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September 15, 2004

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

Re: File No. S7-30-04
Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers

Dear Mr. Katz:

We appreciate the opportunity to comment on the Commission's proposed new rule and rule amendments that would require advisers to certain private investment pools ("hedge funds") to register with the Commission under the Investment Advisers Act of 1940 (the "Advisers Act"). As counsel to a wide-range of registered and unregistered hedge fund advisers, we have received many comments regarding the Commission's proposals. After extensive discussions with our clients and careful review of the Commission's proposals, we believe there are sound policy reasons why the Commission should not adopt the proposed rule. We also understand that there are sound policy reasons for the Commission to know more about the burgeoning hedge fund industry and propose that the Commission adopt, as a condition to the Rule 203(b)(3) exemption, a requirement that the funds claiming such exemption provide information to a Commission "registry." However, we agree with the views expressed by Commissioners Atkins and Glassman in their dissent from the proposed rule that hedge fund advisers should not be required to register as investment advisers with the Commission.

I. Overview

Hedge funds clearly have grown in significance over the past several years and their advisers have become a force in the financial markets. We believe that this growth fully justified the Commission staff in undertaking its recent study of the industry and in producing a report of its findings, entitled *Implications of the Growth of Hedge Funds*. We applaud the staff's efforts and found the report to be thoughtful and well-researched. The report also contained many conclusions with which we agree. Where we differ in opinion from the staff is with the ultimate conclusion that hedge fund advisers should be required to register with the Commission.

We understand that the staff's report has served as the basis for the Commission's current proposals. We have carefully reviewed the staff's report, as well as the Commission's release that accompanied the recent proposals (the "Proposing Release").[1] As explained more fully in this letter, we are concerned with certain policy justifications set forth in the Proposing Release as support for requiring hedge fund advisers to register with the Commission. Our areas of concern include the Commission's assertions that (1) past Congressional and Commission actions support the Commission's current proposals; (2) hedge fund growth has resulted in "retailization" involving investors who need greater protection; (3) the growth in hedge funds has resulted in increased hedge fund fraud and that hedge fund fraud can be prevented by registration of their advisers; and (4) the costs associated with registration are not overly burdensome. Accordingly, we request that the Commission reconsider its proposals. We also urge the Commission to consider the alternative reporting requirement for hedge fund advisers that we describe in this letter.

II. The Commission's Proposals

Many hedge fund advisers rely on a combination of Section 203(b)(3) of the Advisers Act and Rule 203(b)(3)-1 thereunder to determine that registration with the Commission is not required. Section 203(b)(3) generally exempts from registration any investment adviser who during the course of the previous 12 months has had fewer than 15 clients and who does not hold itself out generally to the public as an investment adviser. Meanwhile, Rule 203(b)(3)-1 provides in part that an investment adviser may count any hedge fund it manages as a single client for purposes of the 15-client limit, so long as advice is provided based on the investment objectives of the fund rather than the individual investment objectives of the fund's investors. The Commission proposes to amend Rule 203(b)(3)-1 and add new Rule 203(b)(3)-2, the sum of which will require hedge fund advisers to look through their hedge funds and count each investor as a client for purposes of the 15-client limit. This action will result in mandatory registration for most hedge fund advisers.

III. Policy Concerns

A. Past Congressional and Commission Actions

The Proposing Release cites past Congressional actions as support for its current proposals. After reviewing the Commission's recitation of past Congressional actions and its own past actions, we arrive at a different conclusion. We believe that Rule 203(b)(3)-1 as currently written is consistent with Congressional intent, accurately reflects legislative history and represents sound policy – that an adviser's client is the fund, not the investors in the fund. Moreover, we are concerned that the proposals overstep Commission authority. We present our interpretation of both congressional and Commission history below.

[1] *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. IA-2266, July 20, 2004 ("Proposing Release").

1. Legislative History Supports the Need for Congressional Action

The legislative history of the Advisers Act and the Investment Company Act of 1940 (the "Investment Company Act") indicates a clear precedent for Congressional action to require the registration of hedge fund advisers. Decades before the staff issued its recent hedge fund report, an earlier Commission issued a report to the Senate entitled *Public Policy Implications of Investment Company Growth*, seeking congressional action to amend the federal securities laws. In 1970, acting upon these legislative recommendations,[2] Congress amended both the Investment Company Act and the Advisers Act to require the registration of advisers to registered funds. Previously, those advisers had been exempt from registration under Sections 203(b)(2) or 203(b)(3) of the Advisers Act.

The parallels found between Congress' motivation for the 1970 amendments and the Commission's current motivation are striking. The *Congressional Record* associated with the 1970 amendments states, for example, that when the Investment Company Act was adopted in 1940, "most funds were relatively small in size and advisory fees did not present special problems. However, over the last 10 years, mutual fund ownership has gained increased public acceptance. Advisers now manage funds whose assets amount to billions of dollars. . . ." The *Congressional Record* further stated that in 1940, "it was impossible for the Congress to foresee the explosive growth in mutual funds or the increased compensation that their investment advisers would receive. . ." and that Congress' proposed legislation "would cure that deficiency."[3] Motivated by concerns similar to those expressed in the current Proposing Release – namely the growth of mutual funds, increased public investment in those funds (*i.e.*, "retailization"), and reliance on the Investment Company Act and Investment Advisers Act exemptions from registration by one type of investment company and its investment advisers – Congress enacted legislation to amend both the Investment Company Act and the Advisers Act to require the registration of advisers to registered investment funds.[4]

In 1996, Congress again revised both the Investment Company Act and the Advisers Act. Congress approved a technical amendment to Section 203(b)(3) of the Advisers

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[2] See *Report of the Securities and Exchange Commission: Public Policy Implications of Investment Company Growth*, Report of the Committee on Interstate and Foreign Commerce, December 2, 1966.

[3] Statements of Senator Sparkman, *Congressional Record* (Senate), at 3966, July 24, 1968.

[4] The Committee Report submitted with the Investment Company Amendments Act of 1970 states the following:

> "Section 24(a) of the bill would amend paragraphs (2) and (3) of section 203(b) of the Advisers Act to make inapplicable to investment advisers to investment companies the exemptions from registration under the Advisers Act now available to most of them. Section 203(b)(2) of the Advisers Act now exempts any investment adviser whose only clients are investment companies from the registration requirements of the statute, while section 203(b)(3) of that act provides a similar exemption for any investment adviser who during the course of the preceding 12 months has had fewer than 15 clients and who does not hold himself out generally to the public as an investment adviser. Some mutual fund advisers are registered under the Advisers Act, but most of them, particularly those that serve the large funds and fund complexes, fall within these two exemptions from registration. . . ."

Report of the Committee on Interstate and Foreign Commerce, Investment Company Amendments Act of 1970, H. Rep. No. 91-1382, at 4149 (1970).

Act,[5] and amended the Investment Company Act by adding Section 3(c)(7). This new section of the Investment Company Act provided an additional exemption from the definition of "investment company" and permitted a hedge fund to make a private offering of its securities to an unlimited number of "qualified purchasers."[6] This action by Congress knowingly and significantly expanded the exemption provided by Section 203(b)(3) of the Advisers Act.[7] We believe that if Congress had wished to narrow Section 203(b)(3) or the safe harbor provided by Rule 203(b)(3)-1, it would have done so when it amended the Investment Company Act and the Advisers Act in 1996.[8]

As the Commission notes, it has studied the hedge fund industry continuously since Congress first had the opportunity to amend the statutes.[9] It has also submitted its findings to Congress. However, Congress has not taken action to regulate hedge fund advisers, although it clearly has the power, is aware of the industry and its effects on the capital markets and has had the opportunity to introduce legislation.

2. <u>Legislative Action Indicates that a Hedge Fund is a Single Client</u>

The legislative history of the Advisers Act and the Investment Company Act indicates that a hedge fund should be viewed as a single client for purpose of Section 203(b)(3) of the Advisers Act. When Congress amended the Investment Company Act and the Advisers Act in 1970, it did not define the term "client." The context of the official committee report on the bill is clear, however, that an "investment company" is a "client" of an "investment adviser" (and thus both the Advisers Act and Investment Company Act needed to be amended in order to require the registration of advisers to registered investment companies). In fact, the committee report submitted with the Investment Company Amendments Act of 1970 states the following:

> "The proposed amendment will not affect the existing exemptions from registration for investment advisers whose only clients are insurance companies or for investment advisers other than those advising investment companies who

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[5] *National Securities Markets Improvement Act of 1996*, Sec. 508(d)(1), 110 Stat. 3416 (October 11, 1996).

[6] *Investment Company Act Amendment of 1996*, Sec. 209(a)(4), 110 Stat 3416 (October 11, 1996).

[7] Curiously, in the Proposing Release, the Commission also noted that in 1996 Congress amended the Advisers Act to allocate responsibility over advisers between the SEC and state regulatory authorities (and required advisers with more than $25 million in assets under management to register with the SEC). The Commission accurately stated that the 1996 amendment did not expand or contract the scope of Section 203(b)(3). However, the Commission added that the 1996 amendment should "inform our administration of the section" and, in light of those amendments, Rule 203(b)(3)-1 may be too broad a safe harbor.

[8] We also note that Congress has continued to monitor the hedge fund industry at least since the difficulties experienced by Long Term Capital Management in 1998 and has yet to find sufficient basis to adopt additional legislation imposing additional requirements under the federal securities laws on hedge funds and their advisers. During the same period, Congress significantly revised the federal securities laws through its adoption of the Sarbanes-Oxley Act of 2002. Moreover, the Senate and House have proposed bills regarding the mutual fund industry. However, bills such as the Mutual Funds Integrity and Fee Transparency Act of 2003 contain no references to the hedge fund industry. See *Mutual Funds Integrity and Fee Transparency Act of 2003*, H.R. 2420, November 20, 2003.

[9] Proposing Release at Section I.

neither hold themselves out generally to the public as such nor have 15 or more clients."[10]

In 1980, Congress adopted the Small Business Investment Incentive Act of 1980[11], which counted a business development company as a single entity and specified that the general partner of a limited partnership would be considered the adviser to the partnership, rather than the adviser to the individual limited partners.[12] This revision to the federal securities laws for business development companies was consistent with the 1970 revisions and made explicit the fact that the legal form of organization, limited partnership as opposed to corporate form, would not preclude reliance on the exemptions from registration provided in the Investment Company Act and the Advisers Act. In addition, and as noted above, when Congress enacted changes to the Investment Company Act and the Advisers Act in 1996, it could have defined the term "client" to include a hedge fund's investors. However, it did not do so even though the amendments had the effect of significantly expanding the ability of hedge fund advisers to rely on Section 203(b)(3).

3. SEC Historical Position Supports the View of a Hedge Fund as a Single Client

As a compliment to the legislative history discussed above, the 1985 adoption of Rule 203(b)(3)-1 under the Advisers Act represented a reasonable interpretation of then-existing law with regard to the actual relationship between advisers and their funds. We believe that Rule 203(b)(3)-1 as currently written continues to represent the best interpretation of current law.

In 1977, the Second Circuit Court of Appeal decided a case called *Abrahamson v. Fleschner*.[13] *Abrahamson* created confusion because the court's opinion was republished to remove part of footnote 16 of the original opinion, which had declared each limited partner of a limited partnership to be a "client" of the general partner, rather than considering the limited partnership itself to be the "client" of the general partner. Later, Congress enacted the 1980 legislation for business development companies, explicitly stating that a limited partnership, rather than a limited partner of the partnership, would be considered a "client" for purposes of the Advisers Act exemption.

The Commission adopted new rules in 1985 to provide certainty in light of both congressional and judicial action. The proposing release to the 1985 rulemaking observed the following:

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10 *Report of the Committee on Interstate and Foreign Commerce, Investment Company Amendments Act of 1970*, H. Rep. No. 91-1382, at 4149 (1970).

11 Pub. L. No. 94-477, 94 Stat. 2275 (1980).

12 "The Bill first provides that an investment adviser to a privately held business development company (including the general partner of a limited partnership) will generally not have the beneficial owners of that company counted as clients for purposes of Section 203(b)(3) of that Act." *Small Business Investment Company Act of 1980*, House Report No. 96-1341, 96 Cong. Sess. 4809 (1980).

13 568 F.2d 862 (2nd Cir. 1977).

> "Where an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of participants as a group – it appears appropriate to view the pool – rather than each participant – as a client of the adviser. Thus, for example, an investment company organized as a corporation, rather than each of its stockholders, is generally regarded as the client of the company's investment adviser."[14]

The 1985 rulemaking was intended to make clear that the chosen legal form of an entity should not be decisive in determining whether a pooled investment vehicle was a "client" – rather both corporate and limited partnership legal structures should be included under the concept.

Taken in context, the 1970, 1980 and 1996 amendments by Congress, along with the Commission's 1985 rulemaking initiative, are consistent with one another. An investment company, regardless of its legal form, is considered a "client" under the 1940 Acts, notwithstanding the absence of an explicit definition of the term in the statute. Using the Commission's exemptive powers to redefine the term "client" as applying to investors in an entity exempt under the Investment Company Act, rather than acknowledging that the term "client" may be the investment company itself, strays from the historical use of the word and we believe it is a strained interpretation. Accordingly, we question the wisdom of the Commission's approach in the Proposing Release in making "elastic" the term "client" to fit its objective, absent Congressional action.

B. "Retailization"

One of the most often cited justifications for Commission action comes from the staff's argument that "retailization" of hedge fund investment is occurring. The support for this argument is twofold: first, that hedge funds directly have more investors than in the past and second, that investments made by "funds of hedge funds" and institutions such as pension plans indirectly expose the public to unregulated entities. The staff also implies that the Advisers Act is unique among the federal securities laws because, unlike the other acts, which are premised on the belief that sophisticated investors do not need the protections of federal law, "the Advisers Act is intended to protect all types of investors who have entrusted their assets to a professional investment manager."[15]

1. <u>Sophisticated Investors Do Not Need Commission Protection</u>

We respectfully suggest that the Proposing Release represents a substantial deviation from historical staff interpretations and legislative history. As noted above, in 1996, Congress adopted Section 3(c)(7) to the Investment Company Act explicitly on the theory that sophisticated investors, here as elsewhere, do not need federal protection.[16] In addition, the

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[14] *Definition of "Client" of an Investment Adviser for Certain Purposes Relating to Limited Partnerships*, Release No. IA-956 (February 25, 1985).

[15] Proposing Release, at Section I.

[16] At the time that the bill's sponsor presented the original legislation to the House floor, the sponsor characterized the amendments as follows: "This legislation will do that, but in a way that will insure that only pools of the most sophisticated investors, people who are not in need of the protection of registration under the act, are exempted. Regulation imposes costs, and sophisticated investors not in need of or desiring the protection of the act should be

Commission proposed that Congress enact section 3(c)(7) precisely because the Commission ultimately believed that "no sufficiently useful governmental purpose is served by continuing to regulate funds owned exclusively by sophisticated investors."[17] The Division of Investment Management's reasoning was as follows: "The new exception would be premised on the theory that 'qualified purchasers' do not need the Act's protections because they are able to monitor such matters as management fees, transactions with affiliates, corporate governance, and leverage."[18] The federal securities laws exist to protect retail investors, not those who can fend for themselves. The Proposing Release should not mark a change in that philosophy.

2. <u>Direct "Retailization" Has Not Occurred</u>

Although we appreciate the concerns that the staff raises with regard to direct investors in hedge funds, this fact alone is not a sufficient justification for making the changes here. The relevant question, one specifically asked by the staff in *Implications of the Growth of Hedge Funds*, was whether less sophisticated investors, those who would not meet the Commission's standards to be "accredited," were able to invest in hedge funds. The answer was "no." In fact, the report noted that "most hedge funds maintain investment minimums that effectively limit the entry of minimally qualified investors into the funds."[19]

We agree with the staff findings that the economic prosperity in the 1990s raised the wealth and income of many, resulting in greater numbers of people who now qualify as "accredited" under the Commission's rules. We would support further staff efforts to revisit the criteria, set in 1982, for qualifying as an "accredited investor" and to change the criteria in light of today's economic realities. This would be the direct solution to the staff's concerns. The Proposing Release indirectly raises the criteria for those who may invest in hedge funds since, if the adviser to the fund is registered, only an investor whose net worth exceeds $1.5 million or who has $750,000 invested with the manager meets the "qualified client" test. We do not support the conclusion that registration of hedge fund advisers is an optimal means of addressing the fact that greater numbers of people today are qualified to invest in hedge funds.

3. <u>Indirect Exposure Does Not Justify Action</u>

Similar to the argument about direct "retailization," the Commission is attempting to use hedge fund adviser registration as an indirect means of achieving a result that is better addressed directly through other means. With regard to the Commission's concerns about the growth in investments by pension funds, endowments, and institutions, protections already exist. The pension plans identified in the Proposing Release as increasingly investing in hedge funds are already protected by ERISA, which imposes stringent fiduciary requirements, and, to a lesser extent, by the Internal Revenue Code and the Comptroller of the Currency.[20] More institutions

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free to voluntarily accept greater risk return for the opportunity of greater reward." Statement of Jack Fields, Congressional Record (House), April 7, 1995, at E868.

[17] Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management United States Securities and Exchange Commission, May 1992, at 114-115 (citations omitted).

[18] Id., at 104,105.

[19] Implications of the Growth of Hedge Funds, at 80.

[20] Protecting Investors, at 177-178.

are investing in hedge funds, but we respectfully believe that the current Commission should explore the issue further before coming to the conclusion that the increasing volume of investment alone is a justification for regulatory intervention now. In general, the fiduciaries for pension plans, endowments, and union plans employ experienced investment consultants to advise them regarding their investments. The "institutionalization" of the hedge fund market has had many salutary effects on the industry. Most such institutions require funds to complete voluminous questionnaires about management, investment procedures, and operational and risk controls. The argument that "retailization" exists because pensioners are indirectly investing in hedge funds rings hollow: such institutions are sophisticated, employ sophisticated advisers, and are subject to an existing regulatory regime regarding the exercise of their fiduciary duties.

C. Growth in Hedge Fund Fraud and Deterrence

The Commission cites statistics regarding enforcement actions involving hedge funds as further support for its proposals. Specifically, the Commission states in the Proposing Release that during the past five years it has initiated approximately 2600 enforcement cases including 46 enforcement cases in which the Commission has asserted that a hedge fund adviser has defrauded investors or used a managed fund to defraud others.[21] Based on these statistics, the Commission concludes that instances of hedge fund adviser fraud are increasing. However, the study specifically finds that there is no evidence indicating that hedge funds or their advisers engage disproportionately in fraud. However, of the cases cited, only eight of these matters might have been uncovered by a compliance inspection.[22]

The Commission also has stated that the registration of hedge fund managers will allow the Commission to conduct inspections of hedge fund advisers, which assist the Commission in detecting and deterring fraud. We are concerned that the Commission overstates the likelihood that examinations deter fraud. We note that only approximately 4 percent of all Commission inspections result in an enforcement referral.[23] In addition, it has been our experience that the Commission's inspection efforts more often lead to the identification of technical violations of Advisers Act requirements, rather than the discovery of actual fraud. In our experience, instances of actual fraud are more likely to be uncovered through tips by disgruntled employees or investors. These tips will continue whether or not hedge fund advisers are registered with the Commission. This point is made by Commissioners Atkins and Glassman and reinforced by comments made by Chairman Greenspan of the Federal Reserve Board.[24]

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[21] Proposing Release at Section I(B).

[22] See footnote 15 of the dissent. In addition, the dissent by Commissioners Glassman and Atkins stated in footnote 14 that of the 46 enforcement cases identified by the Commission, thirteen actually involved hedge fund advisers that were or should have been registered with the Commission.

[23] *Id*., at 16. See also THE INVESTMENT ADVISERS LEGAL AND COMPLIANCE GUIDE, Terrance J. O'Malley (Aspen Publishers, 2004) at page 8-10 (containing a chart reflecting reported information about the results of the Commission's compliance inspections from 1996 through 2002). We also were not able to find any publicly available information describing the percentage of enforcement referrals that actually result in the finding of actual fraud or a favorable outcome for the Commission.

[24] See also generally Alan Greenspan, Chairman, Federal Reserve Board, responses to the Senate Committee on Banking, Housing, and Urban Development, July 20, 2004.

Moreover, in order for the Commission to implement an effective compliance program for hedge fund advisers, we believe that the Commission will need to conduct extensive training programs for its inspection staff so that they will be able to conduct meaningful examinations of hedge fund advisers. Unlike other investment advisers, hedge fund managers rely on complex investment strategies, including the use of derivative instruments, side pocket investments and multiple legal entities to make various investments. This complexity necessitates additional, targeted training. We note, however, that the average tenure of the inspection staff currently is approximately 1.9 years.[25] In addition, Commission officials have stated that even with additional staffing for hedge fund adviser examinations, inspections of most advisers will occur only once every four years.[26] The turnover rate among examiners, combined with length of the Commission's inspection cycle, makes the likelihood of uncovering fraud even less likely.

Finally, the Commission has cited the involvement of hedge funds in the mutual fund late-trading and market-timing scandal as support for its proposals.[27] In particular, the Commission has suggested that, if the advisers to those hedge funds had been registered, the Commission may have been able to detect the improper trading sooner or that advisers may have been discouraged from engaging in those transactions at all. We do not fully agree with this logic. We note that every mutual fund whose shares were traded late or improperly timed was managed by a registered investment adviser subject to the full range of Advisers Act requirements and Commission inspections. Yet, none of the alleged abuses were detected by the Commission staff when conducting inspections of those registered entities. Accordingly, we do not believe that the mandatory registration of hedge fund advisers would have detected or prevented those intent on violating the law.

D. The Cost of Registration

The Commission stated in the Proposing Release that registration under the Advisers Act would impose only minimal additional burdens on hedge fund advisers.[28] Based on our experience and comments from our clients, we respectfully suggest that the costs are significant. Our concerns are discussed below.

1. Innovation Disincentives

The hedge fund industry has played a leading role in developing innovative financial products and strategies. These innovations have included strategies involving convertible arbitrage, commercial and mortgage-backed securities, credit default swaps, over-the-counter derivatives, bank debt and loans, and distressed debt, as well as non-dollar and emerging markets strategies and fund of fund strategies. This innovation is critical to keeping

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[25] *Examinations of Investment Companies and Investment Advisers, March 2004,* Memorandum from Lori A. Richards, Office of Compliance Inspections and Examinations to Chairman William H. Donaldson at the request of Richard C. Shelby, Chairman U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 10, 2004, at n. 39.

[26] See Richards Report, at page 9.

[27] Proposing Release at Section I(B).

[28] Proposing Release at Section II(B)(6).

the US capital markets as the leading markets in the world. We are concerned that the use of new products and strategies raises unnecessary concerns by inexperienced examiners and other members of the Commission staff and places hedge fund managers in defensive positions. We are likewise concerned that this dynamic inevitably (although not in a way susceptible to measurement) discourages innovation.

2. The Commission's Inspection Program

Our registered clients who have undergone "routine" examinations have frequently encountered situations where the Commission's examiners, though conscientious and well-meaning, have been ill-prepared to conduct a meaningful examination of a hedge fund adviser's operations. This lack of proper training and market sophistication has caused our registered clients to spend significant amounts of time educating the staff about the basics of the hedge fund industry, including legal structures used by hedge funds and their advisers, trading strategies, complex securities and other financial products, and many other aspects of the hedge fund industry, in addition to each client's unique operations. It also leads to instances where the inspection staff makes inapplicable recommendations. Providing what often amounts to on-site training programs for the inspection staff and addressing inaccurate observations or interpretations by the inspection staff greatly increases the costs of registration.

We also believe that the diversion of a hedge fund adviser's resources necessary to accommodate the Commission's inspection staff may create other undesirable effects. For instance, many smaller hedge fund advisers cannot afford to hire separate compliance officers and the role of the compliance officer is assigned to persons serving other critical functions.[29] During a compliance inspection, the person's time and energies are consumed by dealing with the inspection staff, which increases risks to the hedge fund adviser and ultimately to fund investors.

3. Building an Acceptable Compliance Infrastructure

Our unregistered clients take seriously their obligations to their clients and have established policies and procedures that cover critical operations and areas of potential conflicts of interest. We are concerned, however, that registration will require them to formalize their processes and build an infrastructure to meet the Commission's compliance expectations. Based on our experience, this undertaking requires the expenditure of significant resources. For example, registered advisers must formalize their compliance policies and procedures in a written document (typically in a "compliance manual"), and include new policies and procedures to cover areas applicable only to registered advisers. They also must comply with those provisions of the Advisers Act applicable only to registered advisers, including, for example, the technical requirements of Rule 206(4)-2, the custody rule. In addition, they must create systems for identifying and retaining all books and records required by Rule 204-2, including e-mails. Finally, many registered advisers engage the services of law firms or consultants to conduct

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[29] See *Small Mutual-Fund Firms Cry Uncle*, Wall Street Journal, Monday, September 13, 2004, at p.C15 (stating that many smaller mutual-fund companies are considering leaving the business due to the costs of hiring a dedicated compliance officer and stating that the annual salary for a dedicated compliance officer has reached between $200,000 to $500,000).

periodic "mock audits" to determine whether the adviser is meeting all of the technical requirements of the Advisers Act. We are concerned that the Commission underestimates the full extent of these costs.

4. Duplicative Oversight

Many hedge fund advisers are already subject to periodic examinations and other compliance obligations because they are subject to the jurisdiction of the Commodity Futures Trading Commission ("CFTC"). To the extent that a hedge fund trades futures or options on futures as part of its investment strategy, the fund is deemed to be a commodity "pool" under the Commodity Exchange Act and the sponsors and advisers to such funds must register with the CFTC as commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"), respectively, absent an available exemption or exclusion. Most registered CPOs and CTAs must also become members of the National Futures Association ("NFA"), a self regulatory organization, and are subject to, among other things, periodic audits by NFA. As noted in the Proposing Release, the CFTC has recently adopted rules expanding registration exemptions to cover many hedge fund managers. Many managers, however, are either required to register with the CFTC or choose to maintain a registration. The rule proposal would subject such persons to an additional level of regulation and would expose them to duplicative burdens and costs as a result of being required to satisfy dual compliance obligations. We ask the Commission to take into consideration these potentially duplicative burdens and costs.

IV. Alternative Methods for Achieving the Commission's Objectives

We appreciate the Commission's argument that the public interest might be better served if the Commission obtains certain information from hedge fund advisers. Given the growth of the industry, the Commission's argument that it needs more information about hedge funds is reasonable. Therefore, as an alternative to the Commission's proposals, we respectfully request that the Commission establish a "registry" approach as described below. This approach would allow hedge fund advisers to continue to rely on the registration exemption provided by Rule 203(b)(3)-1 in its current form, provided certain information is made available.

We recommend that, in lieu of its proposals, the Commission amend Rule 203(b)(3)-1 under the Advisers Act to state generally that any hedge fund adviser relying on the rule for an exemption from registration also must file with the Commission an annual report. We believe that this annual reporting requirement would best balance the desire of the Commission to obtain more information about hedge funds and their advisers with legitimate industry concerns regarding the costs of registration and its potential impact on the health and innovation of the industry.

Our proposed annual report would require a hedge fund adviser to submit the following information within 90 days of the end of the hedge fund adviser's fiscal year:

- The name of the adviser, the name of any affiliates of the adviser, the names of the funds managed by the adviser, and the address of the adviser's principal place of business;

- The names and brief biographies of the natural persons who retain voting and investment control over investments held by the funds, and whether any are subject to a statutory disqualification under the Advisers Act;

- The name of the person responsible for compliance;

- The exemption(s) under which each fund advised is exempt from registration under the Investment Company Act;

- The number of limited partners, members and/or shareholders of each fund under management;

- The gross assets and net assets under management by the adviser;

- An indication of the investment strategies employed by the adviser based on a list of potential strategies, including the relative amount of assets allocated to each strategy;[30]

- Performance data (net of fees) for the most recently completed fiscal year;

- Performance data (net of fees) for the most recent 3-year and 5-year periods;

- Disclosure stating whether the funds under management have audited financial statements for the most recently completed fiscal year; and

- The names of all prime brokers with whom the adviser maintains contractual relationships.

We believe that the information listed above would provide the Commission with the information it needs to fulfill its regulatory mission and the opportunity to create a hedge fund adviser registry for monitoring industry developments. For example, requiring hedge fund advisers to publicly file their performance data (which is the same information a hedge fund adviser typically provides to its investors) could expose an unscrupulous investment adviser to enforcement action if the information provided to the Commission is materially lower than that provided to investors. Similarly, the requirement to report both gross and net asset information would give the Commission accurate information about the amount of leverage being used in the industry. Meanwhile, descriptions of investment strategies will provide the Commission with a clearer picture regarding the diversity present within the hedge fund investment community.

In short, we believe that the annual reporting requirement represents a more reasoned approach. The annual report would provide the Commission with beneficial information, while minimizing the amount of resources the Commission may need to oversee growth in the industry. For hedge fund advisers, the annual report approach would minimize the concerns expressed throughout this letter. We believe that our proposal provides an optimal

[30] This list would be generated from hedge fund, private equity, and venture capital indices (recognizing that the structures and investment strategies of these investment entities increasingly carry the attributes of one another).

means of clarifying the issues raised by the Proposing Release, and we encourage the Commission to consider our alternative approach.

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We would be pleased to respond to any inquiries regarding the views set forth in this letter or other aspects of the Proposing Release. Please feel free to contact me at (212) 756-2450 or Terrance O'Malley at (212) 756-2345.

Sincerely,

Paul N. Roth