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September 15, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Via Email

Re: File Number **S7-30-04**

Ladies and Gentlemen:

I am responding to your Proposed Rule, "Registration Under the Advisers Act of Certain Hedge Fund Advisers" (the "Rule"). I commend the U.S. Securities and Exchange Commission (the "SEC," the "Commission," or the "Agency") for continuing the public dialogue that you began with your roundtable.[1]

SUMMARY

I do not oppose mandatory registration of hedge fund ("HF") managers as advisers, but without knowing what information the SEC might collect from the managers, and therefore the benefits to the markets and investors, I cannot endorse the proposed Rule yet.

I do support the collection by the SEC of additional information about the HF industry, and a subsequent vote on whether or not to require mandatory registration of managers.

[1] I write as an individual, but my experience is as an executive at a hedge fund operation with which I have been associated since 1988. The views expressed herein are solely mine.

If the SEC votes to implement the proposed Rule immediately, I urge the Commission to eliminate the two-year lock-up provision. This part of the Rule is poor public policy.

INTRODUCTION

The Commission will soon decide whether HF managers should register as advisers, and, if so, under what current or new regulatory scheme. Before the Commission answers these questions, it must decide what it hopes to accomplish, and determine which information it needs to achieve its goals. To paraphrase the famous sage, Hillel, "The rest is commentary."[2]

"The primary mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors and maintain the integrity of the securities markets."[3] The issue of whether registration of HF managers under the Investment Advisers Act of 1940 would improve the SEC's ability to fulfill its mission raises questions about practical implementation, the specific risks related to HFs, and overall regulatory balance and fairness.

PRACTICAL IMPLEMENTATION

The Commission should be aware that even if it does not mandate HF managers to register, it is likely that, because of investor demand, many voluntarily will choose, in the coming years, to do so. More and more pension plans are insisting upon registration as a prerequisite to investment. Managers that want access to those very large investors will have two choices: register or do without this large amount of potential capital. If market solutions are preferable to new rule writing, the Commission may want to consider whether the growing movement toward voluntary registration will accomplish the goals of mandatory registration.

The Commission has asked: if managers were required to register, would U.S. HFs choose to move offshore and away from the SEC's jurisdiction. Although I doubt there would be an immediate rush to move offshore, the ability to do so, through a bit of legal and financial

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[2] *Babylonian Talmud, Shabbat* 31a
[3] http://www.sec.gov/about/whatwedo.shtml

structuring, certainly exists. This would result in diminished regulatory power because the SEC might not be able to assert its current anti-fraud powers. Specifically, the U.S. HF manager could become a trading advisor to a non-U.S.-domiciled fund without U.S. investors. U.S. investors who wanted to participate in the fund's returns could invest in derivative financial instruments through a chain of U.S. and foreign intermediaries. The infrastructure for such an arrangement already exists. Note that, when it comes to HFs, tax-exempt entities like US pension plans, endowments, and charities usually prefer to invest offshore.

RETAILIZATION AND PENSION PLANS

With regard to the issue of retail investors, the Commission should address two separate issues: U.S. registered funds of funds (RFFs) and structured products.

If the SEC feels a need to protect retail investors who provide capital to RFFs, it simply might require that an RFF that has investors who do not meet certain net-worth requirements can only invest (including through derivative financial instruments) in underlying funds whose managers are registered with the Commission.

The SEC's task with structured products is much tougher because financial engineers are engaged to construct ways that derivatively will achieve the same economic result, but avoid the regulations. Thus, if the Agency decides that it only needs to protect retail investors—and not others—the Commission, for example, may not have the authority to protect the retail investor who deposits money in a bank and receives a variable-rate principal-protected note, whose economic results derive from the performance of an HF.

I am sympathetic to the concerns that many beneficiaries of pension plans that invest in HFs may need greater protections. Although some additional regulatory safeguards may be appropriate to ensure pension beneficiary protection today, I am not sure that the SEC can make the changes without joint action with the Department of Labor ("DOL"). The DOL, whose responsibilities include protecting retirement benefits, could write a rule that requires that any pension money can be invested, directly or indirectly (including through derivative financial instruments), in a HF only if that fund's manager registers with the SEC.

This is a good plan because the HFs would decide whether to register rather than the SEC's compelling them to do so. One possible downside to this rule would be that the most attractive HFs might be the ones with the least reason to register. U.S. pension funds, in theory, could end up suffering from "adverse selection."

If the DOL wrote such a rule, it would need to consider whether to "grandfather" pension plans that invested in a HF before the date of enactment. While, at first glance, a grandfather rule would be least disruptive to the market, the fact would remain that a significant number of beneficiaries would lack SEC protection.

VALUATIONS

The SEC can have a real impact on investor protection and market integrity in the HF industry by initially focusing on valuations. Valuations are the easiest places for managers to commit fraud and the hardest areas for investors to detect problems.

I would recommend developing an official Commission manual on valuations around the white paper on valuation concepts prepared by the International Association of Financial Engineers ("IAFE").[4] Such a manual would have many roles. First, it should be used to educate the staff, especially examiners. Moreover, as a deterrent to investor fraud, the SEC could announce that it intends to use questions in the paper in its examinations. If the Commission ultimately decides to require mandatory registration of HF managers, it might even consider requiring the managers to complete a version of the manual, under penalties of perjury, with an attestation by an independent reviewer, *e.g.*, accounting firm, law firm, or valuation consultant. By relying on these private sector resources, the Commission could devote attention to other equally important areas.

REGULATORY BALANCE

With regard to maintaining the integrity of the markets, the Commission should apply the same rules to HF managers and others that engage in the same trading activities.

[4] http://www.iafe.org/upload/IAFEValuationConcepts0604.pdf

Institutional investors, proprietary trading desks of commercial and investment banks, and even some individuals may have many times more investment capital than HFs. Whether the issue is insider trading or manipulation of prices, HFs should be under the same level of market surveillance for these types of activity as any like-sized investor or one that has a similar level of trading. Therefore, the Agency should collect data that would help it assess the risk that such activities could be taking place to such an extent that surveillance would otherwise fail to detect them.

Many of these investors are not subject to the Agency's oversight because they already are regulated by, say, the Federal Reserve or Office of the Comptroller of the Currency. Yet, many HF managers currently are registered as commodity pool operators with the Commodity Trading Futures Commission ("CFTC"). The Rule suggests that CFTC-registered fund managers that want to avoid dual registration should de-register from the CFTC. It appears that, in some instances, the SEC is willing to cede oversight to some government agencies but not to others.

TWO-YEAR LOCKUP

As principal editor of the recently released IAFE white paper on valuations, I assure you that the drafters felt that valuation principles applied equally to HFs; mutual funds; real estate, venture capital, and private equity partnerships; insurance companies; commercial and investment banks; broker-dealers; government-sponsored enterprises; etc. No one thought that HFs should be subject to a different set of rules. Yet, the two-year lockup suggests that HFs be held to a different standard.

Will the SEC's proposal encourage funds to have their investors vote on changing the terms to a two-year lockup for those whose lockup is shorter? Assuming investors agree to this change, will the SEC be satisfied with this result? Even if investors would be telling the Agency that they were not interested in its protections, how would the lockup provision address market integrity? Will the practice of new funds be to have two-year lockups?

Interim valuations for, say, a private equity fund ("PEF") also matters. Here are some reasons. First, if an investor dies, for estate tax purposes, the investment should be valued at its fair market value. Second, some HFs may invest capital in PEFs. Withdrawing investors from an HF should be entitled to the same robust valuation procedures for all of the HF's investments. Third, financial counterparties ought to have accurate valuation information before they make credit decisions. Fourth, if a current investor wants to sell or transfer his or her current investment interests to another party, at what value should it be sold or transferred?

RECOMMENDATION

The SEC should survey HF managers with regard to their valuation practices and collect data to help it assess the risk that its market surveillance techniques, which it uses for other market participants, work equally as well for HFs. Based upon such information, it should assess the risks that HF investors are being defrauded and that HFs spoil market integrity. If, after such honest assessment, it concluded that HF manager registration would help it protect a large number of investors and better maintain market integrity, I would stand shoulder-to-shoulder with its Rule other than the two-year lockup. Absent assurances from the SEC that such study and data collection have taken place, I must refrain from endorsing the Rule.

Respectfully submitted,

Leon M. Metzger