

THE PRIVATE FUNDS REPORT

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Understanding Seed Capital Arrangements

The benefits that a seed investor's capital or other services offer a start-up fund manager may be significant. Even seasoned managers may sometimes opt for such arrangements to launch a new fund, increase their size or visibility, or gain access to the seed investor's input.

Most managers will view seed capital as a seed investor's greatest contribution to the success of a start-up fund. A substantial initial investment not only generates fees, but may also provide the legitimacy necessary to attract additional investors and the critical mass needed to implement certain trading strategies. In addition to seed capital, some seed investors may also offer access to a broader investor base, as well as administrative, accounting and other support services.

While the value of these contributions to a fund's success can be substantial, a manager needs to understand fully how these alliances work. The typical seed capital arrangement, which may be perpetual or last for as long as ten years, is negotiated on a case-by-case basis and will usually grant the seed investor a share in the manager's fees through equity ownership in the manager or a long-term contractual arrangement. Set forth below is a synopsis of the most important considerations from the manager's perspective:

- *Fee Sharing Structure.* While fee sharing structures may vary significantly, a manager can expect that anywhere from 10% to 50% of its fees will be allocated to the seed investor on an annual basis. The fee sharing arrangement may be based on total assets under management or may be limited to certain contributions. It may fluctuate during the term of the arrangement depending upon assets raised and/or performance results. If a seed investor on the accrual basis of accounting has an equity ownership in the manager, some fee sharing arrangements may prevent the manager from deferring fees from its offshore funds. The terms of the

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Blue Sky in a Nutshell

A significant compliance matter for private investment funds is compliance with State "blue sky" filing laws. Essentially, a "blue sky" filing is a filing that is made with a State relating to a sale of interests (i.e., securities) in a fund to any U.S. investor in that State. The following are some basic guidelines that should be followed:

- New York is the only State that currently requires a filing prior to any offer being made in the State.
- Most other States require a filing within 15 days after the first sale in such State.
- A number of States (e.g., Florida, New Jersey, Colorado, Illinois) have de minimis, institutional investor or other exemptions, however, before relying on any such exemption, counsel should be consulted.
- Certain States (e.g., New York, New Hampshire, Georgia, Illinois and South Carolina) require that renewal filings be made after the initial filing.
- Material changes (e.g., a change of name, address or general partner) will usually require an amendment filing to be made.
- Blue sky filings are also required in connection with the acceptance of any U.S. investors (including U.S. tax-exempt investors) in an offshore fund.
- Counsel responsible for making the fund's filings should be notified promptly after any sale.
- Failure to make timely blue sky filings may result in various penalties, including the imposition of fines on the manager and/or the requirement that the fund make a rescission offer to affected investors.
- Typically, a Form D must also be filed with the SEC within 15 days after the first sale of a fund interest. <E>

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arrangement may also prevent the manager from entering into negotiated arrangements with other fund investors.

- *Size and Timing of Commitment.* While a seed investor's capital commitment may be significant, receipt of the full amount, whether in a lump sum or in several tranches, may be conditioned on certain events such as the fund meeting asset benchmarks or achieving specified returns. In addition, the seed capital may be committed for a limited term rather than the term of the fund. While a manager should expect to receive a commitment of at least two to three years, the investor may be permitted to withdraw any appreciation on its initial investment, or sometimes its principal investment amount, if certain conditions exist, including fund performance falling below specified targets, the aggregate amount of capital in the fund exceeding specified thresholds prior to the end of the commitment period, or the manager's principals ceasing to be actively involved in management.
- *Buy-Out Provisions.* A manager may want the option to repurchase all or part of the seed investor's interest based on a formula price, an appraisal or some other arrangement. Alternatively, the seed investor may request "put" rights, requiring the manager to purchase its interest under certain

conditions, such as the sale of the manager, a performance drawdown, the departure of key talent or simply on the demand of the seed investor. Typically, these buyouts will be based on a multiple of fees earned over a certain time frame.

- *Capacity.* Seed investors will often require the manager to reserve for it a specific amount of the fund's future capacity, thus preventing the manager from diluting the seed investor's future position and influence in the fund.
- *Non-competition.* Seed investors may seek to prohibit the manager's principals from utilizing similar strategies for other accounts for the term of the commitment or arrangement, and often for one to two years thereafter.
- *Tax Issues.* The economic arrangements between the manager and a seed investor could be significantly impacted by a number of tax issues including: (i) the nature of the manager's revenues to be shared with the seed investor (e.g., management fees, incentive fees and allocations, and/or proceeds from the sale of the manager's business); (ii) whether the seed investor is a tax-exempt entity or a non-U.S. person or entity; and/or (iii) whether the arrangement relates to both a domestic and an offshore fund (and the classification of those entities for federal income tax purposes). ↔

Legislative and Regulatory Snapshots

CFTC Roundtable. Jack Rigney, a partner in the Investment Management Group, was a panelist at a CFTC Roundtable held in Washington, D.C. on September 19, 2002 that focused on managed funds and related issues for commodity pool operators and commodity trading advisors. Among other things, the panelists discussed proposed initiatives to harmonize the existing regulations of the CFTC and SEC that are applicable to commodity trading activities (e.g., investments in financial futures) for investment funds and investment managers. *In particular, the panelists discussed possible exemptions from registration requirements for*

managers of private investment funds whose investors meet certain specified financial criteria.

CFTC Provides and Proposes Registration Relief. *Following the CFTC Roundtable, on November 6, 2002, the CFTC issued a press release and an Advance Notice of Proposed Rulemaking (ANPR) providing temporary relief from its registration requirements for certain private investment fund managers who operate or advise pooled investment vehicles. The CFTC stated that, pending the issuance of final rules, it will not pursue enforcement actions against eligible managers who rely on the temporary relief, and, in the event that*

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final rules differ from the temporary relief, persons relying on the temporary relief will be given sufficient time to comply with the new rules. The temporary relief is only available for an operator of a pooled investment vehicle that (i) restricts participation to accredited investors, knowledgeable employees and certain of their family members, and non-U.S. persons, and (ii) limits the aggregate notional value of its commodity interest positions to no more than 50% of the liquidation value of the portfolio. Managers providing advice to funds operated by pool operators who claim this relief would also be eligible for relief. In order to claim the temporary relief, a manager must file a notice with the National Futures Association (NFA) and the CFTC, and must also provide certain disclosures.

The ANPR also requests public comment on proposals by the NFA and the Managed Funds Association for permanent rule changes expanding the categories of pools whose managers need not be CFTC-registered to those pools that limit participation to certain sophisticated investors. The ANPR was published in the Federal Register on November 13, 2002 for a 60-day comment period and may be accessed at www.cftc.gov.

Patriot Act Update. On September 18, 2002, the U.S. Treasury Department (Treasury) issued a proposed anti-money laundering (AML) rule pursuant to Section 352 of the Patriot Act governing all Section 3(c)(1) and 3(c)(7) private investment funds that: (i) have \$1 million or more in assets; (ii) are organized under the laws of the U.S. or any State therein, organized, operated or sponsored by a U.S. person, or sell ownership interests to any U.S. person; and (iii) permit their owners to redeem interests within two years of their purchase. While most hedge funds would be covered by the rule, most private equity funds and venture capital funds would be exempt. The proposed rule requires that, within 90 days following publication of a final rule, funds covered by the rule implement a written AML program "reasonably designed to prevent the company from being used for money laundering or the financing of terrorist activities". Each institution will be expected to tailor its program to fit its particular business, taking into consideration its size, activities, location, risks and vulnerabilities. The four required elements of an AML program would include the: (i) development of internal policies, procedures and controls; (ii) provision for

independent testing; (iii) designation of a compliance officer; and (iv) establishment of an ongoing employee training program. Moreover, because such funds are often not registered with any regulatory body, and are not easily identifiable by the Treasury, the proposed rule also contains a requirement that a fund file a notice with the Treasury no later than 90 days after it first becomes subject to the rule. The notice must include certain information about the fund, the fund's manager, sponsor and compliance officer, total assets under management, and the number of investors in the fund.

Subsequently, on October 25, 2002, the Treasury issued an interim rule extending the temporary deferral of the application of Section 352 of the Patriot Act to various financial institutions, including private investment funds. The Treasury has indicated that it needs more time to study these institutions in order to develop appropriate regulations that will allow these institutions to develop AML programs. The Treasury expects to publish these regulations within six months, as well as regulations relating to customer identification.

SEC Investigates Private Investment Funds. On May 24, 2002, the SEC announced a formal fact-finding order of investigation into the operations of private investment funds in order to determine whether the present state of regulation is adequate. The SEC wanted further information on incidents of fraud, conflicts of interest when a private investment fund and a mutual fund share the same management, and the marketing of private investment funds. In early August 2002, the SEC sent detailed questionnaires to a number of fund managers who were SEC-registered investment advisers. A subsequent request accompanied by a subpoena was sent to various unregistered managers in early September 2002. The information sought by the SEC was data concerning: the nature of advisory services; the structure of the manager's funds; marketing methods; the use of third party consultants; returns over various time periods; investor suitability procedures; brokerage information; the use of leverage; valuation procedures; web site materials; audit processes; administrative support; and key employees. The SEC also requested copies of offering materials, financial statements, reports to investors, trading policies and procedures, Form Ds filed with the SEC and codes of ethics. We are following this matter closely.

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Sarbanes-Oxley Act and Section 16. In an effort to respond to the recent wave of accounting and corporate management scandals involving public issuers, Congress enacted the Sarbanes-Oxley Act of 2002 (the Act) on July 30, 2002. Much of the Act mandates stricter regulation for public companies (and their auditors and lawyers) that have or will have publicly-issued securities in the U.S. markets. (For further information about these parts of the Act, please contact Gary Wolfe or Robert Lustrin, partners in our Capital Markets Group.)

More pertinent to private investment fund managers, the Act also amended the sections of the Securities Exchange Act of 1934 (the Exchange Act) that govern when public issuer Insiders (as defined below) must report their transactions in the securities of such issuers. Section 16(a) of the Exchange Act requires that beneficial owners of more than 10% of any class of equity security registered under Section 12 of the Exchange Act and each officer and director of such an issuer (collectively, Insiders) file an initial report (on Form 3) with the SEC to disclose their holdings. Prior to the Act's passage, Insiders had to report any ownership changes on Form 4 within 10 days of the close of any month in which the change occurred. *The Act now requires Insiders to report such changes before the end of the second business day following the day on which the transaction occurs. Given this short time frame, if your primary attorney at Seward & Kissel is unavailable to handle this filing on a timely basis, please call 212-574-1200 and ask for Anna Sac or Robert Van Grover.*

Amended New York Investment Adviser Law Affects New York Managers & SEC-Registered Advisers. On September 17, 2002, New York amended its investment adviser registration law effective as of January 1, 2003. The new law will require New York-based managers to register with the State as investment advisers, subject to certain exceptions. One exception involves the provision of advice by the manager to fewer than six "persons" (which the law defines as a natural person, corporation, company, partnership, trust or association) resident in New York, other than certain financial institutions or institutional buyers, over the past 12 month period. Note that the old rule contained a 40 person exception. Another exception is the same exception that most private investment fund managers with \$25 million or more under management currently

rely on to avoid SEC registration as an investment adviser (i.e., the manager does not hold itself out to the public as an investment adviser and has had fewer than 15 clients over the past 12 month period (for this purpose, a private investment fund generally counts as one "client")). *Accordingly, these changes should not require a New York-based private investment fund manager to register as an investment adviser, unless the manager has less than \$25 million under management and has more than five clients in New York (with a fund generally counting as a single client).*

The new law also affects SEC-registered investment advisers, in that if they have more than five New York clients within a 12 month period, they must make a notice filing with the State.

Latest New Issues Rule Proposal. On June 27, 2002, in response to the SEC's comments to proposed Amendment No. 3 to the NASD's "new issue" rule (discussed in prior editions of The Private Funds Report), the NASD filed a further reproposal with the SEC. The highlights of the reproposal are as follows:

- The percentage of a fund that may be owned by restricted persons under the de minimis exemption has been increased from 5% to 10% and the 100 share limitation has been eliminated. Accordingly, if a fund has less than 10% restricted person ownership, the whole fund may participate in new issue distributions without making any special carve-outs.
- Portfolio managers will be treated as restricted persons, *even with respect to the funds or accounts they manage*, subject to the 10% de minimis exemption.
- Portfolio managers of family investment vehicles and investment clubs will not be considered restricted persons.
- Various publicly-traded entities (other than broker-dealers or affiliates of broker-dealers authorized to engage in the public offering of new issues) will be exempt from the rule.
- The reproposal eliminates any specific restricted person carve-out procedures and recognizes that accounts may employ a variety of carve-out methods.

Proposed Custody Rule Amendments. On July 17, 2002, the SEC proposed amendments to the custody rule contained in Rule 206(4)-2 of the Investment Advisers Act of 1940. Currently, the rule places various compliance obligations on registered investment advisers (RIAs) who are deemed by the rule to have custody of fund assets.

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Such RIAs are required to, among other things, undergo surprise periodic audits at least annually. Alternatively, RIAs with constructive custody can avoid a surprise audit if they adopt procedures where an independent third party signs off with regard to their receipt of monies from the funds they manage. While the proposal touches upon numerous items, of greatest relevance is an exemption for limited partnerships or other pooled investment vehicles that conduct annual audits and distribute their financial statements prepared in accordance with generally accepted accounting principles (GAAP) within 90 days of the end of their fiscal year. Although this would seem to be a positive development, the proposal does not address the case of those funds-of-funds that may not be able to distribute their financial statements within 90 days, primarily because such funds have not received the necessary information from their underlying managers. The proposal also does not address private investment funds who receive opinions based on GAAP, except with regard to the amortization of their organizational costs (i.e., GAAP requires organizational costs to be expensed when incurred, while most funds amortize such costs over a number of years) and/or take an exception with regard to the disclosure of their investment positions (i.e., GAAP requires the disclosure of certain large positions, while many managers prefer to keep portfolio information confidential). We have submitted a comment letter to the SEC to address these concerns.

Proposed Rule on Proxy Voting. On September 20, 2002, the SEC proposed a new rule that would require RIAs to adopt proxy voting procedures to address an RIA's fiduciary duty to act in the best interests of its clients. RIAs would have to disclose such procedures to their clients and provide copies of them upon request. In addition, the proposal would require RIAs to maintain books and records relating to proxy voting.

Deferred Compensation. On July 11, 2002, the U.S. Senate Finance Committee approved a bill containing a provision which, if enacted

into law, would currently tax certain deferred compensation arrangements. The bill provides that if assets are designated or otherwise available for the payment of nonqualified deferred compensation and located outside the United States, such assets generally will not be treated as subject to the claims of creditors. As a result, the value of the deferred compensation would be taxable when the compensation is no longer subject to a substantial risk of forfeiture, which, in most deferred compensation arrangements entered into by fund managers, would be at the time its earned. Although a deferred compensation arrangement that utilizes an offshore "rabbi trust" would appear to be impacted, it is unclear whether the typical deferral arrangements used by most offshore funds, which are unfunded, do not use rabbi trusts and whose assets are generally located within the United States, would be affected. The proposal would apply to amounts deferred after the date of the enactment of the proposal in taxable years ending after such date.

IRS Ruling on Insurance Companies. In a recent ruling, the IRS concluded that the holder of a variable life insurance contract, not the insurance company, is considered, for tax purposes, to be the owner of an interest in a private investment partnership held in a sub-account that underlies the insurance contract where interests in the partnership are available for purchase not only by a purchaser of the insurance contract, but also by other members of the general public (albeit a limited sector of the general public). Accordingly, under these facts, the IRS concluded that the contract holder would be required to include in his gross income the income and gains from the partnership interest. This ruling should not adversely impact private investment fund variable life insurance products where the private investment fund vehicle owned by the insurance company or companies is not owned by other types of investors (even if the fund manager has separate funds with the same strategy for non-insurance company investors).



Investment Management Group News

SEWARD & KISSEL LLP was named the "top hedge fund lawyers" according to *HedgeWorld's Annual Compendium 2002*. The compendium listed leading prime brokers, administrators and lawyers. Information on the study was listed in the *Financial Times, Companies & Markets* section, June 20, 2002 issue.

ROBERT B. VAN GROVER will speak at IIR's Conference on Hedge Fund Marketing & Client Servicing Strategies on January 14, 2003 at the Crowne Plaza at the United Nations in New York City.

MIKE FARRELL, an associate in the Investment Management Group, spoke at the Center for Professional Education's 2002 Hedge Fund Forum in New York City on December 9, 2002.

STEVEN B. NADEL spoke at the National Investment Company Service Association's Conference on Alternative Investments on November 14, 2002 at the New York Athletic Club about regulatory developments affecting private investment funds.

JOHN E. TAVSS spoke at the Morgan Stanley Prime Brokerage Chief Operating Officers and Chief Financial Officers Forum in Sea Island, Georgia on October 22, 2002. He also spoke at the 2nd Annual Common Sense Investment Management, LLC CFO Forum on September 18, 2002 in Portland, Oregon.

PETER E. PRONT, a partner in the Tax Group, spoke on the tax considerations regarding "seed capital" arrangements at IIR's July 2002 conference on Mastering Effective Tax & Audit Practices for Hedge Funds.

BILLIE COOK became counsel to the Firm on July 1, 2002. Billie specializes in investment management matters relating to private investment funds and registered investment advisers, and has extensive experience in various compliance issues.

DANIEL C. MURPHY became counsel to the Firm on July 1, 2002. Dan specializes in tax matters and works extensively with the Investment Management Group on tax and related issues.

JOHN J. CLEARY was co-fundraising chairman at a benefit for the National Alliance for Autism Research (www.naar.org) held on June 18, 2002 at the Waldorf Astoria. Richard Grasso of the New York Stock Exchange was honored.

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

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

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