September 15, 2004

**VIA 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 (the "Proposed Rule") under the Investment Advisers Act of 1940, as amended ("Advisers Act").[1]

Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and worldwide. Among these are U.S. based and non-U.S. based hedge fund managers and traditional investment advisers. In developing these comments, we have drawn on our long experience in the investment management industry, generally and hedge fund industry, in particular. Although we have discussed the matters addressed in the Release with some of our clients, the comments that follow reflect our own views, and not necessarily those of any client of the firm.

We have limited our comments to interpretive and implementation issues related to the Proposed Rule. We express no view on the merits, from a policy standpoint, of whether hedge fund advisers who would otherwise be exempt from registration under the current formulation of Rule 203(b)(3) should be required to register as investment advisers under the Advisers Act.

**Definition of United States Resident**

The proposed amendments to Rule 203(b)(3)-1 provide that the Proposed Rule would be applied differently to US clients and non US clients for various purposes. To further the policy of providing a reasonable level of regulation and clarity in its applicability, particularly to non-US advisers, we would suggest that the release adopting the final version of the rule (the "Adopting Release") specifically note that for purposes of determining who

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

is a United States resident for purposes of Section 203(b)(3) one may rely on the definition contained in Regulation S or the definition of "US person" previously developed in various no-action letters under Section 3(c)(1), which followed the Staff no-action position in Touche Remnant & Co. (pub. avail. Aug. 27, 1984) ("Touche Remant").[2] This would be consistent with how most non-US funds now track their investors (i.e., as US or non-US based on the definition in Regulation S or the Touche Remnant line's definition).

**Compliance Period and Other Transition Issues**

The Commission has requested comment concerning the length of time that would be needed by hedge fund advisers in order to register and revise their compliance systems to comply with requirements under the Advisers Act. We believe that a transition period of at least one year is appropriate for this purpose, given the significant infrastructure changes that would be needed at many advisory firms. The registration process itself will take significant time, and the significant amount of time that those advisers who are currently registered have been required to spend to develop written compliance programs should also be considered.

We also recommend that the Commission consider a clarification of the "private fund" definition in the context of funds offered prior to the Effective Date of any new rule on this subject. One factor defining private funds under the Proposed Rule is that owners are permitted to redeem any portion of their ownership interests within two years of purchase. We recommend that this criterion be applied only to fund interests offered after the effective date of the new rule, so that funds previously offered under a different redemption structure are not deemed to be private funds solely on that basis. Prospective application of the redemption criterion will permit fund managers to design their fund operations in light of the criteria of the new rule and without assuming new regulatory burdens based solely upon past activity.

**CFTC Registrants Primarily Engaged in Futures Activity**

In the Release, the Commission has stressed that it is not seeking to require Advisers Act registration of hedge fund advisers "whose business consists primarily of advising others with respect to investments in futures." (69 FR 45181 at n.109). As the Commission noted, hedge fund advisers who are registered as commodity trading advisors ("CTAs") with the Commodity Futures Trading Commission ("CFTC") may qualify for the statutory exemption in section 203(b)(6) of the Advisers Act if their business does not consist primarily of acting as an investment adviser. To give effect to the Commission's stated intention not to require Advisers Act registration of hedge fund advisers whose business primarily relates to futures transactions, we recommend that the Commission provide

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[2] See Goodwin, Proctor & Hoar (pub. avail. February 28, 1997) (extending the position in Touche Remant to 3(c)(7)). While the Staff permitted the use of the definition in Regulation S, it did not rescind the letters setting out the prior definition. Id. at fn. 14 and fn. 23.

needed clarification of the section 203(b)(6) exemption as applied to CFTC-registered hedge fund advisers.

First, we recommend a rule provision to correct a technical (and likely unintended) limitation in the section 203(b)(6) exemption. Under the CFTC regulatory structure, a registered commodity pool operator ("CPO") is not required to separately register as a CTA in order to provide commodity trading advice to a commodity pool for which it is acting as CPO. Since CPOs are subject to more comprehensive regulatory requirements than CTAs, no regulatory purpose would be served by requiring registration as a CTA in these circumstances. Consequently, registered CPOs, while not separately registered as CTAs, should be equally eligible for the Advisers Act exemption if their primary business is not that of acting as an investment adviser.

Second, we recommend that the Commission provide clarification of the scope of the securities activity that CFTC registrants may undertake in reliance upon the Advisers Act exemption for advisers "whose business does not consist primarily of acting as an investment adviser." To this end, we suggest that the Commission create a safe harbor from Advisers Act registration for CFTC-registered CPOs and CTAs whose securities advisory activity is limited to advising a fund (or funds) primarily engaged in futures transactions or other non-securities investments, such as swaps or foreign exchange transactions. For the purpose of comparing securities advisory activity to other activity under this safe harbor, we suggest that the Commission use the current market value of securities investments and the notional market value of futures contracts, swaps and other derivative contracts in which the fund invests and treat the adviser to a fund which has less than 50% of its investments in securities as not primarily acting as an investment adviser. We believe that the notional value of futures contracts would provide a more appropriate benchmark for comparing the risk/reward potential of the securities and futures investments of a fund than margin amounts, which reflect the different economic functions of securities and futures margins rather than the economic significance of those components of a fund's portfolio.

**Amendment to Custody Rule**

The Commission is proposing to amend Rule 206(4)-2, the custody rule, to accommodate advisers to private funds of funds. Under the rule, advisers to pooled investment vehicles may satisfy their obligation to deliver custody account information to investors by distributing the pool's audited financial statements to investors within 120 days of the pool's fiscal year end. As noted in the Release, many advisers to private funds of funds will have difficulty meeting the 120 day deadline because of an inability to obtain audits from underlying funds (upon which the fund of funds audit is based) in sufficient time. As a result, the Commission is proposing to extend the 120 day period to 180 days.

We have had significant experience counseling clients who operate funds of funds that are regulated as commodity pools with respect to their obligation to comply with CFTC Rule 4.22(c). This Rule requires the delivery of audited financial statements to investors and the CFTC within 90 days of the fund's fiscal year end. Based upon this experience, we can confirm the difficulties funds would have in complying with the 120 day deadline and strongly support extending the period to 180 days.

However, as proposed, the amendment to 206(4)-2 would be available to all pooled investment vehicles. We are concerned that unless the additional 60 day period is limited to funds of funds, the change will not accomplish its objective. Fund of funds auditors cannot independently audit the underlying funds in which a fund of funds invests and must instead rely upon the audits received from such underlying funds. If all private funds are permitted to furnish their audit within the 180 day period, it is likely that one or more underlying funds will take advantage of the additional time, potentially preventing the fund of funds from completing its audit within the 180 day period. We submit that it would not de difficult to incorporate a definition for a fund of funds into the Rule and urge the Commission to limit the relief being proposed to funds of funds.

**Applicability of Rule to General Partners and Managing Members of Private Funds**

Often, when a private fund is organized as a limited partnership or limited liability company, the sponsor of the fund will create one entity to serve as an investment manager and a second company will be formed to serve as the general partner or managing member of the fund (the "GP"). Typically, when this structure is utilized, the performance compensation is allocated to the general partner or managing member, while asset based investment management fees are paid to the investment manager. However, registered advisers have generally treated this compensation as subject to Section 205 of the Advisers Act, even though the entity receiving it was not itself registered.

Since both entities receive compensation and could be deemed to be providing investment advice, both could be required to register under the Advisers Act. When structured in this manner, the GP engages in no activities other than to serve as general partner or managing member of the fund. In this capacity, the GP generally manages the business of the fund, including oversight of the investment manager. As a practical matter, however, the GP has no employees and delegates substantially all of its administrative duties to the investment manager.

Under these circumstances, we suggest there is no policy that would be served if both the investment manager and GP were required to register. To the contrary, the registration of both entities would result in duplicative filing requirements and additional filing fees, coupled with the creation of an unnecessary compliance trap if there is a failure to update the ADV for each entity each time there is a need to do so to ensure consistency between the two forms. Both entities would have the same clients and would be involved in the management of the same products. It would be unnecessarily confusing to clients to receive separate ADVs for each entity. We ask that the Commission confirm what we understand to be the historical position of the staff that, provided the investment manager of a private fund is registered as an investment adviser under the Act, the fund's general partner or managing member would not be required to also register where (i) the GP engages in no activities other than to serve as general partner or managing member of one or more funds advised by a related person who is registered, (ii) the investment manager treats the books and records of the GP as its own and makes such books and records available for examination, and (iii) any incentive compensation received is treated as subject to Section 205 of the Advisers Act.

This result could be achieved in part by modifying the proposed change to the books and records rule. Proposed rule 204(2)(l) would provide that if a related person of an adviser acts as GP, the books and records of the private fund are records of the adviser for purposes of Section 204 of the Investment Advisers Act. This proposed rule could be further revised to provide that if the GP is not registered (in reliance upon the safe harbor described above because its activities are limited to managing a private fund), its books and records will be deemed to be included in the books and records of the related adviser to the funds.

**Look Through Provisions**

The new rule would contain a special provision for advisers to hedge funds in which a registered investment company invests. Hedge fund advisers would be required to count the investors in the registered fund as clients. A note to the Release indicates that based upon the operation of the Rule this same look through would apply in the case of an investment in a private fund by an unregistered fund of funds.[3]

The footnote further indicates that the Rule would not require the adviser to the underlying fund to receive information as to the precise number or identities of the top-tier investors – it would be sufficient if the adviser to the top-tier fund confirms to the underlying adviser that the top-tier fund has more than 14 owners.

We submit that this approach is unworkable and represents a significant departure from long standing SEC policy on the circumstances under which an investing entity must be disregarded and the indirect investors treated as if they were direct investors in the underlying fund.

The Proposal does not specify when or how often the adviser to the top-tier fund would be required to report to the underlying fund manager the number of investors in the top-tier fund. As an open-end vehicle, the top-tier fund would likely accept additional subscriptions from investors and process redemptions on a periodic basis. A fund could have fewer than 14 investors at the time of its initial investment with an underlying fund and, as the fund of funds grows, could exceed the 14 investor threshold a short time later.

This makes planning by the underlying manager impossible. A registration obligation could be triggered by circumstances wholly outside of the underlying manager's control, and perhaps knowledge.

Section 3(c)(1) of the Investment Company Act requires a look through only if the top tier fund accounts for more than 10% of the lower-tier fund's capital. A manager seeking to avoid registration of the fund under the Investment Company Act could control the percentage of the lower tier's fund held by the fund of funds.

Outside of 3(c)(1), there is a well developed body of law expressed in a series of no action letters which establishes the circumstances under which an investing fund must be disregarded and the disregarded entity's investors treated as if they were investors in the

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[3] Footnote 125 to Release.

underlying fund.[4] An entity will be disregarded if it is formed, or deemed to be formed, for the purpose of investing in the lower-tier fund.

We suggest that a similar approach should be used in the Proposed Rule. Where an investing fund (i) has an unaffiliated investment manager, and (ii) is not formed for the purpose of investing in the lower-tier fund, no look through should be required and the investing fund should be treated as one client.

This analysis becomes even more problematic in the context of an offshore adviser to an offshore fund. Here the Proposed Rule would require that only U.S. investors must be counted. However the Proposed Rule is entirely unclear on whether the same look through requirements would apply. The following example illustrates the difficulty in applying such a rule in the offshore context. Suppose an offshore adviser based in London is advising an offshore fund. The fund has no U.S. investors who have made a direct investment in the fund, but has a fund of funds investor. The fund of funds is organized offshore by an unaffiliated adviser, but has more than 14 U.S investors. Under these circumstances, would the offshore adviser be required to register? We believe that compelling arguments can be made that the U.S. investors in the fund of funds should not be deemed to be "clients" of the offshore manager of the underlying offshore fund. To do so would stretch current principles with respect to the reach of U.S. jurisdiction beyond recognition. It also stretches the notion of "client". The indirect investors can hardly be treated as "clients" if the manager of the underlying fund has never dealt with them and does not even know who they are.

Any U.S. person investing in an offshore fund does so with full knowledge that U.S. protections are unlikely to be available. Such investors tend to be the largest and most sophisticated with less need for the protections afforded by U.S. securities laws. Moreover, if offshore advisers are faced with the choice of registering or declining to accept U.S. investors, many will choose the latter option, depriving some U.S. institutional investors of access to the most talented managers. Where, however, an offshore manager advises a U.S. domestic fund, the adviser should be treated no differently than a U.S. based adviser.

Accordingly, we respectfully request that the Commission reconsider its position on this issue.

**Applicability of Substantive Provisions of Adviser's Act to Offshore Advisers**

The Proposed Rule creates a hybrid status under the Act – the offshore adviser. An offshore adviser to an offshore fund may treat the fund as the client (and not the investors) for all purposes under the Act, other than (i) determining the availability of the private adviser exemption and (ii) those provisions prohibiting fraud (Sections 206(1) and 206(2)). Such

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[4] See, e.g., CMS Communications Fund L.P., SEC No-Action Letter (April 17, 1987); Tyler Capital Fund, L.P./South Market Capital, SEC No-Action Letter (September 28, 1987); Handy Place Investment Partnership, SEC No-Action Letter (July 19, 1989) and Cornish & Carey Commercial Inc., SEC No-Action Letter (June 21, 1996).

an adviser would be required to register, but most (emphasis added) of the substantive provisions of the Advisers Act would not apply to the adviser's dealings with the fund.

While the staff believes the principles expressed in Unibanco provide guidance on the applicability of the substantive provisions of the Act to registered offshore advisers, we submit that this approach creates considerable ambiguity and uncertainty.

For example, the new Compliance Rule was adopted under Section 206 of the Advisers Act. Must offshore advisers adopt written compliance policies and appoint a chief compliance officer? The policies are required to be reasonably designed to prevent violations of the Advisers Act, yet the offshore adviser is not subject to most of the substantive provisions of the Act. Will all of the other substantive rules under Section 206 be applicable to offshore advisers?

Since Unibanco never contemplated an adviser with no US clients, further guidance on the applicability of the substantive provisions of the Advisers Act to offshore advisers would be desirable.

**Exception from the Definition of "Private Fund" for Publicly Offered Funds**.

The Commission has proposed an exception to the definition of "private fund" for certain offshore publicly offered mutual funds. We suggest that the Commission provide a definition of or additional guidance regarding an "offshore publicly offered fund." The current exception provides that a company would be excepted from the definition of "private fund" if it (i) has its principal place of business outside the United States, (ii) makes a public offering of its securities outside the United States, and (iii) is regulated as a public investment company under the laws of a country other than the United States

Since the scope and nature of the regulation of "public investment companies" varies considerably from jurisdiction to jurisdiction and is constantly changing, we believe that additional clarification on this issue would be helpful. For example, in order for a company to be "regulated as a public investment company under the laws of a country other than the United States," should there be any requirement that the regulation by a jurisdiction be substantive? If a foreign jurisdiction permitted registration using the equivalent of a notice filing, would that constitute "regulation"? What if a jurisdiction were to permit a hedge fund to register for public distribution in that jurisdiction? It is likely that certain jurisdictions might consider this possibility. In addition, must a publicly offered fund offer its shares in the jurisdiction in which it is regulated?

We believe that additional guidance could prevent potential evasion of this exception, and respectfully request the Commission to provide such guidance.

We appreciate the opportunity to comment on the Proposed Rule. Please feel free to contact George Mazin at (212) 698-3570, David Vaughan at (202) 261-3355, Susan Ervin at (202) 261-3325 or Karen Anderberg at (011-44-207) - 583-7313 if you would like to discuss any of our comments.

Very truly yours,

Dechert LLP