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September 15, 2004

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

Re: SEC Release No. IA-2266 (File No. S7-30-04)

Dear Mr. Katz:

The Committee on Private Investment Funds of The Association of the Bar of The City of New York (the *"Committee")* is composed of lawyers with diverse perspectives on investment advisory issues, including members of law firms and counsel to private advisory and financial services firms. The Committee focuses on, among other things, the issues, trends and regulations relating to a wide variety of private investment funds, including hedge funds, buyout funds, venture capital funds, mezzanine funds, distressed funds and funds of funds. *(A list of our current members is attached.)*

The Committee is pleased to submit this letter in response to a request by the Securities and Exchange Commission (the *"Commission")* to provide comments on the proposed rule and amendments entitled *"Registration Under the Advisers Act of Certain Hedge Fund Advisers,"* Investment Advisers Act Rel. No. 2266 (July 20, 2004) (the *"Proposed Rule").*

Although we do not express a position in this letter on the relative merits of compulsory registration of hedge fund advisers under the Investment Advisers Act of 1940 (the *"Advisers Act"),* we have serious concerns that requiring most hedge fund advisers to register would be an unnecessary burden for many advisory firms whose activities are otherwise subject to the anti-fraud provisions of the federal securities laws, who maintain effective compliance controls and whose clients are financially sophisticated.[1] Moreover, although we do not address the issue in this letter, we are

[1] On December 8, 2003, the Committee submitted a comment letter on the report of the Staff of the Commission, entitled *"Implications of the Growth of Hedge Funds."* In our letter we suggested limiting the scope of the registration requirement to advisers to hedge funds relying on the exemption provided by Section 3(c)(l) of the Investment Company Act of 1940.

concerned with, and would like to further consider, the statutory authority of the Commission to count clients using the "look-through" method as provided in the Proposed Rule.

I. Definition of Private Fund

A. *General*

The Proposed Rule would require an adviser to a "private fund" to "look-through" its investment funds and count the number of investors in each (rather than counting each fund as a single client) when determining whether it is eligible for the private adviser exemption.[2] Advisers to "private funds" with 15 or more investors would be subject to registration under the Advisers Act. Defined by reference to characteristics shared by most hedge funds in the marketplace, a "private fund" is one that, among other things, permits investors to redeem any portion of their ownership interests in the fund *(i.e.,* sell them back to the fund) within two years of the purchase of such interests.

B. *Knowledgeable Employees*

The Proposed Rule suggests that all investors in a "private fund" must be counted when determining the number of clients for purposes of the private adviser exemption. The Committee believes that the Commission should exclude "knowledgeable employees" (as defined in Rule 3c-5 promulgated under the Investment Company Act) from any such investor count.

C. *Exception for Extraordinary and Unforeseeable Events*

The Proposed Rule attempts to address the special redemption or withdrawal rights that private investment funds requiring long-term commitments of capital (such as private equity and venture capital funds) typically allow for legal, regulatory or other similar reasons. The definition of "private fund" includes a limited exception for funds that allow investors to redeem their ownership interests within two years of purchase due to "events that you find after reasonable inquiry to be extraordinary and unforeseeable at the time the interest was issued."[3] As the adopting release of the Proposed Rule indicates, these extraordinary redemptions or withdrawals should not change the basic character of the private investment fund into that of a hedge fund.[4] The adopting release indicates that the Commission, in describing such events as "extraordinary and unforeseeable," is contemplating circumstances that would make it

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2 Investment advisers with fewer than fifteen "clients" during the preceding twelve months are exempted from registration under Section 203(b)(3) of the Advisers Act. This exemption is generally only available to advisers who do not hold themselves out to the public as investment advisers.

3 Rule 203(b)(3)-2(d)(2)(i) of the Proposed Rule.

4 *See* Footnote 140 to the Proposed Rule.

illegal or impractical for an investor to continue to own an interest in the fund.[5] The Committee is concerned that the term "unforeseeable" is ambiguous and difficult to apply in practice.

In many cases, the partnership agreement, the limited liability company agreement or other constituent document of a private equity or venture capital fund provides for extraordinary circumstances causing or permitting the redemption or restriction on the continued participation of an investor in the fund. For example, an investor subject to the Employee Retirement Income Security Act of 1974 *("ERISA")* may have certain contractual withdrawal rights if its continued participation would result in a violation of ERISA. Similarly, a foundation investor may be permitted to withdraw or restrict its participation if its continued investment would alter its tax status. If an investor is in default of funding its commitment or is excused from participation in a particular investment, the continued participation of the investor in the fund may be expressly restricted. Although these and other similar extraordinary circumstances rarely occur, all of them are foreseeable in the sense that they are contractually contemplated as a possibility. Therefore, we urge the Commission to remove the "unforeseeable" standard from the Proposed Rule.

D. *Private Equity and Venture Capital Funds*

Although the Proposed Rule is not intended to apply to private investment funds that are not hedge funds, the Commission is seeking comment on whether the scope of the Proposed Rule should be extended to include advisers to private equity and venture capital funds.[6] The Committee firmly believes that the Proposed Rule should not capture private equity funds,[7] venture capital funds[8] and funds of funds (including secondary funds) aimed at each of the foregoing types of funds.[9]

Many of the Commission's stated policy considerations relating to hedge funds do not apply to these other types of funds. For example, these funds generally hold securities of private companies and, therefore, do not tend to participate in the public securities markets. Even when they do, they tend to be long-term holders of large blocks of securities, rather than active traders. Consequently, the Committee does not believe

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[5] Id.

[6] *See* "Request for Comment" in Section II.D of the adopting release to the Proposed Rule. *See also* "Request for Comment" in the Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins.

[7] *See* Footnote 142 to the Proposed Rule.

[8] *See* Footnote 143 to the Proposed Rule.

[9] There are some investment management firms that advise multiple investment funds and products, including hedge funds and private equity funds. The proposed amendment to Rule 205(3) appears to cover only existing investors in hedge funds. In order to avoid the situation of investors who are not "qualified clients" being forced to redeem their interests in related private equity funds, the Committee believes that the proposed amendment should also address investors in these funds.

that these funds have a significant impact on the financial markets. Furthermore, we believe that enforcement problems and incidences of fraud relating to private equity and venture capital funds have been rare or limited.

Importantly, these types of funds use a vastly different distribution methodology to compensate the adviser *(i.e.,* distributions are generally based on available cash proceeds rather than the value of the underlying investments and, accordingly, any performance allocation to the adviser is distributed out of the realized proceeds from investments).[10] As a result, the adviser has little incentive to manipulate the value of its unrealized portfolio to the detriment of the fund's investors. Finally, the constituent documents of these types of funds tend to be heavily negotiated by large, sophisticated financial institutions, such as state pension funds, university endowments and insurance companies, that can contractually protect themselves, and that have the resources to monitor compliance by the adviser with the negotiated provisions.

II. The Look-Through Requirement

A. *General*

The Committee is concerned about the implications of adopting a "look-through" analysis on the important relationship between an adviser and its client. Among other things, we believe that "looking through" a private investment fund should not alter the duties or obligations owed by an investment adviser. By viewing a fund as a single client, the adviser is able to respond to the collective objectives and interests of the investors in each particular fund. The Proposed Rule should not in any way imply that an adviser must instead consider the diverse and specific investment objectives of each individual investor (notwithstanding that it is participating in a collective investment vehicle). We urge the Commission to clarify this point.

B. *Funds of Hedge Funds*

The Proposed Rule contains a special provision for advisers to hedge funds in which a registered investment company makes an investment.[11] Hedge fund advisers would be required to count the investors in the registered fund as clients. The adopting release to the Proposed Rule indicates that, based upon the operation of the Proposed Rule, this same "look-through" would apply in the case of an investment by an

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[10] The "value" of the underlying portfolio has a more limited relevance in private equity and venture capital funds. In certain private equity funds, unrealized losses may need to be returned through distributions before the general partner or manager receives its 20% performance allocation. Moreover, in certain venture capital funds, the general partner or manager is precluded from receiving its 20% performance allocation until the fund has satisfied a so-called "net asset value" test. In all of these cases, any valuations are only necessary to preserve the ultimate allocations based on realizations. However, it should be noted that valuation remains relevant for purposes of reporting to investors and for the marketing of follow-on or successor funds.

[11] Rule 203(b)(3)-2(b) and Section II.C.2 of the Proposed Rule.

unregistered fund of funds.[12] Furthermore, the Proposed Rule would not require the adviser to the underlying fund to receive information as to the precise number or identities of the top-tier investors - it would be sufficient if the adviser to the top-tier fund confirms to the underlying adviser that the top-tier fund has more than 14 investors.

The Committee believes that this approach is unworkable in practice and represents a significant departure from the long standing policy of the Commission on the circumstances under which an investing entity must be disregarded and the indirect investors treated as if they were direct investors in the underlying fund. The Proposed Rule does not specify when or how often the adviser to the top-tier fund would be required to report to the underlying fund adviser the number of investors in the top-tier fund. As an open-end vehicle, the top-tier fund would likely accept additional subscriptions from investors and process redemptions on a periodic basis. A fund could have fewer than 15 investors at the time of its initial investment with an underlying fund and, as the fund of funds grows, could exceed the 15 investor threshold within a short period of time thereafter. This makes planning by the underlying adviser almost impossible. A registration obligation could be triggered by circumstances entirely outside of the underlying adviser's control (and perhaps knowledge).

Section 3(c)(l) of the Investment Company Act requires a "look-through" if the top-tier fund accounts for more than 10% of the lower-tier fund's capital. An adviser seeking to avoid registration of an investment fund under the Investment Company Act could control the percentage of the lower tier fund's capital held by the fund of funds. Outside of Section 3(c)(l), there is a well-developed body of law (expressed in a series of no-action letters) that establishes the circumstances under which an investing fund must be disregarded and its investors treated as if they were investors in the underlying fund.[13] An entity will be disregarded if it is formed, or deemed to be formed, for the purpose of investing in the lower-tier fund. The Committee recommends using a similar approach in the Proposed Rule. Where an investing fund (i) has an unaffiliated investment adviser and (ii) is not formed for the purpose of investing in the lower-tier fund, no "look-through" should be required and the investing fund should be treated as one client.

C. *Offshore Advisers to Offshore Funds*

The "look-through" requirement in the Proposed Rule becomes even more problematic in the context of an offshore adviser to an offshore fund where the adviser would only be required to count U.S. investors. The Proposed Rule is unclear on whether the same "look-through" requirement would apply. The following example illustrates the difficulty in applying such a rule in the offshore context. Suppose an offshore adviser

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12 *See* Footnote 125 to the Proposed Rule.

13 *See, e.g.*, CMS Communications Fund L.P., SEC No-Action Letter (April 17, 1987); Tyler Capital Fund, L.P./South Market Capital, SEC No-Action Letter (September 28, 1987); Handy Place Investment Partnership, SEC No-Action Letter (July 19, 1989); and Cornish & Carey Commercial Inc., SEC No-Action Letter (June 21, 1996).

based in London is advising an offshore fund. The fund has no U.S. investors who have made a direct investment in the fund, but has a fund of funds investor. The fund of funds is organized offshore by an unaffiliated adviser, but has more than 14 U.S. investors. Under these circumstances, would the offshore adviser be required to register?

The Committee believes that compelling arguments can be made that the U.S. investors in the fund of funds should not be deemed to be “clients” of an offshore adviser to the underlying offshore fund. To do so would stretch current principles with respect to the reach of U.S. jurisdiction beyond recognition, as well as the notion of “client.” The indirect investors can hardly be treated as “clients” if the adviser of the underlying fund has never dealt with them and does not even know who they are. Any U.S. person investing in an offshore fund does so with full knowledge that U.S. protections are unlikely to be available. Such investors tend to be the largest and most sophisticated with less need for the protections afforded by U.S. securities laws. Moreover, if offshore advisers are faced with the choice of registering or declining to accept U.S. investors, many will choose the latter option, depriving some U.S. institutional investors of access to the most talented managers. Where, however, an offshore manager advises a U.S. domestic fund, the adviser should be treated no differently than a U.S.-based adviser. Accordingly, we respectfully request that the Commission reconsider its position on this issue.

III. Applicability of Substantive Provisions of Advisers Act to Offshore Advisers

The Proposed Rule creates a hybrid status under the Advisers Act - the offshore adviser. An offshore adviser to an offshore fund may treat the fund as the client (and not an investor) for all purposes under the Advisers Act, other than (i) determining the availability of the private adviser exemption and (ii) those provisions prohibiting fraud (Sections 206(1) and 206(2)). Although such an adviser would be required to register, most of the substantive provisions of the Advisers Act would not apply to the adviser's dealings with the fund.[14]

While the staff of the Commission believes that the principles expressed in *Unibanco*[15] provide guidance on the applicability of the substantive provisions of the Advisers Act to registered offshore advisers, we are concerned that this approach creates considerable ambiguity and uncertainty. For example, the new compliance rule was adopted under Section 206 of the Advisers Act.[16] Will offshore advisers therefore be required to adopt written compliance policies and appoint a chief compliance officer?

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[14] If an offshore adviser can hold itself out as a “Commission registered investment adviser,” even though the substantive rules of the Advisers Act do not apply to it, then this may raise a false expectation with U.S. investors that by investing with the offshore adviser they are afforded the protection of the U.S. securities laws.

[15] *Uniao de Banco de Brasileiros S.A.*, SEC Staff No-Action Letter (July 28, 1992).

[16] Rule 206(4)-7.

The policies are required to be reasonably designed to prevent violations of the Advisers Act, yet the offshore adviser is not subject to most of the substantive provisions of the Act. Will other substantive rules under Section 206 be applicable to offshore advisers? Since *Unibanco* did not contemplate an adviser with no U.S. clients, further guidance on the applicability of the substantive provisions of the Advisers Act to offshore advisers would be desirable.

IV. State Registration

A. *State Registration of Employees of SEC Registered Advisers*

The Proposed Rule, because it revises the definition of "client" for purposes of the Advisers Act, would have an apparently unintended effect on the availability of the exemption for employees of Commission-registered advisers from state registration. Section 203A of the Advisers Act exempts a federally registered adviser from state registration while permitting a state to require the registration of an "investment adviser representative" working for a federally registered adviser that has a place of business in that state. Rule 203A-3 limits the definition of "investment adviser representative" to a supervised person[17] of an investment adviser with more than five clients who are natural persons and not "qualified clients" and who represent more than 10% of such supervised person's clients.[18] Rule 203A-3 further provides that a supervised person may rely on Rule 203(b)(3)-l for purposes of identifying his or her clients. As a result, currently supervised persons of an investment adviser managing a hedge fund would count the fund as the "client" and in most instances would have fewer than five, and often no, clients who are natural persons.

Under the Proposed Rule, supervised persons of investment advisers managing hedge funds may lose the availability of the Section 203A exemption, depending on the number of investors in the fund who are natural persons but not qualified clients. Registered investment advisers are generally prohibited from charging a performance fee to clients who are not "qualified clients." However, since the Proposed Rule would "grandfather" from this prohibition existing investors in a private fund, many hedge fund advisers would be able to continue to charge a performance fee after registration even though a large proportion of the investors in the hedge fund may not be qualified clients. At the same time, however, many employees of such advisers could become subject to registration (and related testing and other requirements) under

[17] Section 202(a)(25) of the Advisers Act defines "supervised person" as any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.

[18] Qualified clients are generally investors, either individuals or companies, that invest at least $750,000 with an investment adviser or that have a net worth of $1.5 million. Additionally, the adviser's executive officers, directors and certain "knowledgeable employees" and Qualified Purchasers as defined in Section 2(a)(51)(A) of the Investment Company Act are also "Qualified Clients."

the state law[19] because they may have more than five “clients” (investors in such funds) who are natural persons but not qualified clients.

This unintended consequence could be remedied by modifying the proposed rule to exclude Rule 203A-3 from 203(b)(3)-l(b)(6) and 203(b)3-2(a), (b) and (c).

B. *State Registration of State Registered Advisers*

Another apparently unintended consequence would arise with respect to the availability of the *de minimis* exemption from state investment adviser registration for advisers not registered with the Commission. (Advisers registered with the Commission have the benefit of the preemption from state registration of the advisory firm provided by Section 203A.) Section 222(d) of the Advisers Act prevents a state from requiring investment advisers that are not registered with the Commission to register with the state if the adviser does not have a place of business in the state and has fewer than six clients in such state during the preceding 12-month period. Rule 222-2 provides that, for purposes of Section 222(d), advisers may use the definition of “client” as set forth in Rule 203(b)(3)-l. Accordingly, hedge fund advisers generally are not subject to state-level registration in any state other than the state in which they are located because they do not have to “look-through” the funds they advise for purposes of counting the number of clients in any state.

The definition of “client” under the Proposed Rule does not provide any special relief for purposes of Rule 222-2. Absent a separate exemption for purposes of Rule 222-2, a hedge fund adviser not registered with the Commission would be required to review the registration requirements of any state in which there are six or more investors in any fund it manages that are not “qualified clients” to determine whether registration in that state would be required. This would be particularly burdensome to advisers of funds whose investors include funds of funds or registered investment

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19 Most state securities laws require the registration of certain employees of advisers. For example, New Jersey Uniform Securities Law (1967) Section 49:3-49(s) defines “investment adviser representative” to mean any person, including, but not limited to, a partner, officer or director, or a person occupying a similar status or performing similar functions, or other individual, except clerical or ministerial personnel, who is employed by or associated with an investment adviser registered as an investment adviser in the State of New Jersey, or who has a place of business located in the State of New Jersey and is employed by or associated with a person registered or required to be registered as an investment adviser under the Advisers Act; and who does any of the following: (1) makes any recommendations or otherwise renders advice regarding securities if the person has direct advisory client contact; (2) manages accounts or portfolios of clients; (3) determines recommendations or advice regarding securities; (4) solicits, offers or negotiates for the sale of or sells investment advisory services; or (5) directly supervises any investment adviser representative or the supervisors of those investment adviser representatives.

Also, most states require that registered investment adviser representatives take and pass the series 65 examination. Registration also involves the filing of form U 4 (which requires disclosures concerning employment, residential and disciplinary history) on the SEC’s IARD system or in paper form with the state and the payment of fees.

companies, because they would be required to count each investor in the "top-tier" fund as a client. In many instances, it may be impossible to obtain this information, particularly with respect to registered investment companies where investors may hold their interests in street name. This result may also be remedied by excluding Rule 222-2 from 203(b)(3)-l(b)(6) and 203(b)3-2(a), (b) and (c).

V. <u>Compliance Period</u>

The Committee believes that the period of time that a hedge fund adviser should have to comply with the Proposed Rule should be one year from the date of its effectiveness. A one-year time period will allow advisers to hire qualified personnel and engage appropriate and competent service providers. We do not believe that a shorter time frame will permit advisers to prepare adequately for the effectiveness of the Proposed Rule without diverting excessive resources away from providing services to existing clients.

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We hope that these comments contribute to the important work of the Commission in the area of hedge funds. Please note that the comments and observations set forth in this letter by the Committee do not necessarily represent the views of the firms or companies with whom the Committee members are associated or the clients that they represent.

Very truly yours,

Marco V. Masotti, Chair
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