agencies, may require as necessary for the public interest or investor protection, including information about sudden changes in net asset value, leverage ratio and the total notional amount of derivatives positions. Upon receipt of such a report, the SEC would transmit copies to the aforementioned regulators and, subject to the protection of any proprietary information, make the report widely available to the public.

Status of Hot Issue Rule Proposal. Since the Fall/Winter 1999 edition of *The Private Funds Report* was issued, the SEC, on January 10, 2000, released the NASD's hot issue rule proposal for public comment. The key changes in the proposed rule affecting private investment funds are:

(i) the requirement that the market price of a new issue increase by at least 5% during its first 5 minutes of trading in order for the new issue to be considered a "hot issue",

(ii) the application of the rule to equity offerings only,

(iii) the elimination of the conditionally restricted person category (i.e., fund managers/investment advisers would be absolutely restricted under the new proposal), and

(iv) the exemption of a collective investment account (e.g., private investment fund) from being restricted, if its beneficial ownership by restricted persons is limited to less than 5% of the account.

As of this edition, the SEC approval period had been extended a number of times and a final resolution may not be forthcoming until later in the year.

CFTC Proposes Revisions to Rule 4.7. On March 2, 2000, the Commodity Futures Trading Commission proposed changes to Rule 4.7. Rule 4.7 provides a simplified regulatory framework for commodity pool operators whose clients are qualified eligible participants ("QEPs") and for commodity trading advisors whose clients are qualified eligible clients ("QECs"). Among the changes proposed are an expansion of the QEP and QEC definitions to include:

(i) principals of QEPs and QECs,

(ii) certain registered securities investment advisers and their principals,

(iii) "qualified purchasers" and "knowledgeable employees" as defined under the Investment Company Act,

(iv) certain employees and their immediate family members, and

(v) trusts whose advisors and settlors are QEPs or QECs. Comments to the proposal were due by May 1, 2000.

SEC Proposes Electronic Form ADV. On April 5, 2000, the SEC issued proposed rules designed to implement the creation of an electronic filing system for investment advisers. The system will permit investment advisers to satisfy their federal and state filing obligations with a single filing over the Internet. The system will be administered by a newly-created NASD subsidiary called the Investment Adviser Registration Depository. As part of the implementation of this system, existing advisers will need to resubmit their Form ADV filings electronically. In addition to the

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foregoing, it is proposed that Form ADV be drastically revised to accommodate electronic filing and to make it more reader-friendly. Comments were due by June 13, 2000.

New Withholding Tax Rules. Effective January 1, 2001, a new withholding tax regime takes effect with respect to payments made to foreign persons. The new rules make significant changes in the manner which withholding is done with respect to payments to foreign entities which are partnerships for U.S. federal income tax purposes (e.g., most "master funds" in a "master-feeder" structure). If appropriate documentation is provided to the withholding agent (e.g., the broker), the withholding agent generally will be required to withhold only on the portion of payments of U.S. source income that is allocable to foreign partners (unlike under the present rules where the entire payment is subject to withholding tax). The foreign partnership generally will be required to provide the withholding agent with:

(i) an IRS Form W-8IMY for the partnership,

(ii) an IRS Form W-8BEN for each of the foreign partners,

(iii) an IRS Form W-9 for each of the U.S. partners, and

(iv) a statement regarding the partners' distributive shares of payments to assist the withholding agent in determining the correct amount of a payment subject to withholding. In the absence of the appropriate documentation, the withholding agent generally will withhold with respect to all payments of U.S. source income (including portfolio interest) to a foreign partnership.

Important Date to Remember

Managers who filed Form 13F for the first quarter of this year, please note that the second quarter filing is due by August 14, 2000.

Name

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Moreover, the geographic expansion of private investment funds to areas beyond the typical financial centers has caused the formation of entities in states which, in the past, might not have been thought of as posing any conflicts. Accordingly, a fund might be formed in New York with the same name as a fund formed in Colorado.

Essentially, while there is no foolproof methodology for eliminating name conflicts entirely, the best approach is the performance of due diligence in all states and the trademark office (which various search companies will perform for less than $500), as well as on the web.

Offshore Developments

Cross-liability Revisited. It has come to our attention that Bermuda has the capability, by Private Act of Parliament (i.e., by special application to the government), for a Bermuda investment fund to establish separate series with no cross-liability between or among the series. More importantly, Bermuda is in the final stages of adopting segregated accounts public legislation, which, although primarily directed at insurance companies, is hoped will apply to all types of companies, including investment funds.

Around the Firm

Robert B. Van Grover became a member of the firm effective July 1, 2000.

John E. Tavss will speak at the Institute for International Research's *Hedge Fund Formation for Institutions and Portfolio Managers Conference* on September 11 and 12 at the Marriott East Side Hotel in New York.

John E. Tavss spoke at the Institute for International Research's *Private Investment Partnership Administration, Operations and Technology Forum* on June 26 in New York.

John F. Rigney spoke at a seminar entitled *Research, Risk and Regulation of Hedge Funds* sponsored by the Duke University Global Capital Market Center held at Duke University.

Steven B. Nadel will be teaching a course on August 22/24 and again in the winter at the New York Institute of Finance regarding the organizational and operational aspects of Hedge Funds. For further information, please go to ***www.nyif.com*** or contact Matthew Gordon at (212) 390-5014.

Important Reminder

During the past two years, NASD-registered broker-dealers (including those affiliated with private investment funds) have received NASD Notices to Members relating to the Series 55 exam (also known as the "Equity Trader exam"). This registration requirement generally applies "if, with respect to transactions in equity, preferred or convertible debt securities effected otherwise than on a securities exchange, such person is engaged in proprietary trading, the execution of transactions on an agency basis, or the direct supervision of such activities". The Series 55 exam is in addition to the general securities registered representative exam (Series 7). The rule does not have a "grandfather" provision. All equity traders satisfying the foregoing criteria were required to have passed the Series 55 exam by May 1, 2000; however, it appears that many have not taken it. The NASD may impose monetary and regulatory sanctions on traders and their supervisors who fail to comply.

The information contained in this newsletter is for informational purposes only and is not intended and should not be considered to be legal advice on any subject matter. As such, recipients of this newsletter, whether clients or otherwise, should not act or refrain from acting on the basis of any information included in this newsletter without seeking appropriate legal or other professional advice. This information is presented without any warranty or representation as to its accuracy or completeness, or whether it reflects the most current legal developments.

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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 by typing in the attorney's last name ***@sewkis.com***

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