INVESTMENT COMPANY INSTITUTE

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April 30, 2003

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OFFICE OF THE SECRETARY

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Roundtable on Hedge Funds (File No. 4-476)

Dear Mr. Katz:

Enclosed please find the Institute's statement for inclusion in the public record of the Commission's roundtable on hedge funds, scheduled for May 14-15,2003.

The Institute's statement focuses on the regulatory framework applicable to hedge funds. The statement notes that hedge funds typically avoid registration and regulation under the Investment Company Act of 1940, and that while it may be appropriate to permit very sophisticated investors to invest in funds that are free from the protections of that **Act,** it is important to keep those funds distinct from registered funds. This distinction is necessary in order to avoid confusion and situations in which less sophisticated investors invest in these funds. In this regard, the statement asserts that the exemptions under the Investment Company Act for these funds were intended to be narrow ones, and that a key aspect of the exemptions is the "public offering" prohibition. Accordingly, the statement stresses the importance of maintaining and strictly enforcing that prohibition.

The statement also urges the Commission and its staff to focus on whether certain structures are being improperly used as conduits for ineligible persons to invest in hedge funds and to strictly enforce the current rules to avoid "retailization" of the market. The statement contrasts those structures with closed-end funds that invest in underlying hedge funds, which also provide **a** means by which some otherwise ineligible investors can be exposed to hedge funds. Unlike those structures, registered funds of hedge funds are subject to SEC oversight and comprehensive regulation under the Investment Company Act. The statement notes, however, that these funds are not appropriate for most retail investors and, therefore, suitability issues are especially important.

Finally, the statement recommends that hedge fund advisers generally be required to register under the Investment Advisers Act of 1940. The statement notes that adviser registration entails minimal costs and burdens for a hedge fund sponsor, but offers significant public benefits. In particular, registration of hedge fund advisers would provide inspection authority for the Commission, which would help to ensure oversight of practices in this area.

The Institute appreciates the opportunity to provide its views concerning the regulatory framework for hedge funds and their advisers. Questions regarding our statement should be directed to the undersigned at 202/326-5815 or Amy Lancellotta at 202/326-5824.

Sincerely,

Craig S. Tyle
General Counsel

cc: The Honorable William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Paul F. Roye, Director
Cynthia M. Fornelli, Deputy Director
Elizabeth G. Osterman, Assistant Chief Counsel
Division of Investment Management

SECURITIES AND EXCHANGE COMMISSION
ROUNDTABLE ON HEDGE FUNDS

STATEMENT OF THE
INVESTMENT **COMPANY** INSTITUTE
April 30,2003

The Investment Company Institute' commends the Securities and **Exchange** Commission for its initiative in scheduling the May 14-15 roundtable regarding hedge funds, **and** appreciates this opportunity to comment.[2] This initiative is particularly timely in **light** of the hedge fund industry's explosive growth in recent years. Because hedge funds themselves, and a significant portion of hedge fund **managers, are** unregistered, fact-finding efforts of this kind **are** necessary and appropriate to provide the Cornmission additional information upon which to base its regulatory policies.

A. Introduction

The term "hedge fund" has no precise legal definition. It generally refers to a **pooled** investment vehicle that, by virtue of certain exceptions under the Investment Company Act of 1940, is not registered with the Commission.

Hedge funds typically avoid registration" and virtually all regulation under the Investment Company Act by relying upon Section 3(c)(1) or Section 3(c)(7).[3] Moreover, the Commission

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1 The Investment Company Institute is the national association of the American investment company industry. **Its** membership includes **8,912** registered open-end investment companies ("mutual funds"), 554 registered closed-end investment companies and ***6*** sponsors of registered unit investment trusts. Its mutual fund members have assets of about $6.254 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

2 **See** Roundtable Discussions Relating to Hedge Funds, 68 Fed. **Reg.** 15,488 (Mar. 31,2003).

3 Section 3(c)(1) excludes from the definition of "investment company" for almost all purposes under the Act any issuer that is not making a public offering and has outstanding securities beneficially owned by not more than one hundred persons. Similarly, Section 3(c)(7) excludes from the definition of "investment company" for almost all purposes under the Act any **issuer** that **is** not making a public offering and has outstanding securities owned exclusively **by** persons who were "qualified purchasers" **at** the time they **acquired** the securities. "Qualified purchasers" generally include individuals with $5 million in investable assets and entities **with** $25 million in investable assets. See Section 2(a)(51)**(A) and** Rules **2a51-1, 2a51-2**

does not currently require that the sponsor or adviser of a hedge fund relying upon Section 3(c)(1) or 3(c)(7) register with the Commission. Many **hedge** fund advisers avoid registration under the Investment Advisers Act of 1940 by relying on Section 203(b)(3). That section exempts from Advisers Act registration an adviser that **has** fewer than fifteen clients in **a** twelve-month period and does not hold itself out to the public **as an** investment adviser. The Commission has interpreted these requirements in a way that facilitates the reliance on this exemption by hedge fund advisers. Rule 203(b)(3)-1 provides, in effect, that a hedge fund (subject to certain conditions) may be counted as **a** single client for these **purposes.** The same rule permits a hedge fund adviser to describe its activities on behalf of the fund in the private placement offering materials, without being deemed to hold itself out to **the** public as an investment **adviser.** Accordingly, the Commission's authority over hedge funds is typically limited to enforcing the anti-fraud provisions **of** the federal securities **laws.**

Operating within these statutory and regulatory exceptions and exemptions from the regime applicable to registered investment companies and registered investment advisers, hedge funds may engage in any investment strategy. There are no regulatory limits on their trading other than those governing the markets **themselves.** Often, the investment strategies in which they engage are complex and highly leveraged.

The Institute believes it **is** very timely for the Commission to consider whether this historical "hands off' approach remains appropriate or should be modified in some fashion. This is because of the significant increase in **the** number of hedge funds, the number of entities sponsoring hedge funds and the number of individuals investing in or otherwise having exposure to hedge fund investments. In light of the importance that mutual funds and other registered investment companies **have** assumed as financial intermediaries, the extensive regulation to which they are subject, **and** the far less risky investment strategies that they typically pursue, the

and 2a51-3 under **the** Investment Company Act. Most hedge funds rely on Rule 506 of Regulation D under the Securities Act of **1933** to avoid engaging in **a** public offering within the meaning of Sections 3(c)(1) **and** 3(c)(7) and to avoid **being** required to register the securities they issue under the Securities Act. Rule *506* requires, among other things, that **the** interests in the **hedge** fund be sold only to "accredited investors" and up **to** 35 non-accredited but sophisticated investors. "Accredited investor" generally includes individuals with **an** income of $200,000 per year {or $300,000 in joint income with their spouse) or a net worth of $1 million **(which** is redundant for 3(c)(7) funds in almost **all** cases). The rule also prohibits **any** "general solicitation or general advertising" **with** respect to the fund, including offers made through periodicals and generally available Internet sites. <u>See</u> Rule 502(c).

Institute believes that it is critically important that the Commission's regulations ensure that no investor confuses a hedge fund with one of these highly regulated investment vehicles. Equally importantly, no investor should inadvertently be drawn to investing in hedge funds. Thus, we would urge the continued strict interpretation **and** enforcement of the private placement requirement as **it** applies to hedge funds.

The Institute also recommends that hedge fund advisers generally be required to register under the Advisers Act. **Adviser** registration entails minimal **costs and** burdens for a hedge fund sponsor, but offers significant public benefits. It **would** ensure, among other things, that hedge fund investors receive certain disclosures about the fund's adviser, and it would assure the ability of the Commission and its staff to monitor the activities of participants in this large, important and growing segment of the securities market. We discuss each of these points in turn below.

B. The "public offering" prohibition should be maintained and strictly enforced.

Hedge funds, which operate outside the requirements of the Investment Company Act, **may** be **an** appropriate investment choice for certain **types** of investors, but hedge funds lack the investor protections that are vital for the investing public at large. The issue **is** not the intrinsic value of hedge funds but rather to whom hedge funds may **be** sold without registration with the Commission and the substantive protections of the Investment Company **Act. As** the Supreme Court has recognized, investments in unregistered securities **are** intended to be available only to those investors who are in fact able to "fend for themselves" in the marketplace.[4] This policy is especially important for investors in pooled vehicles, which present greater opportunities for abuse **and** conflicts of interest. Indeed, because of the unique investor protection issues **raised** by pooled investment vehicles, Congress required not only the registration of securities issued by investment companies but also **the** registration and substantive regulation of the funds themselves under the Investment Company Act. Stringent separation of registered and unregistered funds is thus necessary in order to protect the investors for whom the benefits and protections of Investment **Company** Act regulation **are** intended.

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4 SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) [hereinafter, Ralston Purina].

The Institute recommends that the Commission **seek** to identify **ways** in which it can provide greater assurance of a strict divorce between the broad market in which mutual funds and other registered investment companies operate and that which is available to hedge funds -- to minimize the risk of these products being confused with one another and of investors not knowing what they are (or are not) getting. This can be achieved in part by oversight of the sales practices of hedge funds.[5] It also necessitates upholding the private placement requirement **as a key** investor protection.

Recently, **some** have called on the Commission to abandon its prohibition on general solicitation or general advertising by hedge funds.[6] For current purposes, it **should** be sufficient to answer that Congress specifically decided to prohibit **any** public offering **when** it **adopted Section** 3(c)(7), **as part** of the National Securities Markets Improvement **Act** in 1996.[7] While the Commission's interpretations of the private placement requirement **have** evolved and provided **some** flexibility **at** the margins,[8] we believe **any** fundamental change in policy should require Congressional action, which the Institute would strongly oppose. Repealing or materially weakening the private placement requirement -- for example, by authorizing advertisements for hedge funds in media of **general** circulation -- would engender widespread investor confusion **and** undermine public confidence in the **key** investor protections that characterize the regulated

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5 See, e.g., **NASD** Reminds Members **of** Obligations When Selling Hedge **Funds**, **NASD** Notice to Members 03-07 (Feb. 2003) [hereinafter, NTM 03-07]. ***See*** also Press Release, **NASD, NASD** Fines Altegris Investments for Hedge **Fund** Sales Violations **(Apr.** 22, 2003) (available at http://www.nasdr.com/news/pr2003/release_03_015.html).

6 See The Federalist Society, The First Amendment and Securities Laws, available at http://www.fed-soc.org/Publications/White%20Papers/sec1stamendment.htm. As an alternative to lifting the ban entirely, the **SEC,** in its "Aircraft Carrier" release, offered a **proposal** that would **expand** the permissibility of Rule 135 notices for both public and private offerings, thereby allowing issuers to provide limited notice of their **proposed** offerings or business transactions, See SEC Release 33-7606A (Nov. 13, 1998). See also **Stanley** Keller, From the Chair, **The** Securities Reporter (ABA), Summer 2001, at **3** (discussing the ABA's Task Force on **the** Future of Securities Regulation **proposal** to "[r]etain Regulation D, without limitation on '**general** solicitation' or limitation to use **by** issuers").

7 See National Securities Markets Improvement Act **of** 1996, Pub. **L.** No. 104-290, § 209(a)(4). Like Section 3(c)(1), Section 3(c)(7) was adopted **with** language specifically requiring issuers relying on the Section **not** be engaged in a "public offering" **of** securities.

8 In the 1930s, the private placement requirement **was** interpreted narrowly. See SEC Release 33-285 **(Jan.** 24, 1935). The Commission and its staff have interpreted **the** requirement over time to **keep up** with developments in communications technology, **such** as the Internet. See, e.g., **Lamp** Technologies, Inc., SEC **No-Action** Letter (May **29,** 1998); **Lamp** Technologies, Inc., No-Action Letter (May 29, 1997) (the **"Lamp** Letters"). See **also Use of** Electronic Media, Securities Act Release No. 7856, at 35 n.88 (Apr. 28, 2000) **(noting** that the Lamp Letters **apply** only to 3(c)(1) and 3(c)(7) issuers).

market.[9] The numerical and qualified purchaser eligibility requirements under the Investment Company Act serve a similar **purpose.**

In addition to enforcing the private placement requirement, the Commission and its staff should focus on whether **certain** products and arrangements are being improperly used as conduits **for** ineligible persons to invest in hedge funds, **In** recent years, there has been concern that sponsors **of** hedge funds have sought to attract **less** sophisticated investors, the so-called "retailization" of the market." It is important that the Commission enforce the current rules for products and arrangements that simply pool investments **by** otherwise ineligible investors for purposes of investing in hedge funds.

The recent introduction into **the market** of registered closed-end funds that **invest** in underlying hedge funds provides a means by which some otherwise ineligible investors can be exposed to hedge funds. It is important to note, however, that unlike the conduit structures noted above, **these registered** funds of hedge funds **are themselves** subject to comprehensive regulation, and SEC **oversight** in areas such **as** valuation, under the Investment Company **Act.** Moreover, registered funds of hedge funds, by investing in **a** portfolio of underlying hedge funds, also offer investors **a** different risk/return profile than **a** direct investment in any of the underlying hedge funds.'' **At the** same time, registered funds of hedge funds **are, at** least **for** the most **part,** not appropriate investments for most retail investors. **As such,** it is important that there be strict regulation of sales practices of persons selling these funds, including, in particular, requiring careful attention to suitability standards. *'(Most funds of hedge funds limit their investors to accredited investors (to avoid the **costs** of registration under the Securities Act) or qualified

9 See, e.g., Letter from Rep. Edward J. Markey (D-Mass.) to **SEC** Chairman Arthur Levitt (Dec. **18,** 2000) [hereafter, the **"Markey** Letter"]. **Rep.** Markey, among other things, stressed the importance of the private placement requirements **in** his letter. SEC Chairman Levitt, in his response, noted that, "[t]he Commission believes **that these** prohibitions and limitations are appropriate to protect unsophisticated investors." Letter from **SEC** Chairman Arthur Levitt to **Rep,** Edward J. Markey (D-Mass.) (Jan, 29, 2001).

10 **In** the Markey Letter, Rep. **Markey expressed** concern that the eligibility **requirements** for hedge funds might **be** circumvented by such practices as brokers pooling assets **from** ineligible investors for investment in hedge funds.

11 The SEC staff has taken the position that establishing a registered **fund** to **invest** most of its assets in a single underlying hedge fund, i.e., to serve **as a** conduit **for** investing **in** such hedge fund, would be inconsistent **with** the Investment **Company** Act. See, e.g., Cornish & Carey Commercial, Jnc. **SEC** No-Action Letter (June 21, 1996). The Institute strongly agrees with the staff's position and urges that it be strictly enforced.

clients **as** defined in Rule 205-3 under the Advisers Act (because the fund of funds charges **a** performance fee).) **As** noted above, the **NASD** has issued **a** notice **to** members on sales practices in connection with the offer and **sale** of shares of registered funds of hedge funds; the Institute strongly **supports** strict SEC and **NASD** regulation of sales practices involving these funds.

C. Investment advisers to hedge funds should be required to register.

While **the** general investing public should not have access to information on hedge fund offerings, we **believe** the Commission and its staff should. One consequence of the current "hands off" approach is **a** lack of sufficient information upon which to base sound regulatory policies.[12] Undoubtedly, hedge funds **have grown** in importance **as** financial intermediaries **and they** provide liquidity and efficiencies to the market, but the problems to which they potentially may give rise are difficult for the Commission to police.

Requiring the investment advisers to hedge funds to register under the Advisers Act would address this deficit and provide a mechanism for the Commission to monitor potential fraud or manipulation. Trade allocation **practices --** a traditional **focus** of Commission oversight in the investment adviser arena" -- provide **a** good example. It is unlikely that most private investors or the Commission itself could determine whether an unregistered adviser to a hedge fund was misallocating trades or consistently favoring one account over another. No one but the unregistered adviser itself **may** have access to the information necessary to judge whether

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12 The near-collapse of Long Term Capital Management **in** 1998 pointed up the dearth of information about the extent and systemic implications of the leverage used **by** such funds. Recent concerns about market manipulation have underscored **the lack of** information **on** the nature **of** their short-selling practices. See The President's **Working Group** on Financial **Markets,** Hedge Funds, **Leverage,** and the Lessons of Long-Term Capital Management **(Apr. 1999).** See also Henry Sender, **Hedge** Fund Inquiry **by** Spitzer **is** Turning to Credit Derivatives, Wall St. J., Feb. *7, 2003,* **at C7.**

i3 Registered advisers, including by definition every investment adviser **to** a registered investment company, **are** subject to comprehensive regulation of conflicts **of** interest and trading issues. **A** growing number of fund **advisers also** advise hedge funds, and **the** Cornmission and its staff have sought to alert advisers to the conflicts that may arise. **However,** these potential conflicts are **not** new, nor **are they** unique ***to*** hedge funds. See Hearing on Recent Developments in Hedge Funds Before the Senate Comrn. on Banking, Housing and Urban Affairs, 108th Cong. **(Apr.** 10, 2003) (statement of SEC Chairman William H. Donaldson, stating that the potential conflicts of interest in managing hedge funds alongside mutual funds "are the same as those that exist for any investment adviser **that** manages both registered investment companies and private client accounts"). It **is our** understanding that advisers to mutual funds that **also** manage hedge funds have adopted a variety of policies and procedures in order to address potential conflicts between the registered **funds and the** hedge **funds** that they advise.

allocations are being made in a fair and equitable manner. Inspection authority for the Commission, which registration of hedge fund advisers would provide, would help ensure oversight of practices in this area.

Establishment of a registration requirement is possible through rulemaking, and does not require legislation. The Commission adopted Advisers Act Rule 203(b)(3)-1 in 1985[14] and substantially revised it in 1997.[15] It intended the rule to provide a safe harbor, in light of ambiguity about who was a "client" under the Advisers Act following Abrahamson v. Fleschner.[16] We believe the Commission has broad authority through the rulemaking process to interpret the Advisers Act and that it may change its interpretation after due consideration and administrative process.[17]

Incremental regulation of hedge fund advisers in this manner would have minimal or no impact on their legitimate operations. The anti-fraud provisions of Section 206 of the Advisers Act (including limitations on principal and agency cross trading) already apply, as do broad principles of fiduciary duty under the statute? If required to register, these advisers would become subject to more specific requirements of Adviser Act rules with regard to matters such as advertising, certain disclosure items, proxy voting and record keeping. Most if not all of these additional requirements simply constitute good business practices or implement the anti-fraud provisions already applicable to unregistered advisers.

It should also be noted that many jurisdictions other than the United States require hedge fund managers based there to register. The United Kingdom currently has a registration requirement and, by contrast to other less regulated centers in the EU, London has seen rapid growth in its

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14 See SEC Release IA-483 (July 12, 1985).

15 See SEC Release IA-1633 (May 15, 1997).

16 568 F.2d 862 (1977). The Court held that the general partner of an investment partnership was an investment adviser, and that the limited partners could have a private right of action claim against the adviser for fraud under Section 206 of the Advisers Act.

17 See Advisers Act, § 211.

18 See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963). The Supreme Court recognized the fiduciary duty of investment advisers, particularly in the context of fraud under Section 206, after Congress extended Section 206 to unregistered investment advisers in 1960. See Pub. L. No. 86-750, §§ 8, 9, 74 Stat. 887 (Sept. 13, 1960).

hedge fund industry.[19] Thus, registration of hedge fund advisers would not seem to be burdensome or problematic.

In addition, because hedge funds often trade futures as well as securities, many managers are required to register **as** commodity trading advisers and Commodity **pool** operators with the Commodity Futures Trading Commission. Potential concerns about duplicative regulation, however, **have** been allayed. Congress recently **exempted advisers primarily** trading securities from CFTC registration and commodity trading advisers trading primarily futures from registration with Commission.[20] In effect, a hedge fund manager would register with the regulator responsible for its primary trading activity. While **no** exemption yet exists from commodity **pool** operator registration for **a** hedge **fund** manager primarily trading securities, the CFTC has proposed rules that would grant such an exemption and **has** provided temporary no-action relief from registration while the rule proposal is pending.[21]

As a practical matter, if hedge fund advisers were required to register with the Commission, the qualified client (or **qualified** purchaser) standard would **apply** to **every** fund with a performance fee.[22] Hedge fund **investors generally** would be limited to those individuals with a net worth of $1.5 million or investable **assets** of $5 million. If **a** hedge fund's adviser **is** unregistered, it need not observe any minimum net **worth** requirement with respect to investors who pay performance-based compensation. **As** a result, the minimum accredited investor test -- i.e., $200,000 of annual income -- often applies to investors in their funds. In light of the importance **of** ensuring that only sophisticated investors participate in hedge funds, these higher eligibility requirements would appear to be appropriate.

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19 **Peter** Astleford & **Dick** Frase, London, the Financial Services and Markets **Act** and the Need for Authorisation, in Starting **a** Hedge **Fund - A** European Perspective 7 (ISI Publications 2002).

20 *See* Commodity **Futures** Modernization **Act** of 2000, H.R. ***5660,*** § 251(d) (codified as Section 4m(3) of the Commodity Exchange Act) and § 209(b)(3) (codified as Section 203(b)(6) of the Advisers Act), respectively.

21 See Additional Registration and Other Regulatory Relief for Commodity Pool **Operators** and Commodity Trading Advisors, 68 Fed. Reg. 12622 (proposed **Mar.** 17, 2003) {tobe codified **at** 17 C.F.R. **pt.** 4).

22 Under Rule 205-3, a registered investment adviser must "look-through" a 3(c)(1) fund in determining that performance based compensation is **paid** only **by** qualified clients. While the general prohibition on performance fees in Section 205 does not **apply** to 3(c)(7) **funds,** the eligibility requirements to invest in **a** 3(c)(7) fund are generally higher than the qualified client standards in Rule 205-3.

For these reasons, in our judgment, requiring hedge fund advisers to register under the Advisers Act would be a positive, if limited, step. It should be kept in mind, however, that this incremental regulation concerns only the adviser to the hedge fund, and not the fund itself. The stark differences at the product level between hedge funds and mutual funds and other registered investment companies would remain. Put differently, registration of the adviser should not be confused with registration of the fund under the Investment Company Act. Therefore, if the Commission moves to require the registration of hedge fund advisers, it should assure that hedge fund investors receive clear and prominent disclosure that the fund itself is not registered nor regulated under the Investment Company Act.