SEWARD & KISSEL LLP

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Evaluating the Regulatory Burdens of Registered Funds with Long/Short Strategies

Fund managers are seeking to launch registered funds based on the investment strategies used by their private fund peers. One of the strategies that has recently joined this trend is the long/short strategy.

A fund may implement a long/short strategy that is subject only to the limitations imposed by law, or it may impose greater limitations or define its financing structure in its investment objective and policies. Examples of long/short strategies with a defined financing structure include 110/10, 120/20, and 130/30 funds. 130/30 funds are described in this article for illustrative purposes.

The 130/30 financing structure is typically achieved through the investment of 130% of the fund's assets in long positions in securities and 30% of the fund's assets in short positions in securities. Leverage is created by borrowing the securities sold short and using the proceeds from the short sales to fund a portion of the long positions.

While an investment policy that authorizes short sales may not be new to many registered funds, short sales often have been restricted either to sales of securities that the fund continues to hold long in its portfolio or to similar hedging activities. In contrast, a 130/30 fund expressly intends to engage in short sales that are unrelated to its long positions, which impels the fund to seek securities to short that the manager believes will decline in value and improve the fund's overall return.

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SEC Adopts Rule Prohibiting Advisers from Defrauding Investors in Certain Pooled Investment Vehicles

The SEC recently adopted a new anti-fraud rule, Rule 206(4)-8, under the Investment Advisers Act of 1940 ("Advisers Act") prohibiting investment advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled investment vehicles. The new rule became effective on September 10, 2007.

Rule 206(4)-8 was proposed in response to the court's decision in Goldstein v. SEC, which struck down a rule adopted by the SEC extending investment adviser regulation to advisers to private (or hedge) funds. Rule 206(4)-8 prohibits investment advisers from (i) making false or misleading statements to investors or prospective investors in pooled investment vehicles they advise, or (ii) otherwise defrauding such investors. Under the rule, an adviser's duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with ultimate investors.

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Inside...

The manager and board of directors of a registered fund that employs a long/short investment strategy must consider the regulatory requirements of Section 18 of the Investment Company Act of 1940 (the "ICA") and Regulation T of the Board of Governors of the Federal Reserve System ("Reg. T").

Exception to the Issuance of Senior Securities

The staff of the SEC has indicated that the obligations created by short sales involve leverage and the issuance of senior securities, which are prohibited by Section 18 of the ICA. However, the SEC staff has taken the position that short sales need not be treated as senior securities if a fund covers the exposure of the short sales (generally, the value of the borrowed securities less the value of margin left with the broker) by segregating an equivalent amount of its portfolio securities.

The segregated securities need not be physically segregated but rather may be earmarked on the books of the fund's custodian. In addition, the segregated securities may be equity securities or debt securities of any grade, provided that the securities are liquid, marked to the market daily, and otherwise unencumbered. In the event that the market values of the securities sold short increase in value, thereby increasing the fund's exposure, the amount of segregated securities must be increased on a dollar-for-dollar basis.

Effecting Short Sales and Maintaining Short Positions

Reg. T currently requires a fund to post with its broker as initial margin an amount of cash or securities equal to 150% of the market value of the securities to be sold short. After the short sale, the fund no longer has an initial margin requirement, but it is required to post with the broker the amount of cash or securities that is necessary to satisfy the maintenance margin requirements defined by the broker's designated regulator or pursuant to the broker's internal policies. Therefore, upon completion of a short sale, the proceeds of the short sale, less the amount of cash or securities required to be retained by the broker for maintenance margin, can be returned to the fund's unsegregated account at its custodian or used to purchase additional securities.

The Mechanics of Establishing a 130/30 Portfolio

One approach to establishing a 130/30 portfolio is illustrated by the following example: Assume that a fund is long $100,000 of ABC common stock and wants (i) to sell short through a broker that is a NYSE member $30,000 of XYZ common stock, a NYSE-traded security with a market value per share of $20, and (ii) on the same day and through the same broker reinvest the short sale proceeds in ABC common stock.

To effect the short sale, the fund would have to post $45,000 of ABC in collateral with its broker as initial margin, which also would satisfy the fund's segregation requirement under the ICA. The purchase of $30,000 of ABC common stock on the same day would be made with the proceeds from the short sale.

Once the short sale of XYZ and the purchase of ABC were completed, the fund would have $75,000 of ABC in its account with its broker and $55,000 of ABC in its account with its custodian. The fund would be long $130,000 of ABC and short $30,000 of XYZ.

The next day, only maintenance margin requirements would apply to the fund. Accordingly, the fund could return to the custodian the $45,000 of ABC posted originally and $21,000 of ABC acquired the previous day and leave with the broker $9,000 in ABC, which would satisfy the 30% maintenance requirement for the short sale. On the same day, the fund's custodian would be required to segregate on its books $21,000 in ABC shares to cover the remainder of the $30,000 obligation to the broker associated with the short sale of XYZ. A total of $100,000 of ABC would remain at the custodian outside of segregation.

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Needless to say, a 130/30 portfolio can be established in a number of ways as long as segregation, initial margin, maintenance margin and broker house margin requirements are satisfied during the process. In particular, the allocation of cash and securities between the fund's custodian and broker can be varied from the example given above and the $30,000 of ABC can be purchased on margin.

Additional Considerations of a Long/Short Fund

Long/short funds also have to contend with several other unique factors that are likely to affect the operation of the fund. These factors may include:

- Enhanced oversight of leverage requirements and trading practices by the fund's board of directors;
- Maintaining an allocation of investments that reflects either the intended proportionate balance, e.g., 130/30, or a balance that is substantially within defined ranges of that balance;
- Potential limitations on the ability to enter into, among other things, futures, forward contracts, options, and reverse repurchase agreements because of the additional asset segregation requirements for these transactions;
- Administrative burdens due to the supervision of securities allocations among segregated and unsegregated custodial accounts and tripartite accounts with the custodian and brokers;
- Additional fund expenses incurred as a result of borrow and margin fees charged by the fund's broker; and
- Gains derived from short sales that increase the amount of the fund's earnings that are treated as ordinary income, rather than capital gains distributions.

Conclusions

Proponents of long/short funds claim that the investment strategy provides fund managers with enhanced opportunities to hedge securities positions, utilize negative research about specific securities, and speculate on downward trends in the market. However, the funds' detractors assert that, when hedging strategies are employed, the funds may underperform their benchmarks, and when hedging strategies are not employed, the funds have greater risk exposure due to increased leverage. Irrespective of the merits of long/short funds, the one thing upon which virtually all commentators agree is that the funds have only begun to emerge in the marketplace.

Fund managers that are considering whether to launch long/short funds should carefully evaluate whether they have the resources to manage the additional administrative requirements of such funds and should consult with counsel early in the managers' planning. Managers of fund complexes with established policies and procedures for handling the segregation of securities, execution of short sales, and compliance with margin regulations are not likely to experience many new administrative burdens. However, fund managers without preexisting policies or procedures or administrative experience regarding the underlying transactions should take particular care in establishing a long/short fund.

If you have any questions concerning the issues discussed in this article, please contact Tony Nuland (nuland@sewkis.com), Kathleen Clarke (clarke@sewkis.com), Paul Miller (millerp@sewkis.com) or Patrick Ogle (ogle@sewkis.com) via e-mail or by phone at (202) 737-8833.

SEC Adopts Anti-Fraud Rule

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Scope of Rule 206(4)-8

Rule 206(4)-8 applies to both registered and unregistered investment advisers with respect to any "pooled investment vehicle" that they advise. The rule defines a pooled investment vehicle as any investment company defined under Section 3(a) of the ICA and any privately offered pooled investment vehicle that is excluded from the definition of investment company under either Section 3(c)(1) or 3(c)(7) of the ICA. As a result, the rule applies to not only advisers to investment companies but also to advisers to unregistered companies such as hedge funds, venture capital funds, and other types of privately offered investment pools.

The rule prohibits advisers from making any material misstatements or omissions to any current or prospective investor in the pooled investment vehicle. Accordingly, the rule applies to account statements, private placement memoranda, offering circulars, responses to requests for proposals, electronic solicitations, and personal meetings. Despite some commenters' arguments against including prospective investors within the scope of the rule, the SEC constructed the rule broadly to encompass prospective investors based on the reasoning that false or misleading statements and other frauds by advisers are no less objectionable when made in an attempt to draw in new investors than when made to existing investors.

Prohibition of False or Misleading Statements

The rule's prohibition of false or misleading statements is very similar to that in other antifraud provisions under the federal securities laws. A noteworthy difference is that unlike Rule 10b-5 under the Securities Exchange Act of 1934, the rule prohibits investment advisers from making any materially false or misleading statements regardless of whether the pool is offering, selling, or redeeming securities. For example, the rule prohibits investment advisers from making materially false or misleading statements regarding the following:

- Investment strategies the pooled vehicle will pursue;
- Experience and credentials of the adviser (or its associated persons);
- Risks associated with an investment in the pool;
- Performance of the pool or other funds advised by the adviser;
- Valuation of the pool or investor accounts in it; and
- Operation of the adviser's advisory business.

Prohibition of Other Frauds

The rule applies more broadly to deceptive conduct that may not involve statements. The SEC, in adopting the rule, purposefully avoided explicitly identifying conduct that would be fraudulent under the rule. The SEC noted that, otherwise, the new rule would fail to prohibit fraudulent conduct that it did not identify and could provide a roadmap for those wishing to engage in fraudulent conduct.

Negligence Standard and Other Matters

Unlike under Rule 10b-5, the SEC would not need to demonstrate that an adviser violating Rule 206(4)-8 acted with scienter. The SEC, quoting judicial precedents, noted that use of a negligence standard is appropriate as a method reasonably designed to prevent fraud. It further noted that since the SEC is authorized, under Section 206(4) of the Advisers Act, to proscribe conduct that goes beyond fraud as a means reasonably designed to prevent fraud, prohibiting deceptive conduct done negligently is a way to accomplish this objective.

Rule 206(4)-8 neither creates any additional fiduciary duty nor alters any duty that an adviser has under any federal or state laws. Rather, the SEC may bring an enforcement action against an investment adviser that violates a fiduciary duty imposed by any such laws if the violation also gives rise to a cause of action under Rule 206(4)-8. The SEC has stated that there is no private right of action under the rule.

If you have any questions concerning Rule 206(4)-8, please contact Kathleen Clarke (clarke@sewkis.com) or Paul Miller (millerp@sewkis.com) via e-mail or by phone at (202) 737-8833.

Legislative and Regulatory Update

FINRA

The previously approved consolidation of the NASD and the member regulation, enforcement and arbitration operations of the New York Stock Exchange ("NYSE") became effective on July 30, 2007. The name of the consolidated organization is the Financial Industry Regulatory Authority, or FINRA. While the corporate reorganization has been implemented, some of its operations are still in a transitional phase. For instance, until the two sets of rules are consolidated, the FINRA rulebook will consist of both NASD rules and certain incorporated NYSE rules.

Principal Trading Relief for Dual Registrants

The SEC has adopted a temporary rule under Section 206(3) of the Advisers Act that provides an alternative method for investment advisers that are registered as brokers to comply with Section 206(3). The rule is not available to advisers that use their affiliated brokers to effect client transactions.

Rule 206(3)-3T allows dual registrants to engage in principal transactions with their advisory clients without obtaining trade-by-trade written client consent. Specifically, the rule permits a dual registrant, with respect to a non-discretionary account, to comply with Section 206(3) by, among other things: (i) providing written prospective disclosure regarding the conflicts arising from principal trades; (ii) obtaining written, revocable consent from the client *prospectively* authorizing the adviser to enter into principal transactions; (iii) making certain disclosures, either orally or in writing, and obtaining the client's consent before each principal transaction; (iv) sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and (v) delivering to the client an annual report itemizing the principal transactions. The rule, which was effective September 30, 2007, will expire on December 31, 2009.

A copy of the SEC's release is available at: http://www.sec.gov/rules/final/2007/ia-2653.pdf

Use of 22c-2 Information

In an August 21, 2007 letter to the ICI, the SEC has reminded funds of the application of Regulation S-P (Privacy of Consumer Financial Information) to shareholder data that funds receive from intermediaries pursuant to Rule 22c-2 under the ICA. The reminder was triggered by several recent news articles suggesting that such information could provide funds with a useful marketing opportunity. As discussed in the adopting release concerning Rule 22c-2, the disclosures made under the rule fall within a Regulation S-P exception, and redisclosure and reuse of the information is permitted only for the purpose for which the information was received, which does not include marketing purposes. The only exception to this would be if the intermediary's privacy policies disclose the information sharing and the consumer has not opted out.

A copy of the letter is available at: http://www.sec.gov/divisions/investment/guidance/ici082107.pdf.

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SEC Staff Issues No-Action Letter Addressing the Custody Rule

On September 20, 2007, the SEC staff issued a no-action letter to the Investment Adviser Association ("IAA") regarding Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (i.e., the custody rule). The IAA sought no-action relief from the staff under Section 206(4) for investment advisers that promptly forward, to their clients or qualified custodians, certain client funds or securities that they inadvertently receive: (i) when providing administrative services to their clients in connection with tax filings; (ii) when filing proofs of claim for their clients or other documentation relating to class action lawsuits or other legal actions; and (iii) when receiving stock certificates or dividend checks in the name of their clients. In granting the no-action request, the staff stated that it would not recommend enforcement action against any adviser if it promptly forwards client assets to its client (or former client) or a qualified custodian within five business days of the adviser's receipt of such assets. The staff also stated that it expects any adviser receiving client assets from third parties in more than rare or isolated instances to adopt and implement written policies and procedures reasonably designed to ensure that the adviser: (i) promptly identifies client assets that it inadvertently receives; (ii) promptly identifies the client; (iii) promptly forwards the client assets to the client or qualified custodian no later than five business days following the adviser's receipt of the assets; (iv) promptly (in no event later than five business days following the adviser's receipt of such assets) returns to the appropriate third party any inadvertently received client assets that are not forwarded to the client; and (v) maintains and preserves appropriate records of all client assets inadvertently received.

A copy of the no-action letter is available at: http://www.sec.gov/divisions/investment/noaction/2007/iaa092007.pdf

SEC Filing Fees

The fee rate for the registration of securities under the Securities Act of 1933, which is adjusted annually and is applicable to filing fees pursuant to Rule 24f-2 under the ICA, among other things, will be *increased* from the current rate of $30.70 per million dollars of securities sold to $39.30 per million dollars five days after the date of enactment of the SEC's regular appropriations for Fiscal Year 2008. The enactment date of the SEC's regular Fiscal Year 2008 appropriations is uncertain, but is not likely to occur before November 16, 2007. In the meantime, the fee rate will remain at $30.70 per million.

New York Regional Office Document Request Letter

The SEC's New York Regional Office ("NYRO") has prepared a 27-page document request letter in connection with its investment adviser examinations. The letter has surprised many industry participants because its scope is well beyond what the SEC has historically requested. For instance, the letter asks for a list of publicly traded companies for which the adviser's "employees and affiliates" (rather than "officers and affiliates," in the case of other exam letters) serve as

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officers or directors. Also, the letter requests all of the documents at the start of the exam, rather than during or after the exam as circumstances warrant. Recent comments from senior SEC officials suggest that portions of the NYRO document request letter may be incorporated into the SEC's standard examination request letter.

Please contact Michele Downey (downey@sewkis.com) for a copy of the NYRO document request letter.

Use of Standardized Compliance Manuals

On October 4, 2007, the SEC instituted administrative proceedings against a registered adviser most of whose clients are pension funds. The firm was fined $20,000 (and its chief compliance officer, $10,000) for several violations with respect to its compliance procedures, chiefly, failure to (i) maintain appropriate written compliance policies and procedures and (ii) accurately document receipt by the firm's supervised persons of the firm's code of ethics. The firm had purchased from a commercial vendor a standardized compliance manual that was designed for discretionary accounts, not for institutional accounts, and thus did not take into account the unique risks and conflicts of interest associated with the firm's advisory services to pension funds. The firm had also failed to obtain written acknowledgement from its supervised persons that they had received the firm's code of ethics and when that failure was noted in the SEC staff's deficiency letter, the CCO proceeded to distribute acknowledgement forms and to instruct its personnel to backdate them so that it appeared the code of ethics had been timely received and acknowledged.

A copy of the order is available at http://www.sec.gov/litigation/admin/2007/34-56612.pdf.

Compliance Reminders

❑ Director and Portfolio Manager Questionnaires: Have Directors and Portfolio Managers updated their annual questionnaires?

❑ Rule 22c-2: Funds must be able to request and promptly receive shareholder identity and transaction information pursuant to shareholder information agreements after October 16, 2007.

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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 registered investment companies or registered investment advisers by telephone at (202) 737-8833 (DC) or (212) 574-1200 (NY) or via e-mail.

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