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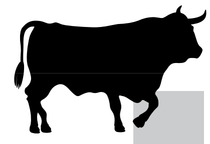

SEC Investment Adviser Registration and Compliance

The SEC recently proposed changes that would require most managers of hedge funds to register as investment advisers (see more detailed article below under *"Legislative & Regulatory Snapshots"*). Currently, many hedge fund managers are exempt from registration if they have less than 15 "clients" (counting each fund as one client). Set forth below, is a discussion of the principal registration and compliance requirements for advisers registered with the SEC (state requirements may differ).

Registration Requirements: Generally, in order to become an investment adviser registered with the SEC, a manager must have more than $25 million under management and must file Part 1 of a completed Form ADV with the SEC.

Part 1 of Form ADV. Advisers seeking to register must file Part 1 of Form ADV electronically through the SEC's Investment Adviser Registration Depository (which is accessible by the general public over the internet). Part 1, which is mainly in a check-the-box format, discloses background and other basic information about the adviser, such as control persons, disciplinary history and assets under management. The SEC has 45 days after receipt of Part 1 to declare an adviser's registration effective. There is no examination requirement as part of the Form ADV filing. Filing fees range from $150 to $1,100 for the initial filing and from $100 to $550 for each annual amendment, depending on assets under management and the number of state notice filings. A registered adviser is required to amend its Form ADV each year by filing an annual updating amendment within 90 days of the end of its fiscal year, with more frequent updates required for certain material changes.

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Drafting an Employee Handbook

As companies grow and more employees are hired, communication of company policies and procedures, as well as compliance with legal posting and notice obligations, becomes increasingly more difficult. Once a company reaches this point, an employer should consider adopting an employee handbook that clearly explains its employment policies. A careful employer should take the time to tailor the handbook to meet its specific concerns and should review it periodically to ensure its currency in light of relevant developments.

Topics addressed in an employee handbook may vary from company to company, depending on size, organizational needs and state law. Most handbooks begin with an introduction, which typically provides a brief history and business philosophy of the company and sets a tone for the remainder of the handbook. Employers often find that the handbook is also an ideal place to provide what is expected of employees in terms of work hours, attendance, use of drugs and alcohol, standards of behavior and appropriate dress, as well as what benefits employees can expect to receive from the company, such as sick time, vacation time, holidays, personal days, paid leave, and group insurance and retirement plans. Other typical policies include those involving non-discrimination and anti-harassment, communications and technology systems, confidential information, travel and business expenses, and paydays. Setting out policies in handbooks may also satisfy certain state legal notice requirements, including those relating to smoking, drug testing or access to employee records.

Advantages to maintaining an employee handbook are numerous. If drafted, distributed and acknowledged properly, a handbook can be a practical tool to help manage a company. It limits disagreements as to whether an employer communicated certain policies to its employees and helps ensure that the policies

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Registration and Compliance

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Part II of Form ADV. A registered adviser is also required, pursuant to the "brochure rule", to furnish all clients with a written disclosure statement or brochure that provides detailed information about business practices, fees and conflicts of interest. Typically, Part II of Form ADV is used to satisfy the brochure rule. Although it is currently not required to be filed with the SEC, certain states may still request copies of Part II.

Compliance Requirements: Once an adviser is registered with the SEC, it will be subject to numerous ongoing compliance obligations (which may be checked via surprise periodic SEC examinations of the adviser), including:

• *Compliance Program:* Effective October 5, 2004, registered advisers will be required to (i) adopt and implement compliance procedures; (ii) annually review them; and (iii) designate a chief compliance officer. Compliance procedures should address, among other areas of operations: portfolio management processes; trading and brokerage practices; proprietary trading and personal trading; disclosures to clients; custody of client assets; recordkeeping; marketing of services; insider trading; client information safeguards; security valuations; and business continuity planning. The chief compliance officer should be knowledgeable regarding the Investment Advisers Act of 1940 and empowered with full responsibility and authority to develop and enforce the compliance procedures. Advisers may designate a principal or existing employee to serve as chief compliance officer, provided that such person is qualified. *Seward & Kissel's Investment Management Group can help educate and advise chief compliance officers about relevant compliance and Investment Advisers Act issues, and can also assist in the preparation and ongoing maintenance of a comprehensive compliance manual and code of ethics (discussed below).*

• *Code of Ethics:* Registered advisers will also be required to adopt codes of ethics to prevent fraud by firm personnel, with minimum provisions to address: standards of business conduct, compliance with federal securities laws, personal securities reporting, pre-approval of certain transactions, and reporting of code of ethics violations.

• *Recordkeeping:* Registered advisers are required to make, maintain and preserve certain books and records concerning client accounts, including any required records that may be in e-mail form (see more detailed article below under *"Legislative and Regulatory Snapshots"*). These records are subject to SEC inspection. Generally, these books and records must be kept in an easily accessible place for at least five years and may, subject to certain requirements, be maintained electronically.

• *Custody:* Registered advisers who have direct or indirect control over client assets (and, accordingly, have custody over such client assets) must maintain client assets with a "qualified custodian" and, subject to certain exceptions, arrange for account statements to be sent to clients at least quarterly by the custodian or the adviser (see related article below under *"Legislative and Regulatory Snapshots"*).

• *Performance-Based Fees:* Registered advisers are generally prohibited from charging fees based on the appreciation of a client's assets, unless the arrangement complies with SEC rules. The most common permitted arrangement is that an adviser can charge a performance-based fee, if the client has a net worth exceeding $1.5 million or at least $750,000 under the adviser's management. If the client is a fund itself, the fund must either be a 3(c)(7) fund or each investor in the fund must satisfy the above test.

• *Advertising and Performance Reporting:* Registered advisers are subject to numerous SEC interpretations related to marketing their services and the disclosure of their performance.

• *Insider Trading Procedures:* Registered advisers must adopt written procedures designed to prevent the misuse of inside information by the adviser and its employees.

• *Proxy Voting Procedures:* Registered advisers with voting authority over client proxies must adopt written procedures to address material conflicts of interest, disclose such procedures, and disclose their proxy voting history.

Drafting an Employee Handbook

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are communicated consistently. It also reduces employee anxiety about job requirements and the correct procedures to follow if and when certain events occur.

Please feel free to contact an attorney in our Employment Practices/Litigation Group, if you have any questions about employee handbooks.

Legislative and Regulatory Snapshots

SEC Proposes Hedge Fund Manager Registration. On July 14, 2004, the SEC announced a ***proposed rule that would require most hedge fund managers with at least $25 million under management to register as investment advisers with the SEC.*** The proposal was approved by the SEC commissioners by a three to two vote, with the two dissenting commissioners voicing strong opposition. There is a comment period available for interested parties.

The SEC cited in its reasoning in support of the rule: (i) the increase in hedge funds and their assets; (ii) the increase in hedge fund fraud cases and the 40 hedge funds implicated in the recent mutual fund scandals; (iii) that pensions, funds-of-funds and other vehicles now allow access to hedge funds by many smaller retail investors; and (iv) that registration would be a way to detect at an earlier stage possible fraud, compliance issues and other bad practices.

The proposed Rule 203(b)(3)-2 of the Investment Advisers Act of 1940 would eliminate the registration exception that many hedge fund managers currently rely on by requiring "private fund" managers to count their underlying fund investors as "clients". A manager with more than 14 clients and over $25 million under management would have to register. A "private fund" would be defined as an investment fund: (i) relying on Section 3c1 or 3c7 of the Investment Company Act of 1940; (ii) not imposing a lockup of two years or more (except for redemptions during such lockup in extraordinary circumstances); and (iii) offered based on the skills of the adviser. The rule would also apply to offshore advisers to a somewhat limited extent, if they have more than 14 U.S. clients. Finally, the rule would grandfather existing investors in hedge funds whose managers are not SEC-registered, so that the manager could charge them a performance fee without them having to be "qualified clients" (i.e., generally, $750,000 under management or $1.5 million in net worth).

The passage of the proposed rule in its current form is by no means a certainty, given the opposition that has been voiced within the SEC, as well as by Federal Reserve Chairman Alan Greenspan, CFTC Chairman James Newsome, New York Attorney General Eliot Spitzer and Congressman Michael Oxley. We are following this matter closely and will notify you of any developments.

Relief for Funds-of-Funds under the Custody Rule. On September 25, 2003, the SEC approved amended Rule 206(4)-2 of the Investment Advisers Act of 1940, which requires registered investment advisers who are deemed to have custody of client assets to maintain client assets with a "qualified custodian" and arrange for account statements to be sent by the custodian or the adviser to clients at least quarterly. The new rule provides an exemption from the account statement requirement for private investment funds, if fund financial statements are audited at least annually, prepared in accordance with U.S. GAAP and are distributed to fund investors within 120 days of the fund's fiscal year-end. Many funds-of-funds raised concerns about the 120 day deadline and, in response, the SEC issued further guidance on March 18, 2004 which allows funds-of-funds to rely on that exemption, provided that they have a "reasonable belief" that their audited financials will be distributed within such 120 day time frame. This relief may be limited, however, because if an underlying manager fails to deliver timely financials to a fund-of-funds in one year, it may be unreasonable for the fund-of-funds manager to believe that the manager will deliver the financials on time in later years. Fund-of-funds managers may wish to consider obtaining assurances from underlying managers that the underlying fund financial statements will be delivered in time to comply with the 120 day requirement. (Note further that the SEC, as part of its hedge fund manager registration proposal, has proposed an extension to 180 days and the SEC will not recommend action against any fund-of-funds relying on the proposal.)

SEC Brings First Ever Enforcement Action Against Principal of Unregistered Adviser for Failure to Supervise. On December 15, 2003, the SEC announced its first "failure to supervise" enforcement action against the principal of an *unregistered adviser* to various hedge funds. In the same action, the SEC charged the adviser's director of investments with defrauding the investors in such hedge funds. The SEC indicated that the principal's "failing reasonably to supervise" led to a violation of the antifraud provisions of the federal securities laws (including the Investment Advisers Act of 1940), and that any adviser, whether registered or not, is subject to such provisions.

E-Mail Retention and Instant Messages. Since the mutual fund scandals last fall, the SEC has indicated that it intends to rely more heavily on e-mails to find out "what's really going on" inside a firm and has been asking registered advisers to provide e-mails in routine SEC audits. Although there has been no clear guidance on exactly which e-mails must be kept or for how long, registered advisers

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should keep all e-mails that relate to the various categories listed in the books and records rule for the time periods required by the rule (usually five years).

In addition, the SEC has indicated that it believes it has the right to require the production of *any* e-mail (possibly even those covered by attorney-client privilege), whether or not it is a required record, if maintained. Accordingly, registered advisers should consider adopting e-mail procedures and deleting only those e-mails that have been reviewed and verified by the compliance department as not business-related. Instant messages present a unique problem because, without specific software, they cannot be retrieved or retained, but might include required records under the rules. There are several service provider firms that sell filtering systems to assist advisers in the review, storage and deletion of e-mails and instant messages. In addition, the attorneys in our Investment Management Group can assist you, if you would like to implement e-mail retention procedures.

Advertisements and Testimonials. In a recent no-action letter to the Investment Counsel Association of America, the SEC staff stated that a registered adviser may provide clients, prospective clients and consultants with written information regarding past specific recommendations and client testimonials when responding to direct requests for such information. However, the adviser may not directly or indirectly solicit such request, because the information may be considered an "advertisement" in violation of the Investment Advisers Act.

CFTC Registration Exemptions and Ongoing Requirements. Since the CFTC's passage in 2003 of various registration exemptions under Rules 4.13(a)(3) and 4.13(a)(4) (see *The Private Funds Report, Vol. VII*), many hedge fund managers have filed for these exemptions. Such managers are reminded that despite being exempt from registration, they must still "keep all books and records prepared in connection with its activities as a pool operator" for at least five years, and such books and records must be kept "readily accessible" for the first two years of the five year period. In addition, managers are required to file the annual financial statements of any funds to which they served as CPOs for any partial year of registration.

CFTC Issues Rule 4.13(a)(3) Interpretation. On April 14, 2004, the CFTC issued an interpretation indicating that non-U.S. persons do not have to meet the "accredited investor" or "qualified eligible person" criteria for a fund manager to seek relief from registration under the recently-passed Rule 4.13(a)(3). This supercedes earlier CFTC guidance that indicated that non-U.S. persons did have to meet such criteria.

NASD's Related Performance Information Ban Not Applicable to 3(c)(7) Funds. On October 2, 2003, the NASD issued a letter indicating that NASD member broker-dealers may not distribute private investment fund "related performance information" in sales material (see *The Private Funds Report, Vol. VII*). Thereafter, on December 20, 2003, the NASD issued another letter clarifying that such a ban would not apply to private investment funds operating pursuant to the 3(c)(7) exception under the Investment Company Act of 1940.

SEC Adopts Changes to Short Sales Rules. On June 23, 2004, the SEC adopted various changes to its short sale rules. The changes include: (i) effective January 23, 2005, the suspension for a pilot one-year period of the "uptick rule" for (a) approximately one-third of all Russell 3000 index stocks and (b) Russell 1000 index stocks between 4:15 pm EST and the open of the consolidated tape on the following trading day; and (ii) the creation of a uniform SEC rule requiring brokers to determine the availability of borrowable securities and the imposition of additional requirements on certain securities. The SEC has decided to defer further action on its proposal to replace the "uptick rule" (see *The Private Funds Report, Vol. VII*).

An Introduction to the EU Savings Directive. The EU Savings Directive is intended to take effect on January 1, 2005 and *could impact funds invested in distressed debt or fixed income instruments.* The Directive will allow the local taxing authorities of certain EU taxpayers to identify the receipt by such taxpayers of "interest payments" that might otherwise not be declared. The EU taxpayers covered by the Directive would include individuals tax resident in an EU member state, as well as "residual entities" (i.e., essentially, certain entities where individuals are considered the ultimate beneficiaries). The Directive will require a paying agent (generally, the last person in a payment chain, e.g., possibly the fund, the administrator or a nominee) in an EU member state or associated territory (including the Cayman Islands and Jersey) who makes interest payments to any EU taxpayers to either pass on information about the income to the paying agent's domestic taxing authority or (in certain jurisdictions such as Austria, Belgium and Luxembourg) levy a withholding tax. Certain countries outside of the EU (such as

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Switzerland) will also enact provisions equivalent to those of the Directive, which will apply if interest payments are paid by a paying agent resident in such countries to individuals in the EU.

Certain payments relating to private investment funds fall within the Directive, including distributions of income from funds with 15% or more of their assets invested in debt instruments or cash and amounts derived from the sale and redemption of shares or units in funds that hold more than 40% of their assets in debt instruments or cash. The Directive will require fund managers to report information about private investment fund clients with whom "contractual relations" arose on or after January 1, 2004. Therefore, fund managers should be considering how to ensure they obtain any necessary information.

The implementation of the Directive is, however, uncertain. There are still several practical issues to determine (e.g., definition of paying agent, procedure for establishing percentage of fund assets invested in debt instruments, etc.), and the effectiveness of the Directive will require certain non-EU states to pass similar legislation.

This article was contributed by Paul Hale and Martin Shah of the London office of the international law firm of Simmons & Simmons.

Proposed Treasury Regulations Regarding Notional Principal Contracts. In February 2004, the Department of Treasury issued proposed regulations concerning the tax treatment of notional principal contracts (NPCs) that provide for contingent nonperiodic payments, such as certain total return swaps. Currently, taxpayers commonly take contingent nonperiodic payments into account for tax purposes when the payment becomes fixed and determinable. The proposed regulations reject such a "wait and see" approach and require that such payments be included in taxable income over the term of the NPC. The proposed regulations call for the use of a non-contingent swap method pursuant to which a taxpayer would project the amount of each contingent nonperiodic payment, adjust the projection at each "redetermination date" (generally, each anniversary date of the NPC), and take into account over a one-year period any difference between the old projection and the new projection. The proposed regulations also permit a "mark-to-market" election as an alternative to this non-contingent swap method. Under the proposed regulations, payments made pursuant to a NPC generally are ordinary, not capital, in character. A "bullet swap" (i.e., a financial instrument that provides for the settlement of all of the parties' obligations at or close to the contract's maturity and that is measured by reference to a specified index on a notional principal amount) is not subject to the proposed regulations. The proposed regulations are proposed to be applicable to NPCs entered into on or after 30 days after final regulations are published. However, the preamble to the proposed regulations suggests that a taxpayer who has not adopted a method of accounting for NPCs with contingent nonperiodic payments prior to March 27, 2004 is required to adopt a method that takes such payments into account over the life of the NPC under a reasonable amortization method.

Investment Management Group News

Seward & Kissel was again named as the ***number one hedge fund law firm,*** this time according to a survey published by CogentHedge.com in July 2004.

Seward & Kissel recently published the first edition of its latest newsletter, *The Distressed Debt Report*. The new newsletter, which may be found on our website, focuses on the legal and business developments relevant to our clients in this sector. If you would like to be added to the mailing list, please contact Royce Wain, wain@sewkis.com.

Seward & Kissel was recently ranked by the *PIPEs Report* as one of the leading law firms in PIPEs transactions.

Robert B. Van Grover will speak about establishing effective compliance programs at FRA's 4th Hedge Fund Regulation and Compliance forum on November 15, 2004 at the New York Helmsley in New York City.

Steven Nadel will speak about regulatory developments at IIR's Tax & Financial Reporting Practices for Hedge Funds seminar on November 9, 2004 at the Park Central Hotel in New York City.

Jack Rigney spoke at Banc of America's 3rd Annual CFO/COO Summit on July 14-15, 2004 at the Rye Hilton in Rye, New York.

John Cleary spoke at the Goldman Sachs Seventh Annual Hedge Fund Conference on May 18, 2004 at the Ritz Carlton in New Orleans.

Reader Survey

We would like to thank you, our readers, for your continued support of The Private Funds Report and would like to take this opportunity to invite you to contact any partner in the Investment Management Group with any questions, suggestions or comments you may have about the newsletter.

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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