PROSKAUER ROSE LLP®

Private Investment Funds Update

March 2008

This update for clients of our Private Investment Funds Practice summarizes recent developments affecting hedge funds, private equity funds, venture capital funds and their managers.

U.S. Developments

- SEC Requires Electronic Filing of Form D
- SEC Proposes Rule to Facilitate Investments in ETFs
- SEC Proposes Revised Part 2 of Form ADV
- Courts Uphold Legality of PIPE Transactions Hedged with a Short Sale
- SEC Fines Investment Adviser for Gifts
- SEC Proposes Amendments to Privacy Rules

UK and European Developments

- JMLSG Anti-Money Laundering Update
- HFWG Best Practices
- Report on Risk Management Practices
- UK Investment Management Tax Exemption

SEC Requires Electronic Filing of Form D

Form D serves as an official notice of an offering of securities made without registration under the Securities Act of 1933 in reliance on an exemption provided by Regulation D and is filed by both private investment funds and portfolio companies. On February 6, 2008, the SEC issued final rule amendments mandating the electronic filing of Form D and revising the form. The final rules are available at http://www.sec.gov/rules/final/2008/33-8891.pdf. The final rules list four principal objectives of the amendments: (1) easing filing burdens; (2) better public availability of Form D information; (3) federal and state uniformity and coordination; and (4) improved collection of data for SEC enforcement and rulemaking efforts. Press reports frequently cite the offering information contained in Form D filings and this information will now be more readily available.

The revisions will take effect on September 15, 2008, at which time issuers will have the option of filing reports on Form D either in paper form or electronically. Electronic filing becomes mandatory on March 16, 2009. The new 16-item format for Form D retains most of the requirements of the current form and provides for the disclosure of some additional items of information. Some of the significant revisions include:

- replacing the current requirement to provide a business description with a requirement to select from a list of industries;
- eliminating the requirement to identify as "related persons" owners of 10% or more of a class of the issuer's equity securities;
- requiring revenue range information for the issuer, or net asset value range information in the case of private funds (subject to an option to decline to disclose);
- requiring reporting of the date of first sale in the offering (or reporting that the first sale has yet to occur);
- requiring reporting of whether the offering is expected to last more than one year; and

- replacing the requirement to disclose information on a wide variety of expenses with a requirement to report only expenses paid for sales commissions and finders' fees.

For continuous offerings, such as for hedge funds, the Form D will be required to be restated, including offering amount, at least annually.

In order to file electronically, issuers will need the same codes as are currently required to file on EDGAR, the SEC's electronic filing system. If an issuer does not have EDGAR filing codes, it will need to obtain the necessary codes from the SEC.

The SEC and the NASAA are currently exploring a "one-stop filing" approach; however, this capability will not be available when the electronic filing of Form D becomes mandatory on March 16, 2009.

The electronic filing of Form D data will make the information filed more readily available and will facilitate increased scrutiny by regulators and members of the public. The information will be available on the SEC's web site and will be interactive and searchable. The increased public availability has raised concerns regarding compliance with Regulation D's prohibition on the use of general solicitation and general advertising. In order to address these concerns, the SEC is revising Rule 502(c) to include a safe harbor from the prohibition on "general solicitation" and "general advertising" for information provided in a Form D filed with the SEC if the information is provided in good faith and the issuer makes reasonable efforts to comply with the requirements of Form D.

SEC Proposes Rule to Facilitate Investments in ETFs

On May 11, 2008, the SEC proposed two new rules to the Investment Company Act of 1940. The proposed rules are located at http://www.sec.gov/rules/proposed/2008/33-8901.pdf and the SEC is accepting comments until May 19, 2008. One of the rule changes (Rule 6c-11) will significantly streamline the application process for Exchange Traded Funds (or ETFs) by permitting ETFs to operate without the need to obtain individual exemption orders.

The other rule change is proposed Rule 12d1-4. Section 12(d)(1) of the 1940 Act prohibits a registered or unregistered fund (including a hedge fund) from acquiring more than 3% of any other investment company's outstanding voting securities. The new rule would allow a higher percentage where the securities acquired are shares of an ETF provided that the following conditions are satisfied:

- The acquiring fund could not exert control over the ETF. There would be a rebuttable presumption that owning more than 25% of an ETF is control.
- The acquiring fund could not redeem shares acquired in reliance on the proposed rule. As a result, acquiring funds could not threaten large redemptions to coerce an ETF.
- The acquired ETF could not itself be a fund of funds.
- Sales charges and service fees charged by the acquiring fund could not exceed the amounts set forth in the FINRA sales charge rules for mutual funds.

SEC Proposes Revised Part 2 of Form ADV

On March 3, 2008, the SEC published its long-awaited rules regarding Part 2 of Form ADV. The SEC originally proposed amendments to Part 2 of Form ADV on April 5, 2000. In many ways, the SEC scaled back the 2000 proposed rules. However, these proposals were never adopted. The newly proposed rules are located at http://www.sec.gov/rules/proposed/2008/ia-2711.pdf and the SEC will be taking comments on the proposals until May 16, 2008.

Some of the highlights of the proposal include:

- A movement away from the current "check the box" form to a more plain English narrative brochure.
- The brochure would require a cover page with a summary of material changes to the brochure since the last annual update.
- Advisers would be required to disclose if they charge performance fees and if they also manage accounts not charged such fees and any conflicts that could arise by managing such accounts simultaneously.
- Advisers would be required to disclose in their brochure material facts about legal or disciplinary events that are material to a client's evaluation of the integrity of such adviser.
- Advisers would need to disclose material relationships they have with related financial industry participants and any material conflicts such relationships create and how they are addressed. In addition, advisers that recommend other advisers would be required to disclose any business arrangements between the two firms (e.g., compensation) as well as the related conflicts.
- New disclosures regarding soft dollars would be required including a description of the practices that is clear enough to permit investors to determine the types of products that are being purchased with soft dollars.

- Disclosure would be required on the adviser's trade aggregation practices and if the adviser permits directed brokerage.
- The adviser would be required to deliver the brochure to clients at least once a year no later than 120 days after the end of the adviser's fiscal year.
- A "brochure supplement" would be required that disclosed the educational background, business experience and disciplinary history (if any) of the individuals the client is relying on for investment advice. In smaller organizations, the SEC acknowledged this may only require disclosure about the firm's senior members. Exceptions to this rule include advice given to "qualified purchasers" as defined under the Investment Company Act.
- Part 2 would be required to be filed electronically through the IARD System.

Courts Uphold Legality of PIPE Transactions Hedged with a Short Sale

Three recent court decisions involving PIPE transactions have rejected arguments by the SEC that hedge fund managers have unlawfully distributed unregistered securities in violation of Section 5 of the Securities Act of 1933, which prohibits the offer, sale or delivery of securities unless a registration statement is in effect or an exemption from registration applies.

In *SEC v. Lyon*, 2008 WL 53102 (S.D.N.Y. January 2, 2008), the SEC alleged that hedge fund managers violated Section 5 each time they (1) took a short position in a PIPE issuer's publicly traded shares at a time when no PIPE resale registration statement was in effect and (2) covered their short position with PIPE shares after the effective date of the relevant resale registration statement. The District Court for the Southern District of New York disagreed with the SEC's reasoning, stating that "the delivery of once-restricted PIPE shares to close a short position does not convert the underlying short sale into a sale of PIPE shares." According to the court, "A short sale of a security constitutes a sale of that security" and "how an investor subsequently chooses to satisfy the corresponding deficit in his trading account does not alter the nature of that sale." In addition, as a matter of policy the court rejected the SEC's characterization of the short sale. The court noted that the primary purpose of the Securities Act is to promote full disclosure of material information, but the SEC did not allege that the buyers on the other side of the manager's short sales lacked material information with respect to these securities. Two other recent cases have produced similar results. *See SEC v. Mangran*, 2007 WL 4102743 (W.D.N.C. October 24, 2007) and S*EC v. Berlacher*, Case No. 073800 (E.D.Pa. Filed September 13, 2007).

Leading up to these rulings, the SEC had maintained a position that, in a short sale of securities, the sale of securities occurs at the time of the short sale rather than at the time the short position is covered. *See* Securities Act Release No. 8869 (December 6, 2007), 72 Fed. Reg. 45094, 45096 n.90. Thus, when an investor sells short with the intent to cover with PIPE securities after they become registered, the SEC believes the investor's sale to be during the restricted period. These recent decisions, however, contradict the SEC's line of reasoning. As a result, the SEC may appeal these decisions.

SEC Fines Investment Adviser for Gifts

On March 5, 2008, the SEC fined Fidelity Investments $8 million for receiving inappropriate gifts from outside brokers.

Investment management firms should note the following:

- Although an investment adviser is not required under the Investment Advisers Act to police an employee's receipt of gifts and entertainment, this case clearly indicates that advisers should have a "Gifts and Entertainment" policy and adequate reporting. The SEC positioned their claim as a "failure to supervise" claim under the Investment Company Act and the Advisers Act.
- Advisers must review an employee's receipt of gifts as part of its overall analysis to determine whether it is adequately seeking to obtain best execution.
- Bloomberg e-mails were used by the SEC to support its position.

Please refer to http://www.sec.gov/litigation/admin/2008/ia-2713.pdf for a copy of the proceeding.

SEC Proposes Amendments to Privacy Rules

The SEC issued proposed amendments to Regulation S-P, its rules regarding the privacy and safeguarding of consumer financial information. The proposed amendments are available at http://www.sec.gov/rules/proposed/2008/34-57427.pdf. The proposed amendments would, among other requirements, impose on registered investment advisers an obligation to notify investors and potentially the SEC in the event of a security breach. Regulation S-P, originally issued in June 2000, applies to financial institutions under the supervision of the SEC, including registered investment advisers and broker-dealers. Investment advisers to private investment funds (both registered advisers under Reg. S-P and unregistered advisers under the Federal Trade Commission's privacy rules) are required to maintain privacy policies concerning information about their natural person investors (and IRA accounts), provide their investors the opportunity to opt out of certain specified disclosures to non affiliated third parties and send notices about their policies annually.

(See our May 2007 Private Investment Funds Update about proposed standardized privacy notices, which proposals have not yet been adopted).

The proposed amendments to Reg. S-P are principally designed to prevent and address security breaches and cover 4 areas: (1) requiring more specific procedures with regard to the safeguarding and disposing of consumer information and the reporting of security breaches (both to the individuals effected and the SEC), (2) broadening the scope and applicability of Reg. S-P to include more classes of information and to apply certain of the disposal rules directly to employees, (3) requiring maintenance of written policies, as well as written records as to compliance with such policies, in order to facilitate review by SEC examiners, and (4) permitting the portability of information in limited circumstances in connection with migration of employees from one covered institution to another.

JMLSG Anti-Money Laundering Update

In the area of the UK's anti-money laundering and counter terrorist financing regime (AML/CTF), the Joint Money Laundering Steering Group (or JMLSG) issued revisions to its guidance to reflect changes in that regime to be introduced by the Money Laundering Regulations 2007 which implement the EU Third Money Laundering directive in the UK. The revised Guidance takes account of comments received on the consultation draft that was published in mid-2007, has been approved by HM Treasury as provided under the Money Laundering Regulations 2007, the Proceeds of Crime Act 2002 and the Terrorism Act 2000 and took effect from December 15, 2007, when the Money Laundering Regulations 2007 commenced. The new guidance will help firms meet their new legal and regulatory obligations regarding AML/CTF. The changes include more detailed customer due diligence requirements, such as a new obligation to verify the identity of the beneficial owner and a requirement to apply enhanced customer due diligence measures to politically exposed persons. They also introduce new concepts such as reliance. These new obligations do not constitute a radical departure from current practice, but firms may have to review their existing policies and procedures to ensure their continuing compliance with their AML/CTF obligations.

The JMLSG comprises the leading UK trade associations in the financial services industry. Its aim is to promulgate good practice in countering money laundering and to give practical assistance in interpreting the UK Money Laundering Regulations. The Guidance since 2006 has been based on a number of fundamental principles - including that of senior management accountability and the adoption of a risk-based approach. The latter allows firms to focus their AML/CTF resources on areas where the risk of money laundering/terrorist financing is higher, and therefore embodies proportionate and cost-effective approaches to managing these risks.

HFWG Best Practices

Following a consultation period, on February 27, 2008, the UK based Hedge Fund Working Group (or HFWG) published a set of best practice standards intended to strengthen the confidence of hedge fund investors, lenders, regulators and other market participants. The HFWG comprises 14 leading UK based and FSA-authorized hedge fund managers. The standards are founded on the UK FSA's own set of 11 high level Principles for Businesses which represent the fundamental obligations of all FSA-authorized firms under the UK regulatory system. The 14 firms on HFWG are the initial signatories to the standards. Hedge fund managers generally are being encouraged to volunteer to sign up to the standards. A Hedge Funds Standard Board or HFSB has been set up to act as custodian of the standards. The standards cover: disclosure to investors and counterparties; valuation; portfolio risk management; operational risk management; fund governance; and shareholder conduct including activism. The UK FSA has not been asked to give any regulatory status to the standards. However, in practice compliance with the standards is likely to give a safe harbor from regulatory enforcement action but that cannot be guaranteed.

Report on Risk Management Practices

On March 6, 2008, senior financial supervisors from France, Germany, Switzerland, United Kingdom and United States issued a report assessing a range of risk management practices among a sample of global banking and securities firms identifying in particular which practices worked well and which did not during recent market turmoil where the predominant source of losses for firms surveyed was exposure to securitizations of U.S. subprime mortgage-related credit. The report notes why certain firms took major losses on their holdings, noting that firms which avoided such problems demonstrated a comprehensive approach to viewing firm-wide exposures and risk with senior managers exercising critical judgment and discipline in valuing their holdings of complex or potentially illiquid securities both before and after the turbulence. Using the observations of the report the supervisors involved are critically evaluating the efforts of the individual firms they supervise to address weaknesses in risk management practices. The participating supervisors are: the French Banking Commission; the Germany Federal Financial Supervisory Authority; the Swiss Federal Banking Commission;the United Kingdom Financial Services Authority; and, from the United States, the Securities and Exchange Commission, the Federal Reserve and the Office of the Comptroller of the Currency.

UK Investment Management Tax Exemption

On March12, 2008, as part of the UK Budget, the government announced that long-awaited changes to the Investment Management Exemption, within which UK based investment managers can trade as agent on behalf of non-UK principals, for example, offshore hedge funds, without subjecting those funds to risk of UK tax, would be included in the Finance Bill 2008. In particular, the government announced that the definition of an investment transaction for the purposes of the IME will not be aligned to the definition of activities regulated by FSA given the complexity required for such an approach. Instead a single list of qualifying transactions will be maintained and a streamlined approach to amending the list established. The "cliff edge" provisions of the current exemption will be removed so that where an investment manager undertakes a transaction which falls outside the list of qualifying transactions and thereby fails the IME, only that transaction will be subject to UK tax rather than potentially the whole fund.

The government has proceeded with its proposals to reform the non-domicile rules such that those persons resident but not domiciled in the UK who wish to benefit from the remittance basis of taxation will be levied an annual charge of GBP30,000 if they have been a resident of the UK for 7 years. The levy will be creditable under double tax agreements and there will be an exemption where offshore income is less than GBP2,000.

BOCA RATON • BOSTON • LONDON

LOS ANGELES • NEW ORLEANS • NEW YORK • NEWARK

PARIS • SÃO PAULO • WASHINGTON, D.C.

Private Investment Funds Practice

Our Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity and hedge funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation and secondary purchases and sales.

This newsletter for clients of our Private Investment Funds Practice discusses recent developments affecting hedge funds and private equity funds. For more information about this practice area, contact:

NEW YORK

Christopher M. Wells
212.969.3600 – cwells@proskauer.com

Ira G. Bogner
212.969.3947 – ibogner@proskauer.com

Timothy M. Clark
212.969.3960 – tclark@proskauer.com

Stephen A. Devaney
212.969.3262 – sdevaney@proskauer.com

Bruce L. Lieb
212.969.3320 – blieb@proskauer.com

Amanda H. Nussbaum
212.969.3642 – anussbaum@proskauer.com

Charles H. Parsons
212.969.3254 – cparsons@proskauer.com

Marc A. Persily
212.969.3403 – mpersily@proskauer.com

LONDON

Matthew D.J. Hudson
44.20.7083.8510 – mhudson@proskauer.com

Mary B. Kuusisto
44.20.7083.8602 – mkuusisto@proskauer.com

William Yonge
44.20.7083.8507 – wyonge@proskauer.com

PARIS

Olivier Dumas
33.1.53.05.69.17 – odumas@proskauer.com

Daniel Schmidt
33.1.53.05.68.30 – dschmidt@proskauer.com

BOSTON

Robin A. Painter
617.526.9790 – rpainter@proskauer.com

David W. Tegeler
617.526.9795 – dtegeler@proskauer.com

Laurier W. Beaupre
617.526.9759 – lbeaupre@proskauer.com

Howard J. Beber
617.526.9754 – hbeber@proskauer.com

Daniel P. Finkelman
617.526.9755 – dfinkelman@proskauer.com

Sean J. Hill
617.526.9805 – shill@proskauer.com

David T. Jones
617.526.9751 – djones@proskauer.com

Scott S. Jones
617.526.9772 – sjones@proskauer.com

Arnold P. May
617.526.9757 – amay@proskauer.com

Stephen T. Mears
617.526.9775 – smears@proskauer.com

Malcolm B. Nicholls III
617.526.9787 –mnicholls@proskauer.com

Jamiel E. Poindexter
617.526.9773 – jpoindexter@proskauer.com

Proskauer Rose is an international law firm that handles a full spectrum of legal issues worldwide.

Please visit our Website at **www.proskauer.com**