

MADISON CAPITAL MANAGEMENT, LLC

410 PARK AVENUE, SUITE 540
NEW YORK, NEW YORK 10022

September 15, 2004

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Attention: Jonathan G. Katz, Secretary

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

Dear Mr. Katz:

I am writing to you to express our views on the Commission's proposed rule and rule amendments contained in Release No. IA-2266 "Registration Under the Advisers Act of Certain Hedge Fund Advisers," dated July 20, 2004 (the "Proposed Rule").

By way of introduction, Madison Capital Management, LLC ("Madison") is a New York-based alternative investment management firm specializing in distressed, real estate and special situations financial assets. Since the firm's founding in 1996, Madison has invested approximately \$300 million on behalf of a select group of institutions and family offices.

OVERVIEW

It is our view that the Proposed Rule does not appropriately address the problems associated with hedge funds. Rather, we believe that the unintended but significant consequences of the Proposed Rule will be to induce hedge funds to admit retail investors and to encourage retail investors to overlook the risks of such an investment. We believe that it is more consistent with the Commission's historic missions of investor protection and regulation of the capital markets to relieve from the registration, information and reporting obligations of the Investment Advisers Act of 1940 (the "Advisers Act") those fund managers and advisers:

1. whose investment strategies do not create significant risks within the capital markets or cause market volatility, and
2. whose investors are of such size and sophistication that they can bear the risk of their investment.

PROPOSED SOLUTIONS

We value the Commission's concerns about the growth of the hedge fund industry and hedge funds' continued integration into the capital markets and into the investment portfolios of unsophisticated investors. However, we believe that registration will not alleviate these anxieties.

If the Commission's intent is to mandate hedge fund registration so as to better monitor the capital markets and to deter and detect fraud, we propose two possible solutions:

1. Require all hedge fund managers to provide the Securities and Exchange Commission with the annual audited financial report of their hedge fund investment vehicle and require hedge funds to distribute these reports to their investors.
2. Use currently available information, such as Form D filings, to gather information about the industry.

If the Commission's intent is to mandate hedge fund registration so as to protect unsophisticated investors from investing in a product whose risks they do not understand, we propose two possible solutions:

1. Only require hedge funds who accept money from pensions and Non-Qualified Purchasers to register.¹
2. Require investors to sign a waiver informing them of the risks that they are assuming and attached to the waiver include a summary of several hedge fund failures.

THE PROPOSED RULE DOES NOT APPROPRIATELY ADDRESS THE PROBLEMS ASSOCIATED WITH HEDGE FUNDS AND OVERLOOKS CERTAIN OTHER OF THE RULE'S IMPLICATIONS

Rather than address issues we believe have been adequately raised by the Commission's report, we have elected to focus on issues which have been overlooked and are worthy of closer examination. The Commission's report underestimates the financial burden of establishing and maintaining a compliance officer. We believe that the report is too expansive in its scope and unfairly penalizes hedge funds that do not pose risks to the

¹ Section 2.a.51.A of The Investment Company Act of 1940 defines a *qualified purchaser*, in general, as: any person who owns not less than \$ 5,000,000 in investments; or any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$ 25,000,000 in investments.

Assuming the average fund charges a 1% to 2% management fee, a manager with \$200 million under management, such as Madison, would be required to allocate 9% to 17% of management fee income to the compliance role and a \$100 million fund would be required to allocate as much as 35% (refer to Exhibit B). These costs would divert valuable resources from the crux of the business, potentially hampering investment performance and, could lead to increased management fees.

Alternatively, some managers may pass along the costs of compliance to investors. Should a hedge fund manager decide to pass compliance officer costs along to its investors, the performance of a \$200 million fund could deteriorate by as much as 6% and the performance of a \$100 million fund could deteriorate by as much as 13% (refer to Exhibit C). Compliance officer costs are over three to six times a fund's 2% management fee.

Exhibit C
Compliance Officer Cost to Investors

Fund AUM	HFRI Index Return*	Estimated Incentive Income	2% Mgmt Fee	Compliance Cost	HFRI Index Adjusted Return	Change in Performance
200,000,000	2.7%	5,360,000	107,200	347,000	2.5%	-6%
100,000,000	2.7%	2,680,000	53,600	347,000	2.3%	-13%

*As of September 15, 2004, the Hedge Fund Research, Inc. Weighted Composite Index funds had returned 1.8% YTD, which represents 2.7% annualized performance.

Investors subject investment managers to a thorough due diligence review; the compliance officer rule ignores the time, money and information exchange that accompanies this process. Investors do not invest in funds that do not meet their risk control and performance specifications and, redeem money if a manager does not meet disclosure, transparency and performance expectations. The compliance officer role will increase the cost of investing in a hedge fund and subject investors to a form of “double taxation” should managers choose to pass costs through to investors. It is doubtful that an investor will see value in this additional cost.

The Commission estimates that the proposed rule could result in as many as 1,260 new hedge fund manager registrants⁴, many of which would need to fill the compliance role. The proposal would create an industry bottleneck whereby too few experienced compliance officers are sought by 1,260 hedge funds. This supply and demand imbalance should magnify the cost of hiring a compliance officer and reduce the quality of officers given the ‘shortage’ of candidates.

⁴ Securities and Exchange Commission Proposal #2266, Section V, “Effects on Commission Examination Resources,” paragraph four.

Sections IV and VI only refer to the cost of creating and maintaining a compliance system and completing existing forms. No reference is made with respect to the time and expense of preparing for and hosting an examination. As stated in the Release:

During an examination, our staff reviews the advisory firm's internal controls and procedures; they examine the adequacy of procedures for valuing client assets, for placing and allocating trades, and for arranging for custody of client funds and securities. Examination staff also review the adviser's performance claims and delivery of its client disclosure brochure.⁵

Additionally, the majority omits any reference to the time and expense associated with responding to the numerous concerns expressed in the Release and which, we believe, will be the subject of an examination. The examination will explore, and the registered Adviser must be prepared to demonstrate, compliance with internal expense and investment allocation systems and asset valuation policies.

We believe that *more* time and expense will be incurred in the examination process and in preparing for the new areas of Staff concern, such as creating and maintaining an effective compliance system or completing existing forms. In effect, the majority's cost estimate for compliance is, in our view, approximately one eighth of the true estimated cost. The cost of establishing a compliance function far outweighs the benefits. The opportunity costs and real costs are a heavy burden to bear, especially when the current system has not been proven ineffective.

Proposal Deficiency #2: The "Private Fund" Definition Is Artificial and Avoids the Key, Distinguishing Characteristics of Problematic Funds

We appreciate the majority's preference for a regulatory scheme that is objective and easy to administer. However, we believe that those concerns are outweighed by the failure of the majority's "private fund" definition and its application to achieve the majority's ostensible goal: to bring into regulation those fund managers whose funds pose the risks that are at the center of the Staff's concerns. In missing its mark, the majority's proposal sweeps into regulation funds that pose few, if any, of those risks. In brief, the majority's "private fund" centered regulatory scheme creates an arbitrary distinction among funds. There is simply no correlation between the majority's proposal and the harms it seeks to discourage.

We believe that a more rational approach to regulation would look to the strategies employed by the adviser and the assets that the fund holds. In our view, the more significant fund characteristics that should engender regulation of currently unregulated advisers are funds that illustrate any one of the following four characteristics:

⁵ Section II, B, 2 of the Release.

1. Aggressive use of leverage;
2. High volume of trading;
3. Active short selling; and
4. Extensive use of derivatives, options or synthetic securities.

Hedge funds that do not use leverage, such as Madison, do not pose a risk to the market because the fund's liabilities do not significantly outweigh capital. Funds such as Madison's are able to meet obligations and are less volatile. Funds that do not utilize significant leverage should be exempt from regulation.

Private equity-like funds do not pose a destabilizing risk to the securities market, such funds do not actively trade in and out of the market but, invest in non-marketable securities and therefore, are not active short-sellers, as is characteristic of many distressed hedge fund strategies. Such funds are not able to corner markets or dictate market prices due to the long-term, illiquid investment strategy.

Funds that do not use derivative products are not able to synthetically create positions that could possibly move the market. Furthermore, funds that do not trade derivatives are not assuming the added risk of off-balance sheet leverage, as are funds that trade such products as credit default swaps.

The Commission drafted the registration proposal because it is "concerned about hedge funds and their managers, and the impact their investment activities can have on investors and the securities markets."⁶ Funds that do not pose a risk to the securities market should not be forced to endure the burden of regulation. The lack of correlation between regulation and risk is well illustrated by the Madison family of funds. Funds managed by Madison have a net duration of 15 months, never use derivatives, options or synthetic securities and do not use leverage. In fact, Madison funds more closely resemble private equity funds in many respects. And yet, because *one*⁷ of several of its funds permits redemption within two years of investment, all of Madison's fund advisory businesses will, if the Proposed Rule is adopted, be captured by the Advisers Act.

Proposal Deficiency #3: The Proposed Rule Will Aggravate, Rather than Ameliorate, the Goals of Investor Protection

The single greatest reason for hedge funds to refuse retail investor funds is the burden of regulation that would arise under the Advisers Act. If adopted, the Proposed Rule would take issues of regulation out of this analysis, and fund sponsors will see little reason to

⁶ Registration Under the Advisers Act of Certain Hedge Fund Advisers: Background, paragraph 9

⁷ Ironically, this one Madison fund was commenced prior to the date of Release. Had Madison known of the "private fund" test prior to the offering of interests in that one fund, Madison would have conformed that fund's redemption provisions to satisfy the two year test of the Proposed Rule.

exclude retail investors (even if they are Accredited Investors) from their fund. Retail money is inexpensive and easy to aggregate. The market is flush with investors who have amassed a moderate share of capital and are looking for investments that will deliver superior returns in all market conditions. Stocks and bonds do not meet this return criterion. Mandatory registration will remove the drawback to accepting retail investors which could lead to a proliferation of unsophisticated capital into hedge funds, exactly that which the Commission has attempted to prevent. Furthermore, the cost burden of regulation could lead managers to focus on growing the asset base to meet new fee requirements, which, subsequently, could result in a shift in marketing tactics to capture 'cheap' retail investor money. The rule could transform the entrepreneurial aspect of the industry in favor of strictly for-profit operations. Managers will use regulation as an opportunity to grow their assets more quickly, in turn, aggregating retail money. Where no NASD member firm is involved in the placement of fund instruments there will be no gatekeeper to evaluate investor suitability. The Proposed Rule will therefore have induced the general "retailization" of hedge fund products.

Investors are unlikely to appreciate the scope and limits of the benefits that regulation under the Advisers Act will afford them. Worse, investors may believe that, as proposed by the majority, a field examiner's review will provide meaningful comfort that the fund is operating in a manner that is fair or consistent with the promises made in the fund prospectus. However, we feel that modifying the Proposed Rule such that only funds that accept retail or pension money would be captured in the wider regulatory net is a logical means of managing the retail risk hedge funds can pose.

It is our great concern that the unintended but significant consequences of the Proposed Rule will be to induce hedge funds to admit retail investors and to encourage retail investors to overlook the risks of such an investment.

Existing Disclosure Rules and Market Forces Adequately Address the Possible Fraudulent Operation of a Fund

The demands of the marketplace already impose upon fund sponsors, managers and advisers the burden of creating and maintaining auditable systems for trade pricing, investment allocation, expense allocation, custody and conflicts resolution. These procedures are, for marketing purposes, described in each fund's prospectus. Further, investors in hedge funds focus enormous attention on the background, track record and character of fund and adviser management. Here, too, the prospectus provides what is often only the beginning of an investor's extensive due diligence inquiry into the relative merits of the investment.

Existing disclosure requirements both under the Securities Act of 1933 and the Securities Exchange Act of 1934 provide a formidable framework for the regulation of hedge fund disclosure, and by brief extension, operation. Failure to adequately describe fund or adviser management or any of the internal controls that are the rightful and frequent focus of investor inquiry poses risks of administrative and private action, both for the issuer and the placement agent. The majority ignores the existing disclosure requirements of the

Securities Act of 1933, as well as the rights and remedies provided by that Act. Rather, the majority offers a unique and problematic approach to holding issuers accountable for the contents of their prospectuses and compliance with those contents: audit by an SEC field examiner using unpublished merit standards.

It is our belief that these market forces, coupled with the already robust regulation of prospectus contents and broker-dealers, adequately deal with many of the frauds that trouble the majority.

ALTERNATIVE PROPOSAL: BOLSTERED ELIGIBILITY CRITERIA, SPECIFIC EXEMPTIONS FROM THE PRIVATE FUND DEFINITION AND SIMPLE DATA COLLECTION REQUIREMENTS ARE THE BEST APPROACHES TO ADDRESS STAFF AND MARKET CONCERNS

If the majority wishes to maintain the “private fund” concept, we believe that there should be two modifications to the Proposed Rule:

First, an investment fund whose investors are all Qualified Purchasers,⁸ should be counted as one client for purposes of Rule 203(b)(3)-1; and

Second, an investment fund should not be deemed a Private Fund if it (a) does not use significant leverage, (b) maintains an average investment holding term of not less than six months, measured by the value of investments, or (c) does not use derivatives, options or synthetic securities or (d) does not engage in active short selling.

There is Ample Precedent in the Securities Laws for Addressing Investor Protection Concerns Through Heightened Investor Eligibility

There are numerous occasions in the securities laws where Congress or the Commission has exempted an otherwise regulated activity from oversight if the investor to be protected has such sophistication and wealth that he is considered capable of fending for himself. While the majority acknowledges this point in Section I of the Release it only does so in the context of the exemption from the registration provisions of the Securities Act. The majority fails to mention that this philosophy is at the core of the Qualified Client concept in the Advisers Act itself, the Qualified Purchaser concept in the

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We believe, as stated earlier, that pension funds should not be able to avail themselves of this exemption.

Investment Company Act of 1940, the Qualified Institutional Buyer concept in Regulation 144A under the Securities Act and the suitable investor concept in the realm of broker-dealer regulation.

Also, the majority's analysis of the private adviser exemption bears comment. First, even if we assume, as the majority does, that the private adviser exemption may not, at the time of its passage, have been intended to exempt advisers to wealthy or sophisticated clients, it does not follow that the Commission can *not* take the wealth or sophistication of clients into consideration today as it contemplates rulemaking. Second, it may be true, as suggested by the majority, that a sophisticated investor, by the act of engaging an advisor, is acknowledging the need for assistance. However, the act of subscribing to a hedge fund by that same sophisticated investor does not necessarily evidence lack of sophistication, knowledge, ability to withstand loss, bargaining power or the ability to conduct due diligence on the fund. In fact, it is typically the more sophisticated and wealthy investor who can be relied upon to conduct the most thorough due diligence on a prospective fund. Further, while an investor may choose not to invest as a hedge fund manager invests, this does not imply that the investor does not understand the market. Sophisticated investors generally understand the markets in which they invest but, realizing their limitations, allocate money to hedge fund managers. Market efficiency is driven by market participants employing their talents, hedge fund managers are, generally, skilled investors, just as a surgeon is skilled at operating on patients.

Third, the majority states that thirty-nine percent of advisers registered with the Commission report that they advise only institutional and wealthy clients. There is nothing to suggest in that statement, however, that those advisers registered of their own free will without the legal compulsion to do so. And last, if, as stated by the majority, there is no discernable legislative intent to create a wealthy/sophisticated investor exemption to various elements of the Advisers Act, there is certainly no legislative intent to bar the creation of such an exemption by rule.

A Modified "Qualified Purchaser" Standard Is the Correct Approach

For the reasons set out above, we believe that an appropriate balance would be struck between the needs of investor protection and facilitating the raising of capital in collective investment pools if current Rule 203(b)(3)-1 were modified so as to count as a "single client" those investors who reside in any of the entities described in Subsection (a)(2)(i) of that Rule and who (a) are not Qualified Purchasers, (b) are a pension fund or (c) are a regulated investment company.

It has been our experience that prospective investors that satisfy the Qualified Purchaser standards often conduct extensive and penetrating due diligence examinations of their own. In addition, investors who satisfy those standards are often active, inquisitive and demanding investors after admission to our funds.

A Simple Data Collection System Will Satisfy the Staff's Need for Statistical Information

Under the current system, the Commission receives useful information from hedge fund managers that Commission staff could use to help it to achieve its statistical information goal without mandating registration. A notice filing, such as Form D, required by Regulation D, would give the Commission the census data that it seeks. Form D would provide the Commission with information on the number of funds in the industry, the number of investors and the assets under management. Should the Commission have additional questions, the Commission could require funds to submit annual audited financial statements upon request.

CONCLUSION

We believe that the majority's Proposed Rule is flawed for at least three reasons: (1) it unfairly penalizes funds that do not pose a risk to the securities market and that do not accept retail money; (2) it underestimates the cost of establishing and maintaining a compliance officer, and, (3) it will encourage fund managers to amass retail investor money. The Commission should consider amending Proposed Rule (a) to provide that Rule 203(b)(3)-1 counts as a "single client" those investors who reside in any of the entities described in Subsection (a)(2)(i) of that Rule and who are not Qualified Purchasers, are a pension fund or are a regulated investment company, and (b) to exclude from the Private Fund definition those funds that do not use high degrees of leverage, do not actively trade their portfolios or do not use derivatives, options or synthetic securities or do not engage in active short selling. Moreover, we believe the Commission can accumulate the statistical data it seeks without requiring registration, but instead, by analyzing information that managers currently provide in Form D filings and, requesting audited annual financial statements.

Sincerely,

Bryan Gordon, Managing Director