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INVESTMENT MANAGEMENT NEWS

SELECTED ARTICLES ON RECENT DEVELOPMENTS IN THE AREA OF INVESTMENT MANAGEMENT

Curtis is pleased to announce its Investment Management Practice Group newsletter for clients and friends of the Firm. This inaugural issue contains four articles on topics of current interest to the investment management community.

How Proposed Patriot Act Regulation Will Affect Hedge Funds by Marc Cozzolino discusses recent rulemaking by the Department of Treasury implementing the anti-money laundering provisions of the Patriot Act and addresses the impact which the new rules will have on unregistered investment companies.

An article by Paul Jeun, *SEC Revisits Investment Advisers Act Issues relating to Disclosure of Private Investment Fund Information over the Internet*, addresses a recent no-action letter by the SEC which discusses the concept of when an adviser holds himself out as an adviser for purposes of triggering the registration provisions of the Investment Advisers Act.

Included in this issue as well is an article by Marc Cozzolino on new New York State legislation which ties the state's investment adviser registration scheme more closely to the federal requirements and an article by Vic Zimmermann addressing possible new support at the SEC for legislation which would make it easier for finders to register as broker-dealers.

Curtis' Investment Management Practice Group consists of approximately fifteen attorneys from several departments including International Corporate, Tax and Litigation in a number of its offices, both domestic and foreign. Clients of the Firm include managers, organizers and sponsors of both foreign and domestic hedge funds, private equity funds, commodities pools and other investment vehicles, as well as investment advisers, commodity trading advisers and broker-dealers.

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HOW PROPOSED PATRIOT ACT REGULATION WILL AFFECT HEDGE FUNDS

MARC C. COZZOLINO

Ever since the passage of the USA Patriot Act of 2001 (“Patriot Act”), hedge funds have been anxiously awaiting proposed rules to see to what extent they would be subject to the anti-money laundering programs under Section 352 of the Patriot Act. When the Patriot Act was enacted it was clear that proposed regulations would affect “unregistered investment companies” but it was uncertain to what extent the unregistered investment companies would be defined to include hedge funds, commodity pools, and other private investment partnerships and to what extent those funds included in the definitions would be subject to the Patriot Act’s provisions.

The Notice of Proposed Rulemaking¹ defines unregistered investment companies and provides that unregistered investment companies (as defined in the proposed rule) organized, operated or sponsored by a U.S. person (as defined in Rule 902(k) of the Securities Act of 1933), under Section 352 of the Patriot Act, would be required to establish anti-money laundering programs that include, at a minimum: (i) the development of internal policies, procedures, and controls; (ii) the designation of a compliance officer; (iii) an ongoing employee training program; and (iv) an independent audit function to test the program, all of which is consistent with the requirements for mutual funds.

The proposed rule also requires that each unregistered investment company file a short notice (“Notice”) identifying itself and providing some very basic information about the company such as:

- > the name, address, e-mail address and telephone number of the unregistered investment company;
- > the name, address, e-mail address, telephone number and registration number of any

investment adviser, commodity trading adviser, commodity pool operator, organizer or sponsor of the unregistered investment company;

- > the name, e-mail address and telephone number of the designated anti-money laundering program compliance officer;
- > the dollar amount of assets under management held by the unregistered investment company; and
- > the number of participants, interest holders or security holders in the unregistered investment company.

The Notice as described above would have to be filed with the Financial Crimes Enforcement Network (“FinCEN”) which is part of the U.S. Department of Treasury (“Treasury”).

The proposed rule would define “unregistered investment company” as (i) an issuer that, but for exclusions provided in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (“1940 Act”), would be an investment company under the 1940 Act; (ii) a commodity pool; and (iii) a company that invests primarily in real estate and/or interests therein. Thus, several types of investment companies that are not registered under the 1940 Act would be covered by this definition, including hedge funds,² private equity funds,³ venture capital funds,⁴ commodity pools⁵ and real estate investment trusts (“REITs”).

There are, however, several exceptions. Any fund that has a lock-up provision requiring that an investor cannot redeem the interest for 2 years (or more) after the interest was purchased and those funds with net assets under \$1,000,000 would be excluded from the definition. The lock-up provision should exempt most private equity funds and a

number of the larger hedge funds from the Patriot Act's requirements.

The SEC staff has indicated that investment advisers will be captured in proposed rules this Fall to correct their omission from the definition of "covered financial institution" in the Patriot Act. This, too, may have an impact on unregistered investment companies since many of their advisers are not registered with the SEC due to an exclusion or exemption from registration under the Investment Advisers Act of 1940.

Therefore, the rule, as proposed, would apply the anti-money laundering compliance program requirements, already in effect for registered investment companies (mutual funds), to domestic and, potentially, to foreign unregistered investment companies since it would apply to any unregistered investment company organized, operated or sponsored by a U.S. Person. However, on October 25, 2002, Treasury released an interim final rule which defers the implementation of the rule to establish anti-money laundering programs, as required under Section 352 of the Patriot Act. Certain financial institutions affected by this deferral include: investment companies other than mutual funds (*i.e.*, unregistered investment companies), commodity pool operators, and commodity trading advisors. The interim rule is effective until Treasury

issues final rules applicable to the specified financial institutions.

1. *Notice of Proposed Rulemaking, Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies, September 26, 2002.*

2. *The term "hedge funds" refers generally to a privately offered investment vehicle in which the contributions of the participants are pooled and invested in a portfolio of securities, commodity futures contracts, or other assets. These funds are generally offered to persons who qualify as "accredited investors" or "qualified purchasers" under federal securities laws. See 17 CFR 230.501(a) (definition of "accredited investor"); 15 U.S.C. 80a-1(a)(51) (definition of "qualified purchaser"). Investors in a hedge fund are typically able to redeem their investments on a quarterly, semi-annual, or annual basis.*

3. *Private equity funds are privately offered investment vehicles in which the contributions of institutions and high net worth individuals are pooled and invested in a portfolio of unregistered equity securities (of public or private companies). Usually, private equity funds have a duration of eight to twelve years and investors are only able to redeem their investments when the funds liquidate.*

4. *Venture capital funds usually have a duration that is fixed, e.g., ten years. It is a privately offered investment vehicle in which contributions of the participants are pooled to invest in start-up companies.*

5. *Commodity Exchange Act Rule 4.10(d) defines a "pool" as "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests." 17 CFR 4.10(d).*

NEW YORK AMENDS INVESTMENT ADVISER REQUIREMENTS UNDER MARTIN ACT

MARC C. COZZOLINO

Governor Pataki signed Assembly Bill A07907 into law on September 17, 2002. The law will enable New York to participate in the national Investment Adviser Registration Depository (IARD) system, currently administered by the National Association of Securities Dealers (NASD) and developed in conjunction with the Securities and Exchange Commission (SEC), and require investment advisers who have more than five clients residing in New

York to register. The law, which is effective on January 1, 2003:

- > amends the "definitions" section of General Business Law Section 359-eee to decrease, from 40 to 5 (*i.e.*, fewer than 6), the number of clients that trigger the requirement that an investment

adviser register, and adds a definition of “federally covered investment adviser”;

- > does not include “federally covered investment advisers” and persons who would otherwise be required or permitted to register with the SEC as an investment adviser were it not for the exemption from registration under Section 203(b)(3) of the Advisers Act, *i.e.*, private investment adviser (Rule 203(b)(3)-1 also applies) in the definition of “investment adviser”;
- > prescribes that examinations must be satisfactorily completed before an adviser can register and authorizes the Attorney General to require minimum standards of financial responsibility; and
- > changes, from April 1 to January 1 of each year, the commencement of the uniform annual registration period.

Pursuant to the National Securities Market Improvement Act of 1996 (NSMIA), the SEC requested that the states implement an electronic filing system for investment advisers by 2001. The IARD is the electronic filing system for investment advisers.

Under NSMIA, federal covered investment advisers now register at the federal level and submit only a notice filing to the states, which results in the elimination of duplicative regulation. The change in the *de minimus* registration requirements in this law, from 40 clients to 5, is consistent with the federal standard under NSMIA.

Moreover, the law exempts certain persons from the registration requirement. For example, according to the Assembly statement, “new Section 359-eee(1)(a)(7) provides an exemption for [an adviser to] ‘hedge funds’ that service a small number of institutional accounts and sophisticated investors who maintain accounts with significant value (at least \$25 million under current federal regulations).” In addition, amended Section 359-eee(1)(a)(5)

excludes “financial institutions and institutional buyers”¹ from the client count for purposes of determining whether to register as an investment adviser. Most importantly, amended Section 359-eee(1)(a)(5) only addresses investment advisory services that are *sold* during the preceding twelve month period; however, an earlier iteration was much broader to include “a person who solicits, offers or negotiates for the sale of or sells investment advisory services to less than six persons in this state...” (emphasis added).²

At the present time, the Investor Protection and Securities Bureau has made available New Investment Adviser Regulations and Form on its website located at >www.oag.state.ny.us/investors/investors.html.

1. A person who sells or offers to sell any security to a “financial institution” or “institutional buyer” is excluded from the definition of “dealer” in Section 359-e(1)(a); however, neither term is defined in the statute. The conventional wisdom is that “institutional buyer” is a broad term which may encompass the definitions of either “accredited investor” or “qualified institutional buyer” under federal securities law. However, Section 359-eee(1)(a)(5) preserves the power of the Attorney General to define these terms “by rule or regulation.”

2. New York State Assembly Bill 7907--A (March 27, 2001).

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SEC REVISITS INVESTMENT ADVISERS ACT ISSUES RELATING TO DISCLOSURE OF PRIVATE INVESTMENT FUND INFORMATION OVER THE INTERNET – IMPLICATIONS FOR OFFSHORE FUNDS AND THEIR ADVISERS

PAUL JEUN

The staff (Staff) of the Securities and Exchange Commission (SEC) in *Thomson Financial Inc.*¹ recently revisited the issue of whether investment advisers to private investment funds may disclose information about themselves without being considered “holding out” as investment advisers and triggering the registration requirements of the Investment Advisers Act of 1940 (Advisers Act). In *Thomson Financial Inc.*, the Staff indicated that it would not take enforcement action to require registration of investment managers of private investment funds for supplying biographical and contact information on a web site maintained by Thomson Financial Inc. (“Thomson”), a provider of data services.

Thomson operates a password-protected web site that provides information about the equity holdings of entities such as mutual funds, private funds, pension plans, and insurance companies to investment industry professionals. The web site also provides information about such entities’ investment managers, such as the names, phone numbers, fax numbers and e-mail addresses of portfolio managers, analysts and traders; manager biographical data; and firm profile data, such as the year a fund started, total assets, investment philosophy, industry focus, market focus, securities selection strategy and breakdown of assets. Thomson makes its services available exclusively to: (1) the institutional sales and trading desks of registered broker-dealers to streamline their communication with institutional investors for brokerage services, and (2) a small number of fund managers who use its services to monitor the portfolio holdings of competing funds with similar investment strategies.

Thomson also implemented procedures to prevent any person seeking advisory services from gaining

access to the web site by requiring each user of the services to have his or her own password to access the services and by contractually prohibiting such users from divulging any information obtained through its services to any other person. In granting the no-action relief, the Staff noted particularly the representations that Thomson will continue to make its services available exclusively to the institutional sales and trading desks of registered broker-dealers and to fund managers, and that Thomson has implemented procedures that effectively prevent persons who may be seeking advisory services from gaining access to its services.

To date, the only other significant guidance from the SEC on the issue of web site posting of adviser-related information came in the discussions in *Lamp Technologies*.² *Lamp Technologies* involved a web site maintained by an intermediary that was used to solicit information from potential investors to determine their qualification for private placement of private investment fund securities. Each fund manager had exclusive control over the fund information that would be posted on the web site but agreed to post only fund related information and not to offer other services or products on the site. Access to information regarding private funds (which may include offering memoranda) posted on the web site was limited to a select group of accredited investors. Noting that the web site employed procedures designed to limit access to the fund information only to a select group of accredited investors, the Staff indicated that “an investment adviser that posts only private fund information would [not] be ‘holding itself out generally to the public’ as an investment adviser” under the Advisers Act. In the view of some practitioners, *Lamp Technologies* left open the question of how Internet postings of information about the

investment advisers themselves, as opposed to the funds they manage, would alter the “holding out” question.

Thomson appears to shed further light as it suggests that more detailed information about the adviser beyond that which relates to “only private fund information” could be posted on a web site without triggering registration requirements if procedures were implemented to limit access only to a select group of pre-screened viewers. *Thomson* appears to follow the rationale in *Lamp Technologies* in that information was not made publicly available and, in particular, was not made available to persons expected to be consumers of investment management services. Both letters noted significantly that information was restricted to certain pre-qualified viewers.

Lamp Technologies and *Thomson*, however, do not directly address the permissible level of disclosure in the context of first-party web sites (*i.e.*, those that are maintained by the offeror of the securities or its investment adviser) that are used to facilitate the sale of the fund’s securities to potential investors. *Lamp Technologies* and *Thomson* involved web sites operated by third-party intermediaries so no information relating to the adviser needed to be disclosed in order for subscribers to access the fund information. With regard to first-party web sites, some adviser/sponsor/manager information would clearly need to appear on the web site in order for potential investors to access the site in the initial instance so that investors may later view the offering information that may be posted elsewhere on the web site.³

The SEC’s views on this question are relatively sparse. In a previous release, the SEC broadly indicated that if an adviser uses a publicly available medium such as the Internet to provide information about its services, it would not qualify for the *de minimus* exemption under Section 203(b)(3) of Advisers Act.⁴ In the case of the foreign investment adviser, however, the SEC indicated in its release⁵ relating to use of Internet web sites to offer securities

and services (Internet Release) that if a foreign adviser implements measures reasonably designed to guard against directing information provided on the Internet about its advisory services to U.S. Persons, it would not be deemed holding itself out as an investment adviser under the Advisers Act. What constitutes measures reasonably designed to guard against an adviser holding itself out as an investment adviser in the United States will depend on all of the facts and circumstances but may include measures such as a prominent disclaimer making it clear to whom the site materials are (or are not) directed or implementing procedures reasonably designed to guard against directing information about its advisory services to U.S. Persons (*e.g.*, obtaining sufficient residency information such as mailing addresses or telephone numbers prior to sending further information), other than to its fourteen or fewer U.S. clients.

In the context of a first-party web site designed to facilitate sale of securities of an offshore fund, if the offshore fund’s securities offering are intended to take place entirely outside the United States, to the extent any information about the foreign adviser is even deemed to be “holding out,” use of a prominent disclaimer in the nature described above should be sufficient to prevent registration requirements because the intent is not to target potential advisory clients in the United States. The same argument could be made with equal force to U.S. advisers of foreign funds because, again, the intent is not to solicit U.S. advisory clients but rather to provide information that is incidental to the securities offering.

Where, however, the offshore fund seeks to use its web site to target potential U.S. investors, the question is whether and to what extent information relating to the adviser, however incidental to the securities offering, would be deemed “holding out” as there is now activity directed to the United States. It may be the case that if the level of information disclosed about the adviser is minimal, measures such as a disclaimer indicating clearly that information relating to the adviser on the site does

not constitute an offer to provide advisory services (to the public or in the United States or at all) may be sufficient. The *Lamp Technologies* and *Thomson* letters and the Internet Release suggest that the Staff will not categorically conclude that the exemption under Section 203(b)(3) of the Advisers Act would not be available if some information about the adviser is disclosed on a web site, provided that such information is not solicitous in nature and is not readily accessible by the public at large (and possibly, is not directed to persons expected to be consumers of investment management services). Nevertheless, no definitive statements can be made as to the level of permissible disclosure in the context of first-party web sites used to target U.S. investors without further SEC or Staff guidance.

1. Publicly available July 10, 2002. SEC no-action letters are expressions of the staff of the SEC as to enforcement attitudes

and do not necessarily endorse the legal arguments or reasoning of those requesting no-action letters.

2. *Lamp Technologies I*, publicly available May 29, 1997. *Lamp Technologies II*, publicly available May 29, 1998.

3. Securities law concerns may require that offering materials be placed in the non-public portions of the web site.

4. Release No. 33-7288.

5. Release No. 33-7516.

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LIMITED BROKER DEALER EXPLORED BY SECURITIES AND EXCHANGE COMMISSION SMALL BUSINESS FORUM

VICTOR L. ZIMMERMANN, JR.

At the Securities and Exchange Commission's recent annual Government-Business Forum on Small Business Capital Formation, the Securities and Exchange Commission Small Business Forum Ad Hoc Group (the "Ad Hoc Group") presented its proposal on finder registration and regulation.

Current regulation of finders has caused confusion and uncertainty among those involved in capital formation and unfortunately has contributed to widespread evasion of the law. Issuers often have to choose between dealing with a finder whose behavior may be questionable under the law and languishing in an undercapitalized state. The finder is also not in a good position – he can attempt to structure his behavior so as to be outside the type of behavior requiring registration (which can be

difficult) or he can register as a broker in which case he must abandon his finder activities during the course of the registration process.

The Ad Hoc Group's objective is to formulate and propose a new class of limited purpose broker dealer (the "Limited BD") which would be available to applicants who would limit their services to those of a "finder." The Ad Hoc Group envisions that the Limited BD will not have the ability to accept delivery of customer funds or securities; will be subject to supervisory and financial responsibility requirements suitable for the services which they provide and will be subject to new "bad boy" provisions which would serve to protect the investing public from unscrupulous individuals. The Ad Hoc Group also envisions that a Limited BD

applicant would be able to register as such immediately upon filing of a notice of registration.

This proposal met with widespread approval with SEC officials at the conference and there appears to be enough momentum that there could be some rulemaking in this area within the next six months to a year.

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