SEWARD & KISSEL LLP

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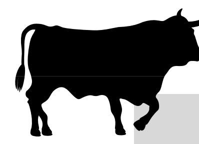

Reporting of Investment Positions

Increasingly, investors in private investment funds have been demanding more information concerning investments held by their funds. In addition to reporting agreed to with investors, there are a number of regulatory reporting requirements with which managers are already obliged to comply, including the following:

Securities Exchange Act of 1934 (Exchange Act). A Schedule 13G filing with the SEC, the issuer and the applicable exchange is generally required if a passive investment position of greater than 5% (but less than 20%) of the outstanding securities of a class of publicly-traded "equity" security registered under the Exchange Act is beneficially owned. Beneficial ownership is determined looking at all accounts over which the investment manager has investment discretion. A Schedule 13D filing is generally required if the position size is 20% or greater, is between 5% and 20% and is not passive, or the manager or an affiliate is a director or officer of the issuer. Schedule 13D filings are required promptly after the initial trigger is met and at various other times to reflect certain changes in holdings or status. Schedule 13G filings are generally not required as frequently and do not require as extensive information as 13D filings. For registered investment advisers, the 13G/13D filing requirements are less frequent. The manager and certain of its principals (and, sometimes the fund itself) generally are the reporting persons on these schedules.

A quarterly Form 13F filing with the SEC is generally required if at the end of any month in the prior year the assets under management (other than personal assets) were in excess of $100 million of long positions in public equity securities (typically, publicly-traded U.S. equities, options, warrants and

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Revisions to Swap Documentation

ISDA, the International Swaps and Derivatives Association, Inc., has recently published the 2002 ISDA Master Agreement, the 2002 Equity Derivatives Definitions and the 2003 Credit Derivatives Definitions, in each case replacing earlier versions of those documents. The Master Agreement is the base agreement that establishes the legal rights and duties of the parties to swap transactions of all types. The Definitions set forth defined terms which are useful in preparing the confirmations for equity swaps and credit default swaps.

A swap transaction involves an agreement between two parties to exchange payments on future dates based on the application of specified indices to a notional amount. There are many different types of swaps, ranging from simple interest rate swaps (where one swaps a fixed rate of interest against a floating rate) and foreign exchange swaps (where one swaps an amount in one currency against an amount in another currency), to more complex transactions such as equity swaps (including total return swaps and options) and credit default swaps, which are the subjects of the new Definitions. Private investment funds may use swaps for hedging and portfolio balancing purposes.

The new ISDA documents represent an evolutionary improvement over the earlier versions rather than a revolutionary change. While the new documents continue to be bilaterally-neutral and are reflective of current market practices and legal constraints, ISDA documents may nonetheless be the subject of substantial negotiations between the parties in connection with numerous variations which are implemented to the standard forms. It is important to note that the new Master Agreement and the new Definitions do not automatically replace the older

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Reporting of Investment Positions

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certain convertible securities). An initial Form 13F filing is required on February 14 (and thereafter quarterly). The SEC provides a quarterly list of the securities disclosable on Form 13F.

A Form 3, 4 or 5 filing with the SEC, the issuer and the applicable exchange is generally required by a director, officer or a greater than 10% beneficial owner of any class of a publicly-traded "equity" security or derivative security registered under the Exchange Act. Beneficial ownership is determined in the same manner as for Schedule 13D filings. Under Section 16 of the Exchange Act, "short swing profits" may have to be disgorged to the issuer to the extent of the beneficial owner's "pecuniary interest" with respect to purchases and sales or sales and purchases made within six months of each other. Purchases and sales may include routine transactions such as rebalancing trades and in-kind distributions. Generally, Form 3 filings are required within 10 days after the initial trigger is met, Form 4 filings are required within two business days after a transaction in the subject security to reflect certain changes in ownership status, and Form 5 filings are required annually to reflect certain other ownership changes. The manager and certain of its principals (and, sometimes the fund) are reporting persons on these forms.

Hart Scott Rodino Antitrust Improvements Act. A filing with both the Federal Trade Commission and the Department of Justice may be required for each fund prior to any acquisition that results in an aggregate position of $50 million or more in the assets and/or voting securities of an issuer being held (regardless of whether the voting securities are publicly-traded). A fee ranging from $45,000 for transactions below $100 million to $280,000 for transactions of $500 million or more must accompany the filing. However, if a private investment fund is able to satisfy either the passive investor exemption (i.e., the acquisition is solely for investment and the acquiring person would end up holding no more than 10% of the issuer's voting shares) or the institutional investor exemption (i.e., generally, banks, insurance companies, broker-dealers, registered investment companies and similar institutions), it will not have to make a filing.

U.S. Generally Accepted Accounting Principles (U.S. GAAP). Under Statements of Position 95-2 and 01-1, private investment funds whose audited financial statements are prepared in accordance with U.S. GAAP are required to categorize their long and short positions (without netting) by security type, country or region, and industry in a condensed schedule of investments. In addition, disclosure of investments constituting more than 5% of net assets must be made. While some private investment funds have previously avoided making these disclosures by relying on an exception to U.S. GAAP, an April 2003 auditing interpretation no longer permits such an exception and will normally require such information to be disclosed.

Revisions to Swap Documentation

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versions, if existing swap transactions are outstanding under the earlier versions. The existing legal documentation in respect of any outstanding swap transaction would have to be amended in order to cause the new ISDA documentation to apply. With respect to new swap transactions, while swap dealers may want to use the new documentation, particularly with new counterparties, many swap dealers are still sending out the older versions to new counterparties.

The principal changes in the 2002 ISDA Master Agreement relate to measure of damages, force majeure termination and reduced grace periods. The principal changes for equity swap transactions in the 2002 Equity Derivatives Definitions relate to expanded product coverage and merger and disruption events. The principal changes for credit default swap transactions in the 2003 Credit Derivatives Definitions relate to a new test for identifying the successor to a reference entity and restructuring credit events.

Since many of these changes are complex, please feel free to contact Craig Hickernell in our Corporate Finance Group at 212-574-1399 or hickernell@sewkis.com, if you have any questions.

Legislative and Regulatory Snapshots

SEC Report on Hedge Funds. On September 29, 2003, the staff of the SEC's Division of Investment Management released its staff report, *The Implications of the Growth of Hedge Funds* (the Report), following the Division's fact-finding study of the industry. The Report summarizes the Division's review of the operations and practices of hedge funds and makes a number of recommendations for the SEC's consideration. The full text of the Report may be found on the SEC's website at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

The staff identified the following areas of concern:

- The SEC's lack of regulatory oversight.
- The scarcity of information available.
- The lack of independent checks on valuation.
- The "retailization" of hedge funds, i.e., less sophisticated investors can now invest in hedge funds through pension plans, registered funds-of-funds and other means.
- The relatively low level of disclosure provided by hedge funds and registered funds-of-funds.
- The conflicts of interest that may arise from the simultaneous management of hedge funds, mutual funds and/or other accounts, and relationships with prime brokers.
- The general solicitation of investors through the media and the Internet (e.g., newsletters, public interviews, advertisements and password-free websites).

Based on its concerns, the staff recommended that the SEC consider the following changes to the regulatory framework relating to hedge funds and their investment advisers:

- Requiring hedge fund advisers to register with the SEC as investment advisers.
- Requiring advisers to provide a brochure specifically designed for hedge funds.
- Requiring certain registered investment companies to follow board-adopted valuation procedures.
- Requiring additional disclosure to be provided about layered fees of registered funds-of-funds.
- Continue monitoring whether suitability obligations are being met.
- Permitting general solicitation in Section 3(c)(7) hedge fund offerings.
- Continue monitoring capital introduction services provided to hedge funds by prime brokers.
- Encouraging the hedge fund industry to embrace and further develop "best practices".
- Continue focusing on investor education about hedge funds.

While mandatory registration of hedge fund advisers would give the SEC power to audit such advisers, impose additional compliance obligations on advisers, and result in greater disclosure to investors, the Report notes that registration should not impede the manner in which a hedge fund adviser invests or operates a hedge fund and should have no effect on their ability to trade securities, use leverage, sell securities short or enter into derivatives transactions. Registration would also not require the disclosure of any proprietary trading strategy or the identity of any clients, or result in additional portfolio disclosure requirements. Hedge funds would continue to be exempt from registering their offerings and generally no modifications would be needed to their organizational structures, lock-ups or repurchase schedules.

House Bill (H.R. 2420) Bans Joint Management of Mutual Funds and Hedge Funds. On November 19, 2003, the House passed H.R. 2420 (known as the "Baker Bill") dealing with mutual fund late trading and market timing abuses, as well as mutual fund governance issues. One provision of the bill, dealing with potential conflicts of interest for mutual funds, prohibits any individual from acting as the portfolio manager or investment adviser to a registered open-end investment company (i.e., a mutual fund) if the individual also acts as a portfolio manager or investment adviser to an investment fund that is not registered (which would include private investment funds such as hedge funds). The Baker Bill allows the SEC to make exceptions "in exceptional circumstances when necessary to protect the interest of investors" provided that (i) there is enhanced disclosure by the mutual fund to its investors regarding any conflicts of interests raised by such joint management and (ii) there are fair and equitable procedures for the allocation of securities to the various portfolios, as well as a certification by the independent directors of the mutual fund that such procedures are fair and equitable. It is not clear at this point whether this provision of the Baker Bill will become law in its current form, nor is it clear how the SEC will interpret what satisfies the "exceptional circumstances" test. In any event, if this portion of the Baker Bill is passed, it may have a significant impact on the hedge fund industry in general and may force certain portfolio managers and/or their management companies to "choose" whether to manage a mutual fund or a hedge fund.

Bermuda Seeks Greater Fund Oversight. Following on the heels of the SEC's Report, the Bermuda Monetary Authority announced

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that it will seek legislation that will expand its oversight of private investment funds, in order to allow it to act more quickly and intervene where appropriate.

CFTC Adopts Registration Exemptions. On August 1, 2003, the CFTC approved amendments to various regulations relating to registration as a commodity pool operator (CPO) and commodity trading advisor (CTA), among other issues. The amendments expand on the No-Action Relief previously issued by the CFTC and are effective immediately.

With regard to CPOs, the CFTC adopted a registration exemption for any manager of a private investment fund whose participants (including its non-U.S. investors) are accredited investors, knowledgeable employees or certain family trusts formed by accredited investors, if the manager represents that the fund will limit futures transactions, whether or not for bona fide hedging purposes, so that, in sum: (1) the aggregate initial margin and premiums required to establish commodity positions will not exceed 5% of the liquidation value of the fund's portfolio or (2) the aggregate net notional value of such positions will not exceed 100% of the liquidation value of the fund's portfolio.

With respect to CPOs of funds-of-funds who wish to rely on the relief above, the CFTC has adopted a new "Appendix" to its registration rules that clarifies how the trading limitations apply to them. The Appendix includes six situations and explains how a fund-of-funds manager should determine compliance with the trading limitations, assuming that the manager meets all the other requirements of the exemption.

The CFTC also adopted a CPO registration exemption that imposes no trading limitations. It applies if each fund participant that is a: (1) natural person is a "qualified purchaser" (generally, a person owning investments of not less than $5 million), knowledgeable employee (including principals of the manager) or a non-U.S. person and (2) non-natural person is either a "qualified eligible person" (generally, an accredited investor owning a securities portfolio of at least $2 million), an accredited investor (generally, having assets in excess of $5 million) or a non-U.S. person or entity.

With regard to CTAs, the CFTC adopted a new exemption that provides registration relief for CTAs to funds whose CPOs are claiming or, if registered, are eligible to claim the CPO relief set forth above.

A more detailed memo may be found at www.sewkis.com under Publications & Speeches.

SEC Adopts New Custody Rule for SEC-Registered Investment Advisers. On September 25, 2003, the SEC released amended Rule 206(4)-2 of the Investment Advisers Act of 1940. The new rule generally requires investment advisers registered with the SEC that have custody of client assets to maintain such assets with a "qualified custodian", to notify their clients of such an arrangement and to arrange for account statements to be sent to clients (i.e., fund investors) at least quarterly by the custodian or the adviser. If the adviser sends out the account statements, it will be subject to a surprise annual audit by an independent public accountant. The new rule provides an exemption from the account statement requirement for private investment funds, if fund financial statements are audited at least annually, are prepared in accordance with U.S. GAAP and are distributed to fund investors within 120 days of the fiscal year end. *Advisers will no longer be able to avoid application of the custody rule by hiring an independent third party to approve of the distributions of fees or capital to the adviser, as the SEC has withdrawn these alternative procedures known as "PIMS procedures".*

NASD Limits Use of Related Performance Information. On October 2, 2003, the NASD issued an interpretive letter responding to questions posed by the Securities Industry Association concerning the NASD's Notice to Members 03-07, relating to the obligations of brokers when selling private investment funds (see *The Private Funds Report, Vol. VI*). Among other things, the letter indicated that an NASD member broker-dealer may not distribute private investment fund "related performance information" in sales material. "Related performance information" includes the performance of (1) other separate investment companies, funds, portfolios, accounts or composites thereof managed by the same investment adviser, sub-investment adviser or portfolio manager that manages the fund promoted by the member, (2) so-called "clone" funds and other similarly managed accounts and funds, (3) funds or accounts that preceded and were converted into the advertised fund, and (4) composites of other similarly managed funds, accounts or portfolios. The term generally would not include the performance of a master fund of which a private investment fund is a feeder, to the extent it reflects the performance of the same portfolio in which the feeder fund's assets are invested. The letter also states that members must not use any hypothetical or back-tested performance that does not reflect the actual performance of the hedge fund. The NASD did, however, subsequently clarify that the related performance

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information prohibition does not apply to performance information included in hedge fund offering memoranda.

Department of Labor Modernizing the QPAM Exemption. The Department of Labor (DOL) recently issued an advisory opinion and proposed an amendment to the QPAM exemption, a class exemption that permits qualified professional asset managers (QPAMs) to engage in a wide variety of transactions with ERISA plan assets. In proposing the amendment, the DOL was responding to the consolidation of the financial services marketplace that has made compliance with certain conditions of the QPAM exemption difficult. Although most of the proposed amendments do, in fact, simplify compliance, the DOL also has proposed raising the financial requirements needed to qualify as a QPAM. The DOL proposes raising the requirement that shareholders' or partners' equity in the QPAM equal $1 million (up from $750,000) and that total client assets equal $85 million (up from $50 million). If you have any questions about ERISA or the QPAM exemption, please contact John Ryan at (212) 574-1679 or ryans@sewkis.com.

Changes to the Hot Issues Rule. On October 28, 2003, the SEC approved of the NASD's proposed rule changes governing the purchase and sale of initial equity offerings. It is anticipated that the new rule will go into effect by January 2004. Under the new rule, restricted persons may generally not participate in any initial public offering of an equity security. Restricted persons would include, among others, brokers, broker personnel and certain owners, certain finders and fiduciaries, and portfolio managers (i.e., persons with investment discretion) for hedge funds, advisers and banks. Restricted persons would not include, among others, registered investment companies, certain ERISA plans and accounts (including hedge funds) where the beneficial interests of restricted persons does not exceed 10% in the aggregate. Brokers will be required to obtain an annual certification from the fund representing that it is in compliance with the rule. A more detailed memo may be found at www.sewkis.com under Publications & Speeches.

Developments for Short Sellers. On October 29, 2003, the SEC proposed new rules governing short sales, known as Regulation SHO. Regulation SHO would require short sellers in equities to have available (through brokers) securities to borrow before selling and would impose strict delivery requirements on securities where many sellers have failed to deliver the securities. Furthermore, Regulation SHO would institute a uniform bid test allowing short sales to be effected at a price that is one cent higher than the consolidated best bid (in lieu of the present "uptick rule" which is based on the last sales price). Finally, the SEC is proposing to suspend the application of the best bid rule for certain liquid securities for two years, in order to study the market impact of relatively unrestricted short selling.

In addition to the proposals, the SEC issued an interpretation of its rules on November 17, 2003 restricting the use in connection with short sales of an arrangement (commonly referred to as a "married put") comprising a simultaneous purchase of (i) a security and (ii) an at-the-market or in-the-money put on the security. The interpretation warns that, in applying the uptick rule, the SEC may elect to treat the security portion of any married put that has certain specified characteristics as not owned by a trader that acquires the married put. If the trader were not deemed to own the security portion of the married put, the trader's subsequent sale of the security, unless otherwise owned by the trader, would in theory be subject to the uptick rule.

In Memoriam

Richard H. Valentine

(1920–2003)

Richard H. Valentine, our esteemed and beloved partner and friend, died Tuesday, December 2, 2003. A graduate of Amherst College and the Columbia University School of Law, Dick joined Seward & Kissel as a partner in 1955. Dick was the head of the Firm's tax group until his retirement in 1990. Dick, a brilliant tax attorney, was a pioneer in the development of hedge funds, advising many prominent hedge fund managers regarding legal and tax issues. Among his many innovations was the offshore structure (which is now commonplace) by which endowments, foundations and U.S. tax-exempt entities could access certain hedge fund strategies without adverse U.S. income tax consequences. Dick was a mentor to many of the current partners of the Firm and his intellect, counsel and guidance will be profoundly missed by his partners, clients, colleagues and friends.

Investment Management Group News

Seward & Kissel LLP was again named as the *number one hedge fund law firm*, this time according to a survey published by CogentHedge.com in October 2003.

Seward & Kissel's Investment Management Group is pleased to announce that various attorneys within the Firm have been dedicated to focus on the increased level of transactional work that we have been handling for our private investment fund clients. For a further description of Seward & Kissel's private investment funds practice and the schedule of legal services we provide, please see the accompanying handout.

John Ashmead has joined the firm as a partner in the Bankruptcy Group. His activities will include assisting private investment fund clients in connection with their investments in companies experiencing financial difficulties.

Beth Alter has joined the firm as counsel in the Litigation Group. Her activities will include assisting private investment fund clients in connection with trademark and other intellectual property matters.

Robert Van Grover will speak about marketing developments at IIR's conference on Hedge Fund Marketing Solutions on February 24, 2004 at the Park Central Hotel in New York City and on regulatory developments at Financial Research Associates' Hedge Fund Regulation Forum on May 3, 2004 at the Crowne Plaza in New York City.

Patricia Poglinco spoke about fund-of-funds' operational challenges at the NICSA Alternative Investments Hedge Funds and Private Equity Conference on November 7, 2003 at the New York Athletic Club in New York City.

John Cleary spoke at the Goldman Sachs Hedge Fund Seminar for CFOs on November 19, 2003 in New York City. He also spoke about the Patriot Act and other regulatory matters at the Cambridge Associates conference on June 13, 2003 in Boston.

John Tavss spoke at the Common Sense Investment Management Forum on September 22, 2003 in Portland, Oregon.

Steven Nadel spoke about regulatory developments at IIR's conference on Mastering Effective Tax & Financial Reporting Practices for Hedge Funds on September 22, 2003 at The Park Central in New York City. He also wrote a chapter on private investment fund regulation for the book entitled *The Capital Guide to Alternative Investment.*

Jack Rigney, Kevin Broadwater and Paul Miller wrote an article entitled *The World of RICs* for the *Alternative Fund Services Review* May 2003 edition.

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.

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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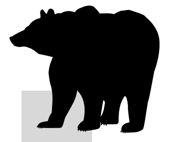

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