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Negotiating an Office Lease

One of the most challenging and intimidating items facing start-up hedge fund managers is securing office space. Office space is typically not a fund expense, but rather an expense borne by the manager (and, hence, its principals). The following is a synopsis of the principal business terms that a manager should consider when negotiating a lease (or, most subleases):

Length of Term: Most office leases have a term of between three to fifteen years. Often, the tenant can obtain a right to extend the term. Given that a start-up hedge fund has uncertain prospects, a short initial term is suggested.

Base Rent and Rent Abatement: The base rent may either stay the same for the entire lease term or change over time. Depending on market conditions, a tenant may be able to negotiate an abatement of the base rent for a specified portion of the lease term (a "free rent" period).

Additional Rent: Many leases provide that the tenant pay, in addition to the base rent, rent attributable to operating the building in which the premises are located. In New York City, this often means that a tenant will pay its percentage share of any increases in the real estate taxes and operating expenses for the building. The tenant should make sure that the current year's expenses are used as the base year for determining such payments.

Preparing the Premises for Occupancy: If any work needs to be done to the premises, the landlord and tenant will need to negotiate who will be responsible for and bear the cost of such work. If the landlord is responsible, the parties will need to agree on precisely what work needs to be done. If the tenant is responsible, then the landlord may agree to provide the tenant with

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Use of the Media by Hedge Funds

Hedge funds are offered and sold to investors through private placements pursuant to an exemption from registration under the Securities Act of 1933. In order for a transaction to constitute a private placement, no form of general solicitation or advertising may be used, including cold calls, public interviews, publicly accessible web sites or use of the media, such as advertisements, press releases or articles. Moreover, although not the focus of this article, a manager may not use the media (or any other means) to hold itself out to the public as an investment adviser, unless the manager is registered as an investment adviser.

With the growing popularity of hedge funds as an alternative asset class, such funds have become the focus of increased media attention. Many articles on various funds and their strategies are being published. Hedge fund managers should be aware that these articles raise potential regulatory concerns. A fund could be considered to run afoul of the private placement exemption, if it were mentioned in such an article, especially if it cooperated voluntarily in the publication. The following are some recent developments in this area:

• In the adopting release of the recently overturned hedge fund adviser registration rule, the SEC expressed concern regarding the "retailization" of hedge funds. The SEC stated that advisers are targeting investors who are not financially sophisticated enough to understand all of the risks associated with an investment in a hedge fund. The SEC noted that some funds have lowered their minimum investment requirements.

• In the SEC's 2003 Staff Report on Hedge Funds, the SEC's staff of the Division of Investment

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an allowance to fund the cost of such work. Note that hedge fund managers can work with certain consultants, as well as persons at various prime brokers, who provide advice about office build-outs.

Electricity and Technology: Hedge fund managers are often heavy users of electricity and technology. Therefore, it is important to determine whether the premises have sufficient electrical and IT wiring capacity. Most leases provide that the tenant will pay separately for electrical consumption, either on a "fixed amount" (commonly called "rent inclusion") basis or on a "submetered" basis.

Building Services: The lease should also cover the costs and types of other services that will be provided to the tenant, including heating, ventilation and air conditioning, hours of access to the premises, cleaning, building directory listings and signage rights. Given the hours that some hedge fund managers are required to operate, it is imperative that these points be considered.

Security/Guarantee: Almost every tenant will be required to provide a security deposit (either cash or, more often, a letter of credit), but the amount of the security deposit will depend on the credit risk that the landlord is willing to assume. A start-up tenant may be required to provide a relatively large security deposit. In such a case, the landlord may agree to reductions in the security deposit after a certain number of years have elapsed, provided that the tenant has not defaulted under the lease and, in some cases, has met certain other conditions.

More importantly, the landlord may also require that the principals of the tenant execute a personal guarantee of the tenant's lease obligations. If a guarantee is requested, it is strongly recommended that it be a "good guy" guarantee, which essentially means that the guarantor's liability ends once the tenant vacates the premises, although the tenant itself may continue to remain liable under the lease following the surrender of the premises.

In sum, hedge fund managers should seek appropriate guidance prior to securing office space. If you have further questions related to the foregoing, please contact Mark Brody or Robert Gorzelany in our Real Estate Group at 212-574-1200.

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Management expressed concern that current marketing practices by some hedge fund managers (e.g., the use of newsletters, the internet, press articles and institutional reporting services) raise questions as to whether the fund is engaging in a general solicitation or advertising.

- On July 12, 2005, the SEC censured and fined two affiliated advisers for making a general solicitation of their hedge funds. The funds were advertised through radio advertisements, seminars and on the internet and accepted initial investments of as little as $50,000.
- The SEC continues to raise concerns about the use of non-password-protected web sites for hedge funds. In one adviser audit, the SEC's audit staff stated that a web site that was open to the general public constituted a general solicitation or advertising, thereby violating both the Securities Act of 1933 and the Investment Company Act of 1940. The SEC asked the adviser to either shut down the web site or password-protect it, so that only qualified investors could access the information regarding the funds.
- Hedge fund managers should be aware that it is common for counterparties to ask for factual representations and legal opinions relating to the fund's private offering status. To the extent that the fund has engaged in activities that could constitute a general solicitation, the fund may be advised to impose a "cooling-off" period on the fund's offering, before it can make the factual representations or obtain an opinion.

In light of the foregoing, managers should be careful to avoid activities that could be considered a general solicitation or advertising and should seek appropriate counsel prior to appearing in the media.

Legislative and Regulatory Snapshots

Hedge Fund Adviser Registration Rule Vacated. On June 23, 2006, the US Court of Appeals for the District of Columbia Circuit issued its ruling in connection with the case that challenged the SEC's authority to pass the SEC "hedge fund adviser" registration rule in 2004, a rule which required most hedge fund managers to register as investment advisers with the SEC. In its ruling, the Court stated, among other things, that the SEC had not adequately explained the rationale for its change from its prior views and that the rule was arbitrary. Accordingly, the Court ordered that the new rule be vacated and remanded once the SEC decided whether it would appeal the decision. On August 7, 2006, SEC Chairman Christopher Cox announced that the SEC would not appeal the Court's decision and the Court issued its final mandate to make the ruling effective on August 18, 2006.

Hedge fund managers who were required to register under the hedge fund adviser registration rule and who wish to de-register will be able to do so by filing a Form ADV-W, provided they do not hold themselves out to the public as investment advisers and have no more than 14 clients (counting each fund and managed account as a client). Moreover, hedge fund managers, who did not register under the hedge fund adviser registration rule in reliance on the two year lock-up exception, may now eliminate such lock-up, if they so desire.

Chairman Cox noted that the SEC would soon propose some new anti-fraud rules and other regulations, as well as issue staff guidance designed to address the legal consequences of the recent court decision. The SEC staff is also considering whether to increase the minimum asset and income thresholds for hedge fund investors. We will apprise you of these developments as they are announced.

ERISA Developments. On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006. The new legislation provides sweeping changes designed to modernize ERISA's fiduciary rules, especially with respect to the "25% test." For our investment management clients, the most significant change is that foreign plans, governmental plans and church plans will no longer be counted for purposes of the 25% test and their assets will not be considered "benefit plan investor" money. Additionally, the Act provides that an entity shall be considered to hold plan assets "only to the extent" of the percentage of equity interest held by benefit plan investors — this means that only that portion of an investment by a benefit plan investor entity that is plan assets will count towards a second entity's 25% calculation. Finally, the Act also provides much needed modernization to several other ERISA prohibitions such as block trading, ECN transactions, transactions with service providers, bonding, foreign exchange transactions, cross trading and prohibited transaction corrections. A more detailed memorandum outlining the Pension Protection Act is available on our website, www.sewkis.com.

Hedge Fund Manager Sued for Failure to Make Hart-Scott-Rodino Filings. Recently, the Federal Trade Commission settled a case for $350,000 with a hedge fund manager who failed to make Hart-Scott-Rodino notice filings. These antitrust-related filings are generally required where there is to be an acquisition of the voting securities or assets of any issuer worth at least $57 million; provided, however, that there is an exception for certain completely passive investors.

ABA Task Force Recommends Easier NASD Registration for Marketers. The American Bar Association's Task Force on Private Placement Broker-Dealers recently submitted a report to the SEC recommending that third party private placement marketers (e.g., hedge fund marketers) be allowed to register as broker-dealers with the NASD under a greatly simplified registration regime, consisting of, among other things, lower fees, more relevant exams and no net capital or audit requirements. Given the clientele and the limited services of these marketers, the Task Force expressed its view that a regime of this sort would be more appropriate.

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SEC Release on Soft Dollars. On July 18, 2006, the SEC published a guidance release with respect to the soft dollar safe harbor found in Section 28(e) of the Securities Exchange Act of 1934 (the Release). Section 28(e) provides a safe harbor that protects a discretionary money manager of a client account from liability for breaching fiduciary duties owed to the client account solely based on the account paying more than the lowest commission amount for brokerage and research services received from a broker-dealer, when the manager determines in good faith that the commission amount was reasonable relative to the brokerage and research services received. The Release was effective as of July 24, 2006, but market participants may continue to rely on the SEC's prior interpretations of Section 28(e) until January 24, 2007.

Eligibility. In order for brokerage and research services to be eligible for safe harbor protection, the manager must determine (i) whether the product or service constitutes research or brokerage under Section 28(e), (ii) whether the product or service in fact provides lawful and appropriate assistance in the investment decision-making function, and (iii) that the amount of commissions paid is reasonable in light of the products or services provided.

Research Services. Under the Release, to qualify as research, a product must reflect the "expression of reasoning or knowledge" either through (i) advice relating to the value of securities, the advisability of investing in securities and the availability of securities or their buyers or sellers or (ii) analyses or reports about issuers, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts. The form of the research may be electronic, paper or oral discussions.

Brokerage Services. Under the Release, to qualify as brokerage, a service must be provided to effect securities transactions during the period beginning when orders are first transmitted to broker-dealers and ending at the conclusion of clearance and settlement of the transactions covered by the orders. The Release refers to the use of this period as a "temporal" approach to identifying brokerage services.

Mixed-Use Items. The Release affirms the continued propriety of following a mixed-use approach to allocate the value of products or services that are used only partially for activities within the safe harbor and emphasizes that a money manager must keep adequate books and records to substantiate the money manager's allocations. Examples of mixed-use items may include order management systems and trade analytical software, as well as proxy services.

Extent of Broker-Dealer Involvement. The Release reiterates past guidance that broker-dealers receiving commissions must be involved in "effecting" the transaction and must be responsible for the brokerage and research services "provided by" them (even when the services are the products of a third party). The Release, however, provides significantly greater flexibility than past guidance in determining whether a broker-dealer is involved in "effecting" a transaction and whether the broker-dealer is responsible for "providing" the services.

A more detailed memorandum containing examples of permitted research and brokerage and generally outlining the Release is available on our website, www.sewkis.com.

Abuses with PIPES. Over the last several years, investments in "PIPE" securities have become popular in the investment management community. PIPEs, an acronym for "private investments in public equities," are transactions in which a publicly-traded company sells restricted equity securities to purchasers in a private placement and agrees under a registration rights agreement to register the securities with the SEC for resale, thereby freeing the shares from selling restrictions, within a specified time period. PIPE transactions offer a number of advantages for both investors and issuers, including:

- *Favorable pricing.* Typically, investors are

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compensated for holding restricted shares for the period prior to an effective registration by way of a discount from the prevailing public market price of the shares.

- *Speed to funding.* Since the PIPE securities are offered on a private basis without SEC filing, deals can be quickly negotiated and closed.
- *Less market risk.* Since PIPE deals are conducted on a confidential basis, investors generally suffer less market risk during the negotiations.
- *Publicly available information.* Since the companies are publicly-traded and subject to SEC reporting requirements, there should be ample information on which to make an informed investment decision.

The SEC has taken action to curb recent abuses in PIPE transactions, particularly in the area of insider trading. Typically, these cases involve short selling shares of the company while the investment manager is aware of a PIPE transaction, but prior to its public announcement. Generally, the public announcement of a PIPE transaction, priced at a discount to market and dilutive in nature, can create downward pressure on the market price of the stock resulting in gains for the investment manager who sells short. The SEC has been involved in a number of such cases which resulted in the imposition of various penalties.

The SEC previously has taken action for securities fraud against an investment manager who bought convertible securities in a PIPE transaction where the number of shares to be received upon conversion would increase as the market price of the company's stock declined. That manager heavily sold short the shares to drive the market price of the company's stock down, allegedly in a market manipulation to receive more shares on conversion of the PIPE securities. The settlement of that case led to the assessment of a civil monetary penalty, among other sanctions.

In addition to the SEC's focus on abuses in PIPE transactions, investment managers should be mindful of structural and securities law issues that may affect their exit from the investment.

If you have any questions about the foregoing, please contact Robert Lustrin at (212) 574-1420 or lustrin@sewkis.com.

AML Update. Based on recent proposals in a report made by the Senate Subcommittee on Investigations, it appears that the Treasury Department may soon be finalizing rules relating to anti-money laundering procedures required to be adopted by hedge fund managers under the USA Patriot Act. Such rules may even include requiring hedge funds to identify their clients (i.e., their ultimate beneficial owners) and file suspicious activity reports. Moreover, the Senate report suggested that "[t]his regulation should apply to foreign-based hedge funds that are affiliated with U.S. hedge funds and invest in the United States". We are following this matter closely and will apprise you of any new developments.

Important Reminder

If a hedge fund is seeking to invest in a registered investment company or a registered open-end investment company (which generally includes most ETFs, since they are usually considered to be investment companies), the fund's manager should be aware of the limits to such acquisition set forth in Section 12(d)(1)(A)(i) and (B)(i) of the Investment Company Act of 1940, which states that no more than 3% of the voting securities may be owned by the acquiring fund and entities controlled by it. Note that recent rule amendments provide an exemption from the 3% limit for investment in money market funds under certain conditions.

Investment Management Group News

Seward & Kissel retained its number one hedge fund law firm ranking in the periodic survey published by CogentHedge.com.

Steven Nadel will be speaking at the Tiger 21 Group 1 meeting on December 13, 2006 about hedge fund regulatory developments and investment pitfalls. He also spoke at the 3rd Annual HedgeWorld Fund Services Expo on September 3, 2006 about hedge fund marketing, public relations and the law.

John Tavss spoke at the Westlaw Investment Compliance Summit on September 3, 2006 about compliance issues. He also spoke at the Banc of America 5th Annual Northeast CFO/COO Summit on July 24, 2006 about current hedge fund legal issues.

Robert Van Grover spoke at the Hedge Fund Regulation & Compliance Forum on May 22, 2006 about anti-fraud issues.

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If you have any questions or comments about this newsletter, please feel free to contact any of the attorneys in our Investment Management Group specializing in private investment funds via telephone at (212) 574-1200 or e-mail generally by typing in the attorney's last name **@sewkis.com**

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