ICAA

September 14, 2004

Via Electronic Delivery

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Registration under the Advisers Act of Certain Hedge Fund Advisers: Rel. No. IA-2266; File No. S7-30-04

Dear Mr. Katz:

The Investment Counsel Association of America[1] appreciates this opportunity to provide comments on proposed rule 203(b)(3)-2 and corresponding amendments under the Investment Advisers Act of 1940, which would require investment advisers to hedge funds[2] to register with the Commission under the Advisers Act.[3] This letter supplements our prior comments submitted in response to the Hedge Fund Roundtable conducted before the Commission in May 2003.[4] The ICAA supports the Commission's proposal to require registration of hedge fund advisers.

As discussed in our Roundtable Letter, the ICAA recognizes the benefits hedge funds offer to eligible investors by providing an effective alternative investment strategy that may reduce portfolio risk, as well as the important role hedge funds can play in contributing to the overall efficiency of our marketplace.[5] We believe that hedge funds

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1 The ICAA is a not-for-profit association that represents the interests of the registered investment advisory profession. Founded in 1937, the ICAA's membership today consists of approximately 350 SEC-registered investment advisory firms that collectively manage in excess of $4 trillion for a wide variety of institutional and individual clients. See www.icaa.org for more information.

2 The term "hedge fund" is not defined under the federal securities laws and has no precise legal definition. The term generally refers to an unregistered pooled investment, privately organized, not advertised, and administered by professional investment managers, whose securities are privately placed with wealthy individual and institutional investors. *See generally* Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission at 3 (Sept. 2003).

3 *Registration Under the Advisers Act of Certain Hedge Fund Advisers*: Rel. No. IA-2266; File No. S7-30-04 (July 20, 2004) (proposal).

4 *Letter to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, from David G. Tittsworth, Executive Director of the Investment Counsel Association of America, Re: Comments on the Hedge Fund Roundtable, File No. 4-476* (July 7, 2003) (Roundtable Letter).

5 Roundtable Letter at 3.

play an important role in the global financial services marketplace. Accordingly, we applaud the Commission for issuing a proposal that does not interfere with or impede innovation and strategies that have characterized the hedge fund industry.

We concur with the Commission's conclusion that more information is needed about hedge funds and their managers. Registration of hedge fund advisers will allow the Commission to gain a better understanding of the industry and enable the Commission to identify any problems before they develop. In addition, investors and the marketplace will benefit from the disclosure, compliance protocols, recordkeeping, and regular examination requirements that will accompany registration of hedge fund managers.

We offer our additional comments and suggestions in response to the proposal below for the Commission's consideration.

1. Definition of Private Fund

Section 203(b)(3) of the Advisers Act currently exempts hedge fund managers from registration under the Advisers Act that have 14 or fewer clients and do not hold themselves out generally to the public as an investment adviser. [6] As discussed in the proposal, the Commission has historically permitted an adviser to treat a limited partnership as the "client" for purposes of this exemption if, among other things, the advice provided to the limited partnership is based on the investment objectives of the partnership rather than those of each limited partner.[7]

The proposal would eliminate this exemption for hedge funds by requiring an adviser to a "private fund" to count each owner of the fund as a client for purposes of determining the availability of the private adviser exemption of section 203(b)(3) under the Advisers Act.[8] We believe this "look through" to the underlying investors for purposes of determining an adviser's obligation to register is appropriate. As discussed in the Roundtable Letter, we strongly agree with the approach in the proposal that the "look through" should be limited to the narrow purpose of requiring hedge fund manager registration.[9]

A "private fund" generally is defined under proposed section 203(b)(3)-2(d)(1) as a fund that: (1) relies on exemption 3(c)(1) or 3(c)(7) under the Investment Company Act of 1940 to avoid registration under the Investment Company Act; (2) permits its owners

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6 This exemption is referred to as the "private adviser" exemption.

7 *See* proposal at 36 (discussing the adoption of Advisers Act Rule 203(b)(3)-1 and related commentary).

8 *See* proposed rule 203(b)(3)-2.

9 Roundtable Letter at 6.

to redeem some portion of their ownership interests within two years of purchase; and (3) is offered based on the investment advisory skills, ability, or expertise of the adviser.[10]

The proposal includes an exemption to this definition for a "private fund" that: (1) is located outside the United States; (2) made a public offering of its securities outside the United States; and (3) is regulated as a public investment company outside the United States.[11] An adviser would not be required to look through funds that have these characteristics to count the individual underlying investors.

We support the definition of "private fund" and its corresponding exemption as proposed. In response to the Commission's specific request for comment,[12] we also support as proposed: (1) applying the current asset under management structure (under which advisers with 25 million dollars or more in assets under management are eligible to register with the SEC) to all advisers; and (2) the two-year lock-up period.

2. Offshore Advisers and Funds

The proposal would require an adviser that is located outside of the United States (an offshore adviser) to look through the funds the adviser manages to count U.S. investors as clients, regardless of the location of the fund. An offshore adviser that manages a fund comprised of 14 or more U.S. investors (or other advisory clients) would generally be required to register under the Advisers Act,[13] regardless of the amount of assets under management attributable to U.S. investors. However, under the proposal the Commission would permit an offshore adviser to a fund located outside the United States (an offshore fund) to treat the fund as a client for all purposes under the Advisers Act, other than (1) determining the availability of section 203(b)(3); and (2) the provisions prohibiting fraud.[14]

We believe that the requirement for registration under the Advisers Act should turn on the number of U.S. investors, and that the amount of assets under management attributable to U.S. investors is a secondary consideration. We also agree with the proposal's aim of limiting the extraterritorial application of the Advisers Act to offshore funds. Accordingly, we strongly support as proposed the Commission's approach to the regulation of offshore advisers and offshore funds.

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10 *See* proposal at 89.

11 Proposed Section 203(b)(3)-2(d)(3).

12 Proposal at 40 and 49.

13 As discussed in the proposal, if no other exemption is available, the adviser would be required to register regardless of its assets under management, because the $25 million threshold does not apply to advisers that do not have a U.S. principal place of business (Proposal at 42 and accompanying notes).

14 Proposal at 44 (discussing the applicability of *Uniao de Banco de Brasileiros S.A.*, SEC Staff No-Action Letter (July 28, 1992) under such circumstances).

3. Performance Records

The Advisers Act requires an adviser to maintain certain documents to support the firm's performance claims for a period of five years after the performance information is last used.[15] The proposal would permit a new registrant to retain whatever information the firm has to support the performance earned prior to registration under the Advisers Act, and would excuse the firm from fulfilling the specific requirements of rule 204-2 for the period before becoming registered.[16]

We understand the importance of permitting hedge fund managers to preserve their performance history. However, this interest must be balanced against the potential to mislead investors. As a solution, we suggest that registrants that cannot fulfill the requirements of rule 204-2 be required to include a legend on any advertisement that alerts investors that the firm has not maintained records supporting performance calculations for the period in question.

4. Qualified Clients and Performance Fees

Rule 205-3 currently permits registered advisers to charge performance fees only to "qualified clients" and requires the adviser to a fund exempt from registration under section 3(c)(1) of the Investment Company Act to look through the fund to determine whether all investors are qualified clients.[17] As discussed in the proposal, although many managers of hedge funds require investors to meet the criteria of a qualified client, many do not. The proposal would amend rule 205-3 to avoid requiring hedge fund investors to divest their current interests in a fund because they do not meet the definition of "qualified client." The amendment would permit current investors that are not qualified clients to retain their existing investments in that fund and to add to that account.

We agree it would be unfair to the particular investors and disruptive to markets generally to require investors who are not qualified clients to divest from their funds, and therefore strongly support this aspect of the proposal. However, we recommend limiting this exemption to current accounts and prohibiting an investor that is not a qualified client from opening a new account or investing in other accounts managed by the same adviser that charge performance fees.

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15 *See* Advisers Act Rule 204-2(a)(16).

16 Proposal at 51.

17 Advisers Act Rule 205-3(a) and (b). In order to qualify as a "qualified client" an investor must generally place a minimum of $750,000 under management with a particular adviser or have a net worth of $1.5 million.

5. CFTC Registration

In a dissent to the proposal, Commissioners Glassman and Atkins specifically request comment on whether there should be an exemption to registration under the Advisers Act for advisers that are registered with another government agency.[18] We do not necessarily believe that registration under the Advisers Act should be required for managers that are registered as commodity pool operators (CPOs) or commodity trading advisers (CTAs) under the Commodity Exchange Act (CEA) with the Commodity Futures Trading Commission (CFTC). Registered CPOs and CTAs are subject to disclosure and recordkeeping requirements, as well as to examinations by the National Futures Association (NFA),[19] and we are not aware of any evidence to suggest that the CFTC reporting requirements and the NFA examination process is insufficient to provide proper regulation of these entities.

Requiring the dual registration of a hedge fund manager with the CFTC and the Commission would impose an unnecessary, additional layer of regulation on the manager and therefore may be an unjustifiable commitment of Commission resources. In response to the Commission's concern that amendments to the CEA may allow advisers to avoid registration,[20] we recommend that the Commission provide an exemption from registration under the Advisers Act only to hedge fund managers that are actually registered as CPOs or CTAs with the CFTC and subject to NFA examination.

6. Costs Associated with Registration under the Advisers Act

Finally, we must take issue with the statements in the proposal that the burdens of registration under the Advisers Act are "minimal" and the costs associated with registration "would not be high."[21] Registered advisers incur considerable costs in their commitment to fulfilling their fiduciary obligations under the Advisers Act. The dissent correctly notes that registration under the Advisers Act is meaningful and carries with it substantive requirements[22] including: compiling and updating Form ADV,[23] developing

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18 Dissent to the proposal at 110.

19 Proposal at 34-35; *See also Testimony of Patrick J. McCarty, General Counsel of the Commodity Futures Trading Commission before the U.S. Senate Committee on Banking, Housing and Urban Affairs* (July 15, 2004) (stating that CPOs and CTAs are inspected generally on an average of every 2.5 to 3 years for compliance with CFTC recordkeeping, disclosure, and reporting requirements).

20 Proposal at 35 and accompanying notes.

21 Proposal at 31, 63 (estimating the costs to establishing a compliance infrastructure to be "$20,000 in professional fees and $25,000 in internal costs including staff time").

22 Dissent to the proposal at 104-05.

23 We note that Form ADV will provide many details about hedge fund advisers that are needed to address concerns about the hedge fund industry. Part 1 of Form ADV provides much more than "a census of name, address, and amount of assets under management" (see dissent to proposal at 101). Part 1 provides, among other things, information about clients, other business activities of

and overseeing proxy voting policies and procedures, establishing and implementing a compliance program designed to prevent violations of the securities laws, and developing and enforcing a code of ethics.[24] The new investment adviser compliance program rule alone has resulted in significant, additional costs for many investment advisory firms. The rule, which was unanimously approved by the Commission, will result in fundamental changes in investment adviser compliance activities and will require a substantial expenditure of time, effort, and resources by all investment advisory firms. On one hand, we believe it is inconsistent to argue that the proposed hedge fund rule should not be adopted due to the significant costs involved, when the Commission has unanimously voted to impose such costs on all investment advisory firms, including the thousands of advisory firms that are small businesses.[25] On the other hand, we disagree with the claim that the costs of adviser registration and compliance are relatively inconsequential and thus will not pose any burden for hedge fund advisers. The fact is that investment adviser registration and compliance have become increasingly complex and costly.

Despite these costs, the relative risks involved with many hedge fund activities, as compared to many investment advisory activities, clearly justify the imposition of investment adviser registration and compliance requirements for hedge fund advisers. The fact that an increasing number of hedge fund managers already are voluntarily complying with the Advisers Act registration and regulatory requirements would appear to support the conclusion that such requirements do not present inappropriate obstacles to hedge fund management. We also note that the costs associated with registration under the Advisers Act have been borne by thousands of small investment advisers; we believe that hedge fund advisers are in at least an equal, if not better position to bear these costs.

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We commend the Commission for the thoughtful and deliberate approach taken to the issue of registration of hedge fund managers. Please do not hesitate to contact our organization if we can be of any further assistance.

Sincerely,

David G. Tittsworth
Executive Director

Caroline Schaefer
Associate General Counsel

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the adviser, financial industry affiliations, limited partnerships and limited liability companies for which the adviser serves as a general partner or manager, participation or interest in client transactions, custody of client assets, control persons, and financial and disciplinary issues.

24 *See* Form ADV Part 1 and II, and Advisers Act rules 206(4)-6, 206(4)-7, and 204A-1.

25 *Evolution Revolution: A Profile of the Investment Advisory Profession* (May 2004) at 6 (finding that 50% of registered advisory firms reported having between one and five employees, and that 68.5% reported having ten or fewer employees).

Cc: Hon. William H. Donaldson
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