INVESTMENT COMPANY INSTITUTE

September 15, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

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

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to express its views in support of the Commission's proposal to require hedge fund advisers to register under the Investment Advisers Act of 1940.[2] The Commission's proposal is the right approach at the right time.

Requiring hedge fund advisers to register under the Advisers Act will provide the Commission with meaningful information about this significant and growing segment of the securities markets,[3] without adversely impacting the legitimate operations of hedge fund advisers.[4] Many of our investment adviser members -- all of whom are registered with the Commission -- currently operate hedge funds and have found that registration is not overly burdensome and does not interfere with their investment activities. Far from being draconian, the Commission's proposal is a measured and appropriate response to address the risks that hedge funds pose to the securities markets and participants in those markets.

We have outlined below our views in support of requiring hedge fund advisers to register under the Advisers Act. In addition, we note the importance of the requirement that advisers keep records to substantiate their performance claims and our recognition that excepting hedge fund advisers from this requirement is an accommodation to permit them to

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[1] The Investment Company Institute is the national association of the American investment company industry. More information about the Institute is available at the end of this letter.

[2] *See* SEC Release No. IA-2266 (July 20, 2004); 69 Fed. Reg. 45172 (July 28, 2004) (the "Proposing Release").

[3] According to the Proposing Release, the rate of growth of hedge funds has been substantially greater than that of other sectors, and hedge fund assets have been projected to grow to over a trillion dollars by the end of 2004. Proposing Release at 45174-75.

[4] *See* Statement of the Investment Company Institute at the Securities and Exchange Commission Roundtable on Hedge Funds (April 30, 2003) (where the Institute advocated the registration of hedge fund advisers).

communicate their performance histories to clients. We also request that the Commission clarify that, under the exception for offshore advisers to offshore private funds, the Commission will have access to certain records of offshore advisers and urge the Commission to monitor the use of this exception to ensure that there are not any unintended consequences.

<u>Registration of Hedge Fund Advisers</u>

The Proposal

Section 203(b)(3) of the Advisers Act provides an exemption from registration for advisers that have 14 or fewer clients.[5] The Commission adopted Rule 203(b)(3)-(1) under the Advisers Act to permit advisers to count any client that is a partnership, trust, or corporation as a single client. Because of this rule, advisers that advise these types of clients have not been required to register under the Advisers Act even though they manage large amounts of client assets and provide advice to more than 14 persons. Proposed Rule 203(b)(3)-2 would require investment advisers to count each owner of a "private fund" as a client for purposes of determining the availability of the Advisers Act's 14 client exemption.[6] As a consequence, the proposal generally will require hedge fund advisers to register under the Advisers Act. This result benefits and advances the public interest.

Requiring hedge fund advisers to register under the Advisers Act will provide the Commission with important information about hedge fund advisers and the hedge fund industry that the Commission does not have today. The tremendous growth experienced by hedge funds and their activities[7] -- particularly the use of leverage -- can present serious systemic risk to the market.[8] The Commission must have ready access to reliable, current and complete information about the hedge fund industry to enable it to monitor the activities of participants in this large, important, and growing segment of the securities market.

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[5] The exemption is conditioned on an adviser having no more than 14 clients during the preceding twelve months and not holding itself out to the public as an investment adviser.

[6] Proposed Rule 203(b)(3)-2(d)(1)(i) would define a "private fund" by reference to three characteristics shared by virtually all hedge funds, as discussed below.

[7] The Commission estimates that hedge funds account for approximately $795 billion in assets. Proposing Release at 45174.

[8] The near-collapse of Long-Term Capital Management in 1998 exposed the dangers that large, opaque, highly leveraged hedge funds present to the stability of the financial system and to other investors. At the time of its near-failure, the LTCM Fund was the most highly leveraged large hedge fund reporting to the Commodity Futures Trading Commission. The combination of LTCM Fund's large capital base and high degree of leverage allowed it to hold more than $125 billion in total assets, nearly four times the assets of the next largest hedge fund and an overall leverage ratio of more than 25-to-1. As a result of its leverage, LTCM faced severe market liquidity problems when its investments began losing value and the fund attempted to unwind its positions. The responsibility and burden for resolving LTCM's difficulties remained with the primary trading counterparties and creditors that had allowed the hedge fund to build up such large positions. A default by LTCM could have resulted in significant losses in the many markets where the LTCM Fund held sizable positions. *See* The President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (Apr. 1999) 12-14, 17 ("Long-Term Capital Management Report").

Importantly, as a result of registration, the Commission will have, for the first time, the ability to inspect *all* hedge fund advisers. This will enable the Commission to proactively address – not reactively respond to – potentially fraudulent activities in the hedge fund arena. According to the Proposing Release, the Commission has brought 46 cases in the last five years alleging that hedge fund advisers defrauded their investors and others of an estimated $1 billion. In the less than two months since the Proposing Release was issued, the Commission has brought an additional three cases against unregistered hedge fund advisers with alleged investor losses of approximately $32 million.[9]

Moreover, the requirement to register under the Advisers Act will provide the Commission with a powerful tool to deny the registration of any hedge fund adviser that has been convicted of a felony or has a disciplinary record subjecting them to disqualification.[10] Screening, and denying registration, by the Commission will help prevent unfit persons from using hedge funds as vehicles for perpetrating frauds.

As noted above, many of our members currently advise hedge funds and have found that registration is not overly burdensome or inconsistent with their investment strategies. Registration will not require hedge fund advisers to reveal their trading strategies, disclose their portfolio holdings, or interfere in any way with their ability to leverage their portfolios. Likewise, nothing in the proposal will restrict the ability of hedge funds to provide liquidity to the market. Rather, these advisers will become subject to Advisers Act rules covering such matters as disclosure, recordkeeping, and proxy voting, none of which will interfere with their business operations or affect their investment activities.

Dissent from the Proposal

Commissioners Glassman and Atkins jointly dissented from this proposal. They suggest, among other things, that the Commission undertake a study of hedge funds to identify the qualitative and quantitative information that would raise red flags and provide systemic data on hedge fund trends and practices. We respectfully disagree with this recommendation.

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[9] *See SEC v. Scott B. Kaye, TrueHedge Advisors, LLC, and TrueHedge Capital Partners, LP*, Civil Action No. 04:1275MLB (D. Kan. Aug. 24, 2004); *SEC v. Angelo Haligiannis, Sterling Watters Group, LP, Sterling Watters Capital Advisors, LLC, and Sterling Watters Capital Management, Inc.*, Civil Action No. 04 CV 06488 (RJH) (S.D.N.Y. Aug. 12, 2004); *SEC v. Anthony P. Postiglione, Jr., William J. Lennon, Fountainhead Fund, LP, and Fountainhead Asset Management, LLC*, Civil Action No. 04-CV-3604 (E.D. Pa. Aug. 9, 2004). *See also SEC v. Charles L. Harris, Tradewinds International, L.L.C. and Tradewinds International II, L.P.*, Civil Action No. 04C5725 (N.D. Ill., filed Sept. 1, 2004) (complaint) (the Commission alleges that a hedge fund adviser fraudulently raised funds from investors and made false and misleading statements regarding past rates of return and the use of investor funds).

[10] Section 203(c)(2) of the Advisers Act provides the Commission with the authority to grant or deny an adviser's registration. That provision requires the Commission to deny the registration of any adviser convicted of a felony or with a disciplinary record subjecting them to disqualification.

The Commission has undertaken periodic studies of the hedge fund industry over the past 35 years. [11] Without registration and staff examinations, it will be difficult – if not impossible -- for the Commission to obtain an in-depth understanding of the hedge fund industry and to identify compliance problems and practices that may be harmful to investors at an early stage. In this regard, the involvement of hedge fund advisers in the recent enforcement actions involving late trading and market timing of mutual funds underscores the need for Commission oversight of hedge fund advisers.[12]

Commissioners Glassman and Atkins suggest that, after completing the recommended study, the Commission should consider whether to require hedge fund advisers to periodically file certain information with the Commission, which the Commission could then monitor for red flags and trends. They asked commenters to address this approach.

A notice filing and periodic reporting regime is not an acceptable alternative to requiring hedge fund advisers to register under the Advisers Act. Unlike notice filings and periodic reports, registration of hedge fund advisers will provide the Commission with the authority to inspect hedge fund advisers. As stated above, through inspections, Commission staff gain an understanding of a registrant's business and are in a better position to detect and deter fraud. Notice filings and periodic reports will not achieve these results.

Commissioners Glassman and Atkins also question the adequacy of Commission resources to oversee hedge fund advisers. Congress recently responded to the challenges faced by the Commission in carrying out its mission by appropriating significant additional financial resources to the Commission and giving the Commission authority to provide its staff with salaries equivalent to those paid to other federal financial regulators.[13] The Institute has consistently supported -- and continues to support -- an adequately funded Commission. [14]

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[11] *See* Proposing Release at 45174. Recent examples include the following*: Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission*, (Sept. 2003); Securities and Exchange Commission's Hedge Fund Roundtable (May 2003); and *Long-Term Capital Management Report*, discussed above.

[12] The Commission stated in the Proposing Release that "the frequency with which hedge funds appear in these cases and continue to turn up in the investigations is alarming." Proposing Release at 45175-76. Certain actions include allegations that mutual fund advisers permitted hedge fund advisers to obtain special trading opportunities in exchange for the hedge fund adviser agreeing to make significant investments in other funds. *See, e.g., State of New York v. Canary Capital Partners LLC* (Sup. Ct. N.Y. County filed Sept. 3, 2003)(complaint) available at http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf. Other regulatory actions allege that hedge fund advisers sought to remain undetected by mutual fund personnel by working with intermediaries to conceal the hedge fund's identity. *See, e.g., SEC v. Geek Securities, Inc., Geek Advisors, Inc., Kautilya "Tony" Sharma, and Neal R. Wadhwa*, Civil Action No. 04-80525 Paine/Johnson (S.D. Fl. June 4, 2004); *SEC v. Security Trust Company, N.A., Grant D. Seeger, William A. Kenyon, and Nicole McDermott*, Civil Action No. CV 03-2323 PHX JWS (D. Ariz. Nov. 25, 2003).

[13] *See, e.g.,* GAO, *Report to Congressional Requesters: Securities and Exchange Commission Review of Fiscal Year 2003 and 2004 Budget Allocations* (July 2004). The GAO stated in its report that since Congress increased the Commission's budget, it had made significant progress in hiring staff and was continuing to fill the remaining vacancies.

[14] *See, e.g., Hearings on the U.S. Securities and Exchange Commission's Appropriations For Fiscal Year 2005 Before the Subcommittee on Commerce, Justice, State, The Judiciary and Related Agencies of the House Committee on Appropriations* (2004) (Statement of the Investment Company Institute); *Hearings on the U.S. Securities and Exchange Commission's Appropriations For Fiscal Year 2004 Before the Subcommittee on Commerce, Justice, State, The Judiciary and Related Agencies of the House Committee on Appropriations* (2003) (Statement of the Investment Company Institute); and *Hearings on the*

We support Chairman Donaldson's view that the Commission's resources can, and should, be used to oversee hedge fund advisers.[15] In that regard, the Chairman recently stated: "[C]ritics cannot have it both ways. They cannot demand that the Commission try to prevent and detect emerging, but as of yet unforeseen harms, while at the same time argue against collection of information to facilitate identification of such harms."[16] We believe that adequate funding coupled with the Commission's newly adopted risk-based approach to potential securities law violations,[17] should permit it to "'look over the hill and around the corner' for indicators of future problems and violations. It turns out the hedge fund industry is a one-trillion-dollar corner along Wall Street, with 'warning signs' flashing at us. We simply can't afford to continue to walk by and ignore it."[18]

Performance Records

The proposal would amend the Advisers Act's recordkeeping rule to permit hedge fund advisers to use performance they earned prior to their registration with the Commission even though they do not have records to substantiate that performance.[19] Rule 204-2 requires a registered adviser that makes claims concerning its performance to keep documentation supporting those performance claims. The supporting records must be retained for a period of five years after the performance is last used. We believe this requirement is very important. At the same time, we recognize that excepting hedge fund advisers from this requirement is an accommodation to permit them to communicate their performance histories to clients.

Minimum Assets Under Management

The proposal does not change the minimum assets under management that an adviser must have to determine its eligibility to register with the Commission or the appropriate state securities authority. Thus, hedge fund advisers with assets under management of less than $25 million will generally not be eligible for Commission registration, and hedge fund advisers with assets under management between $25 and $30 million will be eligible, but not required, to register with the Commission. The Institute supports this approach. We see no reason to

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U.S. Securities and Exchange Commission's Appropriations For Fiscal Year 2003 Before the Subcommittee on Commerce, Justice, State, The Judiciary and Related Agencies of the House Committee on Appropriations (2002) (Statement of the Investment Company Institute).

[15] *See* Paul Schott Stevens, President, Investment Company Institute *America's Mutual Funds: The Road Ahead* (June 15, 2004) (National Press Club) (stating that Chairman Donaldson's call for registration of hedge fund advisers should be heeded).

[16] *Closing Statement by SEC Chairman William H. Donaldson*, U.S. Securities and Exchange Commission, at July 14, 2004 Open Meeting ("Closing Statement"). This statement is available at http://www.sec.gov/news/speech/spch071404whdclose.htm.

[17] *See, e.g.,* United States Securities and Exchange Commission, *2004-2009 Strategic Plan* 25.

[18] *Closing Statement* discussed above.

[19] The Proposing Release notes that once a hedge fund adviser is registered under the Advisers Act, it must comply with Rule 204-2, the recordkeeping rule, going forward.

distinguish hedge fund advisers from other advisers for purposes of determining whether they are more appropriately regulated by the Commission or state securities regulators.

<u>Offshore Advisers</u>

Under the proposal, hedge fund advisers located offshore will be required to look through private funds whether located in the United States or offshore and count investors that are U.S. residents for purposes of determining whether they qualify for the fewer-than-15-client exemption. The Institute supports this approach and sees no reason to treat offshore advisers to hedge funds differently than any other type of offshore adviser providing advice to U.S. residents.

Advisers to Offshore Private Funds

To limit the extraterritorial application of the Advisers Act, the Commission will not apply the substantive provisions of the Advisers Act to offshore advisers to offshore private funds. As a result, offshore advisers that will be required to register under the Advisers Act will not have to comply with the brochure rule, performance fee restrictions, and other Advisers Act requirements. The Commission requested comment on whether there is a significant concern that some U.S. hedge fund advisers would seek to use this exception to evade the Advisers Act's requirements.

We believe the Commission's approach is similar to the "conduct and effects" test the Commission currently uses in applying the Advisers Act to the non-U.S. clients of an offshore adviser.[20] We do not object to extending this policy to offshore advisers to hedge funds. If, however, the exception encourages U.S. hedge fund advisers to move offshore to avoid the Advisers Act's requirements, we believe the valid policy reasons for requiring hedge fund advisers to register with the Commission would be undermined. Thus, we urge the Commission to monitor this exception to ensure that there are not any unintended consequences.

We also recommend that the Commission clarify that, under the exception, it will have access to certain records of offshore advisers to offshore private funds. We believe that conditions on access to records, such as those outlined in *Unibanco* and the staff's subsequent letters, enable the Commission to enforce a registered offshore adviser's performance of its

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[20] The "conduct and effects" test, was first formally applied in *Uniao de Bancos de Brasileiros S.A.*, SEC No-Action Letter (July 28, 1992) ("*Unibanco*"). Under the test, conduct that takes place in the United States, wholly or in substantial part, will be deemed sufficient to justify application of the Advisers Act. The test also contemplates that the Advisers Act will be applied to conduct outside the U.S. that has or is intended to have substantial effects within the United States. Since the publication of *Unibanco*, the staff has applied the conduct and effects test in a number of situations generally involving multinational financial firms with numerous affiliated entities that shared personnel and resources and had both U.S. and non-U.S. clients. *See, e.g., Royal Bank of Canada*, SEC No-Action Letter (June 3, 1998); *ABN AMRO Bank, N.V.*, SEC No-Action Letter (July 1, 1997); *Murray Johnstone Holdings Limited*, SEC No-Action Letter (Oct. 7, 1994); *Kleinwort Benson Investment Management Limited*, SEC No-Action Letter (Dec. 15, 1993); *Mercury Asset Management plc*, SEC No-Action Letter (Apr. 16, 1993); and *The National Mutual Group*, SEC No-Action Letter (Mar. 8, 1993).

obligations to its U.S. clients and to ensure the integrity of U.S. markets.

Advisers to Offshore Publicly Offered Funds

Because the activities of offshore publicly offered funds do not raise the public interest concerns that Advisers Act registration is intended to address, the Commission has proposed to except offshore publicly offered funds from the definition of "private fund." Accordingly, a company that has its principal office and place of business outside the U.S., makes a public offering of its securities outside the U.S., and is regulated as a public investment company under the laws of a country other than the U.S. would not be considered a "private fund."

The Institute supports this aspect of the proposal. We believe it is appropriate for the Commission to exclude advisers of regulated public funds, such as UCITS funds,[21] from having to register with the Commission merely because more than 14 investors are U.S. residents. At the same time, we urge the Commission to interpret the exception narrowly and monitor its use so that it cannot be used by hedge fund advisers to avoid registering with the Commission.

Private Funds

Proposed Rule 203(b)(3)-2(d)(1)(i) under the Advisers Act defines a "private fund" as a fund that: (i) would be an investment company but for the exceptions in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940;[22] (ii) permits owners to redeem their ownership interests within two years of purchase; and (iii) is offered based on the investment advisory skills, ability or expertise of the investment adviser. The Proposing Release explains that by so defining "private fund," the Commission intended to reach hedge funds, but not other types of pooled investment vehicles such as private equity funds and venture capital funds.

The Institute supports the proposed approach of requiring only advisers to hedge funds to register under the Advisers Act. To our knowledge, the Commission has not encountered significant enforcement problems with advisers to private equity and venture capital funds. Given the tremendous growth in hedge funds and increase in enforcement cases involving hedge fund advisers, it is reasonable for the Commission to focus its resources on hedge fund advisers.

Recordkeeping Rule Amendment

The proposal amends Rule 204-2 to clarify that, for purposes of Section 204 of the Advisers Act, the books and records of a registered hedge fund adviser include records of the private funds for which the adviser acts as general partner. The Proposing Release points out

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[21] Undertakings for Collective Investment in Transferable Securities (UCITS) funds are funds that comply with the European Union's UCITS Directive and are authorized and regulated by an EU Member State for sale throughout the EU.

[22] Section 3(c)(1) of the Investment Company Act excludes from the definition of "investment company" those funds with fewer than 100 shareholders, and Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company those funds that permit only investors that are "qualified purchasers," which for natural persons generally means having investments of at least $5 million.

that because many hedge fund advisers establish a separate special purpose vehicle to be named as the fund's general partner, the proposed amendment also would cover private funds for which a related person of the adviser acts as general partner, managing member, or in a similar capacity. The Proposing Release explains that the purpose of this clarification is to ensure that Commission examiners have access to all records relating to the adviser's activities with respect to the fund, including records relating to the adviser's service as the fund's general partner. The Institute supports this approach. Providing access to all records relating to the adviser's activities with respect to the fund is essential to enable Commission examiners to determine whether the adviser is complying with the Advisers Act.

<u>Performance Fee Rule Amendments</u>

The proposal amends Rule 205-3 under the Advisers Act, the performance fee rule, to permit current investors of a hedge fund charging a performance fee who are not qualified clients (*i.e.*, those who do not have either a net worth of at least $1.5 million or at least $750,000 of assets under management with the adviser) to retain their existing investment in that fund, and to add to their accounts. The Proposing Release explains that while hedge fund advisers will be required to comply with the performance fee rule going forward, the proposal will permit advisers to continue receiving performance fees from current investors that are not qualified clients. The Institute supports the proposed approach. It recognizes that some current investors in hedge funds may not be qualified investors and avoids disrupting existing arrangements with these investors. As such, it is a reasonable accommodation for persons currently invested in hedge funds.

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The Institute appreciates the opportunity to comment on this significant proposal. We applaud the Commission for developing this timely and balanced approach for overseeing hedge fund advisers. If you have any questions or need additional information, please contact me at (202) 326-5815, Amy B.R. Lancellotta at (202) 326-5824, or Dorothy M. Donohue at (202) 218-3563.

Sincerely,

Elizabeth R. Krentzman
General Counsel

cc: The Honorable William H. Donaldson, Chairman
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

The Honorable Paul S. Atkins, Commissioner
The Honorable Roel S. Campos, Commissioner

Paul F. Roye, Director
Robert E. Plaze, Associate Director
Division of Investment Management

About the Investment Company Institute

The Investment Company Institute's membership includes 8,600 open-end investment companies ("mutual funds"), 630 closed-end investment companies, 135 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $7.351 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 231 associate members, which render investment management services exclusively to non-investment company clients. These Institute members and associate members manage a substantial portion of the total assets managed by registered investment advisers.