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Investment Funds Group Update

Over the last few weeks, the following important developments have occurred relating to private investment funds: (i) the National Association of Securities Dealers, Inc. (the "*NASD*") issued an interpretative letter allowing the use of related performance information by private investment funds relying on Section 3(c)(7) of the Investment Company Act of 1940 (the "*Investment Company Act*"); (ii) the Internal Revenue Service (the "*IRS*") issued final regulations that generally make the tax shelter confidentiality carve-out language in fund agreements no longer necessary; and (iii) the NASD issued a "Notice to Members" announcing the Securities and Exchange Commission's (the "*SEC*") approval of Rule 2790 relating to "new issues" (which replaces the NASD's previous "hot issues" rule).

I. NASD Updates Interpretation on Related Performance Information

On December 30, 2003, the NASD issued an interpretative letter (the "*Interpretation*") modifying its position regarding the use of related performance information by private investment funds. ("Related performance information" includes the performance of funds, accounts or composites thereof managed by the same sponsor that sponsors the investment fund being promoted.) The Interpretation provides that NASD members will generally be permitted to include related performance information in sales materials for a private investment fund relying on Section 3(c)(7) of the Investment Company Act ("*3(c)(7) Funds*"). As a result, a member must ensure that all recipients of such sales materials are "qualified purchasers" under the Investment Company Act. (A "qualified purchaser" generally is an individual with more than $5 million of investments and an entity with more than $25 million of investments.)

The NASD had previously issued an interpretative letter (the "*Prior Interpretation*") providing that its prohibition on the use of related performance information applies to sales materials for all hedge funds. Based on informal discussions with the NASD, it is generally believed that its position applied also to the use of related performance information by private equity funds. In carving out 3(c)(7) Funds from the Prior Interpretation, the NASD staff concluded that qualified purchasers are sufficiently sophisticated financially not to require the same degree of regulatory investor protection as investors in other types of funds, including mutual funds. Consequently, the Prior Interpretation's restrictions appear to continue to apply to private investment funds relying on Section 3(c)(1) of the Investment Company Act.

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II. IRS Significantly Narrows Confidentiality Trigger

In a March 7, 2003 memorandum, we recommended that the confidentiality provisions of most fund agreements be modified to exclude certain tax-related matters. This recommendation was prompted by regulations issued by the IRS as part of its efforts to eliminate abusive tax shelters. Under those regulations, participation in a "confidential transaction" resulted in reporting and record-keeping requirements, and we suggested that most parties would choose to avoid these burdens by expressly authorizing disclosure of tax treatment and tax structure.

On December 29, 2003, the IRS issued new regulations that significantly change what is considered to be a "confidential transaction" for these purposes. Under the new regulations, the definition of a "confidential transaction" is limited to transactions in which an advisor who is paid a significant fee places a limitation on disclosure of the tax treatment or tax structure of the transaction. Confidentiality obligations that are imposed solely by the parties to a transaction will not cause a transaction to be a "confidential transaction" for purposes of these regulations. There is some uncertainty about how these new rules will be applied to transactions in which a participant is both an advisor and a principal, such as certain financial transactions in which a commercial bank or investment bank is both an advisor and a party to the transaction.

These new regulations are effective for transactions entered into on or after December 29, 2003, (and they may also be relied on for transactions entered into on or after January 1, 2003 and before December 29, 2003). Accordingly, the tax confidentiality carve-out language that had become standard in fund agreements is generally not needed. In addition, the failure to include the language (or the inclusion of ineffective language) in prior fund agreements should not have any adverse consequences.

III. NASD Issues Notice to Members Relating to New Issues Rule

On December 23, 2003, the NASD issued a "Notice to Members" announcing the SEC's approval of Rule 2790: "Restrictions on the Purchase and Sale of Initial Equity Public Offerings" ("*Rule 2790*"), which replaces NASD Interpretative Material 2110-1, commonly known as the "Free-Riding and Withholding Interpretation" or "hot-issues rule" (the "*Free-Riding Interpretation*").

There are several key differences between the Free-Riding Interpretation and Rule 2790:

- First, Rule 2790 applies to all "new issues" as opposed to only "hot issues." A "new issue" is defined as any initial public offering of an "equity security" as defined in Section 3(a)(11) of the Securities Exchange Act of 1934 made pursuant to a registration statement or offering circular. In other words, debt securities, preferred securities and other enumerated securities are excluded. Rule 2790 generally prohibits an NASD member from selling a "new issue" to any private investment fund or account in which a "restricted person" has a beneficial interest. In general, "restricted persons" include: (i) NASD members or other broker-dealers; (ii) broker-dealer personnel; (iii) finders and fiduciaries; (iv) portfolio managers; (v) owners of broker-dealers; and (vi) immediate family members of restricted persons.

- Second, Rule 2790 eliminates the category of "conditionally restricted" persons, which means that all persons will now be categorized as either restricted or non-restricted.

- Third, Rule 2790 adopts a "*de minimis*" exemption, that allows a private investment fund or account that is beneficially owned in part by restricted persons to purchase new issues if such persons account for no more than 10% of the fund's or account's beneficial ownership. In addition, Rule 2790 provides more flexibility concerning the methods of effecting a "carve-out" procedure for restricted persons, recognizing that there may be many effective means of segregating interests of restricted persons. Some private investment funds may choose to establish separate accounts, while others may choose to maintain one account, but adjust the capital accounts of restricted persons to remove any gains or losses attributable to new issues.

- Fourth, under Rule 2790, NASD members are no longer required to receive written opinions from an attorney or certified public accountant to a private investment fund relating to the eligibility of such fund to purchase "hot issues." However, Rule 2790 requires NASD members to obtain evidence that sales to private investment funds and accounts are in accordance with Rule 2790. Specifically, a member is required to obtain within 12 months prior to a sale of a new issue to a private investment fund a representation from such fund, or a person authorized to represent the investor(s) in such fund, that the fund is eligible to purchase new issues in compliance with Rule 2790. The initial verification of a person's status under Rule 2790 must be a positive affirmation of non-restricted status; however, annual verification of a person's status may be conducted through the use of negative consents.

- Finally, Rule 2790 eliminates the cancellation provision of the Free-Riding Interpretation. In light of the fact that Rule 2790 applies to all new issues – rather than to hot issues where it was not always known whether an offering would become a hot issue – the cancellation provision was deemed unnecessary.

Through the period ending March 22, 2004, NASD members may comply with either Rule 2790 or the Free-Riding Interpretation; however, *effective March 23, 2004, all members must comply with Rule 2790*. As a result, private investment funds that wish to purchase new issues should begin to circulate an investor questionnaire that complies with the requirements of Rule 2790 to all existing investors. In addition, such investor questionnaire should become a part of the subscription materials for such funds.

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Please contact any member of our Investment Funds Group with questions regarding the foregoing developments. The summary set forth herein is intended to be general in nature. This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content.

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