SEWARD & KISSEL LLP

THE PRIVATE FUNDS REPORT

Summary 2009 Edition
Vol. XII

A publication of the Investment Management Group

Compliance Considerations for Unregistered Advisers

Many hedge fund managers who are not registered as investment advisers with the Securities and Exchange Commission (the "SEC"), and are therefore not required by the Investment Advisers Act of 1940 to maintain a compliance manual, nonetheless consider it appropriate to have a compliance manual in place. Such managers often view the implementation of a compliance manual as an effective tool in operating a business as well as adhering to high compliance standards required by many institutional investors. Moreover, a report of the Investors' Committee of the President's Working Group on Financial Markets, entitled "Principles and Best Practices For Hedge Fund Investors", emphasized that a hedge fund manager adhering to best practices should have robust compliance policies and procedures in place, including a written compliance manual. Recommended best practices for hedge fund investors include a review of an adviser's written compliance manual and verification that the adviser's compliance function is appropriately independent and supported by sufficient resources and authority. In light of the introduction of recent proposals regarding the registration of investment advisers and the increased due diligence efforts by investors as a result of recent market events, hedge fund managers should review their existing compliance policies and procedures.

A compliance manual for an unregistered investment adviser generally should, at a minimum, have provisions covering the following areas, each of which should be tailored by the adviser depending on its size, nature of its business and its preferred practices:

- Disclosure and marketing standards, including how to calculate and disclose performance history;

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Current Issues Relating to Side Pockets

In order to access unique opportunities in the market, certain hedge funds from time to time may make illiquid or restricted investments (including private equity investments) if permitted by the fund's investment strategy. These opportunities offer risk-reward considerations that are different than those offered by publicly traded securities. In particular, both the timing of liquidation and the valuation of these investments may be difficult to assess. As a result, a hedge fund manager may structure a fund to enable the manager to segregate such investments from the liquid portion of the fund's portfolio into designated accounts ("Side Pockets").

An investor may not voluntarily withdraw the portion of its investment attributable to a Side Pocket and will generally be required to continue to participate in a Side Pocket in which the investor has an interest until the particular investment is liquidated or otherwise realized. While most hedge funds already have certain liquidity protections available to the fund (e.g., in-kind distributions, liquidating accounts, suspension of withdrawals and/or gates), in light of the current market environment, Side Pockets may provide an additional layer of protection. In particular, a Side Pocket may be beneficial when a manager is concerned about managing the liquidity needs of a fund while simultaneously ensuring that investors who withdraw from the fund do not cause a significant liquidity burden to investors who remain in the fund (i.e., by forcing the fund to sell liquid investments to pay withdrawal requests and retain illiquid investments for its remaining investors).

While hedge funds have historically valued a Side Pocket investment at cost until such investment is liquidated or otherwise realized, on November 15, 2007,

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- Portfolio management processes, including allocation standards;
- Trading and brokerage practices, including how to ensure best execution, how soft dollar arrangements are structured and monitored, how trades are allocated across multiple clients, and when principal and cross transactions can occur;
- Valuation procedures to ensure consistency across portfolios and securities;
- Procedures to prevent insider trading;
- Procedures addressing applicable anti-money laundering and Office of Foreign Assets Control requirements;
- Code of ethics, including personal trading procedures and gift and business entertainment policies;
- Privacy policy and procedures and program for protecting client information;
- Proxy voting policy and procedures;
- Identification of conflicts of interest and risks; and
- Business continuity and disaster recovery plan.

Please contact an attorney in our Investment Management Group if you have any questions related to your compliance program.

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the Financial Accounting Standards Board made effective its Statement of Financial Accounting Standards No. 157 ("FAS 157") which requires hedge funds to determine the "fair value" of all assets, including Side Pockets. FAS 157 defines fair value as "... the price that would be received to sell an asset ... in an orderly transaction between market participants ... ." In order to comply with FAS 157, Side Pocket investments will be valued at fair value for purposes of preparing a fund's financial statements; however, for purposes of computing a fund's net asset value, Side Pocket investments will generally continue to be valued at cost. Accordingly, there may be a difference between the overall net assets of a fund used to compute fees and the net assets reported in a fund's financial statements. In such event, the fund's financial statements may include a reconciliation detailing such difference.

If you have any questions related to Side Pockets, please contact an attorney in our Investment Management Group.

Unregistered Brokers Face Increased Scrutiny by the Securities and Exchange Commission and the New York State Courts

On June 19, 2009, the Securities and Exchange Commission (the "SEC") settled administrative and cease-and-desist proceedings with an intermediary in the PIPEs (private investments in public equities) market arising out of the intermediary's role in various PIPE offerings while the intermediary was not registered as a broker-dealer under the U.S. Securities Exchange Act of 1934 (the "Exchange Act"). These proceedings follow prior actions concluded in 2008 against arrangers of private placement transactions who also were not registered as broker-dealers under the Exchange Act. The results of these actions signal that, in the future, persons such as finders, intermediaries, solicitation agents and placement agents who engage in brokerage activities without being registered (collectively, "finders") may be subject to increased scrutiny and enforcement actions under the Exchange Act. Further, other parties to a securities transaction such as an issuer (e.g., a hedge fund) may also be subject to increased scrutiny and adverse consequences

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under the federal securities laws as a result of utilizing a finder that is impermissibly engaging in brokerage activities.

The Exchange Act defines a broker as any person engaged "in the business of" effecting transactions in securities for the account of others and requires that all brokers register with the SEC. Generally, each registered broker-dealer must be a member of the Financial Industry Regulatory Authority, Inc. ("FINRA") and may be required to register under state securities laws depending on whether it is acting as a broker-dealer in a particular state. There is no specific exemption for "finders" (or those who are compensated for having introduced parties to a transaction) under the Exchange Act.

The role of finders who are not registered as broker-dealers has concerned the SEC and other regulators for years. Although finders function like brokers, many have not registered as broker-dealers either because they were not aware that they were required to register or avoided doing so due to the burdensome registration process and subsequent heightened level of scrutiny. In determining whether such SEC registration is required, the SEC and the courts look to a variety of factors, including: the receipt of transaction-based compensation as opposed to a flat fee; the rendering of advice as to the structure of a transaction; assisting in the conduct of "due diligence"; the finding of investors actively rather than passively; advertisement or solicitation on behalf of the issuer of the securities; being involved in the negotiations between an issuer and investors; engaging in any of the foregoing with regularity; being an employee of the issuer; and possessing client funds and securities. Under current SEC guidance, a finder risks being deemed to have engaged in impermissible brokerage activities when taking actions beyond making an introduction between a company and a prospective investor. Furthermore, a finder's fee should not be structured as a percentage commission of funds raised or as an incentive fee to ensure financing; for a finder, fees should be based upon the value of the service provided, not the size of the transaction. Actions which expand beyond the infrequent introduction of parties may violate prohibitions against engaging in a securities brokerage business without registration as a broker-dealer.

In June 2009, Ram Capital Resources, LLC ("Ram") and its principals Michael E. Fein ("Fein") and Stephen E. Saltzstein ("Saltzstein") settled administrative and cease-and-desist proceedings instituted by the SEC arising out of Ram's failure to register with the SEC as a securities broker or dealer in connection with its business as an intermediary in the PIPEs market.

The SEC found that Ram, through Fein and Saltzstein, engaged in the business of identifying investors for PIPE offerings. Typically, Ram received compensation from a solicited investor equal to 3.5% of the cash invested by the investor and 25% percent of any warrants allocated to the investor. Ram also engaged in structuring PIPE offerings and negotiating the terms of such offerings. The SEC alleged that Ram acted as an unregistered broker or dealer in connection with PIPE offerings and that Fein and Saltzstein acted as brokers without being registered or associated with a registered broker-dealer. The proceedings were settled by, among other things, the entry of a cease-and-desist order against Ram, Fein and Saltzstein from committing or causing future violations. In addition, as part of the order, Fein and Saltzstein each agreed to pay disgorgement and interest of $448,378, Fein accepted a civil penalty of $90,000 and Saltzstein accepted a civil penalty of $60,000. Further, Fein and Saltzstein were suspended from association with any broker or dealer for a period of 12 months and 6 months, respectively.

Similarly in April 2008, a New York trial court issued a decision in Torsiello Capital Partners LLC v. Sunshine State Holding Corp. against an unregistered broker whereby the court refused to enforce an investment banking and advisory services agreement and required the unregistered broker to forfeit its fees. Torsiello Capital Partners LLC ("Torsiello") had entered into an agreement with Sunshine State Holding Corp. ("Sunshine") to act as the sole placement agent for Sunshine's securities, in exchange for a fee equal to 3.5% of the total proceeds raised by Sunshine. In particular, the agreement required Torsiello, among other things, to review Sunshine's capital structure, prepare an offering memorandum describing Sunshine and the terms of a private placement, formulate and execute a marketing strategy for the securities, identify prospective purchasers, contact such purchasers and assist in negotiations with such purchasers. The court held that the agreement was void and

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rescindable since Torsiello was not a registered broker-dealer. In addition, the court ordered Torsiello to repay its retainer fee of $50,000, since Torsiello intentionally misrepresented its status as a registered broker-dealer.

The results of the actions by the SEC and the trial court illustrate a recent priority to enforce regulations prohibiting unregistered persons from engaging in brokerage activities. Unregistered brokers engaging in such activities, as well as other parties to a securities transaction such as the issuer, may also be subject to other provisions of the federal securities laws. For example, acting as an unregistered broker to facilitate securities transactions constitutes a violation of the antifraud provisions of the federal securities laws, exposing the unregistered broker to potential civil and criminal penalties. In addition, an issuer of securities, such as a hedge fund or other private investment vehicle, who knowingly or recklessly employs an unregistered broker to raise capital from investors may be liable for aiding and abetting the unregistered broker's fraud and could find itself subject to a variety of adverse consequences, including, in some states, investor rescission rights and possibly jeopardizing the private placement exemption for the offering of interests in the fund. Further, an issuer of securities is required to disclose its solicitation agents on Form D along with such agents' CRD numbers. A failure to do so may result in adverse consequences to the issuer.

Legislative, Regulatory and Other Snapshots

President Obama's Administration Proposes Private Fund Investment Advisers Registration Act of 2009. On July 15, 2009, President Obama's Administration proposed legislation that would require: (1) most previously unregistered investment advisers to register with the SEC and (2) all registered investment advisers to comply with new reporting and recordkeeping requirements and to provide information to the SEC about private funds which they manage, including assets under management, use of leverage (including off-balance sheet exposures), counterparty credit risk exposures, trading and investment positions and trading practices.

Specifically, under the proposed legislation, investment advisers with more than $30 million in assets under management will have to register under the Investment Advisers Act of 1940. An exemption would be available for certain foreign private investment advisers with limited U.S. clients. The legislation would also give the SEC authority to require registered advisers to provide reports, records and other private fund information to investors, prospective investors, counterparties and creditors.

SEC Permits Expiration of Rule Requiring Institutional Investment Managers to Disclose Short Sales. Interim final temporary Rule 10a-3T (the "Rule"), which required certain institutional investment managers to report short sale information to the SEC on Form SH, expired on August 1, 2009. Instead of renewing the Rule, the SEC is working to increase the public availability of short sale related information through a series of other actions. In particular, the SEC expects that: (1) self regulatory organizations ("SROs") will publish daily aggregate short selling volume in each individual equity security on their web sites, (2) SROs will publish, on a one-month delayed basis, information regarding specific individual short sale transactions in all exchange-listed equity securities on their web sites, and (3) it will enhance the publication on its web site of fails to deliver data so that fails to deliver information is provided twice per month and for all equity securities, regardless of the fails level.

SEC Finalizes Rule to Curtail "Naked" Short Selling Abuse. Effective July 31, 2009, the SEC made permanent interim final temporary Rule 204T of Regulation SHO that seeks to reduce the potential for abusive "naked" short selling in the securities market. In a "naked" short sale, an investor sells shares short without first having borrowed them. The permanent rule, Rule 204, requires broker-dealers to promptly purchase or borrow securities to deliver on a short sale.

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SEC Proposes New Custody Rule Requirements. On May 20, 2009, the SEC issued proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940 in response to the recent enforcement actions brought against investment advisers and broker-dealers alleging fraudulent conduct. The amendments would significantly affect registered investment advisers with custody, including those advisers that serve as the general partner or managing member to a limited partnership or other comparable hedge fund investment vehicle ("Fund Advisers"). In particular, all advisers with custody of client assets would be required to undergo an annual "surprise examination" by an independent public accountant. For a Fund Adviser, the surprise examination requirement would apply regardless of whether the pooled investment vehicle it manages undergoes an annual audit and distributes audited financial statements to its underlying investors. Further, a Fund Adviser would be subject to enhanced disclosure regarding its custodial arrangements on Form ADV and could be subject to a requirement of obtaining a more extensive internal control report prepared by independent auditors. For further information on the proposed amendments, please refer to the Seward & Kissel memorandum on our website (www.sewkis.com) under the Investment Management Practice heading, "Publications."

SEC Proposes Reconstituted "Uptick Rule" and Other Restrictions on Short Selling. On April 10, 2009, the SEC issued proposed rules that would amend Regulation SHO to restrict short selling activities based upon certain security market price trends. The proposed rules would apply to all national market securities, which include securities listed on the New York Stock Exchange, the American Stock Exchange and the NASDAQ. The release contains two possible and alternative price trend restrictions — a "Short Sale Price Test" and a "Circuit Breaker" — and further alternative variations on each. The Short Sale Price Test proposals would, effectively, be a return to a form of uptick rule that was eliminated by the SEC in July 2007. The SEC also has proposed an amendment to Regulation SHO that would require certain sell orders to be marked as "short exempt." Please refer to the Seward & Kissel memorandum regarding the release on our website (www.sewkis.com) under the Investment Management Practice heading, "Publications," for further information regarding the proposed rules.

SEC Amends Form D. The SEC's rules amending the content of Form D, the timing of filings and the requirement to file electronically via the SEC's EDGAR site were generally effective on September 15, 2008; however, use of the new Form D and electronic filing became mandatory on March 16, 2009. For further information relating to the amendments to Form D, please refer to the Seward & Kissel memoranda on our website (www.sewkis.com) under the Investment Management Practice heading, "Publications."

Regulatory Reminder: Investment Advisers Act Requires Notice to Clients Following Change in Custodial Arrangements. Pursuant to Rule 206(4)-2(a)(2) of the Investment Advisers Act of 1940, registered investment advisers are required to notify a client promptly in writing when a custodial account is opened for the client with a qualified custodian. The notice must include the custodian's name, address and the manner in which the funds or securities are maintained. Further, if any information in the notice changes, the adviser must notify the client promptly in writing of such changes.

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.

Publications. 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.

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Investment Management Group News

Pat Poglinco and **Rob Van Grover** spoke at a seminar co-hosted by Seward & Kissel LLP and European law firm Simmons & Simmons on July 13, 2009 in New York, New York regarding various regulatory challenges and opportunities in the United States and Europe. To view the seminar, please visit our website (www.sewkis.com) under the Investment Management Practice heading, "Events."

John Tavss spoke at a conference hosted by Deutsche Bank on June 2, 2009 in New York, New York.

John Cleary spoke at a conference hosted by Goldman Sachs on May 21, 2009 in New York, New York.

Steve Nadel authored an article titled "Hedge Funds Affected by Slew of New Rules, Regs" published in the 2009 Hedge Fund Industry Report and an article titled "Opinion: How to Reinvigorate Investment in Hedge Funds" published on HedgeWorld.com.

Rob Van Grover authored an article titled "Staunching the Bleeding – Seward & Kissel Examines Options for Managing Hedge Fund Redemptions During Challenging Times" published in the Hedge Fund Survival Guide.

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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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