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September 15, 2004

Re: **File No. S7-30-04**

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

Dear Mr. Katz:

We are writing in response to the Commission's request for comments on proposed new Rule 203(b)(3)-2 and amendments to Rules 203(b)(3)-1, 204-2, 205-3 and 206(4)-2 and Form ADV (the "**Proposed Rule**")[1] under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). The Proposed Rule would require advisers to certain private investment pools ("**private funds**"), commonly known as hedge funds, to count such funds' investors as "clients" for purposes of the Advisers Act and would have the effect of requiring many of these advisers to register with the Commission under the Advisers Act. We appreciate the opportunity to comment on the Proposed Rule.[2]

We recognize the Commission's important role in regulating the activities of investment advisers and the Commission's legitimate desire to understand the scope of the hedge fund industry. However, we believe that the Proposed Rule

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[1] REGISTRATION UNDER THE ADVISERS ACT OF CERTAIN HEDGE FUND ADVISERS, Securities and Exchange Commission Proposing Release No. IA-2266, File No. S7-30-04, 69 Fed. Reg. 45172, proposed July 28, 2004 (hereinafter referred to as the "*Proposed Rule*"). Page references to the Proposed Rule herein are to the Proposed Rule as released in Commission Proposing Release IA-2266.

[2] The opinions expressed herein represent those of the undersigned and not necessarily those of our clients.

will not achieve the Commission's objectives[3] and will cause unnecessary strain on both the hedge fund industry and the Commission's resources.

If the Commission determines that the Proposed Rule should be adopted, we respectfully submit that the Proposed Rule should be narrowed in scope to better balance the Commission's oversight role with the impact of regulation on the hedge fund industry. We ask that the Commission consider the following issues and recommendations prior to final adoption of the Proposed Rule.

I. Summary of Recommendations

- If adopted, the Proposed Rule should be amended to require a hedge fund adviser to count as clients only those owners of a private fund that are not "qualified purchasers," as defined in the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). This would minimize the regulation of funds offered solely to sophisticated investors that, as recognized elsewhere by Congress and the Commission, are in a position to safeguard their own interests and would allow the Commission to focus its investor protection resources on investors that are in greater need of the Commission's oversight.

- If the Commission desires additional census information about the hedge fund industry, the Commission could effectively obtain such information by requiring hedge fund advisers to either (i) file and update Part I of Form ADV as an information disclosure document or (ii) file and update a "Notice of Exemption" for each hedge fund advised. We recommend such alternatives in lieu of requiring full registration of advisers.

- The Proposed Rule requires advisers to a hedge fund to "look through" any funds that invest in the hedge fund. We believe that investors in a fund-of-funds are not clients of an underlying hedge fund and that the hedge fund adviser therefore should not be required to count the fund-of-funds investors as its clients. In addition, we believe that the look through provision will prevent hedge fund advisers with fund-of-funds investors to control the timing of their registration obligations and could cause hedge fund advisers to restrict participation by fund-of-funds investors, including publicly registered funds-of-funds. For these reasons, we suggest that the look through provision be removed from the Proposed Rule or, in the alternative, that the look through be applied only to funds-of-funds that either (i) are formed for the purpose of investing in the private fund or (ii) account for more than ten percent of the private fund's capital at the time of investment.

[3] The Commission has stated that the Proposed Rule is primarily intended to allow the Commission to (i) better detect and prevent fraud in the hedge fund industry, (ii) limit the "retailization" of hedge fund investors and (iii) generate census information about the hedge fund industry, in each case without fundamentally disrupting the important role that hedge funds play in the U.S. capital markets. Proposed Rule at 20-31.

- We suggest various technical clarifications to the Proposed Rule, including clarifications of (i) the definition of "private fund," (ii) the recordkeeping requirements for affiliated entities, (iii) relief for charging performance fees to existing non-"qualified clients" and (iv) the extraterritorial reach of the Proposed Rule.

- We concur with the Commission's finding that the Proposed Rule should not be extended to cover advisers of other private investment vehicles, including private equity and venture capital funds.

- We believe that the Commission underestimates the costs and market effects of registration and incorrectly infers that registration imposes only minimal burdens on advisers.

II. Exclusion of Sophisticated Investors

We are concerned that the Commission's ability to properly oversee registered advisers, given the Commission's already stretched resources, will be increasingly diminished as the pool of registered advisers grows. We therefore suggest that the Commission consider limiting registration to a more manageable and appropriate group of hedge fund advisers. In line with the Commission's stated objective of monitoring the "retailization" of hedge fund investors, we believe that the Commission should exclude from the Proposed Rule hedge fund advisers that provide advice primarily to wealthy, sophisticated investors that are well-positioned to safeguard their own interests.

Congress and the Commission have each expressed an intent to regulate certain classes of sophisticated investors more lightly under the Investment Company Act, the Securities Act of 1933, as amended (the "**Securities Act**") and the Advisers Act. In establishing the "qualified purchaser" standard under the Investment Company Act, Congress stated its belief that "financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections. Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights" and are able to "fend for themselves without the protection of the Investment Company Act."[4] Congressional intent in establishing the "qualified purchaser" standard was in part to significantly reduce regulatory restrictions that affect investment pools that sell exclusively to qualified purchasers.[5]

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[4] THE SECURITIES INVESTMENT PROMOTION ACT OF 1996, REPORT OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, UNITED STATES SENATE, Report 104-293, 104th Cong., 2d Sess, June 26, 1996 at 10.

[5] SECURITIES AMENDMENTS OF 1996, REPORT OF THE COMMITTEE ON COMMERCE, UNITED STATED HOUSE OF REPRESENTATIVES, Report 104-622, 104th Cong., 2d Sess., June 17, 1996 at 18.

The Commission expressed similar views when establishing the "qualified client" standard under the Advisers Act in 1985.[6] The Commission "concluded that it is consistent with the protection of investors and the purposes of the [Advisers] Act to permit clients who are financially experienced and able to bear the risks associated with performance fees to have the opportunity to negotiate compensation arrangements which they and their advisers consider appropriate."[7] The Commission concluded that adopting the qualified client standard would result in additional competition among investment advisers "without sacrificing investor protections."[8]

We note that sophisticated investors frequently undertake an extensive due diligence process prior to investing with a hedge fund adviser. This due diligence tends to address many of the concerns identified by the Commission, such as valuation of assets and disclosure of conflicts of interest.

In order to better utilize the resources of the Commission and further Congressional and Commission intent, and in line with the Commission's focus on the "retailization" of hedge fund investors, we suggest that the Commission consider limiting the provisions of the Proposed Rule to hedge fund advisers that provide investment advice to fifteen or more clients that do not meet the "qualified purchaser" standard. Specifically, we recommend amending proposed Rule 203(b)(3)-2(a) to read as follows:

> (a) For purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)), you must count as a client each person who owns the outstanding securities of a private fund and who is not a qualified purchaser (as defined in 15 U.S.C. 80a-2(a)(51)) at the time such person acquires such securities.

In this regard, we also urge the Commission to utilize the existing standard contained in Section 3(c)(7) of the Investment Company Act to define the "owners" of a private fund as persons that "own its outstanding securities" (in lieu of the proposed "shareholders, limited partners, members, other securityholders or beneficiaries" standard). We believe that the proposed language is potentially too broad in scope, while the Section 3(c)(7) standard of "owner" is informed by years of Commission interpretations and market practice, thus making it susceptible to more uniform application upon implementation. We would recommend further that "knowledgeable employees," as defined in Rule 3c-5 under the Investment Company Act, be treated as qualified purchasers for purposes of the Proposed Rule. Moreover, Rule 3c-6 under the Investment Company Act, regarding certain transfers of interest by gift or bequest, should be applied to the determination of the number of clients of an investment adviser.

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[6] *See* Rule 205-3(d)(1) under the Advisers Act.

[7] Commission Release No. IA 996, File No. S7-11-85, 50 Fed. Reg. 48556, available November 26, 1985 at 9.

[8] *Id*.

Similarly, beneficiaries of a trust that is a private fund, who are not themselves trustees or grantors of that trust, should not be regarded as investors who require additional protection under the Advisers Act.

III. Limited Disclosure Requirement

We acknowledge the Commission's desire to better understand the scope of the hedge fund industry and to generate reliable census information. As the Commission notes, approximately 30-50% of hedge fund advisers are currently registered with the Commission.[9] We believe that this critical mass of advisers provides the Commission with current, reliable and significant information on the hedge fund industry as a whole and could serve as a sufficient proxy for the Commission to understand and monitor the hedge fund industry.

However, if the Proposed Rule is enacted, we suggest a more limited disclosure regime that will provide the Commission with the information it seeks without subjecting many hedge fund advisers to the costs of registration under the Advisers Act.

The Commission seeks "information about the number of hedge funds that advisers manage, the amount of assets in hedge funds, the number of employees and types of clients these advisers have, other business activities they conduct, and the identity of persons that control or are affiliated with the firm."[10] We suggest the following two alternative disclosure mechanisms that will provide the Commission with reliable census information on the hedge fund industry:[11]

- *Form ADV*. Hedge fund advisers could be required to file and update Part I of Form ADV as an informational disclosure without being subject to any additional registration or compliance requirements under the Advisers Act.

- *Notice of Exemption Filing*. Each hedge fund adviser could be required to file and update with the Commission a "Notice of Exemption" with respect to each private fund advised by such adviser. The filing would detail (i) the name, address and disciplinary history of the adviser and each of its principals, (ii) the name, jurisdiction of formation, assets and investment strategy of the fund claiming exemption from the Investment Company Act, (iii) the exemption claimed and (iv) aggregate assets under management by the adviser.

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[9] Proposed Rule at 32, footnote 98.

[10] Proposed Rule at 24.

[11] We note with favor the Commission staff's recommendation that general solicitations be permitted for funds relying on the exemption contained in Section 3(c)(7) of the Investment Company Act. The Commission should consider permitting such general solicitations and utilizing the consequent publicly available information as an additional source of census data on hedge funds and their advisers. *See* IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION, September 2003 at 87.

We believe that these alternatives would satisfy the Commission's stated goal while not burdening the industry (and ultimately investors) with the high cost of registration (as discussed at the end of this letter).

IV. Look Through Provisions

The Proposed Rule requires hedge fund advisers to count not just the owners of the hedge fund as clients, but also the owners of any fund (private or registered) that is an owner of the hedge fund.

We believe that this provision will inappropriately impose registration on advisers that limit their client base to fifteen or fewer clients. A hedge fund adviser that has a fund-of-funds investor does not have a client relationship with the investors in the fund-of-funds. Rather, the hedge fund adviser deals with the adviser to the fund-of-funds that, in turn, acts for its investors. To treat the fund-of-funds' investors as clients of the underlying hedge fund seems inappropriate and inconsistent with actual practice. The adviser to the fund-of-funds is subject to its own regulatory issues and will be registered if it has more than fifteen clients or if the fund it advises is registered under the Investment Company Act. We note that Section 208 of the Advisers Act would make illegal any scheme to avoid registration through the establishment of feeder fund vehicles.

In addition, we are concerned that the look through provision will prevent hedge fund advisers that have fund-of-fund investors from being able to plan for or control the timing of their registration obligations and will cause such hedge fund advisers to potentially and inadvertently fail to comply with the Proposed Rule. For example, a hedge fund adviser that admits an unaffiliated fund-of-funds as an investor could be required to register if the unaffiliated fund-of-funds admits additional investors, a circumstance outside of the control, and perhaps knowledge, of the hedge fund adviser.[12]

We believe that the effect of the look through provision will be that certain hedge fund advisers will not make their funds available to funds-of-funds (including registered funds-of-funds). This will limit the available investment opportunities for these funds-of-funds, an outcome that we believe to be contrary to public policy, particularly for public funds. We would hope that public funds-of-funds would have the most investment options available. Instead, the Proposed Rule will effectively mean that the public funds would only be able to invest in hedge funds with registered investment advisers. We note that public funds and their advisers are already regulated by the Investment Company Act and the

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[12] We note that the Proposed Rule requires only that a fund-of-funds confirm to an underlying private fund adviser that the fund-of-funds has more than fourteen owners and does not require a fund-of-funds to provide the exact number of its investors. We believe that this is insufficient to prevent inadvertent non-compliance with the Advisers Act. For example, if a private fund has ten owners and one of them is a fund-of-funds with ten investors, the private fund would be required to register under the Proposed Rule but would not be provided with sufficient information to know that such registration is required. Proposed Rule at 40, footnote 125.

Advisers Act and do not need the additional registration of the advisers of their portfolio hedge funds.

For the reasons set forth above, we suggest deleting the look through requirement from the Proposed Rule by amending proposed Rule 203(b)(3)-2(a) as set forth above under Section II – "Exclusion of Sophisticated Investors"[13] and omitting section 203(b)(3)-2(b) of the Proposed Rule.

Alternatively, we note that Section 3(c)(1) of the Investment Company Act provides for a look through if a top tier fund accounts for more than ten percent of an underlying fund's capital. This type of look through test would at least permit a hedge fund adviser to exercise a degree of control over its registration obligations by monitoring the size of funds-of-funds investments. Consequently, if the look through is not eliminated entirely, we would recommend that the look through apply only where an investing fund either (i) is formed for the purpose of investing in the hedge fund or (ii) accounts for more than ten percent of the hedge fund's capital at the time of the investing fund's initial and subsequent investments in the hedge fund.

V. Other Modifications to the Proposed Rule

We respectfully suggest the following modifications and clarifications to the Proposed Rule and its implementation:

- *Definition of "Private Fund" – Two Year Redemption Lockup*. Under the Proposed Rule, "private funds" include funds that permit their owners to redeem any portion of their ownership interests within two years of the purchase of such interests.[14] We are concerned that the initial implementation of this provision will cause market dislocation as advisers may require investors that have a right to redeem their interests within two years of purchase to redeem their interests and withdraw from the private fund prior to the effectiveness of the Proposed Rule. In order to avoid this market dislocation, we suggest that the Commission make it clear that this provision will not apply to ownership interests outstanding at the time the Proposed Rule becomes effective and will only apply to sales of securities from and after such effective date.

- *Definition of "Private Fund" – Extraordinary and Unforeseeable Redemption Events*. The Proposed Rule excludes from the definition of "private fund" a fund that permits redemptions within two years upon events that are found after reasonable inquiry to be extraordinary and unforeseeable at the time the interest was issued.[15] We

[13] Alternatively, the Commission could delete the phrase "or beneficiaries" from proposed Rule 203(b)(3)-2(a).

[14] *See* proposed Rule 203(b)(3)-2(d)(1)(ii). Proposed Rule at 89.

[15] *See* proposed Rule 203(b)(3)-2(d)(2)(i). *Id*.

are concerned that the requirement that events be "unforeseeable" is ambiguous and will be not be uniformly applied in practice. Specifically, many private equity funds provide that investors subject to ERISA are permitted to withdraw funds if continued investment would result in a violation of ERISA or that any investor may withdraw funds in order to avoid a materially adverse tax or regulatory outcome. These are extraordinary circumstances, but are arguably "foreseeable" at the time the interest is issued. In addition, certain private funds with lengthy lock-up periods permit investors to make withdrawals in order to pay income taxes incurred as a result of investment gains by the private fund. We believe that these redemptions should be excluded from the two year redemption restriction as they do not fundamentally alter the nature of a fund that otherwise restricts redemptions during the first two years after purchase.

We believe that proposed Rule 203(b)(3)-2(d)(2)(i) should be amended to delete the word "unforeseeable" and to clarify that redemptions due to adverse legal or regulatory effects, including adverse tax consequences, and redemptions to facilitate the payment of taxes will be considered "extraordinary" redemption events.

- *Definition of "Private Fund" – Offered Based on Skill of Adviser*. The definition of "private fund" also requires that interests in the fund are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.[16] Our concern is that this standard is too broad since virtually all investment funds are to some extent offered based on the skill of an adviser.

The Commission notes that hedge fund advisers "emphasize the record of the manager" in their marketing.[17] We believe that in order to better capture this emphasis on the manager's record, the definition should refer to funds that are offered "primarily" based on the investment advisory skills, ability or expertise of the investment adviser. This would further the Commission's intent and allow certain funds to be appropriately excluded from the Proposed Rule. We assume, for example, that the Proposed Rule is not intended to include private investment vehicles that are formed primarily for the purpose of acquiring a specific pool of securities or other assets described in the offering documents for the entity. In addition, we believe this change would exclude from the Proposed Rule family investment companies or other pooled vehicles primarily maintained for the benefit of a group of related individuals or their family investment vehicles. We believe that such investment vehicles, which are limited to related individuals, companies established to manage the assets of these related individuals and employees of such companies, are sold based on the relationships between the various

[16] *See* proposed Rule 203(b)(3)-2(d)(1)(iii). *Id*.

[17] Proposed Rule at 48.

investors and not primarily on the advisory skills of the adviser. We also believe that the costs of registration of advisers to family investment vehicles is not necessary or appropriate in light of the costs that would be incurred by family members in those vehicles.

• *Existing "Non-Qualified Client" Relief*. We agree with the Commission that existing, non-"qualified client" investors in private funds should be allowed to maintain and add to existing accounts.[18] Many hedge fund advisers and non-"qualified client" investors have devoted significant resources to developing advisory relationships and, in order to avoid a negative impact on these investors, we submit that such existing non-"qualified client" investors should be permitted to invest in new private funds sponsored by such advisers.

• *Recordkeeping Requirements for Affiliated Entities*. Proposed Rule 204-2(l),[19] would mandate that the records of a private fund adviser be deemed to include the records of a private fund for which the adviser or a "related person" of the adviser (as defined in Form ADV) acts as general partner, managing member or in a comparable capacity. The term "related person" includes upstream and downstream affiliates as well as sister entities under common control with the adviser. We suggest limiting this provision to apply only to upstream and downstream affiliates of the adviser in the same chain of control. Otherwise, registered advisers affiliated with large financial institutions (which may contain several affiliated registered advisers and many private funds) may be required to maintain books and records for each such affiliated private fund. Specifically, we suggest taking advantage of the existing "advisory affiliate" definition in Form ADV[20] and amending the proposed rule to read as follows:

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[18] *See* proposed Rule 205-3(c)(2). Proposed Rule at 91.

[19] *Id.*

[20] The Glossary of Terms of Form ADV defines "Advisory Affiliate" as follows:

Your advisory affiliates are (1) all of your officers, partners, or directors (or any person performing similar functions); (2) all persons directly or indirectly controlling or controlled by you; and (3) all of your current employees (other than employees performing only clerical, administrative, support or similar functions). If you are a "separately identifiable department or division" (SID) of a bank, your advisory affiliates are: (1) all of your bank's employees who perform your investment advisory activities (other than clerical or administrative employees); (2) all persons designated by your bank's board of directors as responsible for the day-to-day conduct of your investment advisory activities (including supervising the employees who perform investment advisory activities); (3) all persons who directly or indirectly control your bank, and all persons whom you control in connection with your investment advisory activities (including directing, supervising or performing your advisory activities), all persons who directly or indirectly control those management functions, and all persons whom you control in connection with those management functions.

> (l) Records of Private Funds. If an investment adviser subject to paragraph (a) of this section advises a private fund (as defined in Section 275.203(b)(3)-2(d)), and the adviser or any advisory affiliate (as defined in Form ADV [17 CFR 279.1]) of the adviser acts as the private fund's general partner, managing member, or in a comparable capacity, the books and records of the private fund are records of the adviser for purposes of Section 204 of the Act [15 U.S.C. 80b-4].

• *Extraterritorial Reach*. We suggest that proposed Rule 203(b)(3)-2(c)[21] be modified to make clear that offshore advisers to offshore private funds subject to the Proposed Rule are required only to file and update Form ADV and comply with the Advisers Act's anti-fraud provisions (and are not otherwise required to comply with the provisions of the Advisers Act, including with respect to record keeping, custody requirements, written compliance policies and the hiring of compliance officers). Our concern is that the Proposed Rule appears to rely on the guidance provided in the *Unibanco* no-action letter,[22] and does not provide specific guidance with respect to the applicability of the substantive provisions of the Advisers Act to offshore registered advisers. We are concerned that this lack of guidance will create significant ambiguity in the Proposed Rule and its application.

We also note that the Proposed Rule does not define the term "United States resident." It has been our experience that this term has caused considerable confusion among clients. In the past, the term was frequently used by the Commission staff in the Advisers Act context and we have spent considerable time advising clients as to its meaning. In recent years, the Commission staff has focused instead on the term "United States person" as defined under Regulation S under the Securities Act. This definition is the subject of considerable guidance and is therefore more easily interpreted and applied by clients. We would urge the Commission to adopt the definition of "United States person" under Regulation S of the Securities Act as a safe harbor for determining whether a person is a United States resident.[23]

• *Performance Record Relief*. We concur with the Commission's finding that proposed Rule 204-2(e)(3)(ii)[24] will provide necessary relief from Advisers Act record-keeping requirements related to

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[21] Proposed Rule at 89.

[22] *See Uniao do Banco de Brasileiros S.A.*, Securities and Exchange Commission No-Action Letter (pub. avail. July 28, 1992).

[23] *See Goodwin Proctor & Hoar*, Securities and Exchange Commission No-Action Letter (pub. avail. Feb 28, 1997).

[24] Proposed Rule at 90.

the use of performance information for currently unregistered hedge fund advisers. As the Commission notes,[25] hedge fund advisers often emphasize their performance data in their marketing activities. Without the proposed relief, many advisers required to register as a result of the Proposed Rule would not be permitted to utilize their past performance in marketing, a significant competitive disadvantage, due to lack of compliance with Advisers Act provisions to which they were not previously subject.

- *Compliance Date*. Given the effort required to properly register an investment adviser, the time needed for the Commission to review pending registrations and the limited number of professionals able to assist in the registration process, we believe that the Proposed Rule should become effective not less than one year from the date the Proposed Rule is adopted in final form.

VI. Other Privately Offered Investment Vehicles

We concur with the Commission's finding that there is no justification for extending the scope of the Proposed Rule to include other privately offered investment vehicles, such as private equity and venture capital funds. We note that many of these other private investment funds provide less incentive for advisers to manipulate asset values to disguise poor interim performance, a key concern identified by the Commission with respect to hedge funds, because (i) adviser compensation is determined with reference to cash distributed to investors from realized investments and (ii) investors are generally unable to withdraw their investment in underperforming funds. As a corollary, we suggest changing the defined term in the Proposed Rule from "private fund" to "look through fund" or another term that is not so broad as to potentially confuse investors in privately offered funds that are not covered by the Proposed Rule.

VII. Costs of Registration

We believe that the Commission materially underestimates the costs of registration and incorrectly infers that registration imposes only minimal additional burdens.[26]

Many of our private fund investment adviser clients have registered with the Commission for various reasons, including affiliation with large institutions that advise many clients, requests from institutional investors and perception of market desires. We do not believe that an inference can be drawn that such registrations, undertaken for market-based or regulatory reasons, impose only minimal burdens.

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[25] Proposed Rule at 48.

[26] Proposed Rule at 31.

We have observed the costs incurred by our investment adviser clients in connection with registration and ongoing compliance under the Advisers Act, including the opportunity costs of time spent away from core asset management duties and the costs of legal and other professional services. Our view is that such costs are substantial and increasing and will in some form be passed on to, and affect returns realized by, hedge fund investors. In addition, we are concerned that offshore advisers, in order to avoid compliance costs and potentially duplicative regulation, may limit the ability of U.S. investors to participate in offshore private funds.

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We appreciate the opportunity to respond to the Commission's request for comments and we hope that these comments and observations contribute to the important work of the Commission. If you have any questions with respect to the matters raised in this letter, please contact any of the undersigned.

Very truly yours,

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