Setting the global standard for investment professionals

30 September 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W., Stop 6-9
Washington, D.C. 20459

Re: File Number S7-30-04, *Registration Under the Advisers Act of Certain Hedge Fund Advisers*

Email: rule-comments@sec.gov

Dear Mr. Katz:

CFA Institute[1] appreciates the opportunity to comment on the SEC's Proposal, File Number S7-30-04, *Registration Under the Advisers Act of Certain Hedge Fund Advisers*.

For over forty years, beginning with the founding of our predecessor organizations, CFA Institute has been firmly committed to establishing and promulgating the highest professional standards for the broad investment profession, including investment advisers, who comprise a substantial proportion of our membership. To achieve this objective, the organization at its inception developed a *Code of Ethics* and *Standards of Professional Conduct* which are binding on each of our members individually. Each year, our members must reaffirm in writing their compliance with, and commitment to, these standards.

In our continuing pursuit of professional excellence, we currently have under development a comprehensive Code of Conduct for asset managers which we expect to be completed and promulgated this fall. This Code is based firmly in our *Code of Ethics* and *Standards of Professional Conduct*, but incorporates the specialized issues arising in the business context of the investment adviser and asset manager. This Code will be voluntary and will apply to firms as well as individual members of the adopting firms. That is, our members may choose to have their firms subscribe to the Code or not. Nonetheless, we expect that a sizable proportion will elect to do so as part of their own due diligence efforts on behalf of their clients. Indeed, we would hope that adoption, along with related implementation and compliance procedures, could

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[1] With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, CFA Institute (formerly, the Association for Investment Management and Research®) is a non-profit professional association of nearly 80,000 financial analysts, portfolio managers, and other investment professionals in 119 countries of which 60,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 129 Member Societies and Chapters in 50 countries and territories.

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be seen as a satisfactory alternative to further regulation, consistent with our history of supporting self-regulation as a more efficient and effective means of protecting the interests of investors and clients.

Despite our long-standing commitment to self-regulation, we recognize that some participants in the financial markets, including some investment advisers generally and, in this instance, hedge fund advisers, may resist all attempts at regulation, whether self-regulation or voluntary registration and compliance with federal requirements. Above all, we believe that the efficient functioning of the financial markets requires that the interests of investors and clients must be protected. Where growing evidence suggests that these interests are not being met, we reluctantly must agree that additional regulation may be necessary to meet these objectives and to ensure that the full trust and confidence of investors and other market participants is maintained.

Hence, we support the SEC's desire for more transparency in the growing hedge fund sector and we see no real harm in requiring such registration. Indeed, we observe that by the SEC's estimation nearly fifty percent of hedge fund advisers, both large and small firms, have chosen to voluntarily seek such registration and compliance. They may have many reasons for doing so including meeting their own high standards or those of potential clients such as pension funds. Nonetheless, we believe that such voluntary registration attests to its growing acceptance as well as to the relatively small burden, if any, registration imposes on firms. We believe that the benefits adhere more broadly to the financial markets and include the ability of the SEC to inspect the fund manager and its records more fully and regularly. These inspections will subject the adviser's disclosures, style adherence, and performance calculations, matters of critical importance to clients, to more timely review.

We are not convinced that registration alone will prevent the possible ethical violations and potential meltdowns that many fear in this sector. The risky strategies used by many hedge fund managers will continue and they should, because, as we have stated before in our remarks to the SEC, such strategies can play an important role in market completion and price formulation. However, subjecting the records of all such managers to regular and timely inspection will, we believe, make it more difficult for fraudulent and unethical behavior to go undetected and thereby help avoid considerable harm to investors.

Specific Comments

B. 6—Imposition of Minimal Burdens

We request comment on the burdens our proposal would impose, and whether those burdens could be alleviated in some manner that also meets our objectives in proposing these rules.

- ***Many hedge fund advisers voluntarily register under the Advisers Act in order to meet client needs or requirements. We infer from these decisions that, in practice, advisers do not consider registration burdensome. Is this inference warranted?***

See our comments above. We have no specific information regarding this issue. However, given that nearly half of all hedge funds, including both large and small firms, have chosen voluntarily to register, we suspect that registration will not be overly burdensome. Moreover, we observe that a significant proportion of our members are principals in very small fund management and advisory firms and are registered under the Investment Adviser's Act.

- ***Many of the advisers registered with us are smaller firms with less than $50 million of assets under management. Many of them are likely to have markedly less cash flow than hedge fund advisers, many of which have a substantial amount of assets under management and charge a customary fee of one to two percent of assets plus 20 percent of gains. We infer from this that the Advisers Act does not impose an undue burden on smaller advisory firms, and that hedge fund advisers are in a position to bear that burden. Is our inference warranted? We request comment on this question particularly from smaller firms such as financial planners.***

With corporate disclosure in general, we have long maintained that complete and accurate transparency is a necessary cost of seeking capital from others. For example, we do not support the promulgation of two separate accounting standards, one for large firms and one for small, so-called "big GAAP" and "little GAAP." If a company engages in a particular transaction or line of business, it should be required to account for it the same way that every other company does.

We believe that this case is no different. If firms wish to engage in this type of business, they have an obligation to clients to provide complete and accurate information and to make their records available for periodic review by regulators. Our members who are relatively small investment advisers tell us that this does not create a hardship or burden. We would agree with the SEC's observation that the fact that many registered advisers are small argues strongly that such registration is not overly burdensome.

C. 2—Funds of Hedge Funds

The new rule would contain a special provision for advisers to hedge funds in which a registered investment company invests. Hedge fund advisers would be required to count the investors in the registered fund as clients. Without this provision, a hedge fund adviser could provide its services to thousands of mutual fund investors through fourteen or fewer mutual funds, each of which could invest in the private fund, and each of which would count as a single client.

- ***We request comment on our "look through" approach with respect to registered investment companies investing in hedge funds. Are its terms clear?***

- ***Have we provided enough detailed guidance on how advisers should count clients? Or, are there points on which further guidance is needed?***

We agree with the "look through" approach to identifying the numbers of clients actually placing investments in a hedge fund. We do not believe that artificial structures and devices should be permitted to allow effective circumvention of regulatory oversight of investment advisers. We believe that the guidance is sufficient.

C. 3.—Offshore Advisers

a. Counting Clients of Offshore Advisers

An adviser to any hedge fund that, in the course of the previous twelve months, has more than fourteen investors (or other advisory clients) that are U.S. residents would generally have to register under the Advisers Act. Offshore advisers to hedge funds would, therefore, be treated in the same manner as any other type of offshore adviser providing advice to U.S. residents.

- ***Should offshore advisers be required to look through their offshore funds only if assets attributable to U.S. residents comprise more than a threshold percentage? If we impose a threshold, what should it be? Should the threshold apply to the cumulative assets of all offshore funds advised by the offshore adviser?***

The issue is not the amount of assets but, consistent with the other thresholds in the proposed regulation, the number of U.S. clients. That is, the regulation should apply equally to all those engaged in the management of hedge funds. This equal-treatment provision is essential, in our estimation, to prevent abuse of the regulation (by those who would relocate offices) and its intent, greater transparency, oversight, and we hope, protection for U.S. investors.

- ***Would registration present difficulties for offshore advisers because of conflicts with the laws of their home jurisdiction? Approximately 350 non-U.S. advisers are currently registered with us, and we are unaware of any conflicts that create problems for those dual registrants. Do offshore hedge fund advisers present different concerns or face different burdens? If so, what are they and how should we address them?***

Businesses of all varieties, including money management and advising firms, must frequently comply with a number of differing requirements. Indeed, we have long recognized this in our *Code of Ethics* and *Standards of Professional Conduct*, which specify that where members and their firms face conflicting standards, they are required to meet the highest standard. We do not believe that this should prove a serious impediment.

b. Advisers to Offshore Publicly Offered Funds

We do not want to require advisers to offshore publicly offered mutual funds or closed-end funds to register with us simply because more than fourteen of their investors are now resident

in the United States. Therefore, we have included in the proposed rule an exception to the definition of "private fund" for a company that has its principal office and place of business outside the United States, makes a public offering of its securities outside the United States, and is regulated as a public investment company under the laws of a country other than the United States.

- ***Is the scope of this exception too broad or too narrow?***
- ***Are there any other types of companies or entities that need to be included in the exception?***
- ***Is there a significant concern that some hedge fund advisers would seek to use this exception to evade the requirements of the Act?***
- ***Hedge funds may be offered publicly in some countries. Would our proposed rule exempt these hedge funds from the definition of "private fund"? Should it?***

We believe that the intent of this provision, that is, to not require registration where publicly offered funds are established offshore, are managed by offshore advisers, and are subject to offshore regulation in other jurisdictions, is a reasonable one. However, we believe it is safe to assume that at least some advisers will seek to use this exception to evade the requirements of this Act. Indeed, some jurisdictions may actively seek to become domiciles of convenience and may otherwise accommodate such activities.

Hence, it is not entirely clear to us how, in practice, the SEC will be able to clearly distinguish between those who are operating legitimately in offshore locations with the intent of serving an offshore clientele and who happen to attract fifteen or more U.S. investors, and those who are domiciled offshore to avoid U.S. registration. However, we are prepared to accept the SEC's approach on this issue.

D. Definition of "Private Fund"

Our rule would define a "private fund" by reference to three characteristics shared by virtually all hedge funds. First, the private fund would be limited to a company that would be subject to regulation under the Investment Company Act of 1940 (the "Investment Company Act") but for the exception provided in either section 3(c)(1) (a "3(c)(1) fund") or section 3(c)(7) (a "3(c)(7) fund") of such Act.

Second, a company would be a private fund only if it permits investors to redeem their interests in the fund (i.e., sell them back to the fund) within two years of purchasing them. Hedge funds typically offer their investors liquidity access following an initial "lock-up" period, and thus most hedge fund advisers would be included within the rules. This "redeemability" requirement would, however, exclude persons who advise private equity funds, venture capital funds, and similar funds that require investors to make long-term commitments of capital. These funds are similar to hedge funds in some respects, but we have

not encountered significant enforcement problems with advisers with respect to their management of these types of funds. In contrast, the Commission has developed a substantial record of frauds associated with hedge funds. A key element of hedge fund advisers' fraud in most of our recent enforcement cases has been the advisers' misrepresentation of their funds' performance to current investors, which in some cases was used to induce a false sense of security for investors when they might otherwise have exercised their redemption rights. Because hedge funds are where we have seen a recent growth in fraud enforcement actions, that is where we propose to focus our examination resources at this time.

Third, interests in a private fund would be based on the ongoing investment advisory skills, ability or expertise of the investment adviser

- ***Should we narrow the rule? If so, how?***
- ***Should "private fund" include private equity, venture capital, and other investment pools that are not hedge funds? If so, how should we broaden the rule?***
- ***Do the three characteristics used in the rule effectively distinguish hedge funds from these other types of funds? If not, what specific tests should apply?***
- ***Is two years an appropriate time period for redemptions? If not, should it be longer or shorter, and why?***
- ***Are there any other circumstances prompting redemptions that need to be excepted from the two-year test?***

We understand that the general thrust of this section is to define those managers who fall within the scope of this rule. We believe that the distinction, if any, rests largely with the first criterion, i.e., those who rely on the 3(c)(1) or 3(c)(7) exemptions to escape registration. The second criterion, that the fund permits redemption of investments in the fund within two years, is not an economic or regulatory distinction, merely the practice of some types of firms, and would seem to us to be somewhat arbitrary. The third, "interests…would be based on the ongoing investment advisory skills, ability or expertise of the investment adviser," would seem to us to apply to potentially any managed fund, including mutual funds.

We recognize that the larger difficulty is that the activities of hedge funds are not clearly distinguishable from those of other types of funds. Nonetheless, it is not clear to us that the second and third criteria add measurably to the first.

We are aware of the SEC's intent from the same section:

> *Our approach to defining the scope of rule 203(b)(3)-2 is similar to that taken recently by the Department of Treasury in defining the scope of its proposed rule requiring "private investment companies" to adopt anti-money laundering programs. Like the Treasury Department, we have tried to keep the definition simple, and provide a "bright line" indicator of when an adviser must look though a client that is a legal organization. We have avoided alternative approaches that would turn on the nature of the investments*

> *made by the pooled investment vehicle because we do not want registration concerns to affect investment decisions of the adviser.*

"Bright line" rules, although attractive in concept, frequently prove problematic almost immediately. They seem to invite the sort of gaming that the rules hope to avoid in the first place. However, we are prepared to accept these guidelines as an initial approach.

F. Amendments to Rule 204-2

Under our rules, a registered investment adviser that makes claims concerning its performance "track record" must keep documentation supporting those performance claims. The supporting records must be retained for a period of five years after the performance information is last used. Thus, if a registered adviser promotes its 20-year performance record in 2004, it must continue to keep its supporting records for its 1984 performance through 2009 — five years after the last time that 1984 performance is included.

We would require these new registrants to retain whatever records they do have that support the performance they earned prior to their registration with us, but would excuse them from our recordkeeping rule to the extent that those records are incomplete or otherwise do not meet the requirements of rule 204-2. Once a hedge fund adviser has registered with us, of course, it must comply with our recordkeeping rule going forward.

- ***Is this exemption necessary? Or, do hedge fund advisers already routinely retain documents substantiating their performance claims that comply with our recordkeeping rules?***

While we cannot speculate on what all hedge fund advisers might do in this regard, we would not be surprised to learn that at least some advisers are not currently able to "meet the requirements of rule 204-2 with regard to recordkeeping in support of prior performance. It is obvious that reported performance is critical to investors, both in evaluating the relative skill and experience of an adviser, and as a basis for calculating the high performance fees common in this industry, payments made from the client's earnings. Thus, the greater the transparency and reliability, the better for clients and the long-term health of the industry.

We believe that transparency going forward would be improved if advisers were required to disclose to clients those years for which the hedge fund adviser has records in support of the reported performance numbers. The adviser should be able to accompany this disclosure with statements recognizing that they were not required to keep such records before registration and thus did not, if that were the case.

We are also proposing an amendment to rule 204-2 clarifying that, for purposes of section 204 of the Advisers Act, the books and records of a hedge fund adviser registered with us include records of the private funds for which the adviser acts as general partner, managing member, or in a similar capacity. Section 204 of the Act generally subjects records of investment

advisers to examination by the Commission. To determine whether a hedge fund adviser is meeting its fiduciary obligations to a private fund under the Advisers Act and rules, our examiners require access to all records relating to the adviser's activities with respect to the fund, including records relating to the adviser's service as the fund's general partner. The general partners effectively control all the operations and assets of the hedge fund. Because many hedge fund advisers establish a separate special purpose vehicle to be named as the fund's general partner, the proposed amendment would also cover private funds for which a related person of the adviser (as defined in Form ADV) acts as general partner, managing member, or in a similar capacity.

- ***Is the scope of this provision too narrow or too broad?***
- ***Are there other entities we should include?***

We believe that this is a necessary requirement. All entities holding records for a particular fund, should be required to submit those records to review. Given the potential for other fund activities of an adviser that are not consistent or even conflict with the best interests of the clients of a particular hedge fund, we believe that advisers should make available for review the records of all such activities. Indeed, our Code of Conduct for asset managers requires that managers take no actions in other funds or activities that could pose a conflict with or otherwise disadvantage their clients.

We note the indicated reach of the Commission's examination from the language above:

> *…our examiners require access to all records relating to the adviser's activities* ***with respect to the fund****, including records relating to the adviser's service as the fund's general partner. The general partners effectively control all the operations and assets of the hedge fund. Because many hedge fund advisers establish a separate special purpose vehicle to be named as the fund's general partner, the proposed amendment would also cover private funds for which a related person of the adviser (as defined in Form ADV) acts as general partner, managing member, or in a similar capacity.*

We construe these statements to mean that the Commission's intent is to examine all records that relate to the specific fund, or related funds, or those that could pose a direct conflict to the best interests of the investors in the fund. We assume that the language does **not** intend that the records of all possible business activities of an adviser, including totally unrelated private business, would be subject to examination.

G. Amendments to Rule 205-3

We are proposing to amend rule 205-3 under the Advisers Act to avoid requiring certain hedge fund investors to divest their current interests in the funds. Most hedge fund advisers charge a fee based on their fund's capital gains or appreciation — a "performance fee." Rule 205-3

permits registered investment advisers to charge performance fees only to "qualified clients," and requires the adviser to a 3(c)(1) fund to look through the fund to determine whether all investors are qualified clients. Generally, to be a qualified client of a registered investment adviser an investor must place at least $750,000 under that adviser's management or have a net worth of $1.5 million. While many hedge fund advisers place these or even more stringent requirements on the investors in their funds, not all do so. Some hedge funds are marketed to "accredited investors," and some may permit a small number of non-accredited investors.

Accordingly, there may be some small number of investors in hedge funds that are not qualified clients. It may, therefore, be against our current rules for the adviser to continue receiving a performance fee from some current investors. While we would require hedge fund advisers to comply with our performance fee rules going forward, we do not believe it is necessary to disrupt existing arrangements with persons who have already invested in the hedge fund. Our proposed amendment to 205-3 would allow a hedge fund's current investors who are not qualified clients to retain their existing investment in that fund, and to add to that account. It would not give them an exemption to open new investment accounts in that hedge fund or other hedge funds.

- ***Is it appropriate to create this exemption for current investors? If not, should we require that investors who are not qualified clients exit the hedge funds, or should we require that they be carved out of paying the performance fee?***
- ***Is the scope of the exemption appropriate? If it is too narrow, should we permit current investors to open new accounts or invest in other hedge funds managed by the same adviser? Alternatively, if it is too broad, should we prohibit current investors from adding to their investment?***
- ***Are there other exceptions or exemptions we should create?***

We believe that this is a reasonable transition approach.

H. Amendments to Rule 206(4)-2

We propose to amend rule 206(4)-2, the adviser custody rule, to accommodate advisers to funds of hedge funds. Our custody rule makes it clear that an adviser acting as general partner to a pooled investment vehicle it manages has custody of the pool's assets. Under the rule, advisers to pooled investment vehicles, including hedge funds, may satisfy their obligation to deliver custody account information to investors by distributing the pool's audited financial statements to investors within 120 days of the pool's fiscal year-end. Some advisers to funds of hedge funds have encountered difficulty in obtaining completion of their fund audits prior to completion of the audits for the underlying funds in which they invest, and as a practical matter will be prevented from complying with the 120-day deadline. We propose to extend the period for pooled investment vehicles to distribute their audited financial

statements to their investors from 120 days to 180 days, so that advisers to funds of hedge funds may comply with the rule.

- ***Is the 180-day period too long?***
- ***Would a 150-day period achieve the same goal?***
- ***Should we keep the 120-day requirement for non-fund of hedge funds advisers?***

Given that major U.S. corporations with widely diversified international operations are now required to meet a 75-day deadline for completion of their audit and filing of their financial statements, we fail to understand why hedge or other investment funds should be granted a 120-day period. Clients of hedge funds have the same needs for complete, accurate, and timely information as do investors in other entities.

Although we recognize the problem involved when the audit of one entity is dependent upon the completion of the audits of others, this again, is in no way different from the example given above of a major corporation. The final financial statements are a compilation of those of dozens or more other entities. We would recommend a reconsideration of these filing deadlines. The driving criterion here should be not past practice or other accommodation, but what best meets the information needs of an investor. Stale information is not useful, especially in an industry that may have completely changed its book of business over a period of a few months.

I. Amendments to Form ADV

We propose to amend Form ADV to identify advisers to hedge funds. The current Form ADV collects information about advisers to pooled investment vehicles without distinguishing hedge fund advisers from other advisers. We would amend Item 7 B. of Part 1A and Section 7 B. of Schedule D to require advisers to "private funds" as defined in the proposed rule to identify themselves as hedge fund advisers in Part 1A and Schedule D of Form ADV. We request comment on this aspect of our proposal.

- ***Are any other changes needed to Form ADV in connection with registering hedge fund advisers?***

We believe that this change is essential to providing complete transparency for the benefit of clients and other users of the information.

J. Compliance Period

We request comment on the length of time hedge fund advisers would need in order to register and revise their compliance systems so as to meet the requirements under the Advisers Act.

Although many hedge fund advisers may be able to transition easily, we recognize that some firms may need to develop control policies and procedures in a number of areas.

- ***Would six months be sufficient?***
- ***Would hedge fund advisers require as long as one year?***

Many advisers are no doubt prepared to meet the requirements, especially given that up to half of all hedge fund advisers are now voluntarily registered and prospective clients may demand such compliance. However, we would expect that a sizable number of advisers would not be fully prepared. Thus, we believe it would not be unreasonable to allow unregistered hedge fund advisers a period of up to one year to fully comply with the requirements.

Conclusion

CFA Institute appreciates this opportunity to comment on the proposal to extend registration to certain hedge fund advisers.

If we can provide additional information, please do not hesitate to contact Rebecca McEnally at 434.951.5319 or rebecca.mcenally@cfainstitute.org.

Sincerely,

/s/ Rebecca McEnally

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