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September 14, 2004

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

Re: Release No. IA-2266; File No. S7-30-04
RIN 3235-AJ25
Registration Under the Advisers Act of Certain Hedge Fund
Advisers: Proposed Rule 203(b)(3)-2 and Amendment to Rule
203(b)(3)-1

Dear Mr. Katz:

We are grateful for the opportunity to comment on proposed Rule 203(b)(3)-2 and the proposed amendments to the 203(b)(3)-1 (collectively, the "Proposed Rule") under the Investment Advisers Act of 1940 (the "Advisers Act").

We know that the Securities and Exchange Commission (the "SEC") will be receiving numerous sophisticated and learned comments on the Proposed Rule. We will not presume upon the SEC's time or resources to reiterate here arguments which, we are confident, will be made more eloquently and more persuasively by others. Rather, we wish simply to emphasize that the Proposed Rule could achieve its desired effect, while at the same time allaying substantially all of the — in our experience, unprecedented — controversy which the Proposed Rule has generated, simply by focusing on assuring compliance with the substantive, rather than the procedural, aspects of the Advisers Act. We would only propose such a focus for advisers ("Exempt Managers") which would be exempt from registration were it not for the Proposed Rules — *i.e.*, advisers whose investors are highly sophisticated and financially experienced, fully able to "fend for themselves" and which have no need of the prophylactic procedural requirements imposed in the retail advisory context. For this very limited group of managers and investors, it should be only the substantive, not the procedural aspects of the Advisers Act that merit regulatory attention, while it is the latter which have done the most to provoke objections to the Proposed Rule.

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The hedge fund industry's concern about the Proposed Rules is certainly not that SEC registration will uncover widespread wrong doing or curtail currently common practices. On the contrary, the industry as a whole welcomes the identification and elimination of fraud and misconduct, and in our experience hedge fund managers ("Hedge Fund Managers") are self-regulated by an extremely strict code of substantive conduct — imposed by their highly influential and sophisticated investors. (We know of few Hedge Fund Managers which do not already fully comply with the substantive provisions of the Advisers Act simply as a matter of "best practices.") Nor is the widespread objection to the Proposed Rules based on any rejection of the oversight authority and jurisdiction of the SEC. In our view, the major reason for the industry's rejection of the Proposed Rules is mundane, practical and purely procedural: the Proposed Rules would subject Exempted Managers to the *routine* SEC audit process.

It is important not to under-estimate the enormous burden of complying with the innumerable technical requirements involved in the *routine* audit process, especially given the complexity of many hedge funds' operations and portfolios. All one needs to do is see the voluminous "standard" SEC audit document request list to comprehend the extent of this burden in the Hedge Fund context. Two Hedge Fund Managers for which we work have each recently spent what we estimate at between \$300,000 – \$500,000 solely in out-of-pocket costs preparing for and then hosting their SEC auditors — a figure which does not begin to reflect the much greater opportunity costs incurred in terms of the time expended by senior level personnel in connection with the audit. Nor is the industry's concern only with cost and administrative burden. There is material concern over the risk of enterprise value damaging SEC "write-ups" for procedural violations undertaken entirely in the good faith. How can a Hedge Fund Manager predict, for example, if the SEC auditors will agree with (or even fully understand) the elaborate and sophisticated valuation procedures which such Manager has developed over the years for esoteric derivatives or with the method in which leveraged performance figures for derived portfolios are explained to highly sophisticated investors? SEC audits are feared by Exempt Managers, despite those Exempt Managers following all "best practices" and having passed muster with the most influential and sophisticated investors in the world, not because of any concern about possible substantive misconduct, but because of the "loose cannon" effect which is an inevitable component of the audit process — especially when rules designed in the retail, traditional investment context are attempted to be applied to Hedge Funds. The irony, of course, is that Exempt Manager's investors are recognized by the SEC itself as those that have the least need of any investor group for audit protection. Hedge Fund investors have the bargaining power and the resources to insist on rigorous and ongoing due diligence, external confirmation of net asset values, special reporting requirements, etc. They neither need nor want the protection of a *routine* SEC audit. (We will not dwell on the point as others have made it forcefully, but *routine* audits of Hedge Funds will also require a massive and ongoing education and reeducation of the SEC audit staff, which can hardly be expected currently to be trained to audit, for example, the mark-to-market pricing of catastrophe bonds, credit derivatives or reinsurance "industry loss warrants.")

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Rather than impose specific record-keeping, performance presentation and *routine* audit requirements on Exempt Managers (of course, if the SEC determines that there is *cause* to audit an Exempt Manager, the SEC would have full authority to do so), we urge the SEC (as the CFTC has done for years under its Rule 4.7) to require simply that Exempt Managers maintain for the statutory period those records which they create in operating their funds. Hedge Fund investors insist on excellent record-keeping; there is no investor-related issue here, only the waste and inefficiency that would result from compelling the Hedge Fund Managers to conform their detailed and customized record-keeping to the technical requirements of the Advisers Act (requirements directed at materially different investment vehicles and strategies than those relevant to Exempt Managers).

Prior to the promulgation of the Proposed Rule, there was talk of an “RIA lite” registration status. We strongly urge that this principle be incorporated into the Final Rule. This approach is, we suggest, the optimum means of harmonizing the SEC’s objective of jurisdictional and supervisory authority over Hedge Funds while avoiding imposing enormous and unproductive audit burdens on Exempt Managers (as well as corollary burdens on the SEC Staff attempting to perform the audits). At the same time, this approach will avoid diverting the SEC Staff’s limited resources from the audit of advisers which have retail clients who cannot “fend for themselves” to the audit of Exempt Managers. Many have argued that Hedge Funds are not in need of regulation; reasonable people may differ over this issue, but we doubt that there can be significant credible dispute that subjecting Exempt Managers to *routine* audits would be costly, time consuming and without regulatory purpose.

In addition to recommending “RIA lite” registration for Exempt Managers, we also strongly recommend that the SEC take note that there are a number of very prominent offshore advisers which are registered with either the Financial Services Authority (“FSA”) in England or the Commission des Opérations de Bourse (“COB”) in France, and which have U.S. “qualified purchaser” clients. (The Staff may, of course, also determine the other countries’ registrations merit similar recognition.) In the case of these advisers, it is often virtually impossible, and always extremely burdensome, to comply with the different regulatory and reporting requirements of the SEC, on the one hand, and those of the FSA and the COB, on the other. In the case of such advisers, we urge the SEC, even if requiring registration under the Advisers Act for jurisdictional and supervisory purposes, to defer to the home jurisdiction of the advisers in respect of their record-keeping and *routine* audit requirements — but, again, only in the case of such advisers which have only “qualified purchaser” U.S. clients. Applying this principle to such “Otherwise Sufficiently Regulated Managers” — as well as to the wholly-owned U.S. subsidiaries through which they typically operate in the U.S. for tax purposes — would do much to eliminate duplicative and inconsistent record-keeping and audit obligations as well as to foster further globalization of the capital markets (not to mention the regulatory goodwill of the affected jurisdictions). Furthermore, without such relief, a number of these advisers may no longer be available to U.S. investors.

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Registration, but with the associated technical compliance requirements appropriately modified to provide an “RIA lite” registration for Exempt Managers and Otherwise Sufficiently Regulated Managers, would achieve the SEC’s oversight goals, conserve SEC Staff and resources, and avoid the wholly unjustifiable regulatory and industry cost of subjecting Exempt Managers and Otherwise Sufficiently Regulated Managers to the *routine* audit process.

Again, our thanks for this opportunity to comment on the Proposed Rule.

Sincerely,

David R. Sawyer