September 8, 2004

By Electronic Delivery

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

Re: **Investment Advisers Act Release No. 2266 (File No. S7-30-04): Registration under the Investment Advisers Act of Certain Hedge Fund Advisers**

Dear Mr. Katz,

We submit this letter in response to a request by the Securities and Exchange Commission ("SEC" or "Commission") for comments regarding the above-referenced proposal for registration of certain hedge fund advisers as investment advisers under the Investment Advisers Act of 1940, as amended ("Advisers Act").[1/]

We show in these comments that the Commission does not have the authority to eliminate the statutory exception for investment advisers with fewer than 15 clients from the registration requirements of the Advisers Act. "The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute."[2/] Counting clients by the "look through" method the Commission now proposes is contrary to the text and the entire history of the Advisers Act.

In 1940, Congress excepted from registration investment advisers with "fewer than fifteen clients …."[3/] In accordance with the ordinary meaning of "client" -- a person or entity directly receiving professional services -- both Congress and the Commission have consistently treated any fund or other legal organization receiving advice from an investment adviser as a single client of the adviser, and have refused to "look through" the organization to treat its

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1/ *See Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Rel. No. 2266 (July 20, 2004) ("Hedge Fund Advisers Release").

2/ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976) (citations and internal punctuation marks omitted).

3/ Investment Advisers Act of 1940 § 203(b)(3). This exception is available only to advisers that do not hold themselves out publicly as investment advisers and do not advise registered investment companies.

individual members or owners as separate clients, unless the adviser also advises them individually. It was therefore the universal understanding in 1940 and thereafter that an adviser to a fund, either registered or unregistered, is not required to register solely because of that relationship. In 1970 Congress amended the Advisers Act so as to require registration by advisers to registered funds, but it did so carefully with targeted language that did not alter the no-look-through principle.

The Commission now seeks to amend the statute again, without Congress's help, to require registration of advisers to *un*registered funds. The Commission would do so by scrapping the no-look-through principle that has been a part of the statutory structure since 1940. It would declare that every investor in a "private fund" (defined so as to include essentially all hedge funds) must be counted as a separate client of the fund's adviser, even when the adviser deals only with the fund and has no actual client relationship with any investor. But the Commission has no power to change the 64-year-old meaning of a statutory term, a meaning that not only accords with common understanding but is central to the structure and purpose of the statute.

Moreover, the Commission's proposal is an obvious effort to circumvent clear statutory exclusions from the *fund* registration requirements in the Investment Company Act of 1940 ("ICA").[4/] Hedge funds have been formed and operated in good faith based on the exceptions and exclusions set forth in the Advisers Act and the ICA, and the SEC has no power to change the statutes so as to eliminate them.

I. Background

The term "hedge fund," which is not defined in the ICA or Advisers Act, is generally understood to refer to a pooled investment vehicle, advised by a professional investment manager, engaged in any of a wide variety of investment strategies, but open only to institutional investors and to individuals meeting threshold net worth or income requirements.[5/] Hedge funds and the hedge fund/adviser relationship are generally designed to qualify for the statutory exceptions and exclusions from registration in the ICA and Advisers Act.[6/]

Specifically, Section 3(c)(1) of the ICA has, since 1940, excluded from the definition of "investment company" any investment company that does not publicly offer or plan to offer its

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4/ Investment Company Act of 1940, as amended, §§ 3(c)(1), 3(c)(7).

5/ *See*, *e.g.*, *Implications of the Growth of Hedge Funds*, Staff Report of the Securities and Exchange Commission (September 2003) at 1-10; *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Report of the President's Working Group on Financial Markets (April 1999), at 1-6; Comment, *Hedge Funds are Headed Down-Market: A Call for Increased Regulation?*, 40 San Diego L. Rev. 1555, 1558-60 (2003). A hedge fund operated under the exclusion provided in ICA § 3(c)(1) could include some investors not meeting the net worth qualifications, but in practice most hedge funds require initial investments of at least $1 million. *See Hedge Funds are Headed Down-Market*, 40 San Diego L. Rev. at 1562 n.35.

6/ They are also generally designed so that their offering and sale of their securities are exempt from the registration requirements of the Securities Act of 1933 ("Securities Act") under Rule 506 of Regulation D. Hedge funds and their advisers are, however, subject to the antifraud provisions of the securities laws.

securities and whose securities are held by one hundred or fewer persons. Section 3(c)(7) of the ICA, added by Congress in 1996,[7/] excludes from the definition of "investment company" any investment company that does not publicly offer or plan to offer its securities and whose securities are held only by "qualified purchasers," chiefly individuals with not less than $5 million in investments or institutions with not less than $25 million in investments.[8/] In 1940 and again in 1996 Congress concluded that the investor-protection benefits of ICA registration are not required, or are outweighed by costs, in these situations.

Section 203(b)(3) of the Advisers Act has, since 1940, excepted from registration any investment adviser "who during the course of the preceding twelve months has had fewer than fifteen clients." Congress did not define "client" in the Act, but it plainly understood that term to mean an entity to which advice is given, not the passive investors in such an entity who are not being advised individually. As we show below, that understanding flows from the ordinary usage of the word "client" in 1940 and is also central to the structure of the Advisers Act. Section 203(b)(2) of the Advisers Act originally excepted from registration any adviser "whose only clients are investment companies …." That exception would have been meaningless if the word "client" could also separately count the investors in an investment company, even where there are no separate advisory relationships. The word "client" necessarily meant, and was universally understood to mean, the fund alone, and only Congress can change that.

The Commission itself routinely assumed the customary definition of "client" when it adopted Rule 203(b)(3)-1(a)(2)(i) in 1985. That Rule states that an investment adviser should count as a single client any legal entity "that receives investment advice based on its [own] investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries."

The Commission's Proposal would create a new category, "private fund," defined by the entity's conformance to the ICA's statutory exclusions. Then, precisely because the funds themselves are excluded from the definition of "investment company" (*i.e.*, precisely because Congress determined that the protections of fund registration were *not* required for these entities), the Proposal would require the adviser to look through the private fund to count each shareholder, limited partner, member, security holder, or beneficiary of the fund as a separate client.[9/] If the adviser advised a fund or funds that together had more than fourteen investors, the adviser would have to register with the Commission. The end result would be that most hedge fund advisers would have to register and the Commission would, through rulemaking, have repealed the exclusions provided in the statute.

7/ *See* National Securities Markets Improvement Act of 1996 § 209, Pub. L. No. 104-290.

8/ "Qualified purchasers" are defined in Investment Company Act § 2(a)(51)(A).

9/ *See Hedge Fund Advisers Release*, text following note 232 (proposed rules 203(b)(3)-1(b)(6) and 203(b)(3)-2).

II. The Commission has no power to eliminate the clear statutory exception for advisers with fewer than fifteen clients

In *Chevron U.S.A., Inc. v. National Resources Defense Council, Inc.*, the Supreme Court ruled that when a court is evaluating an agency's interpretation of a statute the first question is "whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[10/] Congress has unambiguously expressed its intent on the question at issue here. In 1940, Congress excepted advisers with fewer than fifteen clients and it made clear that it intended to except an adviser to one or more funds, each of which was to count as only a single "client." In 1970, Congress amended the Advisers Act to require registration by advisers to registered funds, but it did so in a way that reiterated its understanding that a fund was to count only as a single client. If that principle is now to be replaced by a look-through regime, it is up to Congress make the change.

1. <u>A "client" is a person directly receiving professional services</u>

The Advisers Act excepts from registration an adviser with "fewer than fifteen clients." "Client" is not an infinitely malleable term. In the Advisers Act, it means an individual or organization that receives advice from an investment adviser, and it does not reach a mere investor in the organization receiving advice, where the investor does not receive individual advice from the adviser.

This follows from the plain meaning of the term. A "client" is "a person or company for whom a lawyer, accountant, advertising agency, etc. is acting," or "a customer."[11/] *Black's Law Dictionary* similarly defines a client as "a person or entity that employs a professional for advice or help in that professional's line of work."[12/] A client of an investment adviser, therefore, is a person that has a direct relationship with the adviser pursuant to which it receives the adviser's services. A mere investor in a fund, who has no advisory relationship of his own with the fund's advisor, is not a "client" as the term is used in either ordinary speech or the Advisers Act.

2. <u>The legislative history of the Advisers Act confirms that "client" means a person directly receiving investment advice.</u>

The Advisers Act grew out of a 1939 Commission report entitled *Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services*

10/ 467 U.S. 837, 842-43 (1984).

11/ *Webster's New World Dictionary* 262 (3d. ed. 1989). This definition may, if anything, be broader than the 1940 understanding of "client." In 1940, "client" denoted a more personal relation than did "customer," but the usage "has shifted considerably" in recent years as people have used "client" and "customer" more interchangeably. Bryan A. Garner, ed., *A Dictionary of Modern Legal Usage* 162 (2d ed. 1995).

12/ *Black's Law Dictionary* 271 (8th ed. 2004).

("Investment Advisers Report").[13] As used in the *Investment Advisers Report*, the term "investment adviser" meant a professional who provided individualized services to a client. It was the close, fiduciary relationship between adviser and client that set the investment adviser apart from other financial intermediaries.[14] As one industry representative put it, the difference was that the investment adviser gave "advice in connection with the specific condition of a particular individual," while an investment company provided generalized and less personalized investment services to a set of individuals, keyed for instance to "what would be best for a cross-section of the American public, but not . . . with the peculiar, particular, specific financial condition of the individual and what he hopes to accomplish" in mind.[15] This focus on the personal relationship between adviser and client was reflected in the Act: the House Report on the Act noted that the Advisers Act "recognizes the personalized character of the services of investment advisers and especial care has been taken in the drafting of the bill to respect this relationship between investment advisers and their clients."[16]

The Supreme Court has squarely endorsed this reading of the Advisers Act, stating that the "[Advisers] Act was designed to apply to those persons engaged in the investment-advisory profession--those who provide personalized advice attuned to a client's concerns, whether by written or verbal communication."[17] In *SEC v. Lowe*, the Court's decision that a publisher of a securities newsletter was not an investment adviser under the Act turned on this distinction. His conduct was not covered by the Advisers Act, the Court concluded, since his "publications do not fit within the central purpose of the Act because they do not offer individualized advice attuned to any specific portfolio or to any client's particular needs."[18]

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[13] *See Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services*, H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939); *see also Lowe v. SEC*, 472 U.S. 181, 190-91 (1985) (discussing and relying on the *Investment Advisers Report*); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 187-89 (1963) (same).

[14] On the fiduciary nature of the relationship, *see, e.g., Lowe*, 472 U.S. at 210.

[15] *Investment Advisers Report* at 26-27 (testimony of James White of Scudder, Stevens and Clark). The Supreme Court has taken the report as strong evidence of the intent of Congress in the Advisers Act. *See Lowe v. SEC*, 472 U.S. at 200-02 & n.44; *see also* Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* 222 (3d. ed. 2004).

[16] *Lowe*, 472 U.S. at 201 (quoting H.R. Rep. No. 2639, 76th Cong., 3d Sess., 28 (1940)) (emphasis removed).

[17] *Lowe*, 472 U.S. at 207-08. The Court also referred to "the kind of fiduciary, person-to-person relationships that were discussed at length in the legislative history of the [Advisers] Act and that are characteristic of investment adviser-client relationships." *Id.* at 210.

[18] *Id.* at 208. In *Lowe*, the immediate issue before the Court was whether the publisher of a securities newsletter, who otherwise did not provide personalized investment advice, fell within the statutory exclusion from the definition of "investment adviser" provided to *bona fide* publishers in Advisers Act § 202(a)(11)(D). *See id.* at 211.

3. The structure of the Advisers Act further confirms the meaning of the word "client"

It is beyond dispute that Congress, in 1940, intended to except from registration any adviser "whose only clients are investment companies and insurance companies."[19/] But this provision is comprehensible only if the investors in such an investment company are not themselves "clients." If the term "client" included investors who are not themselves advisees, then (a) there would be no such thing as an adviser whose only client is an investment company, (b) almost all fund advisers would also fail the "fewer than fifteen clients" test, and (c) Congress's plain intention in 1940 to except fund advisers from registration would be thoroughly defeated by its own choice of words.

4. The 1970 Amendments further confirm the meaning of "client."

In 1966, the Commission concluded that it would be desirable to require advisers to registered investment companies to register.[20/] But the Commission understood -- then -- that it did not have the power to achieve this result by altering the meaning of "client" or by any other form of regulation, and it asked Congress to change the law. In 1970, Congress responded by removing the words "investment companies and" from the Section 203(b)(2) exception and by amending Section 203(b)(3) so as to deny the "fewer than fifteen" exception to any adviser who "acts as an investment adviser to any investment company registered under [the ICA]." Significantly, neither the Commission nor Congress suggested any change in the definition of "client" or in the method of counting them. These remained unaltered, so that an adviser to an *un*registered fund remained excepted as long as it advised fewer than fifteen clients, with each fund counted as a single client. The Commission is now proposing to take, on its own, a second step that exactly parallels the step that, in 1970, it recognized that only Congress could take.[21/]

19/ Investment Advisers Act of 1940 § 203(b)(2), 54 Stat. 847. The words "investment companies and" were removed by the Investment Company Amendments Act of 1970. 84 Stat. 1413

20/ *See Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 87-2339, at 344-45 (1966).

21/ Congress again changed Section 203(b)(3) in 1980, adding the sentence: "For purposes of determining the number of clients of an investment adviser . . . no shareholder, partner, or beneficial owner of a business development company . . . shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner." Small Business Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (codified at 15 U.S.C. 203(b)(3)). This provision, making explicit the Act's no-look-through approach, was added in the wake of *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977) (*see infra* note 26), which had briefly raised doubts as to whether a limited partner in a hedge fund might be counted as a client of the fund's general partner. *See* Reginald F. Thomas and Paul F. Roye, *Regulation of Business Development Companies under the Investment Company Act*, 55 S.Cal. L. Rev. 895, 911, 930 (1982).

5. The Commission itself has consistently understood the word "client" not to cover fund investors who were not themselves advisees

The Commission's actions since it turned to Congress in 1966 further confirm its own understanding that "client" does not include ordinary fund investors and that it cannot amend the statute.[22/]

The Commission first formally addressed the definition of "client" in 1985, when it adopted Rule 203(b)(3)-1.[23/] That rule told the general partner of an investment limited partnership to count as a client only the limited partnership itself, and not each limited partner, so long as the general partner "provides investment advice to the partnership based on the investment objectives of the limited partnership."[24/] In 1997, the rule was broadened to allow an investment adviser to count as a single client any legal entity "that receives investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries."[25/]

The rule was originally adopted to clear up any uncertainty as to whether a general partner had to count as a client each limited partner of the partnership it advised.[26/] Underpinning the Rule, however, is an assumption dating back to the passage of the Advisers Act: the test of whether a person is a client of an investment adviser is whether that person receives distinct or individualized investment advice. The Proposing Release specifically noted that its test to determine who was a "client" turned on who received individualized advice, stating that the "rule is intended to be available to a general partner acting as an investment

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22/ An agency is not formally bound by its past interpretation of its statute if (1) the statute is ambiguous and (2) the new interpretation is in harmony with the purposes and text of the statute. *See Chevron*, 467 U.S. at 863-64; *see also National Home Equity Mortgage Ass'n v. Office of Thrift Supervision*, 373 F.3d 1355, 1360 (D.C.Cir. 2004). But the agency does have an obligation to explain the ambiguity and its own change of position. *See Motor Vehicle Manufacturers Ass'n of the United States, Inc., v. State Farm Mutual Automotive Ins. Co.,* 463 U.S. 29, 42 (1983).

23/ *See Definition of 'Client' of Investment Advisor for Certain Purposes Relating to Limited Partnerships*, SEC Rel. No. IA-956 (Feb. 22, 1985) ("203(b)(3)-1 Proposing Release"); *Definition of 'Client' of Investment Advisor for Certain Purposes Relating to Limited Partnerships,* SEC Rel. No. IA-983 (July 12, 1985) ("203(b)(3)-1 Adopting Release"). There were some prior no-action letters. *See, e.g., Hawkeye Bancorporation*, 1971 SEC No-Act LEXIS 874 (May 12, 1971) (requiring the trustee of a "joint investment trust" to count each member of the investment pool as a client); *S.S. Programs, Ltd.*, 1974 SEC No-Act LEXIS 869 (Dec. 2, 1974) (explaining that "we would view each partner as a separate client for purposes of determining the number of clients the general partner would have"); *Vincent Boening,* 1975 SEC No-Act LEXIS 1686 (Aug. 17, 1975).

24/ 203(b)(3)-1 Adopting Release at *5.

25/ SEC Rule 203(b)(3)-1(a)(2)(i).

26/ The uncertainly was caused by *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977), in which the Second Circuit raised the question of whether a general partner providing investment advice to a partnership was adviser to the limited partners severally. An early draft of the *Abrahamson* decision characterized limited partners as clients of a general partner acting as the partnership's investment adviser, but the published version of the decision removed this comment and left the question open. *See Hedge Fund Advisers Release* at n.110.

adviser to a limited partnership that is in fact a collective investment vehicle, rather than one which is merely a device for providing individualized investment advice."[27/] If the advice was to the partnership, and was keyed to the partnership's goals, then the partnership was the client.

There may, of course, be situations in which particular investors in a hedge fund have the kind of individual relationships with the adviser, or receive the kind of individualized advice, that makes it appropriate to treat each of them as a separate client.[28/] But that is a matter to be dealt with case by case, or by rules consistent with the established understanding of "client." The Commission's proposal would, instead, effectively amend the statute to require registration in every ordinary situation in which fund investors are entirely passive and indistinguishable.

6. <u>The Proposal is a transparent attempt to assert SEC control over entities that Congress has excluded from the definition of "investment company"</u>

Hedge funds themselves were apparently first created in 1949 and their number grew rapidly in the 1960s.[29/] Until 1996, hedge funds operated under the exclusion in Section 3(c)(1) of the ICA, which limited them to 100 investors. In the National Securities Markets Improvement Act of 1996, Congress provided an additional exclusion. It added Section 3(c)(7), which excluded funds with an unlimited number of investors, so long as these investors were

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27/ *Id.* (emphasis added). Substantially the same point is made in the Adopting Release at *3. Since adoption of Rule 203(b)(3)-1, Staff determinations as to whether a particular person is a "client" of an investment adviser for purposes of the exemption have focused on whether the investment adviser is providing the person individualized investment advice; compare, for instance, *Burr, Egan, Deleage & Co.*, 1987 SEC No-Act. LEXIS 2025 (Apr. 27, 1987), in which the Staff declined to grant no-action relief to a general partnership seeking assurance that its limited partners would not be counted as its clients, because the GP "would be providing investment advisory services . . . to the limited partners that may not be solely incidental to the stated investment objectives" of the limited partnerships, with *Latham & Watkins*, 1998 SEC No-Act. LEXIS 801 (Aug. 24, 1998), granting no-action relief to a general partner of an investment limited partnership that made decisions for the partnership in light of the investment objectives of the partnership, and not of the individual limited partners.

Before 1998, the Staff also occasionally gave no-action relief allowing a general partner to treat limited partners as clients for purposes of then-Rule 205-3, which required an investment adviser seeking certain kinds of compensation to enter into an arm's-length advisory contract with the partnership. *See, e.g., P.E. Becker, Inc.*, 1986 SEC No-Act LEXIS 2557 (July 21, 1986), 1986 WL 67116. This no-action relief appeared to be chiefly a way of allowing general partners more easily to receive incentive compensation.

28/ We note that hedge fund investors frequently seek and develop important lines of communication with hedge fund advisers so as to fulfill their own obligations or needs to conduct due diligence on their investments. Similarly, an adviser typically obtains substantial information from a potential investor to ascertain the accredited investor and/or qualified purchaser status of the investor, and to satisfy the requirements of anti-money laundering and other regulations. On an ongoing basis, an adviser may also provide periodic reports to investors concerning fund performance and related issues. Accordingly, there may be ongoing communications and strong business relationships that develop over time between an adviser and the investors in its hedge funds. None of those activities constitutes "individualized advice" that would establish an advisory relationship between the adviser and investors in the fund.

29/ *See Hedge Fund Advisers Release*, text accompanying notes 24-25.

"qualified purchasers."[30/] The Senate Report accompanying the 1996 Act explained that the "qualified purchaser pool reflects the Committee's recognition that financially sophisticated investors are in a position to appreciate the risks associated with investment pools that do not have the Investment Company Act's protections."[31/] The Proposal the Commission now makes is plainly an attempt to assert some form of regulatory control over entities -- hedge funds -- that have been excluded from the definition of "investment company" for more than sixty years, and whose exclusion was sharply expanded by Congress less than a decade ago. We do not believe that the times call for a dramatic reversal of Congress's 1996 judgment, but whether they do is for Congress, not the Commission, to decide.

III. Conclusion

Congress has determined that hedge fund investors do not need the protection of registration by hedge funds or hedge fund advisers. The proposal exceeds the powers granted to the Commission and should be withdrawn.

Respectfully submitted,

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30/ Despite this, hedge funds generally limit participation to fewer than 500 investors so as not to be required to register under the Securities Exchange Act of 1934. *See* Securities Exchange Act of 1934 § 12(g)(1) (requiring a domestic issuer of securities with assets in excess of $1 million and a class of equity securities held by more than 500 persons to register the securities).

31/ S. Rep. No. 104-293, at *10 (1996).