SEWARD & KISSEL LLP

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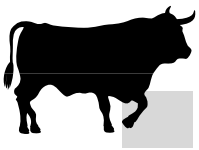

New SEC Investment Adviser Registration Rule Adopted

On December 2, 2004, the SEC issued its final rule release relating to the adoption of new Rule 203(b)(3)-2 (the Rule) under the Investment Advisers Act of 1940 (the Advisers Act) and various related rule changes. The Rule will require many hedge fund advisers that have $30 million or more under management and 15 or more clients (across all funds and accounts they manage) to register with the SEC as investment advisers, thereby subjecting them to extensive compliance, recordkeeping and other regulations, and requiring them to submit to SEC examinations. The Rule became effective February 10, 2005, but ***advisers have until February 1, 2006 to register*** and comply with most of the changes. The Rule will require a hedge fund adviser to "look through" a "private fund" and count the fund's underlying investors for the purposes of determining whether the adviser has "15 or more clients". Hedge fund advisers were previously allowed to count a hedge fund as one client without "looking through".

What is a "Private Fund"? A "private fund" is any 3(c)(1) or 3(c)(7) fund that permits its investors to redeem their interests within two years of acquiring such interests and that is offered based on the skills of the adviser. The two-year redemption test is applied on an investment-by-investment basis, but *only to investments made by existing or new investors on or after February 1, 2006.* The Rule provides exceptions to the two-year redemption test for redemptions

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Changes to Offshore Fee Deferral Rules

The American Jobs Creation Act of 2004 (the Act) will have a significant impact on the typical deferral arrangements that hedge fund managers have entered into regarding the management and/or incentive fees they receive from offshore funds. The following are the key points of the Act as they relate to hedge fund deferral arrangements:

- While deferral arrangements are still permitted after 2004, the terms of existing arrangements will likely be required to be amended to comply with the new requirements imposed by the Act. For example, the Act restricts the type of events that may accelerate the payment of deferred compensation under a deferred compensation plan.
- Deferral arrangements for pre-2005 periods are not affected by the Act, unless a "material modification" is made to the terms of pre-2005 arrangements.
- Pending further Treasury Department guidance, it is unclear whether "back-to-back" deferral arrangements (i.e., where all or a portion of a fund manager's fee deferrals are accelerated upon an employee or member of the fund manager ceasing to work with the manager) are permitted for post-2004 deferrals.
- "Re-deferrals" of prior deferrals are permitted in certain circumstances if specified requirements are satisfied.

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Investment Adviser Registration

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in extraordinary circumstances, interests acquired through the reinvestment of distributed capital gains or income, and distributions or payments initiated by the adviser.

Counting Clients. An adviser need not count non-fee-paying investors, itself nor certain knowledgeable advisory personnel (i.e., certain insiders). An adviser to a private fund in which a fund-of-funds (whether registered or a "private fund") invests must look through the fund-of-funds and count its investors when determining the number of the adviser's clients.

Non-U.S. Issues. A non-U.S. private fund adviser that has 15 or more U.S. clients (regardless of the amount of assets it has under management) will be required to register with the SEC, maintain certain books and records and be subject to SEC examination. However, assuming the non-U.S. adviser has no U.S. clients other than U.S. investors in non-U.S. private funds, it will be exempt from most of the substantive requirements of the Advisers Act, including the compliance policies and procedures rule, code of ethics rule (except having to maintain its access persons' personal securities reports), custody rule and proxy voting rule.

Related Rule Changes. An adviser that will have to register under the new Rule will only be required to keep and maintain appropriate books and records as dictated by the Advisers Act *attributable to performance on or after February 10, 2005.* Moreover, if an adviser will be registering with the SEC by February 1, 2006, *generally, once it registers, only those of its clients that are investors on or after February 10, 2005* will be required to meet the performance fee rule's qualified client standard (i.e., $750,000 under the adviser's management or $1.5 million net worth). Finally, the custody rule has been amended to extend to 180 days the period of time by which a fund-of-funds must distribute its audited financial statements to investors. (Hedge funds are still subject to a 120 day requirement.)

Conclusion. The Rule will have a substantial impact on those currently unregistered hedge fund advisers who have to register, including the implementation of compliance policies and procedures, the designation of a chief compliance officer, the compliance with various other Advisers Act rules and the amendment of fund offering materials. Accordingly, even though the registration compliance date is not until February 1, 2006, *unregistered advisers should start reviewing their options and gain an understanding of the related consequences and time requirements significantly before such date.* If you have any questions regarding the foregoing or if you would like us to assist you with investment adviser registration or compliance issues, please contact your primary attorney in our Investment Management Group.

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- Offshore "rabbi trusts" and similar offshore funding arrangements are no longer permitted.
- Subject to further Treasury Department guidance, deferred amounts (including earnings on previously deferred fees) may currently be reportable by employers to the Internal Revenue Service on a Form W-2 or Form 1099, as the case may be, even though such amounts are not taxed until a later period. The extent to which the new reporting requirements will apply to deferrals made by partners in partnerships or to members of limited liability companies treated as partnerships for tax purposes currently is unclear.

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Legislative and Regulatory Snapshots

SEC Sued Over New Registration Rule. A federal lawsuit has been filed against the SEC in relation to the recently adopted hedge fund adviser registration rule. In sum, the suit claims that the SEC did not have the necessary legal authority to adopt the new rule and that the rule is in violation of Congressional intent to the contrary. The SEC, in response to a number of comment letters it received raising this issue, has stated that it believes it has the legal authority to adopt the rule changes.

States Contemplate New Compliance Rules for Registered Advisers. Following on the heels of the SEC, Ohio recently became the first state to issue a regulation requiring its state-registered investment advisers to adopt written compliance procedures and appoint a compliance officer. Many other states are considering similar actions. The effect of this will be to cause smaller advisers, who otherwise would be exempt from the burdens of SEC registration, to now have to adopt policies and procedures similar to their SEC-registered counterparts.

Bermuda Considers Additional Hedge Fund Legislation. The Bermuda Monetary Authority is expected shortly to introduce new legislation applicable to "collective investment schemes" such as hedge funds. While the precise language of the new legislation is not yet publicly available, we understand that the Bermuda Monetary Authority will be given enhanced information, intervention and enforcement powers, and will also be able to establish gateways for the cross-border sharing of information and cooperation with foreign authorities.

NASD Fines Major Brokerage Firms Over Hedge Fund Sales. The NASD recently fined two major brokerage firms in connection with sales practices relating to their distribution of various hedge fund sales materials. Among the issues cited by the NASD were: (i) certain sales materials did not contain adequate risk disclosures, (ii) certain sales presentations contained targeted rates of return without providing a substantial basis for the targets, and (iii) certain sales materials improperly used hypothetical returns in performance presentations. In light of the foregoing, we recommend that all hedge fund sales materials (including PowerPoints, flip charts and term sheets) be reviewed by qualified persons for compliance with the anti-fraud provisions of the Advisers Act (which apply to all investment advisers) and to reflect the foregoing and other recent regulatory developments related to marketing.

New York LLC/LP Ownership Bill Update. A bill was recently considered by the New York State Legislature that would have required the names and business addresses of the ten owners with the greatest interests in a limited liability company or limited partnership (formed or qualified to do business in New York) to be published in newspapers in their county of principal location. If passed, this bill would have required many newly-formed New York-based hedge funds to disclose their top ten owners. A strong lobbying effort, however, apparently resulted in a proposed amendment to the bill, which would have limited the scope of the publication requirement to those persons *actively involved in the management* of the company. On January 31, 2005, New York Governor George Pataki pocket vetoed the original bill, however, it is possible that it may be reintroduced during the next legislative session.

NASD Issues Memorandum on Scope of Foreign Investment Company Exemption under New Issues Rule. On August 6, 2004, the NASD issued a memorandum clarifying the scope of the foreign investment company exemption under the "new issues rule". The text of the exemption states that the restrictions in the new issues rule do not apply to sales to and purchases by an investment company organized under the laws of a foreign jurisdiction, provided that: (i) the investment company is listed on a foreign exchange or authorized *for sale to the public* by a foreign regulatory authority, and (ii) no person owning more than 5% of the investment company's shares is a "restricted person". While many in the industry interpreted the exemption (and its similar predecessor under the superceded "hot issues"

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rule) as applying to all foreign hedge funds listed on an exchange (regardless of whether they were offered for sale to the public or sold "privately" to high net worth individuals and institutions), the NASD disagreed. Focusing on the phrase "for sale to the public", the NASD indicated that those words modify both the phrase "listed on a foreign exchange" and the term "authorized" and, therefore, a foreign investment company limited to select investors would not be eligible for the exemption. On October 29, 2004, the NASD issued a rule proposal to clarify the foregoing, but the proposal has not yet been published for public comment.

Soft Dollars Update. On November 11, 2004, the NASD issued its Report of the Mutual Fund Task Force on Soft Dollars and Portfolio Transaction Costs in which the NASD provided recommendations for consideration by the SEC. In general, the NASD recognized that soft dollars as set forth in the Section 28(e) Securities Exchange Act "research safe harbor" are an important element in the current system for providing research. However, the NASD did recommend, among other things, a significant narrowing of the types of research services that may be obtained with soft dollars to the "intellectual content" of the research (e.g., investment formulas, ideas, analyses and strategies), intending to target services that will principally benefit clients rather than those that principally benefit advisers. Accordingly, *the NASD recommended excluding from the safe harbor the means by which research is provided (e.g., computer hardware and software, telephone lines, terminals, magazines, newspapers and online news services).* The NASD also recommended an enhanced level of disclosure regarding soft dollar usage in mutual fund prospectuses and to fund boards. Finally, the NASD recommended making compliance with Section 28(e) mandatory for all discretionary investment advisers, whether or not registered with the SEC.

Mandatory Tax Basis Adjustments for Partnerships. Recently enacted tax legislation (the Act) requires partnerships to adjust the tax basis of their securities in certain circumstances. Prior to the Act, these basis adjustments were elective under Section 754 of the Internal Revenue Code, rather than mandatory. Historically, very few investment partnerships made elective Section 754 basis adjustments due to the significant administrative burdens and costs involved in implementing these basis adjustments and, more significantly, because such a Section 754 election would negate the benefits to a partnership (and its remaining partners) of distributing appreciated securities in kind to withdrawing partners.

In the case of a distribution of securities to a retiring partner, if the partner's tax basis for his partnership interest immediately before the distribution (reduced by any cash distributed in the transaction) exceeds the partnership's tax basis for the distributed securities by more than $250,000, the Act requires the partnership to reduce the tax basis of its remaining securities by the entire amount of the excess. In other words, a basis reduction is now required when the amount of the partnership's unrealized gain with respect to the distributed securities exceeds the partner's unrealized gain with respect to his partnership interest by more than $250,000. This change effectively negates the advantage of distributing appreciated securities in kind to a withdrawing partner. A partnership may wish to utilize the "gain stuffing" or "fill up" provision of its partnership agreement as an alternative to distributing securities in kind to a retiring partner. If such a provision is used, the retiring partner would be specially allocated a greater amount of tax gains on his Schedule K-1 for the year of retirement than he would have been allocated in the absence of such a special allocation, but the amount of gain that he would otherwise recognize as a result of the liquidation of his partnership interest would be reduced by a corresponding amount.

Further, if a retiring partner realizes a loss of more than $250,000 upon the redemption of his partnership

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• The Act does not contain any restriction on the types of investments that can be utilized by a fund manager as a measurement of the earnings attributable to compensation deferred under a deferred compensation plan.

• Unless all of the Act's requirements are satisfied by a particular deferred compensation plan, (i) the compensation subject to a deferral election under the plan will be taxable to the service provider in the taxable year in which the services were rendered, (ii) interest at the tax underpayment rate plus one percentage point will be imposed on any underpayments attributable to the failure of the service provider to pay tax currently on the compensation, and (iii) the taxable compensation will be subject to a 20 percent additional tax.

• Although the Internal Revenue Service released guidance in December 2004 with respect to certain aspects of the Act, the guidance did not address many of the issues outlined above. We are expecting further Internal Revenue Service guidance with respect to these issues in future months.

If you have any questions concerning these matters, please contact Dan Murphy or Peter Pront in our Tax Group.

SNAPSHOTS

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interest, the Act requires the partnership to reduce the tax basis of its securities by the amount of the partner's loss. In order to avoid the need to make such basis adjustments, assuming it is not already in its partnership agreement, a partnership may wish to consider amending its partnership agreement to provide for a "loss stuffing" or "fill down" provision. (Depending on the terms of the partnership's limited partnership agreement, such an amendment may require the consent of the limited partners.) If a "fill down" provision is used, the retiring partner would be specially allocated a greater amount of tax losses on his Schedule K-1 for the year of retirement than he would have been allocated in the absence of such a special allocation, but the amount of loss that he would otherwise recognize as a result of the liquidation of his partnership interest would be reduced by a corresponding amount.

Based on the foregoing, we recommend that existing partnerships consider amending their governing documents, as necessary, to allow for both gain and loss stuffing. If you have any questions concerning these matters, please contact Dan Murphy or Peter Pront in our Tax Group.

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 February/March 2005.

ROBERT VAN GROVER will speak about developing an effective compliance program at FRA's Hedge Fund Regulation & Compliance Forum on May 13, 2005 at The Helmsley in New York City.

STEVEN NADEL will speak about hedge fund regulatory developments at NICSA's Alternative Investments Seminar on April 28, 2005 at the New York Athletic Club in New York City and at GAIM's Hedge Fund Forum on June 21, 2005 at the Doubletree Metropolitan Hotel in New York City.

JOHN CLEARY spoke at a roundtable discussion about mutual funds and hedge funds at Fordham Law School on January 31, 2005 in New York City.

STEVEN NADEL, PATRICIA POGLINCO AND ROBERT VAN GROVER wrote an article entitled *SEC Issues Final Rule Requiring Registration of Most Hedge Fund Advisers* which was published in the January/February 2005 edition of the MFA Reporter.

SEWARD & KISSEL represented Asset Management Finance Corporation (AMF) in its organization and initial raise of $90 million of equity and debt. Seward & Kissel has also been involved in the development of the innovative financial solutions AMF offers to asset management companies in need of capital infusions, which allow for the provision of capital to asset management firms without requiring them to incur fixed obligations associated with the sale of equity to a third party.

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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