Sept. 15, 2004

Jonathan Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth St. NW
Washington D.C. 20549
By Email to rule-comments@sec.gov

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

To the Commissioners:

I write this letter concerning the Commission's above-captioned rule proposal to require operators of hedge funds to register with the Commission as investment advisers. I am a partner at the law firm of Bingham McCutchen LLP, where I represent broker-dealers, investment advisers and investment companies (both registered and currently exempt from registration), and other participants in the securities markets. I was previously the Commission's Assistant General Counsel for Market Regulation, and later I was General Counsel for a major national dual registrant broker-dealer/investment adviser. I submit this comment letter solely on my on behalf, and not on behalf of any current or former clients, my law firm, or any partners or associates at my law firm.

In this letter I will not address whether the Commission has legal authority to reinterpret the term "client" so as to look through a hedge fund to its underlying investors, although I believe this to be an important and open issue. Rather, I write here to urge the Commission to think through carefully all of the practical implications of hedge fund adviser registration. In particular, I urge the Commission to focus on whether it has the inspection and examination resources necessary to review what the Proposing Release estimates may be 1,000 or more new registered investment advisers.

Since the passage of the Sarbanes-Oxley Act, the Commission has seen its budget nearly double. After investments in technology and real estate and salary enhancements for existing employees, the Commission has been able to increase its number of employees by some 50%. The largest share of these new resources has gone to the Commission's examination program. When the Commission was first offered these new resources, it proposed to cut the "cycle" time between routine examinations for investment advisers from once every six to seven years or more, to once every three years. But as I understand it, due to an increase in the number of "cause" and "mini-sweep" examinations and the increased scrutiny in many exams, the Commission in fact has made essentially no progress in cutting down the length of the cycle between investment adviser examinations.[1]

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[1] The one exception, where the Commission has recently succeeded in cutting the cycle time of exams, is the comparatively small number of investment advisers to mutual funds.

Since the passage of NSMIA in 1996, SEC-regulated investment advisers are no longer subject to examinations by state securities regulators. Investment advisers have never been subject to SRO examinations. The SEC (as well as federal criminal prosecutors and state regulators) have brought a worrisome number of fraud cases against investment advisers, and the number of those cases has been increasing. Many of those cases have involved outright theft, forgery and/or embezzlement. Especially in bad markets, registered investment advisers appear not to be immune to temptation.

In my view, the Commission should strive to examine SEC-registered investment advisers at least once every year or two years.[2] Absent explicit congressional direction, the Commission should not seek to expand its jurisdictional mandate unless it can provide at least this much examination coverage for the mandate it already has. Calling an adviser "SEC registered" creates an impression among investors that the adviser is therefore adequately and effectively overseen - it lulls investors from taking their own steps to oversee their adviser. I think most investors would be very surprised to learn that the Commission staff does not examine SEC-registered advisers even as often as twice a decade. If the Commission is going to bless some advisers with the title "SEC registered," it should make sure that promise of investor protection real and effective.[3]

It may be objected that if fraud and misconduct is too common at investment advisers who are examined only every six or seven years, surely this fact argues in favor of requiring registration of hedge fund advisers, whom the Commission does not examine at all. But the Commission has not provided support for such an argument, and indeed the relevant data points in the opposite direction. When the Commission Staff recently studied hedge funds, it found no statistically significant evidence that fraud or other misconduct was more common among unregistered hedge fund advisers than among the many SEC-registered hedge fund advisers.[4] The original rationale for not requiring hedge fund advisers to register with the SEC was that sophisticated and wealthy investors could negotiate and obtain sufficient and effective protections for themselves. The data collected by the Commission Staff supports this proposition; that data does not support

[2] In the broker-dealer world, firms are examined (usually by their SRO) at least once a year. Larger brokerage firms typically are examined several times a year, by multiple SROs, the Commission and the states.

[3] The Commission estimates that the proposed rule would require some 1,000 hedge fund advisers to register in addition to the 8,000 current SEC-registered investment advisers. If so, and if hedge fund advisers on average are no more complex to examine than the currently registered advisers, adding this many new advisers should be expected to slow the average "cycle" time between investment adviser examinations by about a year. In reality, even once the SEC starts inspecting hedge funds, it is likely to take a substantial amount of time and effort for its examiners to understand what they are seeing - hedge fund trading strategies and operations are often far more complex than those at mutual funds and retail-oriented investment advisers. This fact could slow the SEC's examination "cycle" time even further.

[4] In order to accept money from investors regulated under ERISA, many hedge fund advisers already register with the SEC as investment advisers.

requiring registration.[5] When not promised that the SEC will oversee the adviser, hedge fund investors have been able through private ordering to negotiate adequate protections for themselves - protections apparently at least as effective as those provided by SEC registration and oversight. Ironically, requiring SEC registration may cause investors to forego those privately negotiated protections, on the misplaced expectation that the SEC will be "on the job."

The Commission Staff has anticipated my objection that hedge fund adviser registration will stretch its resources too thin. The Staff argues that its new examination risk assessment system will enable it to target examinations more effectively without additional resources. I applaud the effort to create such a system, which as I understand has yet to be finally designed, much less made available for public scrutiny. However, to have enough data to be truly reliable, such a risk assessment effort may take a decade. And, with all respect, as they say in Missouri, "show me". The Commission does not have any track record in determining what statistical factors are likely to predict future compliance problems. The SEC can have only limited confidence in the accuracy of the self-reported census data from advisers that will populate the risk assessment - firms which have other compliance problems may not reliably report the information from which the Commission makes its initial risk assessment judgments. In my view, there is no replacing the discipline of regular, annual (or at least biennial) examinations to provide an incentive to strong compliance. The Commission should not rely on a risk assessment model to replace regular cycle examinations - certainly not until such a model has been rigorously tested and has a track record of effective implementation.

In sum, the Commission should demonstrate that it has the resources and expertise to accomplish successfully its current mission of examining its existing population of investment advisers, before it bites off a substantial new piece of jurisdiction. While the Commission is making some progress in examining its existing population of investment advisers, it isn't there yet. In my view, for the Commission to promise protection to hedge fund investors, without being able effectively to provide it, is likely to cause more harm to American investor confidence than leaving unregulated a sector in which the need for regulation has not yet been convincingly demonstrated. I

[5] Hedge funds have been widely reported to have played a major role in the recent mutual fund market timing and late trading scandals. The Staff has argued that this fact justifies hedge fund adviser registration. But the Commission has brought virtually no enforcement cases on these issues against hedge funds. It is far from clear how a violation of Rule 22c-1, which on its face applies only to mutual funds, could be charged against a customer of the fund. And it is even less clear how market timing - which the SEC has repeatedly conceded is not on its face illegal - could be charged as a violation against the customer (especially given the vague, generally discretionary market timing policies described in most mutual fund prospectuses). In any event, the proposed hedge fund adviser registration requirement would not apply to offshore hedge funds with offshore advisers, who seem to have conducted much of this trading. Serious as it is, the mutual fund scandal is primarily about misconduct at entities already subject to SEC jurisdiction - misconduct which the Commission missed for years in its examination program. This scandal does not justify spreading the SEC's limited examination resources even more thinly.

appreciate the opportunity to comment on this important issue, and would be happy to discuss these comments further or provide any other assistance the Commission or its staff may desire.

Sincerely,

W. Hardy Callcott