

The United States of America

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1 Introduction

A fund sponsor desiring to offer the shares of its funds to investors in the United States may avail itself of either the public or private distribution schemes under the United States securities laws. The sponsor may simultaneously offer the shares to investors in the US and offshore (a "combined offering").

A public distribution of shares in the United States by a fund will require registration of the shares with the Securities and Exchange Commission (the "SEC") pursuant to the Securities Act of 1933, as amended, and the rules and regulations promulgated thereunder (the "Securities Act"), and registration of the fund with the SEC pursuant to the Investment Company Act of 1940, as amended (the "Investment Company Act"). Under the Securities Act and the Investment Company Act, and as used in this Chapter, the term "United States" or "US" means the United States, each of its states, the District of Columbia, and each of its territories and possessions, such as the Puerto Rico and the U.S. Virgin Islands. Registration with the SEC will also subject the fund to numerous regulations and rules regarding structure of the fund, management of its portfolio, composition of its board of directors, distribution of its shares, required disclosure and permissible advertisement as set forth in the Securities Act and Investment Company Act. Conversely, a private distribution will involve somewhat less burdensome regulatory and disclosure requirements than a public offering, but does impose limitations on the method of distribution and selling and on the purchasers who will qualify to participate in such distribution. Private distributions under Rule 144A of the Securities Act for resales of restricted shares may provide the fund a broader resale market, albeit a market limited to qualified institutional buyers.

A fund may also participate in combined offerings if the fund expects to sell its shares to both United States and non-United States investors. Offerings of shares made outside the United States should comply with Regulation S of the Securities Act that provides for "safe harbor" rules for avoiding registration. Such a combined offering of shares may be made in the United States pursuant to a private or public distribution plan.

In addition, fund service providers, such as investment advisers and broker-dealers, will be subject to federal and state securities laws. Investment advisers may be required to register with the SEC and will be subject to advertising regulations promulgated by the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Broker-dealers will be subject to regulations promulgated by the SEC and the National Association of Securities Dealers, Inc. (the "NASD"). Lastly, a fund offering its shares in the United States must take account of a number of other miscellaneous issues including commodity regulations, pension fund regulation and tax provisions.

What follows is a brief discussion of the various offering methods and regulatory requirements found in U.S. under the federal securities and tax laws, as well as an overview of pension fund considerations and various issues related to operators of commodity pools. A complete discussion of the many structural and management requirements for SEC-registered funds is beyond the scope of this Chapter. State laws are also not covered. The reader should not construe the contents of this summary as legal or tax advice and should consult its own professional advisors with respect to the matters discussed herein.

2 Public Offerings of Shares

2.1 Registration Requirements

Any fund intending to offer shares for public distribution in the United States must comply with both the federal and state laws governing the offer and sale of securities. There are also extensive U.S. income tax rules that affect the management and structure of public funds. The tax rules are summarized below in Section VII.

Federal rules require that a fund that intends to offer its shares to the public register itself and the shares with the SEC. Foreign investment funds that desire to make a public offering of their shares will also be subject to registration. Such foreign funds, however, must first obtain an order from the SEC permitting them to register under the Investment Company Act. Because of the difficulty of obtaining this kind of an order from the SEC (the SEC has never actually granted one, except for a small number of Canadian funds pursuant to special rules applicable to such funds), the sponsor of a foreign fund desiring to offer its shares to the public in the U.S. is urged to create, instead, a mirror fund under the laws of one of the U.S. states that follows the same investment strategies as the foreign fund and to register this mirror fund with the SEC. The discussion in this Section I presumes that the sponsor has chosen to organize a U.S.-based fund.

The registration process for public investment funds involves registration under the Investment Company Act and the Securities Act, both of which can be accomplished by means of a joint registration statement. For open-ended investment funds, the joint registration is done through the Form N-1A, and for closed-ended investment funds, registration is done through the Form N-2. As stated above, an investment fund, through registration in the aforementioned forms, registers itself under the Investment Company Act and its shares under the Securities Act. The registration statement mandates certain disclosure about the offering, the business of the fund and financial information about the fund.¹

Once the fund registers with the SEC, it will be subject to the rules and regulations of the Investment Company Act and the offering of its shares will be subject to the Securities Act. These acts regulate distribution of shares, compensation to underwriters, advertising, dealers and sales personnel, printing and mailing of prospectuses to Investors other than current shareholders, and printing and mailing of sales literature. The fund will further be required to file certain notices with the various states under each state's securities laws ("blue sky" laws).

2.2 Distribution Rules

Open-end and closed-end investment funds are generally subject to different rules and regulations under the Investment Company Act with regards to the methods they may use for the distribution and pricing of shares, and their capital structure. There are, nonetheless, common rules and regulations that pertain to both types of investment funds. Both types of funds, for example, must have a net worth of at least \$100,000 before they can make a public offering, each type of stock offered must generally be voting stock with equal voting rights, and neither type of fund may issue stock for services or for any property other than cash or securities, except as a dividend or distribution to security holders or pursuant to a reorganization. Moreover, neither type of investment fund may issue warrants or rights for the securities they issue, and both are subject to specific rules regarding the payment of dividends.

2.2.1 Open-End Investment Funds

Two key features of an open-end investment fund that bear on distribution arrangements are the continuous offering by the fund of its shares and the right of its shareholders to have their shares redeemed at net asset value. Under the Investment Company Act, the shares of an open-end investment fund must, upon their presentation to the fund for redemption, be redeemed by the fund, and the shareholder is entitled to receive his proportionate share of the fund's current net asset value which generally must be computed no less frequently than once daily. Current net asset value is typically calculated by pricing the portfolio securities for which market quotations are readily available or, if not readily available, at the fair value as determined in good faith by the board of directors and deducting any investment advisory fees, federal income taxes, dividends receivable and other income derived from the fund's holdings.

Further, an open-end fund's right to suspend the shareholder's right of redemption is severely restricted. Accordingly, a fund needs to establish and maintain on a continuous basis an effective distribution system for the sale of its shares for the purpose, among other things, of offsetting decreases in fund assets occasioned by continuing redemptions. A fund can sell shares itself or use other means such as underwriters and broker-dealers, fiduciaries or banks. If the fund decides to use a third party to distribute its shares, the third party will generally be responsible for the distribution system. Otherwise, if the fund distributes the shares itself, it will be responsible. Also, funds are now taking advantage of the Internet as a means to distribute their shares. Distribution through the Internet can be effected by the fund itself or through third parties. The following is an explanation of the various possible public distribution systems.

(a) Distribution through an Underwriter.

A fund may contract with an underwriter to distribute its shares. The underwriter, in turn, typically will sell the shares itself through its own sales representatives or through broker-dealers or financial service intermediaries that enter into selling group or agency agreements with the distributor, or it may employ a combination of both methods. The distribution agreement between a fund and its distributor must be approved by a majority of the board of directors of the fund, including a majority of the fund's independent (i.e., non-interested) directors. No shareholder approval is required. The initial term of the distribution contract may not be more than two years, and thereafter the contract may not be continued unless approved annually by the fund's board of directors.

With regard to permissible charges, Section 22(d) of the Investment Company Act permits open-ended funds to charge investors sales charges or loads, including contingent deferred sales loads and distribution fees in connection with their investment in the fund provided certain conditions are met, including that the fees be reasonable in relation to the services provided. Section 2830 of the NASD Conduct Rules places certain maximum limits on the amount of sales loads and distribution fees that can be charged by NASD members. In the case of a "load" fund that imposes a charge on the sale of its shares, the distribution system is the primary responsibility of the fund's distributor pursuant to the distribution or underwriting agreement.

A fund may also participate in a fund supermarket. A fund supermarket is a program made available by a broker-dealer or other institution that allows investors to buy and redeem shares of various mutual funds with or without paying transaction fees. The sponsoring broker-dealer may further provide certain administrative and shareholder services, such as consolidated statements, to these customers. Funds will pay a fee to the sponsoring broker-dealer for the right to participate in the supermarket either pursuant to a 12b-1 plan (see below) or outside of the 12b-1 plan depending on the purpose of the payment and the party making the payment. The sponsor of the fund supermarket usually charges a fee to each participating fund if the sponsor does not charge the investors a transaction charge. The fees are to compensate the broker-dealer for (1) administrative services provided to the customer and (2) distribution services provided to the fund.

(b) Fund acting as Distributor

As previously stated, when an issuer is acting as the distributor, it will be responsible for creating a distribution system. Distribution expenses are typically borne by the fund. The fund, however, must follow stringent rules when providing for the payment of distribution fees from the fund's assets. Rule 12b-1 under the Investment Company Act regulates the payment of these distribution fees. The rule permits, subject to specified conditions, funds to adopt a distribution plan and to charge distribution fees to shareholders to finance activities that are primarily intended to result in the sale of the fund's shares to other investors. The plan is referred to as a 12b-1 plan and it must contain all material aspects of the proposed distribution financing. The 12b-1 plan and any related agreements must be approved by the board of directors of the fund. Since the inception of Rule 12b-1, a variety of plans have developed. The following is a summary of some common plans:

- **Third-Party Payment Plans.** Under this plan, the fund, its adviser or its distributor makes payments to other financial institutions from the fund's assets attributable to their customer accounts.
- **Direct Payment Plans .** Under this plan, either the adviser/distributor receives a distribution fee in addition to the regular advisory fee for use in financing distribution, or the fund pays the distribution expenses directly.
- **Defensive Plans.** Under this plan, the fund adopts a plan but does not charge its investors a fee. Instead, the plan authorizes the investment adviser to use a portion of its fee to pay for distribution.
- **Spread Load Plans.** Under this plan, there is a combination of a distribution fee and a contingent deferred sales charge, whereby the fee is paid by the investor upon redemption.

- **Enhanced Plans.** Under this plan, a fund may issue multiple classes of shares that differ primarily as to their distribution structures.

(c) Distribution over the Internet

Increasingly, mutual fund sponsors are providing means for shareholders to perform various account activities over the Internet. Such activities include purchasing shares, redeeming shares, exchanging shares of one fund for those of another and changing account information. This area does not bring up many novel distribution concerns that were not previously stated and is more a security and consumer acceptance issue than a regulatory one. However, as stated in the Section 3.4 below, there are additional content and prospectus delivery issues connected with Internet sales.

2.2.2 Closed-End Investment Funds

The Investment Company Act differentiates between open-end and closed-end funds based upon the redeemability of their shares. In practice, these funds also differ in how they offer their shares. Although both open-end and closed-end funds may distribute their shares on a continuous basis, subject to compliance with the requirements of the Investment Company Act and the Securities Act, open-end funds typically offer shares on a continuous basis while closed-end funds offer shares in discrete underwritten public offerings. Closed-end funds are often used as a means of investing in illiquid markets, such as emerging market debt or bank loan participations. A registered closed-end fund may, pursuant to specified requirements, issue debt securities and one class of preferred stock. However, under Section 18(d) of the Investment Company Act, a closed-end fund is prohibited from issuing rights or warrants, other than rights or warrants that expire not later than 120 days from date of issuance and that have been issued ratably to a class or classes of the fund's security holders, and warrants issued in exchange for outstanding warrants in connection with a plan of reorganization. Moreover, closed-end funds are prohibited from issuing their securities in exchange at a price below the current net asset value of the shares, except under certain conditions.

Section 23(b) of the Investment Company Act further prohibits a closed-end fund from selling common stock of which it is the issuer at a price below the current net asset value of such stock, exclusive of any distributing commission or discount except under certain specified circumstances.

In theory, Section 23(b) of the Investment Company Act does not preclude sales of shares of a closed-end fund at a price in excess of the fund's per share net asset value. The SEC, however, has stated that such sales may be prohibited under the Investment Company Act if the sales would benefit promoters of the investment fund.

2.3 Prospectuses, Advertising and Sales Literature

In general, the Securities Act regulates sales activities and the quality of information that must be provided to investors. Pursuant to section 5(b)(1) of the Securities Act, it is unlawful for any person "to transmit any prospectus relating to any security . . . unless such prospectus meets the requirements of Section 10." This "statutory prospectus," which must contain extensive

disclosure, is filed as part of the N-1A or N-2 registration and must typically be provided to the investor at the time of sale of any fund shares. However, because Section 2(10) of the Securities Act defines the term "prospectus" as including, among other things, any "notice, circular, advertisement, letter, or communication, written or by radio or television" which offers any security or sale, except material accompanied or preceded by a statutory prospectus, virtually all sales literature and advertisements will also fall within the ambit of the Securities Act's definition of a prospectus. Because such materials ordinarily will not meet the requirements for a statutory prospectus under Section 10, they cannot be distributed or used without an available regulatory exemption unless accompanied or preceded by a statutory prospectus. A fund's annual and semi-annual reports are considered sales literature under these provisions, and must be preceded or accompanied by a statutory prospectus.

Consequently, the SEC has provided exemptions that permit some uses of sales literature and advertising. The following is a brief overview of such exemptions as they currently exist: ⁱⁱ

(a) Rule 134 "Tombstone Advertisements." Rule 134 of the Securities Act excepts from the term "prospectus" any notice, circular, advertisement, letter, or other communication published or transmitted to any person after a registration statement has been filed if it contains only the statements required or permitted to be included therein by the provisions of Rule 134, which include, among others, the name of the fund, the type of fund, and the title and amount of shares offered. Of importance, however, is that performance figures cannot be disclosed and that the ads must contain certain legends providing disclosure to investors.

(b) Rule 135A Generic Advertisements. Rule 135A of the Securities Act permits the publication of sales literature or advertisements that will "not be deemed to offer any security for sale." In order to accomplish this, Rule 135A ads must be "generic ads" that do not "specifically refer by name to the securities of a particular investment fund, to the investment fund itself, or to any other securities not exempt" from registration under the Securities Act. Such ads are typically used by the investment adviser or distributor of an investment fund to describe the investment fund's complex as a whole rather than focusing on a particular investment fund.

(c) Rule 482 Omitting Prospectus Advertisements. Rule 482 ads are referred to as "omitting prospectuses" because, while they only contain information "the substance of which is included in the Section 10(a) prospectus," they need not follow all the requirements of a Section 10(a) prospectus. A major advantage of issuing Rule 482 ads as opposed to Rule 134 ads is that Rule 482 ads may contain certain types of performance information.

(d) Rule 498 Profiles. Rule 498 provides that a fund "profile" issued by open-end management investment funds may be deemed a prospectus under the Securities Act. A profile must contain certain information about a fund, which may be presented in a question and answer or narrative format and may be disseminated by any means. A profile may also include or be accompanied by a purchase application, and investors may purchase shares based on the profile prior to receipt of the fund's Section 10(a) prospectus. However, a Section 10(a) prospectus must be delivered to investors with their purchase confirmations.

(e) Internet Advertisements. The SEC has stated that it would view information distributed through electronic means as satisfying the delivery or transmission requirements of federal securities laws if such delivery provides intended recipients with information that is substantially equivalent to what a recipient would have received had the information been delivered in paper form. The SEC has prescribed specific rules regarding delivery of information over the Internet. As with paper delivery, there should be an opportunity for the recipient to retain a permanent record of the information. Any document delivered electronically must be prepared, updated and delivered in compliance with the federal securities laws.

In addition to the requirements of the rules discussed above, general standards also apply to the content of the sales literature of investment funds. For example, under Rule 34b-1 of the Securities Act, any sales literature containing performance information (including sales literature accompanied or preceded by a prospectus) is deemed to be misleading unless it contains the appropriate uniformly computed performance data and the legend disclosure required in Rule 482 advertisements. For purposes of Rule 482 and Rule 34b-1 of the Securities Act, an advertisement that refers to a fund's comparative performance ranking is not "performance advertising," provided that the advertisement does not include a quotation of the fund's total return, yield or similar performance data. However, such an advertisement generally must comply with the NASD's ranking guidelines, which specify a number of disclosures that must be provided.

Further, all advertisements and sales literature issued by mutual funds must meet the standards imposed by the anti-fraud provisions of the securities laws (i.e. Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Rule 10b-5 thereunder). Rule 156 under the Securities Act identifies certain statements contained in investment fund materials as misleading. Such misleading materials include, for example, predictions of future performance, exaggerated claims about management skill, and unwarranted or incomplete comparisons to other investment funds.

Lastly, NASD rules and guidelines apply to any investment fund shares sold in the United States through broker-dealers, including no-load fund shares sold through limited purpose broker-dealers. Advertising and sales literature used by these broker-dealers must be filed with the NASD. NASD Conduct Rule 2210 sets forth various general and specific standards applicable to communications with the public by NASD members. These standards are similar to those imposed by Rule 156 under the Securities Act. A small number of no-load funds are distributed directly, and not through broker-dealers, and are not subject to NASD rules and guidelines.

3 Private Placements

Shares of an investment fund may be sold in the United States without registration with the SEC or state regulatory authorities as long as the shares are offered only in private placements. To be sold through a valid private placement, the shares must be sold through private negotiation between the issuer and/or representatives of the issuer and the purchasers. An issuer can offer its shares to U.S. investors by means of a private placement transaction by meeting the exemption requirements as set forth in Regulation D under the Securities Act ("Regulation D") and either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. ⁱⁱⁱ A variation on the

traditional private placement concept with regard to the Securities Act is the placement of shares that are eligible for resale under Rule 144A.

3.1 Regulation D Exemption Under the Securities Act

Regulation D is a series of eight rules (Rules 501-508) issued by the SEC under the Securities Act that encompasses the Securities Act's Section 4(2) "private placement" and the Section 3(b) "small offering" exemptions and provides a "safe harbor" exemption from the registration requirements of the Securities Act for certain offerings of securities. Although Regulation D provides an exemption from registration, it does not provide any exemption either from the antifraud, civil liability or other provisions of the federal securities laws or the rules and regulations of the NASD and the states.

Under the provisions of Regulation D most typically used by funds, sales of private placement securities are restricted to persons or entities that qualify as "Accredited Investors" or to no more than 35 non-Accredited Investors who are nevertheless deemed to be "Sophisticated Investors." ; For purposes of Regulation D, the following persons or entities are deemed to be Accredited Investors:

(a) A bank, savings and loan institution, building and loan association, cooperative bank, credit union, broker or dealer registered under the Exchange Act, insurance company, investment fund registered under the Investment Company Act, business development company, or a licensed small business investment company;

(b) An employee benefit plan that is

- established and maintained by a state or its instrumentalities for the benefit of its employees and has assets exceeding \$5 million;
- subject to the Employee Retirement Income Security Act of 1974 ("ERISA") and either has assets exceeding \$5 million or is managed by a plan fiduciary that is a bank, savings and loan association, insurance company, or investment adviser registered under the Advisers Act; and
- a self-directed plan whose investment decisions are made solely by Accredited Investors;

(c) A private business development company as defined under the Advisers Act;

(d) A corporation, business trust or partnership, or charitable or other tax-exempt organization, not formed for the purpose of acquiring the shares, with total assets exceeding \$5 million;

(e) A director, executive officer, or general partner of the issuer, or a person occupying any such position with a general partner of the issuer;

(f) Any natural person with an individual net worth or joint net worth with such person's spouse exceeding \$1 million;

(g) Any natural person with an individual income exceeding \$200,000 in each of the two most recent years or joint income with that person's spouse exceeding \$300,000 in each of those years and who reasonably expects to reach that income level in the current year;

(h) Any trust with total assets exceeding \$5 million, not formed for the specific purpose of acquiring the shares offered, whose purchase is directed by a Sophisticated Investor (as defined below); or

(i) Any entity in which all of the equity owners are Accredited Investors.

For purposes of Regulation D, Rule 506(b)(2)(ii) states that a Sophisticated Investor is a person who, either alone or with his purchaser representative, has "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."

3.2 Sections 3(c)(1) and 3(c)(7) Exemptions under the Investment Company Act

In a private offering, an investment fund organized in the U.S. or elsewhere can rely on one of two exemptions in order to be exempt under the Investment Company Act. The first exemption is referred to as a section 3(c)(1) exemption, and the other is referred to as a 3(c)(7) exemption. Both exemptions work in conjunction with the Regulation D provisions described above.

3.2.1 Section 3(c)(1).

Section 3(c)(1) of the Act provides that certain private investment funds are not considered "investment companies" for purposes of the Act. A fund relying on Section 3(c)(1) cannot make a public offering of its securities and cannot have more than 100 beneficial owners of its outstanding securities. ^{iv} If another fund owns 10% or more of the investment fund's voting securities, all of the investors in the other fund must be included when calculating the number of beneficial owners of the first fund. Special rules apply in determining whether investments by certain employee benefit plans result in the fund treating the plan as a single investor or the plan's beneficiaries as separate investors. Note that if a fund relying on 3(c)(1) is organized outside of the U.S., generally only beneficial owners that are U.S. Persons (as defined below) are taken into account in calculating the 100-owner limit and the fund may have an unlimited number of non-U.S. Person beneficial owners. In contrast, if the fund is organized in the U.S. or is an offshore feeder fund for a U.S. master fund relying on 3(c)(1), all U.S. and non-U.S. beneficial owners must be taken into account.

3.2.2 Section 3(c)(7).

Section 3(c)(7) of the Act excludes another type of private investment fund from the definition of "investment company." As is the case with Section 3(c)(1), a fund relying on Section 3(c)(7) cannot publicly offer its securities in the US. Unlike Section 3(c)(1), however, there is no limit to the number of shareholders a Section 3(c)(7) can have. For a fund to rely on Section 3(c)(7), all

of its beneficial owners must be "qualified purchasers." A qualified purchaser is any of the following: (i) a natural person who owns \$5 million in investments (including property owned with a spouse); (ii) a family-owned business that owns \$5 million in investments; (iii) a trust that was not formed for the purpose of acquiring the securities in question, and for which the trustee and each settlor or other person contributing assets to the trust is a qualified purchaser; or (iv) any person who, for his own account or for the account of other qualified purchasers, in the aggregate owns and invests on a discretionary basis \$25 million in investment. In determining whether investors are qualified purchasers, the term "investments" is defined very broadly to include securities, real estate held for investment purposes, commodities held for investment purposes, other financial contracts such as swaps and futures, commitments to make capital contributions to certain investment vehicles, and cash equivalents held for investment purposes. If all of the beneficial owners of an entity are qualified purchasers, then the entity also is a qualified purchaser, even if it does not have the minimum amount of investments. ^v Note that if a fund relying on 3(c)(7) is organized outside of the U.S., generally only beneficial owners that are U.S. Persons must be qualified purchasers. In contrast, if the fund is organized in the U.S. or is an offshore feeder fund for a U.S. master fund relying on 3(c)(7), all U.S. and non-U.S. beneficial owners must be qualified purchasers.

3.3 Prohibition against General Solicitation

An investment fund's means for offering and selling shares is limited in private placements and may not be accomplished by means of advertising, listing on quotation or other market systems, or other means involving general solicitation. The rules applicable to offers and sales of securities issued in the U.S. in a private placement are found in Regulation D under the Securities Act, although there are other available exemptions. Specifically, Rule 502(c) of Regulation D provides that:

[N]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

1. Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
2. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertisement."

When determining whether there is a general solicitation or advertisement, the SEC analyzes cases of possible violations of this Rule under a two-step inquiry:

- (a) Is the communication in question a general solicitation or general advertisement; and
- (b) if so, is it being used by the issuer or someone acting on the issuer's behalf to offer or sell the securities?

This determination may be based upon three factors:

- (a) *The relationship between the person making the communication and the prospective investor:*
The SEC has generally held that a sale will only be deemed private if the issuer or placement

agent has a pre-existing relationship with the purchaser and knows that the purchaser currently has adequate financial means to bear the risks of the investment and adequate financial sophistication in order to analyze those risks (and thus is currently an Accredited or Sophisticated Investor). It is important to note, however, that solicitation activities directed only to Accredited or Sophisticated Investors may still be general solicitation, as in the case of mass mailings to or "cold calling" of persons the offeror merely suspects are Accredited Investors.

(b) *The subject matter of the communication:* A communication referring explicitly to an investment being offered or contemplated for offering would clearly involve the offer of securities. However, a generic communication, such as one describing an issuer without referring to any current or contemplated offering, may not be viewed as involving an offer or sale of securities, provided that such communication makes clear that (1) it is not an offer to sell securities; and (2) no offers for any securities will be accepted prior to the receipt by a prospective investor of a completed disclosure document and the determination that such prospective investor may purchase the securities under Regulation D.

(c) *The timing of the communication:* If general solicitation or advertising is promulgated at a time sufficiently near to that of an offer or sale of securities, the solicitation or advertising may be deemed to have been used in connection with such offer and sale, even where a communication makes no explicit reference to a current or contemplated offering.

3.4 Private Offerings through the Internet

As previously stated, a private placement of securities must be made without any general solicitation to the general public. Because the Internet is accessible to virtually anyone anywhere in the world, an issue regarding general solicitation may arise if control measures are not in place to limit the ability of U.S. investors to access a fund's web-site. Accordingly, funds that are conducting offers or sales through the Internet must create web access-control features if they want to preserve their exemptions under the Securities Act and Investment Company Act. The access-control features generally must screen out any casual visitors from the web site and deny them access to material on the site that could be deemed offering materials. The web site may, however, elicit financial and investment information from prospective U.S. investors that visit the site in order to determine whether the investors are accredited/qualified. If the information received from the visitor meets the minimum qualification conditions established by the fund, the fund may issue a pass-word to the visitor in order to permit the visitor to review the rest of the site. While not specifically required in Regulation D, it is advisable for funds using the Internet to establish a period of time (generally 30 days) between the visitor's first visit to the web site and date on which the visitor may actually purchase shares in the funds promoted through the Internet. This cooling-off period gives time to the fund to review the potential investor's financial picture and investment sophistication and time to the investor to review the fund offering materials. The SEC and certain members of Congress have criticized web sites for non-SEC registered funds that permit visitors to visit the web sites for a first time, obtain pass-words and access to the non-public portions of the web sites and purchase shares all in a single visit or short time span.

4 Resales under Rule 144A

Rule 144A provides investment funds with an alternative to the traditional private placement mechanisms by permitting the resale of shares to and among certain qualified U.S. buyers under circumstances that would not strictly comply with the private placement requirements under Regulation D. This rule is an exemption from registration of the shares under the Securities Act but not an exemption from registration of the fund under the Investment Company Act. However, the SEC has indicated that for the purposes of the 3(c)(1) and 3(c)(7) exemptions under the Investment Company Act, it will not consider Rule 144A resales as creating a public offering.

Rule 144A offerings take place in two steps. First, an investment fund sells its securities to an intermediary or an underwriter either outside of the United States in compliance with Regulation S or inside the United States in a private placement under either Section 4(2) or Regulation D and the intermediary or underwriter agrees with the fund to resell the securities pursuant to 144A. Next, the intermediary resells the securities to qualified institutional buyers ("QIB's") meeting the definition contained in Rule 144A, which include:

(a) any insurance company, investment fund or business development company, small business investment company, employee benefit plan of a state or its subdivision or instrumentality, private employee benefit plan, organization, corporation (other than a bank or savings and loan association), partnership or business trust and any registered investment adviser that, acting for its own account or the accounts of other QIB's, in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers not affiliated with the entity;

(b) a dealer registered under Section 15 of the Exchange Act (a "Registered Dealer"), acting for its own account or the accounts of other QIB's, that in the aggregate owns and invests on a discretionary basis at least \$10 million of securities of issuers not affiliated with the entity, excluding unsold allotments or subscriptions as a participant in a public offering;

(c) a Registered Dealer acting in a riskless principal transaction on behalf of a QIB;

(d) an SEC-registered investment fund, acting for its own account or that of other QIB's, that is part of a family of investment funds that owns in the aggregate at least \$100 million in securities of issuers not affiliated with the investment fund or family of investment funds;

(e) an entity all of whose equity owners are QIB's, acting for its own account or the account of other QIB's; or

(f) bank or savings and loan institution or foreign bank, savings and loan institution or the equivalent, acting for its own account or the account of other QIB's, that in the aggregate owns or invests on a discretionary basis at least \$100 million in securities and that has an audited net worth of at least \$25 million.

The intent of the intermediary to resell the securities does not otherwise affect the availability of the exemption or safe harbor from the registration requirements so long as all of the following four conditions are met:

- (a) The intermediary offers or sells only to purchasers it reasonably believes to be QIB's;
- (b) The seller, or anyone acting on behalf of seller, takes reasonable steps to ensure that the purchaser is aware that the seller may rely on Rule 144A; and
- (c) If the issuer is neither subject to the reporting requirements of the Exchange Act or exempt from such requirements, then the issuer must provide current information, including a statement of the issuer's business and financial statements of the past two fiscal years.
Although not required, the use of an underwriter as the intermediary is generally preferred by both United States investors and foreign issuers.

5 Combined Offerings

Combined offerings are a hybrid used when a foreign issuer desires to sell its securities both inside and outside the United States. The combined offering may consist of three simultaneous offerings:

- (a) a global offering made outside the United States in reliance on Regulation S,
- (b) a domestic offering in the foreign issuer's home country, also in reliance on Regulation S, and
- (c) a public (i.e., SEC-registered) offering in the United States.

Another possible combined offering would match categories (i) and (ii) with a private placement of in the United States under Regulation D or resale pursuant to Rule 144A. This latter combination could not be used, however, if the issuer were publicly offering similar securities in the United States within the same general time frame. Compliance with Regulation S for the sales made outside the United States is a necessary component of the combined offering: foreign and domestic offerings that are close in time, even if not simultaneous, may be "linked" or "integrated" for purposes of the United States securities laws and a plan of distribution may be established.

Regulation S is a series of rules promulgated by the SEC to clarify the extraterritorial application of U.S. securities registration laws. Regulation S was adopted in May of 1990 and was intended to replace the hodgepodge of then-existing SEC policies on international securities sales. Regulation S provides, as a general rule, that offers and sales of securities made outside of the jurisdiction of the United States (i.e., outside of Puerto Rico and the U.S. Virgin Islands as well as the 50 states) are not subject to the requirement that the securities be first registered with the SEC. The principal thrust of the Regulation thereafter is to assist issuers and securities professionals in determining what constitutes offers and sales outside of the United States and to provide "safe harbor" rules for avoiding registration.

The SEC exercises broad jurisdiction over securities offerings and will impose sanctions on issuers and securities professionals that offer and/or sell securities to the general public in the United States, as opposed to accredited investors in private offerings, without registering the securities. The SEC will not impose its jurisdiction on securities that are offered and sold offshore and that will remain offshore. Often, however, it is not entirely clear where the offers and sales take place or where the securities will eventually be traded.

In order to provide guidance to the securities industry in avoiding non-exempt unregistered securities offerings in the United States, the SEC has created a regulatory framework based upon the type of the securities being sold and the facts surrounding their sales. The SEC's rules focus primarily on those securities that, although offered and sold offshore, are likely to flow into the U.S. markets. Securities subject to this tendency, e.g. offshore offerings of U.S. domestic funds and offshore offerings of foreign funds with significant U.S. presence, fall within the SEC's scope of concern as the principal regulator of U.S. securities markets. Equally, securities that may have little potential U.S. market but that are offered or sold in the United States or offshore to "U.S. Persons," as defined by Regulation S, also fall within the SEC's scope of concern because of the likelihood that U.S. investors may own the securities or that foreign investors may have purchased them in reliance upon U.S. securities laws. The term "U.S. Person" is an integral part of Regulation S and is defined to mean, generally, any natural person resident in the U.S., any partnership or corporation organized in the U.S. and certain trusts or accounts where a benefit would accrue to a U.S. person. However, the definition does not include as a U.S. person any discretionary or non-discretionary accounts or similar accounts (other than an estate or trust) held by a professional fiduciary or dealer organized in the U.S. if for the benefit of a non-U.S. person. In addition, a foreign estate or trust is excluded from the definition even if a U.S. fiduciary is acting as trustee as long as there is a non-U.S. co-trustee who has either sole or shared investment discretion and no beneficiary is a U.S. person.

Generally, a security will be exempted under Regulation S if it is sold in an "offshore transaction" and there are no "directed selling efforts" made by the offeror to create a market in the United States for the security. The offer and/or sale of a security is made in an "offshore transaction" generally when the offer is made to a person physically located outside of the United States at the time of the offer and the sale is made to a buyer who, at the time the buy order was originated, was outside of the United States.^{vi} However, transactions involving persons exempted from the definition of a "U.S. Person," such as investment accounts managed by U.S. fiduciaries for the benefit of non-U.S. Persons, are also considered offshore transactions. "Directed selling efforts" are those activities that could reasonably be expected to condition the market in the United States for the securities being offered in reliance on the Regulation, including marketing efforts in the United States designed to induce the purchase of the securities purportedly being distributed abroad.^{vii} The prohibition would not apply, however, to communications by broker-dealers to non-U.S. Persons from the United States or marketing activities directed toward discretionary investment accounts that are not deemed to be U.S. Persons by virtue of the exceptions described above.

Regulation S then sets forth a series of safe harbor rules that provide investors and securities professionals a high level of comfort that, if they follow the requirements of the safe harbor, initial issuances and resales of securities will not be in violation of the registration rules. The implications of a failure to comply with a condition or restriction of the safe harbors are not specifically addressed by Regulation S. However, failure to satisfy the conditions of an applicable safe harbor does not necessarily trigger the registration requirement of the Securities Act, as a transaction that has failed the safe harbor conditions may nevertheless be deemed to have occurred outside the United States.

6 Exchange Act and Broker-Dealer Registration

Under Section 15 of the Exchange Act, any person deemed to be engaged in the business of effecting transactions in securities for the account of others, including selling or promoting securities of an issuer, in the U.S. is required to register as a broker-dealer with the SEC unless otherwise exempted from registration. These rules apply to both foreign and domestic U.S. entities that sell securities in the U.S. in either a public offering or a private placement. Numerous state securities laws have similar registration requirements.

A problem with respect to broker-dealer registration will only arise if a fund were to use U.S. jurisdictional means to offer its shares or partnership interests (*i.e.*, telephone, Internet and other communication links from, through or to the U.S.). This would mean, generally, that a fund, its employees, the investment manager, its employees, and any placement agent may not contact any U.S. investors in the U.S. or contact non-U.S. Investor from the U.S. without registering as broker-dealers. Thus, the placement agents that will be contacting potential U.S. investors should be registered U.S. brokers (unless they have established relationships with such U.S. investors and the communications are permitted under Rule 15a-6, the Exchange Act rule which defines certain parameters for communications between U.S. investors and non-U.S. brokers).

On the other hand, there is an exemption from broker-dealer registration if a fund sells its own securities through its own directors, officers and employees (or the directors, officers and employees of the fund's investment manager) so long as the officers/employees do not receive any commissions or other direct compensation for those efforts and certain other conditions are met. The SEC and state authorities also provide an exemption from broker-dealer registration for any "bank" as defined in Section 3(a)(6) of the Exchange Act, that engages in the business of effecting transactions in securities for the account of others. The term "bank" ; includes an entity that is doing business under the laws of the United States and is supervised and examined by federal banking authorities. This exemption for banks has been sharply limited by recent U.S. legislation and is the subject of ongoing SEC rulemaking.

7 Money Laundering

U.S. registered open-end funds are required to establish anti-money laundering ("AML") programs under recent Treasury Department regulations. The Treasury Department is also considering how to apply these requirements to closed-end funds and unregistered funds. An AML program generally consists of internal policies and procedures designed to prevent and detect money laundering transactions involving shares of the fund, designation of an officer responsible for compliance with applicable regulations, training of employees, and independent testing of the program. Other financial institutions, including banks and broker-dealer firms, also are required to comply with AML requirements.

8 Sarbanes-Oxley

The recently enacted Sarbanes-Oxley Act of 2002 ("SOX") imposes a number of new requirements on U.S. registered open-end and closed-end funds. The SEC is in the process of adopting extensive rules to implement various requirements. Significantly, SOX requires the chief executive officer and chief financial officer of a registered fund to certify certain of the fund's financial statements filed with the SEC. Funds will be required to maintain controls and

procedures designed to ensure that information the fund is required to disclose in its periodic reports is recorded, processed, summarized and reported on a timely basis. Funds will be required to periodically evaluate the effectiveness of these disclosure controls and procedures.

9 Investment Advisers Act

Investment managers and advisers must register with the SEC under the Advisers Act under certain circumstances. Managers and advisers with offices in the United States may also be required to register with the states in which their offices are located.

Generally, investment managers and advisers organized and operating outside of the U.S. must register with the SEC once they have 15 or more clients in the U.S. in any one 12-month period or once they hold themselves out to the public in the U.S. (e.g., advertise) as investment managers/advisers. Further, a manager/adviser (as well as any sub-adviser) of a fund that is registered with the SEC must register as well with the SEC under the Advisers Act. Accordingly, if a fund is considering marketing its shares in the U.S. it must pay close attention to the consequences for its manager/adviser. In determining whether a fund's manager/adviser will need to register, the manager/adviser will need to count up the number of its U.S. clients and review its promotional materials. With respect to counting the number of clients, a fund generally counts as a single client unless the investors have the ability to "opt in" or "opt out" of specific fund investments. If the fund and the manager/adviser are organized outside of the U.S., the fund will generally not count as a U.S. client even though it may have U.S. shareholders. Equally, the offer and sale of a fund in the U.S. would not cause, without more, the fund's manager/adviser to be holding itself out to the public in the U.S. as an investment manager/adviser. Of course, if the fund sponsor decides to register the fund with the SEC, the fund's manager/adviser and sub-adviser would have to register with the SEC under the Advisers Act.

10 Special Considerations for Sales to Employee Benefit Plans Subject to ERISA

An investment fund offering its shares to U.S. investors that are employee benefit plans or trusts within the meaning of, and subject to, the fiduciary provisions of ERISA (an "ERISA Plan") or Individual Retirement Accounts ("IRA") or Keogh Plans ("Keogh Plan") subject to the prohibited transaction rules of the Internal Revenue Internal Revenue Code (ERISA Plans, IRAs and Keogh Plans being collectively referred to hereafter as "Plans," and each U.S. investor that is a Plan is referred to hereafter as a "Plan Investor") should consider the following. [viii](#)

10.1 General Fiduciary Matters

Fiduciaries of a Plan typically analyze, in light of the substantial restrictions on transfers and redemptions by shareholders and the illiquidity of shares offered by a fund, whether the investment is in accordance with the documents and instruments governing the Plan and the applicable provisions of law relating to a fiduciary's duties to the Plan. ERISA and the Internal Revenue Code impose certain duties on persons who are fiduciaries of plans and prohibit certain transactions involving the assets of a Plan and its fiduciaries or other interested parties. Under ERISA and the Internal Revenue Code, any person who exercises any authority or control over

the management or disposition of the assets of a Plan is considered to be a fiduciary of the Plan, subject to certain exceptions that are not relevant to a fund.

10.2 Investment Analysis Required

In determining whether to make an investment in a fund, ERISA Plan fiduciaries must give appropriate consideration to, among other things, the role that a particular investment plays in such ERISA Plan's portfolio, taking into consideration whether the investment is designed reasonably to further the ERISA Plan's purposes, an examination of the risk and return factors, the portfolio's composition with regard to diversification, the liquidity and current return of the total portfolio relative to the anticipated cash flow needs of the ERISA Plan, the projected return of the total portfolio relative to the ERISA Plan's objectives and the right of investors to redeem or to transfer their shares in the investment. Accordingly, in deciding whether to make an investment in a fund, ERISA Plan fiduciaries must consider the fund's investment objectives and risks, and any applicable transfer or redemption limitations or restrictions.

10.3 Representations by ERISA Plan Fiduciaries

The fiduciaries of each ERISA Plan proposing to invest in a fund should represent that they have been informed of and understand the investment objectives, policies and strategies of a fund, and that the decision to invest assets of the ERISA Plan in a fund, is consistent with the provisions of ERISA that require diversification of ERISA Plan assets and impose other fiduciary responsibilities.

10.4 Effect of Having Relationships with Affiliates of a Fund

To the extent that a prospective Plan Investor may have relationships with the investment manager of a fund, the sponsors of the fund, or any of their affiliates, each of the latter may be deemed to be a party in interest to and/or a fiduciary of such ERISA Plan. ERISA prohibits Plan assets from being used for the benefit of a party in interest and also prohibits an ERISA Plan fiduciary from using its position as a fiduciary to cause the ERISA Plan to make an investment from which it or certain third parties in which such fiduciary has an interest would receive a fee or other consideration. Accordingly, any ERISA Plan Investor with a relationship with any of the parties referred to above should consult with counsel to determine if its participation in a fund, is a transaction that is prohibited by ERISA or the Internal Revenue Code. In some cases, such investment is permitted if the Plan Investor satisfies certain additional conditions and the fiduciaries of such Plan represent that the decision to participate in a fund, was made by them as fiduciaries who are independent of such affiliated persons, who are duly authorized to make such investment decision and who have not relied on any advice or recommendation of such affiliated persons as a primary basis for making the decision to purchase shares of a fund. Similar prohibitions apply under the Internal Revenue Code to fiduciaries of IRAs and Keogh Plans.

10.5 Fund Assets as Plan Assets

If the assets of a fund are regarded as "plan assets" of a Plan, the investment manager of the fund would be a "fiduciary" (as defined in ERISA) with respect to such Plan, and would be subject to

the obligations and liabilities imposed on fiduciaries by ERISA. Moreover, various other requirements of ERISA also would be imposed on the fund. In particular, rules restricting transactions with "parties in interest" and prohibiting transactions involving conflicts of interest on the part of fiduciaries would be imposed on the fund unless the fund obtained appropriate exemptions from the U.S. Department of Labor. Any of these developments could have a material adverse affect on the performance of a fund.

The U.S. Department of Labor has published a regulation (the " Regulation") describing when the underlying assets of an entity in which a Plan invests will constitute "plan assets" for purposes of ERISA and the Internal Revenue Code. The effect of the Regulation is to treat certain entities as pooled funds for the collective investment of plan assets. The Regulation provides that, as a general rule, when a Plan invests assets in another entity, the Plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity. However, when a Plan acquires an "equity interest" in an entity that is not (a) a "publicly offered security," (b) a security issued by an investment fund registered under the Investment Company Act, or (c) an "operating company," then the Plan's assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established that the equity participation in the entity by "benefit plan investors" is not "significant."

Equity participation in an entity by benefit plan investors is considered " ;significant" if 25% or more of the value of any class of equity interests in the entity is held by such benefit plan investors. Benefit plan investors include employee benefit plans as defined in section 3(3) of ERISA, whether or not subject to Title I of ERISA, plans described in Section 4975(e)(1) of the Internal Revenue Code (which includes IRAs and Keogh Plans), government plans, foreign (*i.e.*, non-U.S.) plans, church plans and entities whose underlying assets include plan assets by reason of a Plan's investment therein. Furthermore, for purposes of determining whether benefit plan investors hold 25% or more of the value of any class of equity interest, those equity interests held by any person (other than a benefit plan investor) who has discretionary authority or control with respect to the assets of a fund or any person who provides investment advice for a fee (direct or indirect) with respect to such assets or any affiliate of such person, will be disregarded. Accordingly, funds that are not registered with the SEC are cautioned to limit the percentage of their shares that may be held by Plans to below 25%.

11 U.S. Tax Considerations for U.S. Registered Funds

11.1 Taxation of U.S. Funds Registered as Investment Funds

Investment funds that are registered with the SEC can eliminate their U.S. income tax liability as long as they comply with certain requirements of the U.S. Internal Revenue Code. Briefly, corporations and certain business trusts operating in the United States are normally subject to income tax on their net income, including their net realized capital gains. After these income taxes are paid by the corporation or trust, the net income will be taxed again once it is distributed by the corporation or trust to its shareholders or beneficiaries. In contrast, the net income received by a registered fund is not subject to income and excise tax at the fund level provided, among other things, at least 98% of the fund's net investment income, and realized net capital

gain, received during each tax year is distributed to the fund's shareholders. Further, a registered fund must maintain a high level of diversification among its portfolio securities, having at least 50% of its assets consisting of U.S. government securities and/or securities in which it has invested no more than 5% of its assets. For example, if a fund had 20% of its assets in U.S. treasuries and another 40% in investments where the fund had invested more than 5% of its assets, then the other 40% of its assets would have to be small holdings, i.e., each less than 5% of its assets. In addition to satisfying the diversification requirement, the fund also must derive at least 90% of its gross income from its investments in securities and other financial instruments, such as dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of securities or foreign currencies, or other income derived from its business of investing in such stock, securities, or currencies, such as gains from options, futures, or forward contracts.

11.2 Taxation of U.S. Shareholders

If a fund meets the above requirements, U.S. shareholders are then required to include their respective portions of the distributed net investment income and capital gains in their personal income tax returns. When the net income is distributed, the fund must notify its U.S. shareholders what percentage of the income being distributed constitutes ordinary income (basically dividend and interest income and short-term capital gains) versus long-term capital gains. This information is of particular importance to individual U.S. shareholders because ordinary income and long-term capital gains are taxed at different rates (currently, maximum 38.6% versus 20% for U.S. individual taxpayers) and can have other financial consequences. A registered fund's unrealized capital appreciation is not taxable.

11.3 Taxation of Non-U.S. Shareholders

Generally, non-U.S. investors receive favorable tax treatment on their U.S. securities investments. Under the basic rules, non-U.S. investors are exempt from U.S. income and withholding taxes on capital gains received from the sale of U.S. equity and fixed-income securities. Non-U.S. investors will be subject to withholding taxes at the rate of 30% (or lower treaty rate, if any) on dividends received on U.S. equity securities but will generally be exempt from withholding taxes on interest received from most types of U.S. fixed-income securities. These tax rules apply to investments in funds but can have unexpected consequences. First, distributions to non-U.S. shareholders are generally treated as dividends and funds must therefore deduct (and remit to the IRS) the 30% withholding taxes from these distributions (absent an applicable lower treaty rate). As a consequence, withholding taxes must be deducted on interest income distributed as dividends by such funds from fixed-income investments even though there would have been no withholding obligation if the non-U.S. shareholders had held the fixed-income investments directly. Further, a fund is required to deduct withholding taxes on the distribution of its short-term capital gains arising from the sale of securities held by such fund even though again there would have been no withholding obligation for non-U.S. shareholders if they had disposed of such securities directly. On the other hand, distributions of a fund's long-term capital gains will not be subject to withholding taxes. Short-term capital gains are gains derived from the sale of an investment that has been held by the fund for a year or less and long-term capital gains are derived from investments that have been held by the fund for more than a

year. Note that the question of whether a fund's gains are long or short-term does not depend upon how long the non-U.S. shareholder has held his or her shares in the fund. In fact, there can be some odd consequences to this distinction. For example, a shareholder that purchases his or her shares in a fund late in a calendar year could still be liable for a portion of the taxable income or capital gains that were generated prior to the shareholder's investment even though the shareholder has experienced a loss in the net asset value of his or her shares since the investment date.

A fund's distributions are treated as U.S. source income notwithstanding that all or a part of its income may come from non-U.S. sources. As a result, U.S. withholding taxes must be deducted from distributions to non-U.S. investors of dividend and interest income and short-term capital gains from the fund's foreign-source income even though there would have been no withholding obligation if the investor had received the income and capital gains directly.

Funds must file Form 1042 with the IRS to report and remit withholdings made for non-U.S. shareholders. The name and registered address of each such shareholder must be disclosed on the form.

Additional U.S. tax problems arise under the estate (inheritance) tax laws. Under the generally applicable U.S. estate tax principles, non-U.S. investors are subject to estate taxes on their U.S. situs property. The term "situs" is a technical tax concept that assigns a location to different classes of assets based on various factors. For example, equity and fixed-income securities have a situs at the headquarters of their issuers. Accordingly, non-U.S. individual investors may be subject to U.S. estate taxes on their investments in securities that have a U.S. situs. This estate tax principle applies to shares in U.S. funds as well. However, there is an additional adverse consequence for non-U.S. investors because the estate tax laws will ignore the situs of the investment assets held by the funds. Therefore, a non-U.S. shareholder of a U.S. fund that holds investments in non-U.S. securities (*i.e.*, securities that do not have a U.S. situs) would effectively become subject to U.S. estate taxes on the value of the non-U.S. securities held by the fund even though the investor would not have been subject to such tax if he or she had held the non-U.S. securities directly.

Based on the tax consequences outlined above, non-U.S. fund sponsors that plan to organize SEC-registered funds should not allow their non-U.S. clients to invest in the funds absent some other compelling reasons and full disclosure of the tax consequences.

12 U.S. Tax Considerations for Foreign Funds

Foreign funds (meaning funds organized as corporations outside of the United States) that desire to distribute their shares in the United States must weigh any U.S. tax consequences to the funds and their U.S. taxable and tax-exempt investors.

12.1 Taxation of a Foreign Fund in the United States.

Following the adoption of the Taxpayer Relief Act of 1997, Section 864(b)(2) of the Internal Revenue Code, provides that, for tax years beginning after December 31, 1997, a foreign fund

that engages in the United States in trading securities or commodities (including futures or other contracts or options to buy or sell securities or commodities) for its own account and does not engage in other activities that constitute engaging in a U.S. trade or business will not be treated as being engaged in a U.S. trade or business. If a fund is found to be engaged in a U.S. trade or business, it would be taxed on its income at corporate rates up to 35%.

If a foreign fund is not deemed to be engaged in a U.S. trade or business, it will not be subject to U.S. income tax on any of its trading profits. A foreign fund will, however, be subject to tax at a flat rate of 30% (or lower tax treaty rate) on the gross amount of certain U.S. source income that is not effectively connected with a U.S. trade or business, generally payable through withholding. Income subject to such a flat tax is of a fixed or determinable annual or periodic nature, including dividends and certain interest income. Certain types of income are specifically exempted from the 30% tax.

A foreign fund that is organized as a partnership or other form of flow-through entity, will be treated as tax-transparent by the Internal Revenue Service. Because of this, the limited partnership or limited liability company form of organization is attractive to U.S. investors as an alternative to the perceived complexity of the PFIC/QEF form of organization.

12.2 U.S. Taxation of Taxable U.S. Investors.

A foreign fund organized as a corporation will generally be treated as a Passive Foreign Investment Company ("PFIC") for U.S. federal income tax purposes. U.S. investors in PFICs, other than U.S. investors that make the QEF election described below, are subject to special rules for the taxation of "excess distributions" (which include both certain distributions by a PFIC and any gain recognized on a disposition of PFIC stock). In general, Section 1291 of the Internal Revenue Code provides that the amount of any "excess distribution" will be allocated to each day of the U.S. investor's holding period for its PFIC stock. The amount allocated to the current year will be included in the U.S. investor's gross income for the current year as ordinary income. With respect to amounts allocated to prior years, the tax imposed for the current year will be increased by the "deferred tax amount" (an amount calculated with respect to each prior year by multiplying the amount allocated to such year by the highest rate of tax in effect for such year, together with an interest charge, as though the amounts of tax were overdue).

If the U.S. investor makes the qualified electing fund ("QEF") election provided in section 1295 of the Internal Revenue Code, the U.S. investor will be required to include its pro rata share of a fund's ordinary income and long-term gains (i.e., the excess of net long-term gains over short-term losses) in income for each taxable year and pay tax thereon even though such income and gain is not distributed to the U.S. investor by the fund. If a fund later distributes the income or gain on which the U.S. investor has already paid taxes, amounts so distributed to the U.S. investor will not be further taxable to the U.S. investor. A U.S. investor's tax basis in fund shares will be increased by the amount so included and decreased by the amount of nontaxable distributions. The QEF election is effective only if certain required information is made available by a fund to the IRS.

U.S. tax law also contains special provisions dealing with controlled foreign corporations ("CFCs"). If a U.S. investor owns at least 10% of the voting stock of a foreign fund, the U.S. investor is considered a "United States Shareholder" with respect to the fund. If United States Shareholders in the aggregate own more than 50% of the voting power or value of the stock of such fund, the fund will be classified as a CFC. If a fund is classified as a CFC, a United States Shareholder would generally be subject to current U.S. tax on the income of the fund, regardless of cash distributions from the fund. In addition, gain on the sale of the CFC's stock by a United States Shareholder (during the period that the corporation is a CFC and thereafter for a five-year period) would be classified in whole or in part as dividend income under current law.

12.3 U.S. Taxation of Tax-Exempt U.S. Investors.

Tax-Exempt U.S. Investors (meaning U.S. investors that are exempt from U.S. federal income tax) have special tax considerations. Income recognized by a Tax-Exempt U.S. investor is generally exempt from federal income tax except to the extent of the investor's unrelated business taxable income ("UBTI"). UBTI is defined generally as income from a trade or business regularly carried on by a Tax-Exempt U.S. Investor that is unrelated to its exempt purpose. Section 512(b) of the Internal Revenue Code generally provides that in computing UBTI there shall be excluded all "dividends," "interest" and, with certain exceptions, "gains or losses from the sale, exchange or other disposition of property."

However, if a Tax-Exempt U.S. Investor's acquisition of stock in a fund is debt financed, Internal Revenue Code Section 512(b) specifically provides that a Tax-Exempt U.S. Investor's debt-financed income will be included in computing UBTI regardless of whether such income would otherwise be excluded as dividends, interest or other similar income. Generally, debt incurred by a foreign fund organized as a corporation and not a flow-through entity is not attributed to its U.S. shareholders under current U.S. tax law, so that a Tax-Exempt U.S. Investor in a foreign corporate fund should not be attributed any borrowing or debt incurred by the fund. Accordingly, a Tax-Exempt U.S. Investor's income from a foreign corporate fund should not be treated as debt financed income under the UBTI rules (assuming such investor has not itself borrowed to acquire its investment in a fund and has not made a QEF election with respect to the fund) by reason of a fund borrowing, incurring debt or purchasing securities on margin.

If a foreign fund is treated as a PFIC for U.S. federal income tax purposes, a Tax-Exempt U.S. Investor generally should not be taxable under Section 1291 of the Internal Revenue Code on actual dividends or capital gains recognized with respect to the fund to the extent the Tax-Exempt U.S. Investor is otherwise not taxable under the UBTI provisions with respect to its stock in a fund. Under proposed regulations, if a shareholder of a PFIC is a Tax-Exempt U.S. Investor, the PFIC rules would not apply to such a shareholder unless a dividend from the PFIC would be taxable under subpart F. Under subpart F, dividends generally would not be taxable to a Tax-Exempt U.S. Investor.

13 Commodity Rules

The U.S. Commodities Exchange Act (the "Act"), and the rules and regulations promulgated thereunder, generally requires the operator of a pooled investment vehicle that invests in

commodity futures and commodity options and has U.S. investors to register as a commodity pool operator ("CPO") with the Commodity Futures Trading Commission (the "CFTC") and become a member of the National Futures Association Inc. ("NFA"). A pool is any investment fund, trust, syndicate or similar form of enterprise. The pool itself is not required to register with the CFTC although there are certain disclosure items that must be included in pool prospectuses associated with registered CPOs absent an available exemption under the Act.

13.1 Jurisdiction of the CFTC.

With limited exceptions, as described below, the CFTC has exclusive jurisdiction over futures contracts and commodity options. The CFTC does not have jurisdiction over options on securities, options on securities indices or options on foreign currencies that are traded on a U.S. securities market. The Commodity Futures Modernization Act of 2000, recently passed, prohibits transactions commonly known as wash sales, fictitious sales, accommodation trades or executed on the basis of prices that are not true or are not bona fide. The new legislation also expressly allows trading of security futures, including single securities and security indices. Lastly, the Commodity Futures Modernization Act of 2000 gives the SEC jurisdiction over security futures.

13.2 Regulation and Registration of Commodities Pool Operators.

As mentioned above, the commodity rules govern CPOs rather than the commodity funds. The CFTC's jurisdiction over CPOs depends on the existence of contacts with the United States or with U.S. persons and whether the CPOs are investing in commodities subject to the CFTC's jurisdiction. States also regulate CPOs.

According to the applicable rules and regulations, it is unlawful for any person not registered as a CPO to operate a commodity pool that trades in futures contracts or commodity options on or subject to the rules of any U.S. commodity exchange or non-U.S. commodity exchange if such person solicits, accepts or receives funds, securities or other property for investment in the pool from any U.S. Persons. The CFTC has asserted that the registration requirement extends to the operator of a foreign pool even if the operator is not a U.S. resident.

In addition to the registration of the CPOs, the commodity regulations obligate "associated persons" and "principals" of the CPOs to register with the NFA. Associated persons are partners, officers, employees, consultants and any agents of the CPOs. Principals are individuals that are sole proprietors, general partners, officers, directors, branch officers, managers, designated supervisors, or other persons performing similar functions or having the power to exercise a controlling influence over the applicant or any holder or beneficial owner of 10% or more of the outstanding shares of any class of stock of the applicant or any person who has contributed 10% or more of the outstanding shares of any class of stock of the applicant or any person who has contributed 10% or more of the capital.

As a registered CPO, the entity must meet certain disclosure, reporting and recordkeeping requirements. CPOs must provide prospective investors with a disclosure document. In addition to disclaimers of CFTC review or approval, the document must contain other extensive

information. The CPOs are also required to file with the CFTC two copies of their annual reports to pool participants . Lastly, CPOs must record different types of data regarding their activities .

13.3 Exclusions from Commodity Pool Operator Definition.

A non-U.S. operator of an offshore fund that has no U.S. investors may invest directly (or may employ a U.S. commodity adviser or futures commission merchant to invest) in the U.S. futures contract markets and trade U.S. exchange-traded commodity instruments without being required to register as a CPO with the CFTC. Specifically, the CFTC staff has stated that it would not recommend enforcement action based upon the failure of a person operating a commodity pool outside of the United States to register as a CPO with the CFTC even though the pool invests in U.S. commodity futures where the following facts are present:

- (a) such person is located outside of the United States;
- (b) such person confines its pool activities to areas outside the territorial United States;
- (c) none of the participants in the pool is a resident or citizen of the United States; and
- (d) no funds or other capital are contributed to the pool from U.S. sources.

Also, certain persons are excluded from commodity regulations on the basis that such persons are subject to regulation by other federal or state agencies. In this regard, the following are excluded:

- (a) persons that exclusively operate SEC-registered investments funds;
- (b) insurance companies;
- (c) banks, trust companies or other financial depository institution; and
- (d) persons maintaining plans subject to title I of ERISA.

13.4 Exemptions from Regulation.

Under the "single pool" exemption, a CPO that operates one pool at a time and does not receive any direct or indirect compensation and does not engage in marketing efforts is exempted from regulation. Also, a CPO that receives gross capital contributions of less than \$200,000 (including all pools that it operates) and none of its pools has more than 15 participants at any time, is exempted from commodity regulations.

An operator located outside the United States that operates a non-U.S. commodity pool that has U.S. investors may nonetheless be exempt from CPO registration if the operator only trades non-U.S. commodities futures contracts and commodity options and no more than 10% of the pool's shareholders at any one time are U.S. residents and no more than 10% of the pool's shares are held at any one time by or on behalf of U.S. residents.

13.5 Qualified Pools.

In 1992, the CFTC adopted Rule 4.7 that exempts certain CPOs from several disclosure, reporting and record-keeping provisions otherwise applicable to them. The application of this rule is subject to the fulfillment of various conditions, in particular that the pool's units must be offered on a private-placement basis only to certain highly accredited investors and non-U.S. Persons, called "qualified eligible persons."^{ix} CPOs seeking this exemption must file a notice with the CFTC claiming the application of this rule.