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U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
Attention: Jonathan G. Katz, Secretary

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

Ladies and Gentlemen:

We are submitting this letter in response to a request by the Securities and Exchange Commission (the "Commission" or the "SEC") for comments regarding the above-referenced proposal to require certain hedge fund advisers to register as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act").

INTRODUCTION

The Congress, in adopting the Advisers Act and through several amendments, has recognized that a fund, whether or not exempt from registration under the Investment Company Act of 1940 (the "1940 Act"), is itself the client of an investment adviser and that the several investors in such a fund, if their assets are managed collectively, are not themselves separate advised clients. The Commission's proposal is inconsistent with that congressional intent and indeed does violence to the statutory pattern. If adopted, in our view it would be reversible as a matter of law.

Requiring hedge fund managers to register under the Advisers Act would increase by a considerable amount the burdens on the Commission and its staff without any commensurate benefit to investors. As Commissioners Atkins and Glassman noted in their dissent, there is not a competent body of evidence supporting the proposal. The demonstrated incidence of misconduct by unregistered hedge fund advisers is no greater than it is for registered advisers and many of the advisers that committed such misconduct would not be required to register under the proposal in any event. Proper conduct by investment advisers to registered investment companies seems to have more to do with the integrity of the individuals involved than with the presence of Commission regulation. Blunderbuss or "prophylactic" solutions to problems of abuse (that is to say, broader solutions than the ills discovered would justify) often do not make for good public policy. Often, the cost occasioned by overregulation exceeds the risk sought to be insured against.

Investors today can choose whether to avail themselves of whatever benefits might be thought, mistakenly we believe, to accrue from Advisers Act registration. Evidently, many investors have decided to forego those putative benefits. Those investors are among the most sophisticated in the world.

The Commission has a number of alternatives available to it other than Advisers Act registration of hedge fund advisers, including conditional exemptions from registration. The Commission should consider those before adopting a scheme of registration that is unnecessary, unwise and inappropriately burdensome.

DISCUSSION

Statutory Pattern. The Advisers Act's exclusion from registration of advisers that, among other things, have fewer than 15 clients was never designed to count each of the investors in a fund managed as a single entity. If that were the case, the 1970 amendments to the Advisers Act, which added the requirement that any adviser to an investment company registered under the 1940 Act had to register, would not have been necessary since, almost by definition, a fund that was itself registered would have more than 15, and probably more than 100, investors in light of the registration exception in Section 3(c)(1) of the 1940 Act. The Congress recognized that a registered investment company would itself count as one investor for purposes of the Advisers Act exclusion and it was therefore necessary to negate what would otherwise have been an airtight exception from Advisers Act registration for investment advisers to registered investment companies.

The Congress was fully aware that the 1970 amendment was needed to bring investment advisers to registered investment companies within the Advisers Act registration provision given the clear exemption Section 203 gave them if they had fewer than 15 investment company or other clients within a twelve-month period:

> The amendments . . . would remove provisions of the Advisers Act which now afford investment advisers to investment companies special exemptions from regulation under the Advisers Act.[1]

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1 Investment Company Amendments of 1969, Report of the Senate Comm. on Banking and Currency to Accompany S.2224, S. Rep. No. 91-184, 91st Cong., 1st Sess. 44 (1969).

More recently, when the Congress added Section 3(c)(7) to the 1940 Act, it had another opportunity to change the statutory pattern, this time in the wake of a Commission rule establishing that a private investment company is to be considered a single investor for purposes of the 15-investor test in the Advisers Act and a substantial, recent and well-known history of growth in private investment companies. The Congress declined to take the action the Commission now is pursuing through self-help.

In a situation analogous to this, the Commission adopted Rule 3b-9 under the Securities Exchange Act of 1934 (the "Exchange Act") several years ago, revoking the statutory exception for banks from broker-dealer registration. As in this case, the Congress had amended the Exchange Act on numerous occasions while fully aware of the increasing growth of brokerage activities by banks and without changing or limiting the bank exception. In voiding the Commission's rule, the United States Court of Appeals for the District of Columbia Circuit rejected the Commission's effort to overrule the congressional decision to leave banking regulation to the bank regulators:

> In the end, all of the SEC's efforts to avoid the 'plain meaning' of the definitions of 'broker,' 'dealer' and 'bank' fail. We give effect to the statutory language not because its meaning is as 'plain' as can be, but because it reflects a basic decision by Congress . . . . Rule 3b-9, whatever its beneficial purpose or the regulatory need for some such authority, still . . . is tantamount to one of the regulatory players unilaterally changing the rules of the game. The SEC by itself cannot extend its jurisdiction over institutions expressly entrusted to the oversight of the Comptroller, the Board of Governors, the FDIC, and others.[2]

The Commission's proposed rule has similar but greater infirmities. When it adopted its ill-fated Exchange Act Rule 3b-9, the Commission was relying on express statutory permission in Exchange Act Section 3(b) "by rules and regulations to define technical, trade, accounting, and other terms used in [the Exchange Act]." The Commission cannot claim any similar reliance here.

Of the six major statutes administered by the Commission, all but the Advisers Act authorize the Commission to define "accounting, technical and trade terms" used in the respective Acts.[3] The omission of that definitional authority from the Advisers Act likely was not accidental and cannot be ignored. It casts grave doubt on the Commission's ability to define the term "client" for purposes of the Advisers Act registration requirement, particularly if the Commission's purported

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2 *American Bankers Assoc. v. Securities & Exch. Comm'n*, 804 F.2d 729, 755 (D.C. Cir. 1986).

3 *Compare* Securities Act of 1933 §19(a); Exchange Act §§3(b), 23(a); Public Utility Holding Company Act of 1935 (the "1935 Act") §20(a); Trust Indenture Act of 1939 §§319(a) and (b); 1940 Act §§38(a), 39 *with* Advisers Act §211(a) and (b). *See* Loss and Seligman, Fundamentals of Securities Regulation 1512 (5th ed. 2004).

definition is at odds with the longstanding effect of the statute and the evident congressional purpose. Indeed, as discussed below, the Commission's choice to redefine "client" in this result-oriented way not only exceeds its statutory powers[4] but contradicts the Congress's clear statements as to what it understood Section 3(b)(3) of the Advisers Act to mean. In that way, the Commission is taking even more serious legal risks in this instance than it did when it promulgated the failed Exchange Act Rule 3b-9.

The Commission ignores those realities at its peril in asserting that it nevertheless has the statutory power to reverse the congressional decision. We respectfully submit that the Commission's action in the current proposal exceeds the Commission's rulemaking authority under the Advisers Act. Consequently, if the Commission adopts the proposal, its action would be reversible as a matter of law.

The Factual Case. Even in situations where the Commission does have statutory authority to exercise rulemaking authority, that exercise must be rational and must relate to real problems, not imagined ones. On the merits, there is not much we can add to the well reasoned and well articulated dissent by Commissioners Atkins and Glassman. We draw the Commission's attention to a statement by the United States Court of Appeals for the District of Columbia Circuit that we believe is relevant in this regard:

> A regulation perfectly reasonable in the face of a given problem may be highly capricious if that problem does not exist.[5]

In this instance, the Commission does not have a legally sufficient factual predicate for its purported exercise of rulemaking power. In the absence of a demonstrated need grounded in investor protection, its adoption of the proposed registration requirement would be arbitrary and capricious as a matter of law and, on that basis as well, would be reversible.[6]

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4 *See also, Lowe v. Securities & Exch. Comm'n*, 472 U.S. 181 (1985).

5 *City of Chicago v. Fed'l Power Comm'n*, 458 F.2d 731 (D.C. Cir. 1971).

6 As the Commission knows, its use of rulemaking power is invalid under the Administrative Procedure Act if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" or "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right." 5 U.S.C. §706(2)(A) and (C). To evaluate whether the SEC has been arbitrary or capricious, a court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment. The absence of a real problem, as is the case here, is sufficient demonstration that the Commission's action is arbitrary and capricious and an abuse of discretion. *See City of Chicago v. Fed'l Power Comm'n, supra*. The absence of definitional rulemaking power, as is the case here, means that the Commission's adoption of the proposal would not be in accordance with law. *See generally, Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971). An administrative agency such as the SEC acts arbitrarily when it departs from prior interpretive or other precedent without giving any good reason for doing so. *North California Power Agency v. F.E.R.C.*, 37 F.3d

(Footnote continued)

Commission Arguments. The arguments advanced by the Commission ring hollow. There is no substantial incidence of so-called “retailization”. Typically in our experience, the wealthy and sophisticated investors who buy interests in hedge funds neither want nor need the “protections” of Advisers Act registration or Commission inspections. If they wished to avail themselves of the benefits of Commission regulation, they could always invest in the hedge funds managed by registered investment advisers.

The Commission has ample investigative power today under, among other provisions, Section 209(a) of the Advisers Act. In addition, Exchange Act Section 21(a) authorizes the Commission to investigate conduct by “any person” that may violate, inter alia, the antifraud provisions of the Exchange Act. It would be a rare offense by an investment adviser that did not, in addition to violating the Advisers Act, also constitute a possible violation of the general antifraud provisions of Exchange Act Section 10(b) and Rule 10b-5 thereunder.

The fact that hedge funds have experienced a remarkable growth over the last decade and more does not suggest they are therefore in need of greater regulation. While regulators may abhor a regulatory vacuum, investors do not. That explains why so many investors have voluntarily chosen to forego whatever protections the Commission thinks derive from Advisers Act registration and Commission regulation and to opt instead for the superior investment performance many unregulated hedge funds have provided.

An Alternative. We respectfully submit that the Commission could accomplish most if not all of its regulatory objectives, as well as avoid the risk of a judicial reversal of its action, by crafting a more targeted regulatory approach. For example, the Commission could establish an exception to its rule mandating certain hedge fund advisers to register if the adviser does, for example, the following:

1. Files an application for exemption that, like certain applications under the 1935 Act,[7] would accord an effective exemption upon filing.

(Continued footnote)

1517, 1522 (D.C. Cir. 1994); *Pontchartrain Broadcasting Co. v. FCC*, 15 F.3d 183, 185 (D.C. Cir. 1994); *IRS v. FLRA*, 963 F.2d 429, 434 (D.C. Cir. 1992). That, as Commissioners Atkins and Glassman pointed out in their dissent in this rulemaking proceeding, is the case here. In general, moreover, the courts owe deference to an agency’s decision making within its area of expertise (*Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837 (1984)), but *Chevron* deference does not allow an agency “to alter the clearly expressed intent of Congress.” *Board of Governors of the Federal Reserve System v. Dimension Financial Corp*., 474 U.S. 361, 368, (1986). *See also Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) and *The Business Roundtable v. Securities & Exch. Comm’n*, 905 F.2d 406 (D.C. Cir. 1990).

[7] *See* 1935 Act §3(c).

2. Provides audited annual financial statements of the hedge fund to its investors.

3. Discloses to investors in advance of their investment the fund's portfolio valuation methodology and, subsequently, any material change in the methodology.[8]

We further suggest that the Commission exempt, from its proposed rule requiring Advisers Act registration, any adviser that is registered as a commodity pool operator or a commodity trading adviser under the Commodity Exchange Act. The Congress wisely recognized in the recent amendments to that Act and the Advisers Act the need to avoid duplicative regulation by the Commodity Futures Trading Commission (the "CFTC") and the SEC. The Commission should follow suit and recognize that CFTC regulation and inspection suffices to achieve whatever benefits the Commission asserts would inhere in Advisers Act registration and Commission inspection.

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We note in closing that the comment period on this important rulemaking proceeding is exceedingly short, particularly since it spans a period in August when many people are on vacation. We support the request by the Managed Funds Association and several other trade organizations for an extension of the comment period to allow all interested persons an appropriate opportunity to comment. Although we have been able to get our comment letter in by the Commission's deadline, we believe the Commission should grant an extension so that it can have the benefit of comments by others who will not be able to submit their comments before the deadline.

We appreciate the opportunity to make our views known to the Commission. If the Commission or the staff wishes to discuss these matters with us, please contact any of the undersigned.

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[8] In advancing this suggestion, we are mindful that Commission action even to condition a statutory exemption from such registration could be challenged per se for lack of statutory authority to limit an exemption the Congress granted and has left in place through several amendments to the Advisers Act. We nevertheless expect an exemption along the lines suggested would substantially reduce the risk, as a practical matter, that litigation would be brought to challenge the Commission's proposal.

Respectfully submitted,

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Daniel Schloendorn

Emily M. Zeigler

cc: The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
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