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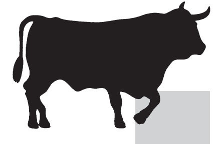

Negotiating a Software License Agreement

An investment manager relies on software to automate many functions essential to the operation of its business, including portfolio analysis, investor and fund reporting, investor relations and marketing. While software is an invaluable tool, a manager risks liability if its use of the software exceeds the scope of its license with the software vendor. Investment managers can also be exposed to significant risk if the software fails to perform or is not secure. In order to minimize potential pitfalls and liability, an investment manager should consider the following factors, among others, when negotiating a software license agreement.

Scope of the license: Many software licenses are granted for "internal business purposes only". This may limit a manager's ability to share information or reports generated by the software with investors, third party service providers or others outside its organization. If a manager will be using the software for external reporting, the manager should ensure that permission to do so is explicitly granted in the license agreement. In addition, since investment managers may be comprised of many related entities, the agreement should provide that the agreement is transferable to the manager's related entities.

Warranties: Many licenses state that the software is provided "as is" with no warranties. At a minimum, managers should negotiate for guarantees that the software will perform in accordance with its documentation and that the software does not infringe upon any third party rights.

Indemnification: The license should provide that the software vendor will indemnify the manager if the manager is sued for infringement based on its use of the

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Responding to SEC Inquiries About Trading Activities

With the SEC now having an enforcement group that focuses on investment partnerships and companies, investment managers often receive inquiries from the SEC about their trading activities – especially after there is "unusual" trading activity in a stock before public announcements of earnings or news about mergers or acquisitions. How should a manager handle such a request? The following are some basic guidelines:

How formal is the inquiry? There are several levels of formality for trading inquiries – with accompanying levels of urgency. While the actual information produced by the investment manager in response to the inquiry may be the same, the level of formality gives some guidance as to the extent of the evidence in the SEC's possession and whether the SEC believes wrongdoing has occurred. At the lowest level, the SEC may send an informal inquiry (usually in a letter) about trading in a stock. Such a request usually results from unusual trading patterns that are flagged electronically or otherwise. An investment manager is not required to respond to an informal inquiry and the determination of whether and how to respond should be made based on the facts and circumstances surrounding the inquiry.

The next level is a formal subpoena from the SEC to the investment manager. A subpoena can only be issued pursuant to a formal order of investigation or existing court case. An order of investigation is issued by the SEC Commissioner upon the SEC's enforcement staff presenting evidence to the Commissioner tending to show that certain laws may have been violated. The SEC generally will produce the order of investigation upon

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software as authorized in the license agreement. In addition, while many software vendors will seek to cap their liability, managers should try to eliminate any such cap, particularly in the event of intentionally wrongful or fraudulent conduct on the part of the vendor. If no cap is included in the indemnification section, the manager should confirm the vendor has not included it elsewhere in the agreement.

Security: In order to ensure that the manager's data is protected, at a minimum the agreement should provide that the vendor will maintain commercially reasonable security measures to prevent third party access to the manager's data and passwords.

Confidentiality: The agreement should include an acknowledgment by the vendor that the manager is the owner of the manager's data and that the vendor will not use it or disclose it to any third party. This is particularly important where the software is being used for portfolio analysis, investor reporting or other functions which require the manager to input sensitive, proprietary information.

Maintenance: The license should provide service guarantees from the vendor which address how quickly and how extensively the vendor will respond in the event of a malfunction in the software.

Customization: If the software vendor will prepare customized software for a manager, the manager should confirm that the agreement specifies who will own the software and what restrictions, if any, there will be on use or third party licensing of the software. Many agreements provide that custom software is owned by the vendor, even if it was developed for a specific manager. This could result in the vendor licensing software that was designed for a specific manager to the manager's competitors. If the manager wants to own the software, or if the manager wants to ensure that any custom software developed for it but owned by the vendor is not licensed to its competitors, the manager should confirm that those issues are explicitly addressed in the agreement.

Termination: Many software licenses provide that all copies of the software and other vendor materials should be returned to the vendor or destroyed upon termination of the license agreement. In the event that a manager will require access to data that is stored through the software following the termination of the agreement, the agreement should address this.

Although software vendors often claim that their agreements are "standard" and executed by customers without comment, managers should review agreements carefully to ensure that the agreement adequately protects them.

If you have any questions, please contact Beth Alter in our Intellectual Property Group. ➾

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request subject to an undertaking that its contents will be kept confidential. A subpoena carries the force of law and the SEC can seek compulsion in federal court. Very often, the SEC may believe that material non-public information was leaked by an issuer, insider or broker-dealer and may be trying to determine where it may have been disseminated and whether anyone had traded while in possession of such information. Other areas of inquiry often include conduct surrounding soft dollar practices, PIPE transactions and compliance/recordkeeping matters.

With both the informal inquiry and subpoena, the re: line is often the name of the stock (i.e., In re Trading in ABC Securities). Sometimes, the re: line is the name of another investment manager or broker-dealer, suggesting that the SEC believes it has information about wrongdoing regarding such person or entity.

The third level of formality, the highest "alert" level, arises when the "inquiry" suggests that the investment manager or one of its personnel engaged in wrongdoing. In this case, either the investment manager or the employee's name may appear in the re: line (i.e., In re Investment Manager). Such an inquiry may be accompanied by a brief description of the wrongdoing and the laws that the SEC believes were violated.

What records need to be produced? This depends on the actual inquiry (e.g., voluntary vs. subpoena), but in the

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case of a trading inquiry, production usually involves searching the investment manager's records for all trades in the specified security for a period of time. It also may involve identifying who was responsible for the decision to trade in the security – usually the portfolio manager and possibly the analyst – and searching their email and phone records. If employees have a database of contacts, such as Lotus Notes, it may mean searching the database as well. Search terms and relevant information will differ in each instance. Working with experienced attorneys to identify relevant data is helpful.

What steps will the SEC take after the information is produced? After a production is made, the SEC often requests more information based on the produced materials. It may seek testimony from the portfolio manager or other individuals involved. If testimony is requested, having an attorney involved is especially important in order for the witness to be prepared properly. If it is an informal inquiry, the SEC may request a telephonic interview. The highest level of formality – where the SEC believes the investment manager has engaged in wrongdoing – involves another process under which the SEC provides formal notice to the subject that it intends to recommend that charges be instituted. The subject then has an opportunity to make a submission arguing why charges are not justified or why lesser charges should be substituted. At this stage, the SEC and the subject often engage in negotiations regarding possible agreed-upon charges or remedial steps to be taken. Failing an agreement, the matter will likely proceed to formal legal action in federal court or administrative action within the SEC.

Please contact Mark Hyland or Jack Yoskowitz in our Litigation Group, if you have any questions.

Relocating an Investment Manager's Office

Relocating a business operation will require consideration of a number of issues:

Location: In addition to the costs discussed under "Financial" below, a manager will want to consider the functionality of the new location, its prominence and prestige, as well as its ease of access.

Operations: A manager may want to hire a space consultant and/or architect to design a plan that maximizes the efficiency of the available space.

Financial: While advance planning can minimize the amount of business interruption, typical expenses may include the cost of business interruption, moving and the purchase of new furniture, office and technological equipment, as well as increases in rent, utility and HVAC charges, security services and technological services.

Documents: Fund and management company documents, as well as operating documents (e.g., insurance plans, tax forms, payroll and stationery) will need to be updated.

Notices: The manager should promptly send a letter to its clients, counterparties and other relationships that informs them of the impending move.

Legal/Regulatory: A manager will need to determine whether the move will: have potential tax consequences; require any company restructuring; trigger any investment adviser registration requirements; and/or require amendments to its blue sky or other securities filings. Moreover, renting or purchasing new office space will require the negotiation of a new lease or purchase agreement (for a summary of leasing issues, please see "Negotiating an Office Lease" from the Fall 2006 Edition of The Private Funds Report (Vol. X)). If you have any leasing questions, please contact Rob Gorzelany in our Real Estate Group.

Legislative and Regulatory Snapshots

Taxation Update. Congress is currently considering several legislative proposals in taxation which could have a significant impact on the hedge fund industry.

(1) Limitation of Deferred Compensation Amounts. Congress has considered a number of proposals to limit the ability to defer compensation by a participant in a non-qualified deferred compensation plan. Representative Emanuel and Senator Kerry introduced legislation in the House (H.R. 3923) and Senate (S. 2199), respectively, which would effectively cause all non-qualified deferred compensation paid by certain entities to be included in the income of a service provider on a current basis unless such amounts were "subject to a substantial risk of forfeiture". If enacted, this proposal would effectively eliminate the current type of fee deferrals from offshore funds by investment managers.

This proposal was included in the Temporary Tax Relief Act of 2007 (H.R. 3996) (the "Relief Act") and the AMT Relief Act of 2007 (H.R. 4351) (the "New Relief Act"), mainly to prevent a significant increase in the number of taxpayers subject to the alternative minimum tax, as a revenue raiser. Although these Acts were passed by the House, this provision was stripped from the legislation by the Senate. However, during 2008, the House will consider revenue raisers (which are expected to be retroactive) to pay for the AMT legislation. The prospects for enactment in 2008 remain uncertain because Senate Republicans and the Bush administration have expressed opposition.

(2) Treatment of Carried Interest Income as Ordinary Income. In June 2007, legislation (H.R. 2834) was introduced in the House that would recharacterize carried interest/incentive allocation income as ordinary income subject to ordinary income tax rates and would subject such income to self-employment tax (Medicare tax). This proposal was stripped from the Relief Act when it was passed by the Senate, however, it may be considered as a revenue raiser in 2008. Prospects for the eventual enactment of this proposal are uncertain.

(3) Treatment of Carried Interest Income as Non-Passive Under the Publicly-Traded Partnership Rules. S. 1624, sponsored by Senators Baucus and Grassley, would treat income derived from a carried interest as non-passive income for purposes of the publicly-traded partnership rules. This would cause publicly-traded investment management firms to be treated as corporations for U.S. federal income tax purposes (and thus subject them to corporate income tax) rather than as partnerships. The Relief Act, as originally passed by the House, would have accomplished the same objective. However, this provision was not included in the New Relief Act.

(4) Modification of Tax Treatment of Income Received by U.S. Tax-Exempt Investors. Under H.R. 3501, introduced by Representative Levin in September, income received by a U.S. tax-exempt organization as a limited partner in a partnership (but not as a member of a LLC) which is attributable to debt-financed acquisitions of securities or commodities would not be treated as unrelated business taxable income ("UBTI"). This proposal was included in the original House version of the Relief Act, but was not included in the New Relief Act. The proposal would not, however, eliminate the possibility of a U.S. tax-exempt investor deriving UBTI from an investment in an investment partnership that made certain investments, such as in master limited partnerships ("MLPs") or other pass through entities engaged in business activities where UBTI is generated even if borrowed funds are not utilized.

We are closely monitoring each of these developments. If you have any questions, please contact Peter Pront, Dan Murphy or Jim Cofer in our Tax Group.

Electronic Filing of Form ADV Part II. Investment advisers complete Form ADV to register with state securities regulators or the SEC. Form ADV contains two parts: Part I, which includes information about the adviser's business practices and disciplinary record, and Part II, which requires narrative explanations for certain questions. Part I must be completed online via the Investment Adviser Registration Depository ("IARD") system and is available to the public on the IARD. Although SEC registration does not require an electronic filing of Part II, as of April 23, 2007, if an investment adviser wishes for Part II to be publicly available, it can file a PDF of it on the IARD through an upload.

SEC Approves Changes to Form D. Form D provides the SEC with notification of a securities offering made pursuant to a Regulation D exemption. The SEC has identified two central purposes: 1) data collection for rulemaking and 2) administration of securities laws. On

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December 11, 2007, the SEC approved a rule to change the contents of Form D and require an electronic filing of the form. The SEC believes that this will result in enhanced information collection, increased data dissemination to the public and a potential increase in state and federal uniformity.

Hedge Fund Adviser Registration Update; Email Update. In July 2007, SEC Commissioner Paul Atkins noted that 488 hedge fund managers had withdrawn their investment adviser registration after the June 23, 2006 decision to vacate the relevant registration rule.

Recently, the SEC has required firms to produce emails pursuant to Rule 204-2 of the Investment Advisers Act of 1940, which requires keeping certain books and records. Firms have objected based on the costs. Commissioner Atkins recommended that the SEC continue to request emails, but that the SEC should provide guidelines.

SEC Adopts Antifraud Rule Under Investment Advisers Act. On September 10, 2007, new Rule 206(4)-8 under the Investment Advisers Act of 1940 became effective. The Rule prohibits investment advisers to hedge funds, private equity funds, venture capital funds and mutual funds, whether required or not required to be registered under the Advisers Act, from making false or misleading statements or engaging in any fraudulent, deceptive or manipulative conduct with respect to investors and prospective investors in such investment vehicles. The SEC indicated that the Rule would apply to any materials or statements prepared or made by an adviser to any prospective or existing investor, regardless of whether the pool is offering, selling or redeeming securities. SEC staff have indicated that this does not impose new obligations on advisers and does not create a private right of action.

SEC Issues No-Action Letter Regarding Custody Rule. The staff of the SEC's Division of Investment Management issued a no-action letter to the Investment Adviser Association on September 20, 2007 (the "IAA Letter") in which it stated it would not recommend enforcement action under Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-2 (the "Custody Rule") if an investment adviser that inadvertently receives client assets from a third party, under the circumstances discussed below, promptly forwards such assets to its client or a qualified custodian within five (5) business days of the adviser's receipt of those assets and maintains a record of its actions. The IAA Letter is limited to where an adviser receives: (i) client tax refunds; (ii) client legal action settlement assets; or (iii) stock certificates or dividend checks in the name of its client. Further, the relief would be limited to situations where the adviser had used its reasonable best efforts to direct the third party to deliver the assets properly, had no control over the third party and had not caused the third party to deliver the assets to it.

California Investment Adviser Registration. In September 2007, the California Department of Corporations issued a proposal to amend its state investment adviser regulations that would require all non-SEC registered hedge fund managers in the State, irrespective of assets under management, to register as investment advisers with California. Under the existing rule, a manager is not required to register if the manager: (1) does not hold itself out to the public as an investment adviser; (2) has fewer than 15 clients; (3) is exempt from registration under the Investment Advisers Act of 1940 by virtue of Section 203(b)(3); and (4) either (i) has "assets under management" of not less than $25 million or (ii) provides investment advice only to "venture capital companies." The proposed rule would remove items (2) and (4)(i) above, thereby limiting the exemption to advisers to "venture capital companies". The comment period for this proposal, originally scheduled to close on November 26, 2007, has been extended to March 31, 2008.

Seward & Kissel LLP provides legal advice to its investment management clients on structure, business planning, regulatory, compliance, corporate finance, asset securitization, capital markets, business transactions, derivatives, bankruptcy/distressed debt, tax, ERISA, litigation, trademark, employment, trusts & estates and real estate matters. Prior editions of the Private Funds Report and an Index to Covered Topics may be found on the web at www.sewkis.com under Publications & Speeches. Attorney Advertising. Prior results do not guarantee a similar outcome. 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.

Investment Management Group News

Seward & Kissel LLP was ranked as a top tier hedge fund law firm in Chambers USA. In addition, among both Hedge Fund 100 firms and small hedge fund firms, it was ranked as the number one law firm in the most recent Alpha magazine survey.

John Tavss will speak at the IBA/ABA Private Funds Conference in London on March 9, 2008.

Robert Van Grover will participate in a panel at a conference sponsored by Financial Research Associates, LLC in March 2008.

Paul M. Miller became a partner in the Investment Management Group effective January 1, 2008.

Patricia Poglinco and John Tavss presented at the American College of Investment Counsel forum on May 16, 2007 regarding "Investing in Alternative Assets: Current Issues for Institutional Investors".

John Cleary participated in a panel at a Goldman Sachs conference on May 21, 2007 in Las Vegas.

Patricia Poglinco spoke at the Seventh Annual Common Sense Forum in August 2007 and at a Credit Suisse conference on October 2, 2007 regarding "130/30: The New Long Only".

Steven Nadel spoke at the Marathon Asset Management Retreat on October 14, 2007 about legal and business trends in the industry and spoke at the Ernst & Young internal global hedge fund group seminar about marketing issues on October 25, 2007.

John Tavss participated in a panel at Goldman Sachs' Fifth Annual Hedge Fund Seminar on December 13, 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 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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