SEWARD & KISSEL LLP

THE PRIVATE FUNDS REPORT

Summer 2001

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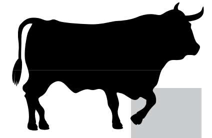

Private Investment Funds Established by Mutual Fund Firms

Many mutual fund managers have established private investment funds in order to retain talented money managers and provide their institutional and high net worth clients with alternative investment options. We believe that this trend is likely to continue.

Private investment funds, of course, differ from mutual funds in that private investment funds generally have more flexible investment strategies (e.g., the ability to effect short sales and utilize leverage) and typically charge performance fees. Because of these and other differences, mutual fund firms establishing private investment funds must closely monitor any conflicts of interest among the mutual funds, other investment advisory clients and private investment funds under their umbrella, particularly when such clients have common portfolio managers.

Since private investment funds have performance fee arrangements and may also include capital invested by the portfolio manager and other personnel affiliated with the mutual fund manager, mutual fund managers must ensure that appropriate allocation procedures are in place so that private investment funds are not favored over mutual funds or other investment advisory clients. Allocation procedures should include procedures for allocating purchases and sales of long positions among mutual funds, other investment advisory clients and private investment funds, as well as allocation procedures for IPOs. Mutual fund complexes also typically develop procedures to ensure that private investment funds do not sell short securities of issuers whose

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Calculating ERISA's 25% Test

Employee benefit plans have become increasingly interested in investing in alternative investments, including private investment funds. Private investment funds and their advisers need to be concerned with the possible application of ERISA's fiduciary rules to their funds and themselves.

The U.S. Department of Labor has issued a regulation (the "Regulation") which provides, in part, that a private investment fund and its adviser will be subject to ERISA's fiduciary rules if the investments in the fund by benefit plan investors (as defined below) are a significant percentage of the fund's assets. The Regulation defines this significant percentage as 25% or more of the value of any class of equity interests of a private investment fund (the "25% test"). When a private investment fund reaches this 25% threshold, it may be prohibited from making certain investments and its adviser will be a fiduciary to each investing employee benefit plan.

Under the 25% test, each class of equity interest must be tested separately and the test must be computed upon each subscription to or redemption from the fund. If a fund issues class A and class B shares, the 25% test must be conducted for each class, and if the percentage of shares of either class held by benefit plan investors (including foreign benefit plan investors) equals or exceeds the 25% threshold, the fund would be deemed to hold plan assets. When calculating the 25% test, the value of any equity interests held by the adviser or any affiliate is generally disregarded in both the numerator and the denominator, however, if the adviser or any affiliate invests retirement assets in the fund, such assets would need to be included in both the numerator and denominator.

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Private Investment Funds

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securities are held long in other accounts managed by the same portfolio manager. The mutual fund manager will also likely have to review its Code of Ethics to ensure that the interests of the general partner and other personnel in the private investment fund are not considered violative of the existing personal trading policies. In several recent public comments, the Director of the SEC's Division of Investment Management has indicated that the SEC expects mutual fund firms to have appropriate compliance procedures in place to address these conflicts of interest concerns and that the SEC will examine these procedures during its inspection process.

Postscript. Many other financial institutions have also entered the private investment fund arena, including banks, brokerages and insurance companies. Each of these institutions has its own unique set of regulatory and other issues to contend with in creating fund structures and appropriate procedures aimed at addressing conflicts of interest and other relevant concerns.

ERISA's 25% Test

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In order to apply the 25% test, the Regulation includes as "benefit plan investors" the following general categories:

(i) Employee benefit plans, whether or not subject to ERISA (e.g., ERISA plans, defined benefit plans, defined contribution plans, 401(k) plans, multiemployer plans and Taft-Hartley plans, as well as governmental plans, church plans, foreign benefit plans and excess benefit plans);

(ii) Plans described in section 4975(e)(1) of the Internal Revenue Code (e.g., 403(b) plans, Keogh plans, IRAs, and medical savings accounts); and

(iii) Entities whose underlying assets include plan assets by reason of plan asset investments in such entities (e.g., other private investment funds that have reached the 25% threshold, group trusts, common or collective trust funds, and certain insurance company investments).

The foregoing describes the basics of the 25% test. It does not explore many of the subtleties of the Regulation, nor does it address the possibility of structuring a fund where benefit plan investors may exceed the 25% limit (which will be covered in a future edition of this newsletter). Should any concerns arise in a particular situation, a detailed examination of the Regulation and the particular facts would be required.

Important Date to Remember

Managers who filed a Form 13F in the first and second quarters of this year, please note that the third quarter filing is due by November 14, 2001.

U.S. Legislative and Regulatory Snapshots

NASD Revises Proposed New Issue Rule. On December 6, 2000, the SEC published for public comment the NASD's revised version of the proposed new issue rule, which addressed the comment letters received with respect to the original NASD proposal of October 15, 1999. The NASD received various comment letters to the new proposal. On March 19, 2001, the NASD filed a further reproposal with the SEC. The highlights of the March 19th reproposal are as follows:

- Only initial public equity offerings will be covered, while secondary offerings (both debt and equity) and convertible or debt offerings will not be covered;
- Legal or accounting opinions will no longer be required – a representation from the beneficial owner (or authorized representative) or relevant conduit will suffice;
- A de minimis exemption will be available for funds with less than 5% restricted person ownership;
- Portfolio manager personnel with investment decision-making authority will be permitted to participate as fund investors in new issues purchased through any fund that such personnel manage but will otherwise be restricted from participating in new issues; and
- The foreign investment company exception will be amended to eliminate the 100 investor requirement and the limitation on the size of the new issue purchased relative to the size of the fund, so that it will simply provide that an investment company listed on a foreign exchange that has no restricted person owning more than 5% of its shares will be exempt from the rule.

Proposed Amendments to the California and New York Investment Adviser Registration Rules. On March 5, 2001, the California Commissioner of Corporations proposed a rule that would exempt a California-based adviser from registering as an investment adviser with the State, provided that the adviser (i) does not hold itself out to the public as an investment adviser, (ii) has fewer than 15 clients, (iii) is exempt from SEC registration by virtue of Section 203(b)(3) of the Investment Advisers Act which provides an exemption from SEC registration for advisers with fewer than 15 clients who do not hold themselves out to the public as investment advisers, and (iv) either has at least $25 million under management or provides advice only to venture capital companies. It is anticipated that the proposal will be passed in late 2001, in which case many California advisers currently registered with the State under the existing, more stringent laws could seek to withdraw their registrations.

On March 27, 2001, a bill was introduced in the New York State Assembly which, if passed in its current form, would make it more difficult for New York-based advisers to avoid registering as investment advisers with the State of New York. A similar bill was introduced in the State Senate on May 24, 2001. The bill would reduce, from "no more than forty" to "less than six", the number of clients an adviser could have in the State without having to register as an investment adviser. The bill is currently under review by the Committee on Economic Development.

Protecting Non-Public Personal Information. Recently, various federal agencies, including the SEC, FTC and CFTC, have adopted rules governing the privacy of non-public personal financial information (for copies of Seward & Kissel memoranda previously issued on these matters, please contact any of the attorneys in the Investment Management Group). These rules require that covered financial institutions establish procedures to protect the security, confidentiality and integrity of consumer records and information and send their consumers and customers a privacy notice describing their privacy policies and practices, as well as the circumstances under which client information is disclosed to third parties. Unregistered investment advisers (i.e., most private investment fund managers) and private investment funds are subject to the FTC's privacy rule, while commodity pool operators/commodity trading advisors are subject to the CFTC's rule.

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Snapshots

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Private funds and their managers will be primarily affected by the rules applicable to the disclosure of customer information. Such rules require (i) that the delivery of an initial privacy notice to all clients who are individuals was to have been made by July 1, 2001 (except for commodity pool operators who are subject to the CFTC's March 31, 2002 deadline as to the commodity pools they operate), (ii) the delivery of a privacy notice upon the establishment of the advisory relationship, and (iii) the delivery of an annual privacy notice. The privacy notice must also provide for an opportunity to "opt-out" of (i.e., block) the disclosure of personal information to non-affiliated third parties. No opt-out notice, however, need be provided if the disclosure is made under one of the exceptions outlined in the rules (e.g., to affiliates, to third parties who process transactions requested or authorized by clients, to certain service providers that have agreed to keep the information confidential, or to comply with regulatory requests for information).

Hart-Scott-Rodino Act Amended. Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, persons were generally required to furnish a notification to the FTC and the Department of Justice when they intended to acquire at least a $15 million position in the voting securities and/or assets of an issuer. Effective as of February 1, 2001, the $15 million threshold was increased to $50 million. It should be noted that acquisitions by multiple private investment funds or accounts managed by the same manager generally will be treated separately and not aggregated when determining the $50 million. Moreover, if a private investment fund is able to satisfy either the passive investor exception (i.e., acquisition is solely for investment and acquiring person would end up holding no more than 10% of the issuer's voting shares) or the institutional investor exception (i.e., generally, banks, insurance companies, broker-dealers, registered investment companies and similar institutions), it will not have to make a filing.

Practical Considerations

Estate Planning and Related Issues for Fund Managers. Private investment fund managers are often in the uniquely favorable position of being able to achieve the central estate planning goal of passing property (typically, a portion of their general partner's interest in the fund, including both fund appreciation as well as the management fee and performance allocation) along to their beneficiaries at the least possible estate, gift and generation-skipping transfer tax cost.

There are many sophisticated techniques available to achieve this goal, which involve leveraging various tax exemptions and/or outperforming the investment returns assumed by the Internal Revenue Service. These techniques include outright gifts, grantor retained annuity trusts ("GRATs"), charitable lead annuity trusts and installment sales to grantor trusts, among other devices. Generally, the optimal time to utilize these techniques is at a fund's inception, because the appraised value of the transferred general partnership

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Practical Considerations

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interest at such time is usually quite low as a result of its speculative nature.

The following two examples illustrate the benefits of such planning: Under example #1, if the sole principal of the general partner of a $50 million startup private investment fund were to give 10% of the general partner's $1,000,000 capital account to a trust for the benefit of his or her children, assuming a 12% per annum return over 5 years and a 20% incentive allocation, the trust would have approximately $1,000,000 in accumulated fund earnings after 5 years, in addition to the future earning potential of the 10% interest. These assets would generally be excluded from the principal's estate for estate tax purposes at his or her death, although the original gift itself would generally be subject to gift tax. If no gift had been made, and the parent died after year 5 with a substantial estate and no remaining credit shelter amount (i.e., essentially the dollar amount exempt from estate tax), the estate might be assessed an estate tax on the $1,000,000 as high as $550,000, thus leaving only $450,000 for the children. Alternatively, under example #2, if avoidance of gift tax is also important, a parent that has already used up his or her credit shelter amount (or wishes to avoid using up the remaining amount) may avoid virtually all potential gift tax by establishing a GRAT. A GRAT is a trust with a limited term that pays back to the grantor/parent an annuity over its life, the present value of which is equal to the initial appraised value of his or her contribution plus an IRS-assumed interest factor (currently around 5.8%), with the children keeping whatever remains (including any appreciation) after paying back the parent. Because of the repayment of the original contribution to the grantor, a properly structured GRAT produces virtually no gift tax consequence to the grantor, however, the repayment element results in less capital in the hands of the children after year 5 as compared to the first example.

Besides estate planning (including putting into place and keeping up-to-date a will and appropriate trusts), fund managers may have other personal financial planning issues with which they must deal. These issues may involve planning for a marriage, a divorce, an upcoming move to the U.S. by a non-U.S. citizen, a charitable project, asset protection and/or general tax issues.

The most important consideration in establishing any of the foregoing plans is to be sure that they appropriately reflect the manager's personal circumstances, his or her tolerance for complexity, and his or her level of investment sophistication.

Investment Management Group News

STEVEN B. NADEL became a partner of the Firm on July 1, 2001, specializing in investment management matters. He continues to teach a course each semester at the New York Institute of Finance (www.nyif.com) entitled *How to Start a Hedge Fund.*

S. JOHN RYAN became a partner of the Firm on July 1, 2001, specializing in employee benefits matters. John works extensively with the Investment Management Group on ERISA and related issues.

ROBERT B. VAN GROVER will be speaking about *Starting a Hedge Fund* at The Westin Philadelphia on November 13, 2001. He also spoke about *Best Soft Dollar Practices* at the 5th Annual Prime Brokerage Conference at the Marriott in New York on June 26, 2001. He recently contributed a chapter, *U.S. Legal and Regulatory Issues Faced by Offshore Funds and their Sponsors,* to the book entitled *Hedge Funds: Law and Regulation* published in 2001 by Sweet & Maxwell.

JOHN E. TAVSS spoke at the Investment Management CFO Forum sponsored by Common Sense Investment Management on August 29-30, 2001 in Portland, Oregon.

JOHN J. CLEARY spoke at the Goldman Sachs Hedge Fund CFO Conference 2001 on May 8, 2001 at The Wyndham El Conquistador Resort in Puerto Rico.

PETER PRONT has written two chapters on tax issues related to market neutral investing for an upcoming publication entitled *Market Neutral Investing.*

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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