Sheila C. Bair
121 President's Drive #320
Amherst, MA 01003

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549-0609

Re: File Number S7-30-04

Dear Mr. Katz:

On July 28, 2004, the Securities Exchange Commission (SEC) published for comment in the Federal Register rules to require hedge fund advisers to register with the SEC under the Investment Advisers Act of 1940. In general, by changing the way "clients" are counted for purposes of the private adviser exemption[1] contained in Section 203(b)(3) of the Act, the rules would make that exemption unavailable to advisers managing funds with minimum assets of $30 million[2] which allow redemptions within two years. In this way, the SEC hopes to distinguish "hedge funds" from private equity and venture capital funds which generally have considerably longer lock up periods. Advisers to the latter would continue to be exempt from registration.

The rules have been proposed by the SEC with the laudable objective of protecting hedge fund investors. Regrettably, it is far from clear whether requiring hedge fund advisers to register with the SEC will help or inadvertently harm investors by creating unrealistic expectations.

Over the past two decades, we have witnessed explosive growth in the securities markets, fueled in large part by the proliferation of IRAs, 401(k)s and other tax advantaged retirement and savings accounts widely used by retail investors. Never in the history of the SEC have there been more securities investment vehicles available to public investors. Never -- as well -- in the history of the SEC have there been more unsophisticated investors participating, directly or indirectly, in the securities markets, and thus exposed to the attendant risks. Regrettably, the markets and investor community have grown at a much faster pace than have the agency's resources, a phenomenon that

[1] This exemption applies to advisers with fewer than 15 clients within the preceding 12 months who do not hold themselves out generally to the public as investment advisers. Currently, the SEC allows advisers to count pooled investments as a single "client." The proposed rules, among other things, would require that each individual owner of a pool be counted as a "client."
[2] The proposed rule would not alter minimum asset thresholds for fund advisers. Thus, advisers with less than $25 million under management would be subject to state jurisdiction, those with assets between $25 and 30 million would have the option of registering with the SEC, and those with assets over $30 million would be required to register with the SEC.

has tested the ability of the SEC to effectively discharge its vast regulatory responsibilities. A series of high profile scandals in recent years has brought to the forefront the question of whether the SEC is structurally capable of taking timely preventative and remedial actions to address investor fraud and abuse.

Under Chairman Donaldson's leadership, the agency has significantly expanded its supervisory capabilities, hiring 740 new staff, mostly attorneys, accountants and examiners. [3]Significantly, Chairman Donaldson has also created a new risk assessment program to enable the SEC to better identify and manage risk in all segments of the securities markets and has instructed the SEC staff to develop an enhanced risk-based approach to oversight and examinations of investment advisers, including registered hedge fund advisers. [4]

These steps have been wisely undertaken to help the SEC to target its resources to those areas where they are most needed. The SEC is already responsible for examining 8,000 mutual funds with more than $7 trillion in assets managed by 900 investment companies, and 8,000 federally registered investment advisers managing $20.1 trillion – all with an examinations program that totals 495 employees.[5] The proposing release suggests that the extension of SEC registration requirements to hedge funds will help protect investors through, among other things, "our examinations and the obligation to commit to a program of compliance controls." However, as Commissioners Glassman and Atkins point out in their dissent, noncompliance by registered mutual funds had gone undetected during SEC inspections, suggesting weaknesses in the examination program that need to be addressed. The SEC should be revisiting and strengthening its oversight methods, rather than assuming responsibility for more entities through expanded registration requirements. This is particularly true given the relatively high level of sophistication of hedge fund investors, who are in better position than retail investors to understand investment risks and fend for themselves.

Indeed, hedge funds are generally understood to be unregulated, higher risk, pooled investments suitable only for sophisticated investors with significant wealth. Because of this common conception, it can be presumed that investors exercise heightened due diligence before investing in hedge funds, and that many avoid them altogether because of their unregulated status. By bringing hedge fund advisers under its supervisory umbrella, the SEC could be adding a level of legitimacy and safety to hedge fund investments in the eyes of many investors – perversely, perhaps emboldening investors who otherwise would not invest in such funds to do so, out of the belief that the SEC will protect them. By promising a "culture of compliance" through registration, the SEC may be encouraging investors to take a "free ride", reducing the amount of due diligence they would otherwise conduct on their own. The first line of defense for sophisticated

[3] Testimony of William H. Donaldson, Chairman, SEC, before the Subcommittee on Commerce, Justice, State and the Judiciary, Committee on Appropriations, US House of Representatives, "Fiscal 2005 Appropriation Request for the US Securities and Exchange Commission" (March 31, 2004)
[4] Testimony of William H. Donaldson, Chairman, SEC, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, "Investor Protection and the Regulation of Hedge Funds Advisers" (July 15, 2004)
[5] FN 3, at p. 8.

investors should be their own due diligence, not SEC compliance measures, which are already seriously strained. Given the fact that hedge funds do not account for a disproportionate share of fraud cases, it would seem that market discipline is by and large working. [6]SEC registration could weaken that discipline.

Though it is far from clear that SEC registration would help investors, there does appear to be general agreement that more basic “census” information is needed about hedge funds, including their total number, who manages them, the amount of assets they have under management, their client base, number of employees, etc. However, as others have pointed out,[7] there are mechanisms available to the SEC to obtain this information without requiring hedge fund managers to register. Section 206A of the Investment Advisers Act gives the SEC broad authority to condition exemptions under a general “public interest” standard. Thus, the SEC could condition the availability of the current private investor exemption on advisers filing basic information about their funds with the SEC and making specified disclosures to investors. It would also be within the SEC’s power to condition the exemption on the fund’s adherence to higher investor qualifications, if the SEC felt that step was necessary to protect against “retailization.” [8] The conditions could apply only to funds with lock-up periods of less than two years, to maintain the desired distinction between hedge funds and other private investment funds.

Such an approach would avoid the “free rider” problem, while giving the SEC and investors more information about hedge funds. It would not preclude the Commission from later requiring registration. By addressing this issue in stages, however, the Commission would have better information to craft a hedge fund regulatory regime, and some idea of the resources that would be required to effectively supervise hedge fund activity. As it stands now, the SEC does not even know how many new registrants would result under the proposed rules. [9] If the SEC has an immediate concern with hedge fund investments by pension funds and other fiduciaries, it could discuss these concerns with the Department of Labor and other fiduciary regulators, e.g., bank regulators for bank trust departments and insurance commissioners for insurance company investments. Strengthening fiduciary obligations as they apply to hedge fund investments, particularly for pension plans, would be a more direct way of addressing indirect “retail” exposure to hedge funds.

If the SEC decides to proceed with requiring registration, it should make every effort to leverage its resources by deferring to other regulators which already oversee components of the hedge fund industry. Specifically, hedge fund advisers that are registered with the

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[6] Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (available on the SEC’s website) at p. 73. Specifically, the staff report found “no evidence that hedge funds or their advisers engage disproportionately in fraudulent activity.”

[7] Testimony of James Chanos, President, Kynikos Associates, LP before the US Senate Committee on Banking, Housing and Urban Affairs “Regulation of the Hedge Fund Industry” (July 15, 2004)

[8] The proposed rules would have the effect of raising qualified investor thresholds for hedge funds to a minimum investment of $750,000, or net worth of $1.5 million, considerably higher than the requirements under Regulation D. These are the thresholds which apply to registered investment advisers who charge performance fees.

[9] The SEC release estimates the number of new registrants to range from 690 to 1,260. Release at 45190.

Commodity Futures Trading Commission as commodity trading advisers (CTAs) or commodity pool operators (CPOs) should be exempted, [10]as should non-US hedge fund advisers subject to adequate regulation in their home jurisdiction.[11]

The current proposal stems from the best of motives – the protection of investors – and represents the majority's good faith effort to proactively anticipate and prevent hedge fund scandals before they occur. However, the record does not show disproportionately high instances of fraud in this industry, suggesting that market discipline imposed by hedge funds' sophisticated investor base is currently adequate. Moreover, it is far from clear that the SEC has the necessary resources to effectively oversee this industry. By assuming responsibility for supervising the hedge fund industry, the SEC will have to divert examination resources from mutual funds and advisers which are accessible to less sophisticated public investors. At the same time, such action could tempt hedge fund investors to let their guard down in reliance on SEC oversight. Rather than preventing hedge fund abuse, the proposed rules could contribute to it by diluting market discipline, particularly among small pension plans or wealthy individuals who may not fully understand the limits of the SEC's supervision. Under its current leadership, the SEC has done much to restore the agency's luster as protector and champion of investors. I would hate to see that luster tarnished a few years from now by a hedge fund scandal because a well-intentioned SEC prematurely decided to take responsibility for an industry it did not have sufficient resources to oversee.

Sincerely,

Sheila C. Bair
Dean's Professor of Financial Regulatory Policy
University of Massachusetts-Amherst
Former Assistant Secretary for Financial Institutions
U.S. Department of the Treasury
Former Commissioner and Acting Chairman
Commodity Futures Trading Commission

[10] See Testimony of Patrick J. McCarty, General Counsel, Commodity Futures Trading Commission, before the US Senate Committee on Banking, Housing and Urban Affairs (July 15, 2004) for a good summary of the CFTC's compliance program for CPOs and CTAs. The CFTC estimates that the majority of advisers to the largest hedge funds are registered with the CFTC.

[11] See, e.g., Letter to Jonathan D. Katz, Secretary, SEC from the Alternative Investment Management Association (AIMA) re Staff Report to the SEC of September 2003 on the Implications of the Growth of Hedge Funds (March 22, 2004).