

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

**Comments on Proposed Rule: Reporting by Investment Advisers to Private Funds and
Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF**

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Comments Submitted To: Ms. Elizabeth M. Murphy
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I. INTRODUCTION

Thank you for the opportunity to provide comments on the Securities and Exchange Commission's ("SEC") proposed rule requiring certain investment advisers of private funds to file Form PF. I commend the SEC for its efforts to reform the securities laws to properly account for systemic risk build-up within the economy. I respectfully submit these comments in response to the Notice of Joint Proposed Rulemaking that appeared in the Federal Register on February 11, 2011. These comments are prompted by my strong interest in the securities laws and the strength and stability of the United States economy. My name is Christopher Chuff and I am a second-year law student at Villanova University School of Law. I earned my Bachelor of Science degree in finance from the Smeal College of Business at the Pennsylvania State University.

In the summer of 2010, I worked as a Research Assistant for Professor Jennifer O'Hare, a securities fraud expert. While working for Professor O'Hare, I researched and wrote legal memoranda on various topics including the securities laws, the regulation of structured products, and the propensity of securitization to create systemic risk. I also closely studied the enforcement action the SEC brought against, and subsequently settled with, Goldman, Sachs and Co. concerning an allegedly fraudulent synthetic Collateralized Debt Obligation ("CDO").¹ Last,

¹ See Susanne Craig & Kare Scannell, *Goldman Settles Its Battle With SEC: \$550 Million Deal Ends Showdown That Shook Street*, WALL ST. J. (July 16, 2010), <http://online.wsj.com/article/SB10001424052748704682604575369382547871788.html>. (discussing terms of settlement).

I authored a comment suggesting reform of the regulatory structure for securitized products.² It is these experiences that have prompted my interest in, and comments on, the SEC’s proposed rule entitled “Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF.”³

II. BACKGROUND

Private funds have long been free of the regulatory constraints imposed upon other major financial institutions. As a result, unconstrained private fund activity influenced the creation of systemic risk, market volatility, and asset-price bubbles. In response, Congress authorized the SEC and other financial regulatory commissions to exercise broader authority over private funds. This authority includes the power to require private funds to register with the SEC, make periodic reports, and disclose information to the SEC concerning systemic risk.

1. Prior Regulatory Treatment of Private Fund Advisers

Prior to 2011, private funds were not subject to the same regulatory requirements as other financial institutions, such as registration, reporting, and pricing and valuation requirements. Private funds, such as hedge funds, have always been *potentially* subject to the requirements of the Investment Adviser Act of 1940, the Investment Company Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934. These funds, however, have historically avoided the regulatory constraints of these statutes by either falling into statutorily provided exemptions or navigating around the triggering provisions of these statutes and regulations. Private funds have preserved their regulatory freedom mainly by restricting their investment opportunities to sophisticated and wealthy investors who possess the knowledge and net worth requirements to analyze and handle the risks involved in such investments.⁴

2. Systemic Risk Created As a Result of Limited Regulatory Oversight

The regulatory freedoms described above allowed financial institutions, such as private funds, to abuse financial products, create a large amount of systemic risk, and inevitably cause global market failure. For the past decade, investment banks, private funds, and other financial institutions have abused the regulatory freedom they were afforded. As a result, a large amount of systemic risk built up in the financial system.

Without adequate oversight, financial institutions integral to the proper functioning of the economy took extremely large positions in derivative and structured product transactions made up of or referencing mortgage-backed assets and securities. When the mortgage bubble collapsed in 2008, these institutions became liable for large sums under the terms of these

² Christopher B. Chuff, Comment: “*Rolling the Dice*” on *Financial Regulatory Reform: Gambling Law as a Framework for Regulating Structured Investments*, 18 VILL. SPORTS & ENT. L.J. (FORTHCOMING 2011).

³ See generally SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8068-8155 (Feb. 11, 2011) (proposing systemic risk reporting requirements for certain investment advisers to private funds).

⁴ Specifically, private funds were exempt (1) from the Investment Company Act of 1940 by falling into §§ 3(c)(1) and 3(c)(7) exemptions, (2) from the Securities Act of 1933 by fitting into the private-placement exemption provided for by Section 4 and Regulation D, and (3) from the Investment Adviser Act of 1940 by qualifying for the § 203(b)(3) exemption of the Act.

derivative and structured product transactions. As a result, many financial institutions incurred record-breaking losses. These losses left the largest financial institutions without the capital or confidence to finance at reasonable levels in order to keep the United States economy afloat.⁵ Accordingly, every business and individual that relied on credit was adversely affected.⁶ The adverse effects of the credit freeze are numerous. They include, *inter alia*, the following: American businesses filing for bankruptcy at increased rates; consumer spending plummeting; unemployment rates skyrocketing; employee retirement and pension funds losing value, and the stock market's value evaporating.

The foregoing discussion of the financial crisis is a prime example of financial institutions' creation of systemic risk. Systemic risk or economy-wide risk is the risk taken by certain entities that have the potential to affect an entire market or the entire economy.⁷ During the financial crisis, the economy nearly collapsed because of the losses sustained by financial institutions that were relied upon heavily by the financial system. Accordingly, it is imperative for the SEC to collect information on the positions of systemically important financial institutions, assess these institutions' risk of failure, and reduce the likelihood of such failures. Proposed Form PF is a strong step toward accomplishing this goal.

3. Increased Regulatory Oversight of Private Funds Authorized by Dodd-Frank

The United States government responded to the financial crisis by authorizing the SEC to increase the regulatory constraints on private funds. On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")⁸ into law. The Act authorizes a broad range of financial regulatory reform, fills many regulatory gaps, and equips financial regulatory authorities with the tools necessary to mitigate prospective financial crises.⁹

⁵ See William Collins, *Developments in Banking and Financial Law: 2007-2008: IV. Valuing Opaque Assets in an Illiquid Market*, 27 REV. BANKING & FIN. L. 285, 285-90 (2008) (discussing how lack of liquidity in banking system adversely affects remainder of economy because of inability to gain credit). See Michael R. Crittenden & Meena Thiruvengadam, *Treasury Finds No Rise in Bank Lending*, WALL ST. J., Feb. 18, 2009 (noting banks' refusal to lend despite infusion of capital from government bail-out plan); see Michael Lewis & David Einhorn, *The End of the Financial World As We Know It*, N.Y. TIMES, Jan. 4, 2009, at WK9 (noting banks' failure to lend).

⁶ See Brian Perry, *Credit Crisis, Market Effects*, INVESTOPEDIA ULC., <http://www.investopedia.com/university/credit-crisis/credit-crisis7.asp> (last visited Mar. 1, 2011) (discussing effects of credit crisis on businesses and individuals); see Jeannine Aversa, *Fed: Credit Crunch Effects Limited*, WASHINGTON POST (Sept. 5, 2007; 6:42 PM), <http://www.washingtonpost.com/wp-dyn/content/article/2007/09/05/AR2007090501698.html> (explaining adverse effects individuals and business are experiencing due to credit crunch).

⁷ See Dodd-Frank Act, Pub. L. No. 113, 124 Stat. 1376 (2010).

⁸ Pub. L. No. 111-203, 124 Stat. 1376 (2010). A focus of the legislation in particular is to "promote the financial stability of the United States" by monitoring and combating the creation of systemic risk within the economy.

⁹ See SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8069-8155 (Feb. 11, 2011). The Dodd-Frank Act created a framework to reduce systemic threats inherent in the U.S. economy and authorizes financial regulators to carry out that mandate. The primary means of the Dodd-Frank Act's systemic risk mitigation framework is the creation of the Financial Stability Oversight Council ("FSOC"). The FSOC is charged with identifying and addressing systemic threats to the stability of the economy. Once the FSOC has determined that an institution poses systemic risks upon the economy, the Federal Reserve has the authority to increase capital requirements, impose leverage limits, and compel other stringent risk-based requirements in order to reduce the level of systemic risk the institution is imposing.

Indeed, private funds, which long have enjoyed regulatory freedom, are brought under greater regulatory scrutiny as a result of the Dodd-Frank Act. Title IV of the Dodd-Frank Act, entitled “Private Fund Investment Advisers Registration Act of 2010” extends greater regulatory authority over private fund advisers, including those that advise hedge funds, private equity funds, and venture capital funds. Among other things, the Dodd-Frank Act authorizes the SEC to establish registration and reporting requirements for private funds and to collect information from advisers of private funds that the SEC deems necessary to assess systemic risk. This authority provides the potential for systemic risk reduction and greater economic stability.

4. Proposed Regulation: Registration and Reporting Requirements of Private Funds

The SEC furthered the Dodd-Frank Act’s progress by bringing private funds under the Commission’s purview. In carrying out the general mandate of the Dodd-Frank Act, the SEC has proposed three regulations in the past five months that will help reduce market abuses and systemic risk. These regulations, however, pose substantial costs on private funds. The SEC should strongly consider these costs, especially their effect on smaller funds, when promulgating the final rule.

On November 19, 2010, the Securities and Exchange Commission unanimously voted to propose two rules implementing Title IV of the Dodd-Frank Act. The rules, if made final, will subject private funds to rules and regulations that they have historically not been subject. First, the SEC proposed “Rules Implementing Amendments to the Investment Advisers Act of 1940.”¹⁰ This rule proposes rules and amendments to the Investment Advisers Act of 1940 that would require many advisers of hedge, private equity, and other private funds currently exempt from registration, to register and file periodic reports with the SEC. Second, the SEC proposed “Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers.”¹¹ This rule proposes exemptions from the aforementioned registration requirements for (1) venture capital fund advisers, (2) advisers to private funds that manage assets of less than \$150 million, and (3) particular foreign private advisers.

Last, on February 11, 2011, the SEC proposed “Reporting by Investment Advisers to Private Funds, and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF.”¹² This rule seeks to solicit information concerning the size, strategies, and positions of private funds to enable the Financial Stability Oversight Council (“FSOC”) to identify and assess the systemic imprint created by these financial institutions and to maintain economic stability. This proposed rule is the subject of this comment. An analysis of the proposal and suggestions for altering it are provided below. The suggestions focus on the Assets Under Management (“AUM”) thresholds and the frequency of reporting requirements.

¹⁰ SEC Proposed Rule, 75 Fed Reg. 77190-77227 (Dec. 10, 2010) (establishing registration and periodic reporting requirements for certain private funds).

¹¹ SEC Proposed Rule, 75 Fed Reg. 77052-77190 (Dec. 10, 2010) (establishing exemptions from registration requirements for certain private funds).

¹² SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8068-8155 (Feb. 11, 2011) (explaining goals of Form PF).

III. DISCUSSION

A. Introduction of Suggestions

I firmly support the SEC's efforts to reduce the extent of systemic risk within economy. The proposed rule is an excellent attempt by the Commission to institute procedures designed to identify, assess, and mitigate systemic risk. The information Form PF is designed to collect ensures that the FSOC has the data and information it needs to assess systemic risks within the financial system. Although the proposed rule is an impressive attempt at systemic risk reduction, the rule is currently overbroad and should be constrained to sizeable funds. Form PF should be applicable only to private funds truly capable of creating systemic risk. As currently proposed, the regulation applies too broadly and is not properly focused on the private funds that pose the greatest threat to financial stability, the larger private funds. The proposed rule also adds to the undue burdens placed on small private funds.¹³

In order to properly focus the FSOC's efforts on funds that have the greatest likelihood of adversely affecting the financial system and to relieve some of the burdens on smaller funds, the AUM thresholds should be reformulated and the reporting frequency requirements should be increased for funds with the largest systemic impact. The proposed rule should be revised in the following ways:

- (1) Private funds with less than \$500 million AUM should be exempt from filing Form PF;
- (2) Private funds with AUM between \$500 million and \$1 billion should be required to make an annual filing of Section 1 and Section 2 of Form PF, rather than merely Section 1;
- (3) Private funds with AUM of \$1 billion or more should be required to file Sections 1 through 4 of Form PF quarterly, as proposed by the SEC; and
- (4) Private funds with \$5 billion or more in AUM and a trading volume or portfolio turnover rate higher than a SEC specified minimum should be required to file Form PF monthly, rather than quarterly.

With these alterations, the FSOC will have access to a breadth of information focused on private funds that have the greatest potential to impact the U.S. capital markets and economy. These changes will also reduce the burdens imposed on smaller funds. Accordingly, the SEC should strongly consider revising the AUM thresholds and frequency of reporting requirements as outlined above.

¹³ As currently proposed by the rule, all funds with AUM of \$150 million to \$1 billion must file Section 1 of Form PF. The smaller funds, within this AUM category suffer disproportionate filing costs, will likely become less efficient as a result, and may become targets for acquisitions. This may cause a consolidation of the private fund industry and be damaging to systemic risk reduction efforts.

B. Suggestions for Altering the Assets Under Management Thresholds¹⁴

The AUM thresholds should be altered in order to reduce regulatory burdens on smaller private funds and to collect more information from the systemically important funds. The rule, as currently proposed, would require all funds with AUM of \$150 million or more to file Section 1 of Form PF and would require all private funds with AUM of over \$1 billion dollars to file all four sections of Form PF. The AUM thresholds should be restructured as follows:

- (1) Private funds with less than \$500 million in AUM should be exempt from filing Form PF;
- (2) Private funds with AUM between \$500 million and \$1 billion should be required to file Section 1 *and* Section 2 of Form PF, rather than merely Section 1; and
- (3) Private funds with AUM of \$1 billion or more should be required to file Sections 1 through 4 of Form PF, as proposed by the SEC.

This restructuring would reduce the burdens on small funds and focus the regulation on the entities with the greatest systemic impact. Accordingly, FSOC's increased focus on private funds with the largest potential to create systemic risk would further the Council's statutory mandate of identifying and assessing sources of systemic risk.

1. *Why Funds Managing Less than \$500 Million Assets Should be Exempt*

Private Funds with less than \$500 million AUM should be exempt from filing Form PF because:

- (a) these funds create only a small amount of systemic risk within the U.S. economy; and
- (b) requiring funds with AUM of under \$500 million may cause a consolidation of the private fund industry and have counterproductive effects on systemic risk reduction.

a. Small Private Funds Impose Very Little Systemic Risk upon the Economy

Private Funds with less than \$500 million AUM create very little systemic risk. Although the assets managed by private funds have increased greatly in the last decade and are expected to nearly double in the next three years, the relative size of hedge funds as compared to other financial institutions, such as pension funds, mutual funds, insurance companies, and banks is extremely small.¹⁵ (See Appendices I, II, and V). Moreover, hedge funds with AUM under \$500 million represent only a small percentage of the hedge fund industry.

¹⁴ For the request for comment addressed by this section, see SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8077 (Feb. 11, 2011) ("Are there more appropriate dividing lines as to when a private fund adviser should be required to report more information?").

¹⁵ For an illustration of the historical growth rate of hedge funds, see Appendix I. For a chart illustrating the relatively small size of hedge funds when compared with other financial institutions, see Appendix II. See also Casey Quirk & The Bank of New York Mellon, *The Hedge Fund of Tomorrow: Building an Enduring Firm* (April 2009), available at, <http://www.bnymellon.com/foresight/pdf/hedgefundoftomorrow.pdf>.

The size of a private fund is a major factor influencing the amount of systemic risk the fund has the potential to inflict on the economy.¹⁶ Smaller private funds have lower counterparty exposures and do not have enough concentrated weight to seriously affect industry liquidity. In addition, upon failure, the liquidation of smaller fund's positions would not substantially increase volatility of asset prices, as the liquidation of larger funds' assets surely would.¹⁷

In 2009, the entire hedge fund industry had \$1.43 trillion in AUM.¹⁸ This figure represented only 1.1% of global AUM of all major financial institutions.¹⁹ (See Appendix II). Additionally, in 2009, hedge funds with AUM of \$500 million or less only made up 8.4% of the entire hedge fund industry.²⁰ (See Appendix III). Taken together, these statistics show that hedge funds with AUM of \$500 million dollars or less represent only 0.0924% of the AUM of major financial institutions. Thus, funds with AUM of \$500 million or less represent such a small portion of the economy that they are unlikely to create a significant amount of systemic risk. Funds of this size should accordingly be exempt from Form PF.

b. Imposing Costs on Smaller Private Funds Can Have Counterproductive Effects on the SEC's Efforts to Combat Systemic Risk Creation²¹

Requiring private funds with AUM of \$500 million or less to file Form PF can be counterproductive to systemic risk reduction efforts. The costs of filing Form PF, in combination with the costs of filing Form ADV, may cause a consolidation of the private fund industry making each remaining private fund more systemically important. This consolidation would likely occur because of the disproportional costs borne by the smaller funds. Indeed, the costs of filing Form PF are proportionally larger for hedge funds as the size of the hedge fund decreases.²²

¹⁶ Michael R. King and Phillip Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks* (October 2008), available at, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1297188&http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1297188.

¹⁷ Larger private funds take larger positions and have a much greater potential to cause downward pressure on asset prices. Large private funds control a much greater proportion of the supply of certain assets; thus when these funds are forced to sell, the market supply of these assets is increased greatly causing a sharp decrease in the assets' prices.

¹⁸ See Jenny Strasburg & Steve Eder, *Hedge Funds Bounce Back*, WALL ST. J., April 18, 2011, at A1 ("Total hedge-fund assets are approaching \$2 trillion and are soon expected to surpass their peak in early 2008, according to industry analysts.").

¹⁹ For a chart illustrating the relatively small size of hedge funds when compared with other financial institutions, see Appendix II.

²⁰ For a chart showing the percentage of total number of hedge funds in each size category as divided by AUM, see Appendix III.

²¹ For the request for comment addressed by this section, see SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8080 (Feb. 11, 2011) ("Should the thresholds be more or less?").

²² The costs of Form PF and Form ADV are \$8,405,030. See SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8089 (Feb. 11, 2011). See also SEC Proposed Rule, 75 Fed. Reg. 77078 (Dec. 10, 2010). The costs of these regulations are the same for private funds that have AUM of \$150 million and funds that have AUM of \$999 million. The proportionate cost to a \$999 million fund is approximately 0.84% of its total Assets Under Management. The proportionate cost to a \$150 million fund is approximately 5.6% of its total Assets Under Management. This disproportionate cost may incentivize smaller funds to consolidate into funds that approach the \$1 billion AUM threshold.

The costs associated with Form PF, in conjunction with the costs of registration and periodic reporting imposed by the “Rules Implementing Amendments to the Investment Advisers Act of 1940”, create significant burdens for private funds, especially for funds with a smaller amount of AUM.²³ Accordingly, smaller funds will not be as operationally efficient as larger funds and will not be able to obtain the level of returns that larger funds will be able to obtain without pursuing riskier investment strategies. Therefore, these funds will either pursue riskier investment strategies and experience increased attrition rates or become potential targets for consolidations. Inevitably, as a result of Form PF and other regulatory costs, it seems likely that many smaller funds will consolidate with larger private funds.²⁴ This consolidation will tend to decrease the amount of hedge funds in the industry and increase the size of each accordingly. Thus, each private fund would become more systemically important and the failure of each will become more impactful on the economy.

General diversification principles assert that the failure of a financial institution will have a proportionally smaller impact on the overall economy when financial institutions similar in nature to the failing institution exist and are operational. When industries consolidate, the number of entities within that industry decrease, while the size of the entities that remain increase. This results in each entity being more systemically important. Private funds are extremely important sources of liquidity for various counterparties and certain markets. Moreover, as the number of these entities decrease and the size of these entities increase, the failure of one of these entities will have a larger impact on certain markets as well as the broader economy.

This principle was illustrated by the recent financial crisis and the failure of a small number of investment banks. The Gramm–Leach–Bliley Act, enacted in 1999, allowed for the consolidation of commercial banks, investment banks, securities firms, and insurance companies.²⁵ In light of this, once separate financial institutions were consolidated into a few large, complex financial institutions. The repercussions of allowing this consolidation were vividly apparent when a few investment banks that were relied upon heavily by the financial markets collapsed and caused an economy-wide credit crisis. It is for this reason that costs and burdens must be minimized for smaller private funds. It is imperative that smaller funds do not become targets for acquisitions causing a consolidation of the private fund industry such that each private fund becomes more systemically important. Accordingly, private funds with AUM of \$500 million or less should be exempt.

²³ See Steve Eder, *Biggest Obstacles For Small Funds in Rules Overhaul*, WALL ST. J., April 18, 2011, at C5 (“[The regulations are] going to cause consolidation in the industry of smaller managers into larger managers who have the infrastructure and can afford this.”).

²⁴ See *id.* (“While the regulations apply broadly to hedge-fund managers, they may prove the most burdensome to smaller firms Bigger Firms are . . . better-positioned to handle regulation because they often have internal compliance infrastructure in place or have the assets to support additional costs.”).

²⁵ See Lissa Lamkin Broome & Jerry W. Markham, *The Gramm-Leach Bliley Act: An Overview* (2001), available at, http://www.symtrex.com/pdfdocs/glb_paper.pdf.

2. *SEC Should Require Funds with AUM of \$500 Million to 1 Billion to File Sections 1 and 2 of Form PF In Order to Gain a Complete Picture of the Stability of Systemically Important Funds*²⁶

Private funds with AUM of \$500 million to \$1 billion should be required to file Sections 1 and 2, rather than merely file Section 1 because these private funds can impose serious systemic consequences on the economy. A complete understanding of these funds' positions, concentrations, counter-party exposures, and asset market values is necessary to properly oversee the amount of systemic risk posed by these funds. Moreover, requiring funds to disclose their portfolio turnover rate, as required by Section 2 of Form PF, is imperative to truly understand the systemic imprint of these funds.²⁷ Without this data, the FSOC will not be able to accurately determine the amount of systemic risk a private fund actually poses.

Although private funds with AUM of \$500 million to \$1 billion only manage a small proportion of assets managed by all major financial institutions, size alone is not dispositive of the systemic effect of these financial institutions. These funds are fairly sizeable and account for a significant amount of trading volume in the U.S. equities market and an even higher proportion in risky investment devices such as credit derivatives.²⁸ (See Appendix IV). Moreover, these funds tend to dominate trading in markets that have a broader systemic reach.

Hedge funds participate in approximately 60% of credit derivative transactions. Credit derivative transactions often involve substantial amounts of downside risk that could impair a hedge fund's ability to provide liquidity to markets and counter-parties if the values of these investments deteriorate. The rapid and focused trading in instruments that carry the potential to amplify losses of referenced assets can add unnecessary volatility to markets and could influence pricing bubbles in particular asset classes. Accordingly, understanding the systemic imprint of certain private funds will be impossible without collecting information concerning portfolio turnover, as required by Section 2. It is for these reasons why the SEC should require private fund advisers that manage funds with AUM of \$500 million to \$1 billion to file both Sections 1 and 2 of Form PF.

3. *Private Funds with AUM of \$1 Billion or more Should Complete All Sections of Form PF as Proposed*

I fully support the SEC's efforts in soliciting information from private funds that manage assets of over \$1 billion dollars. The size of these funds, their trading volume, their portfolio turnover rate, and the investment strategies these private funds pursue make these financial institutions systemically important. Accordingly, collecting information concerning their positions, concentrations, counter-party exposures, portfolio turnover rates, and financing

²⁶ For the request for comment addressed by this section, see SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8081 (Feb. 11, 2011) ("We request comment on the qualifying hedge fund threshold. Should it be higher or lower? If so, why?").

²⁷ For the request for comment addressed by this section, see SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8080 (Feb. 11, 2011) (Requiring "the turnover rate of the adviser's aggregate portfolios during the reporting period to provide an indication of the adviser's frequency of trading").

²⁸ For data indicating the trading volume attributed to hedge funds in various asset classes and types of securities, see Appendix IV.

arrangements is vital to the stability of the U.S. economy and capital markets. It is for these reasons why I believe that the rule with respect to private funds with AUM of \$1 billion or more is appropriate as proposed.

C. Frequency of Reporting²⁹

The frequency of reporting requirements should be altered in order to collect information more frequently from private funds with more than \$5 billion in AUM and who have high trading volumes and portfolio turnover rates. As currently proposed, the SEC would collect information annually from private funds with AUM of \$150 million to \$1 billion, and would collect information quarterly from private funds with AUM of over \$1 billion. These requirements should be altered as follows:

- (1) Private funds with AUM of less than \$500 million should not be required to file Form PF³⁰;
- (2) Private funds that have \$500 million to \$1 billion in AUM should be required to file annually;
- (3) Private funds with AUM of \$1 billion or more should be required to file quarterly, as proposed by the rule; and
- (4) Private funds with \$5 billion or more in AUM and a trading volume or portfolio turnover rate higher than a SEC specified minimum should be required to file Form PF monthly.

With these alterations, the FSOC would have access to current and timely information concerning systemic risk of the private funds that are the most likely to pose such risk. These alterations would also avoid imposing overly burdensome costs on smaller private funds that do not pose serious systemic threats. Therefore, the FSOC would benefit from having focused information on the most up-to-date statistics and data, and thus be better able to identify and assess systemic risk.

1. *Private Funds with AUM of Less than \$500 million Should be Exempt from Periodically Filing Form PF*

Private funds with AUM of \$500 million or less should be exempt from filing Form PF because: (1) these funds create only a small amount of systemic risk within the United States economy; and (2) requiring funds with AUM of under \$500 million may have counterproductive effects on systemic risk reduction. Funds that have less than \$500 million in AUM are not large enough to impose a significant amount systemic risk upon the economy. Furthermore,

²⁹ For the request for comment addressed by this section, see SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8078 (Feb. 11, 2011) (requesting comments on frequency at which advisers to private funds should report to SEC concerning systemic risk).

³⁰ For a discussion of why advisers to private funds with less than \$500 million in AUM should be exempt, see Section III. D. of this Comment.

increasing burdens on small funds may cause a consolidation effect and actually increase systemic risk creation by hedge funds. (See Section III.D. of this Comment).

2. *Private Funds with AUM Between \$500 million and \$1 billion Should be Required to File Annually As Proposed*

I fully support the SEC's efforts in requiring private funds that manage assets of between \$500 million and \$1 billion to file annually. The size of these hedge funds and their potential for posing systemic risk does not justify the increased burdens of filing more often. Annual reporting provides the amount of information necessary to monitor systemic risk without placing undue costs and burdens on mid-sized private funds. It is for these reasons why I believe that the rule with respect to private funds with AUM of \$500 million to \$1 billion is appropriate as proposed.

3. *Private Funds with AUM of \$1 Billion or More Should be Required to File Quarterly as Proposed*

I fully support the SEC in requiring private funds that manage assets of \$1 billion or more to file Form PF quarterly. The size of these private funds and their potential for posing systemic risk justifies the increased burdens of filing quarterly. Quarterly reporting provides the appropriate balance between providing the FSOC with the timely data it needs to identify emerging risks and minimizing burdens on private funds. It is for these reasons why I believe that the rule with respect to private funds that manage assets of more than \$1 billion is appropriate as proposed.

4. *Private Funds with AUM of \$5 billion or More and Maintain a High Trading Volume or Portfolio Turnover Rate Should be Required to File Form PF Monthly.*

Private funds that have a trading volume or portfolio turnover rate above a level specified by the SEC and manage more than \$5 billion in assets should be required to file on a monthly basis. Monthly reporting is justified for the following reasons:

- (a) Private funds that manage over \$5 billion in assets and have particularly high trading volumes or portfolio turnover rates pose the greatest amount of systemic risk of all private funds;
- (b) Funds of this type render quarterly reporting insufficient to provide the FSOC with the timely data it needs to accurately assess systemic risk;
- (c) Funds of this size can adequately handle the increased burdens of monthly reporting requirements; and
- (d) Without the addition of this threshold, private funds with AUM of \$1 billion or more will consolidate to achieve regulatory economies of scale, and as a result, the hedge fund industry will become more systemically vital.

a. Private Funds that Manage More than \$5 Billion AUM and Have a High Portfolio Turnover Rate or Trading Volume Impose a Substantial Amount of Systemic Risk

Private funds that have a large amount of AUM and pursue rapid and focused investment strategies have the ability to significantly influence the entire economy. The sheer size of these funds and their aggressive investment strategies make the potential impact of these funds relatively large. Funds of this type generally have larger counter-party exposures, tend to use more leverage, and pose the greatest risk of causing asset price volatility. Accordingly, information should be solicited from these types of funds as often as practical in order to guard against the creation of systemic risk.

b. Quarterly Reporting is Insufficient for FSOC to Adequately Assess Systemic Risk

Additionally, monthly reporting is necessary in order to properly track these types of funds' constantly evolving portfolio structures. Private funds that have high trading volume and portfolio turnover rates alter their positions, concentrations, and counter-party exposures rapidly, such that monthly filing of Form PF is necessary for proper oversight of the systemic risks these funds pose. The FSOC needs to be provided with "timely data to identify emerging trends in systemic risk."³¹ Quarterly reporting is not frequent enough to provide the FSOC with the ability to accurately assess the amount of systemic risk imposed by these entities at any given point in time. Accordingly, private funds that have a trading volume or portfolio turnover rate above a level specified by the SEC and manage more than \$5 billion in assets should be required to file Form PF on a monthly basis.

c. Private Funds with AUM of More than \$5 billion Can Handle the Increased Burdens of Monthly Reporting

Last, large private funds have the personnel and resources to file Form PF monthly without incurring undue burdens or being forced to become more conservative in their investment approach. Many hedge funds, especially those with larger amounts of AUM, already prepare monthly data in order to provide institutional investors with this information. Additionally, funds of this size generally have the internal compliance infrastructure in place to support this additional burden. Accordingly, the increased burden of filing Form PF monthly would not unduly burden these private funds.

Indeed, the Coalition of Private Investment Companies ("CPIC") has noted that many private funds already conduct monthly due diligence in order to provide institutional investors with the quantitative and qualitative analyses the institutional investors need to feel confident in choosing to invest with certain funds. For instance, the California Public Employees' Retirement System ("CalPERS"), an institutional investor, "monitors monthly returns and risk profiles to ensure managers deliver as promised CalPERS staff speak with every hedge fund manager monthly and visit them semi-annually."³² Therefore, advisers to funds that manage more than \$5

³¹ SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8078 (Feb. 11, 2011).

³² Coalition of Private Investment Companies, *Hedge Funds: How They Serve Investors in U.S. and Global Markets* (2009), available at, http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf.

billion can handle the increased burdens of filing monthly and should do so to ensure that the FSOC has current and timely data concerning the systemic risk of these vital entities.

d. Private Funds with AUM of \$1 Billion or More Will Consolidate to Minimize the Economic Impact of Form PF and Form ADV Unless An Additional Regulatory Threshold is Established

Imposing uniform costs on private funds with AUM of more than \$1 billion and not establishing a higher threshold accompanied by greater reporting burdens, will result in a greater amount of systemic risk. The proposed rule incentivizes private funds with AUM of \$1 billion or more to consolidate in order to reduce the impact of regulatory burdens. As currently proposed, all funds with over \$1 billion in AUM are subject to the same regulatory constraints and burdens.³³ The impact of these costs and burdens, however, are greater on funds that have less AUM. For instance, the cost of filing Form PF and Form ADV to a fund with \$1 billion AUM is approximately 0.85% of the fund's total assets. The cost of filing Form PF and Form ADV to a fund with \$5 billion AUM is approximately 0.17% of the fund's total assets.³⁴ Although this difference may seem negligible, in an industry that relies on large amounts of liquid assets, this proportional difference could prove significant to hedge fund operations. Like all business, private funds will attempt to minimize the force of these burdens. Accordingly, funds with AUM of \$1 billion or more will consolidate with other like funds to make the regulatory costs a smaller proportion of the fund's total AUM.

This consolidation will decrease the total number of hedge funds with AUM of over \$1 billion and will increase the number of hedge funds with AUM of over \$5 billion. In 2009, 56.5% of all hedge funds had over \$5 billion dollars in AUM.³⁵ (See Appendix III). This number would likely increase greatly because of the regulatory incentives to consolidate and the projected growth of the hedge funds industry.³⁶ (See Appendix V). Thus, without another level of regulatory oversight, private funds with over \$1 billion in assets will consolidate, the size of each private fund will greatly increase within that AUM segment, and the total number of private funds within that segment will decrease.

³³ Costs and burdens from filing Form ADV for funds with AUM of over \$150 million equate to \$8,404,200. [16,675 hours x \$210 = \$3,501,750] + [16,675 hours x \$294 = \$4,902,450] = \$8,404,200. See also SEC Proposed Rule, 75 Fed. Reg. 77078 (Dec. 10, 2010). Costs and burdens from Filing Form PF in the first year for funds with AUM of over \$1 billion equate to \$23,270. In addition, the cost to file subsequent reports would be \$9,700 per filing. Thus, yearly costs to File Form PF for private funds with AUM of over \$1 billion are \$53,270. [\$23,700 + 9,700 + 9,700 + 9,700 = \$53,270]. See SEC-CFTC Joint Proposed Rule, 76 Fed. Reg. 8089 (Feb. 11, 2011). Thus, total costs and burdens for private funds with over \$1 billion dollars as a result of the SEC's recently proposed rules would be \$8,457,470. [\$8,404,200 + \$53,270 = \$8,457,470].

³⁴ The costs of these regulations are identical for private funds that have AUM of \$1 billion and funds that have AUM of \$10 billion. The proportional cost to a \$1 billion fund is approximately 0.85% of its total Assets Under Management. The proportional cost to a \$5 billion fund is approximately 0.17% of its total Assets Under Management. The proportional cost to a \$10 billion fund is approximately 0.085% of its total Assets Under Management. While these differences may seem negligible, in an industry that relies on large amounts of liquid assets, these proportional differences could prove significant to hedge fund operations. Thus, hedge funds may consolidate into larger funds to decrease the proportional impact of regulatory costs.

³⁵ For a chart illustrating the large proportion of hedge funds that have AUM over \$5 billion, see Appendix III.

³⁶ For projections of hedge fund AUM growth by year 2013, see Appendix V.

This result would have adverse effects on systemic risk control. The larger the private fund, the greater the potential that fund has to significantly affect the economy. Additionally, a decrease in the total number of private funds will cause the economy to rely on each remaining private fund more heavily. In turn, the failure of a private fund would have a much more significant impact on the economy. Therefore, a consolidation of the private fund industry would make the industry more systemically important and have adverse effects on the SEC's and FSOC's efforts for systemic risk reduction and control. Accordingly, funds that have AUM of over \$5 billion and have a portfolio turnover rate or trading volume over a SEC established threshold should be required to file monthly in order to deter the consolidation of the hedge fund industry.

IV. CONCLUSION

Although hopes of the resurgence of a stable and steady economy remain grim in the short-term, an important opportunity exists to adopt regulatory measures that will prevent or at least mitigate the possibility of calamities such as the financial crisis in the future. Regulating systemic risk is a necessary part of proper financial reform. A positive development was the Dodd-Frank Act that President Obama signed into law on July 21, 2010.³⁷ The Act authorizes major changes to U.S. securities laws and has extended regulatory jurisdiction over areas of finance that were not previously regulated, including the regulation of private funds.

The Act, however, is merely a general mandate and will only assume its true identity through the implementation by administrative agencies such as the SEC, the Commodity Futures Trading Commission ("CFTC"), and the Department of Treasury.³⁸ I commend the SEC for carrying out the Dodd-Frank Act's statutory mandate and creating rules that will enable the FSOC and other financial regulatory institutions to combat the existence of systemic risk within the U.S. markets and economy. The proposed rule is strong step in the direction of greater financial stability.

I also thank the SEC for the opportunity to comment on this proposed rule. I respectfully request that the Commission consider the suggestions that I have offered in this comment. I believe that these suggestions will help the Commission further the statutory goals of the Dodd-Frank Act. By focusing the proposed rule on the institutions that pose the greatest threat of systemic risk creation, the SEC and FSOC can effectively and efficiently combat systemic risk without causing undue burdens on small private funds, and without stifling private fund growth and innovation.

Respectfully Submitted,

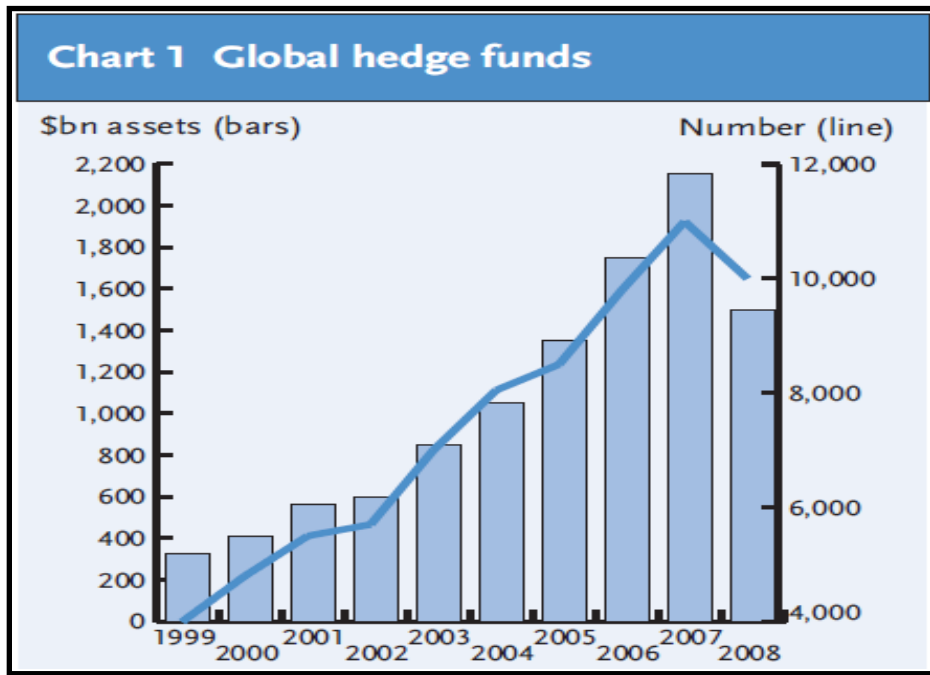
Christopher B. Chuff

³⁷ See The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203 (July 21, 2010) (reforming securities laws).

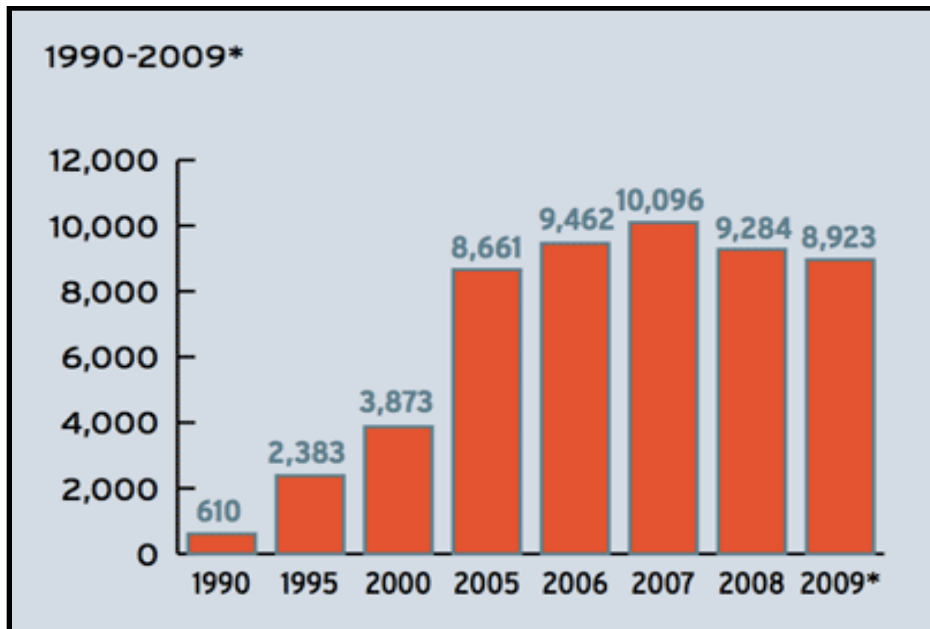
³⁸ See Commissioner Luis A. Aguilar, *An Insider's View of the SEC: Principles to Guide Reform*, 27 NO.1 CORP. COUNS. Q. ART. 1, 1-6 (2011) (outlining SEC's goals for reform).

Appendix I: Growth of Hedge Funds, 1990–2009

A: Growth in Total Number of Hedge Funds

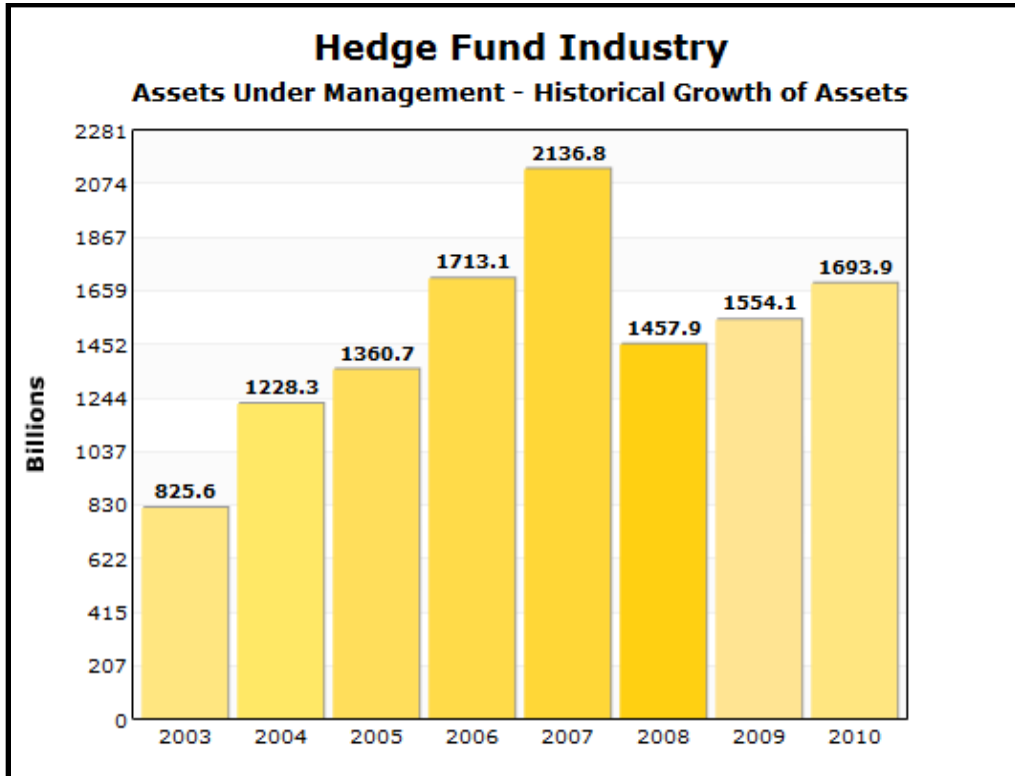


Source: International Financial Services London, Hedge Funds 2009 (April 2009), available at <http://www.thehedgefundjournal.com/research/ifsl/cbs-hedge-funds-2009-2-.pdf>

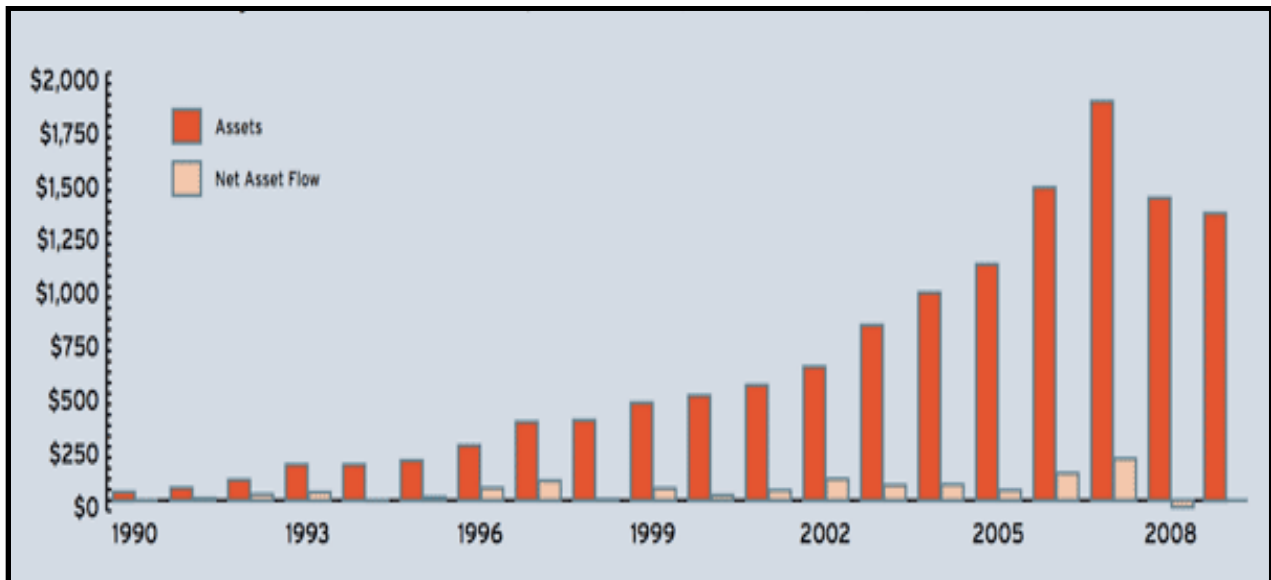


Source: Hedge Fund Research, Inc. available at <http://www.hedgefundfacts.org/hedge/statistics/number-of-funds/>

B: Growth in Hedge Fund Assets Under Management



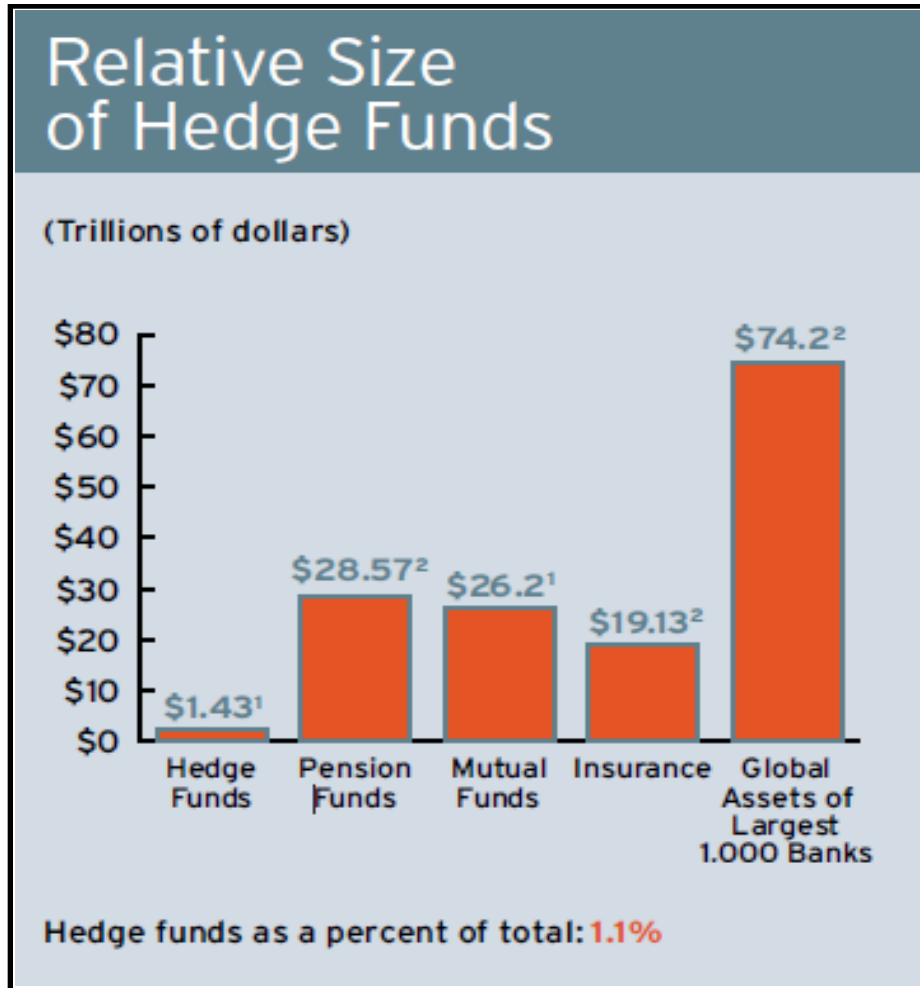
BarclayHedge, The Global Leader in Alternative Asset Research
http://www.barclayhedge.com/research/indices/ghs/mum/Hedge_Fund.html



Source: Hedge Fund Research, Inc. Available by subscription at: www.hedgefundresearch.com.

Appendix II: Relative Size of Hedge Funds In Comparison To Other Financial Institutions

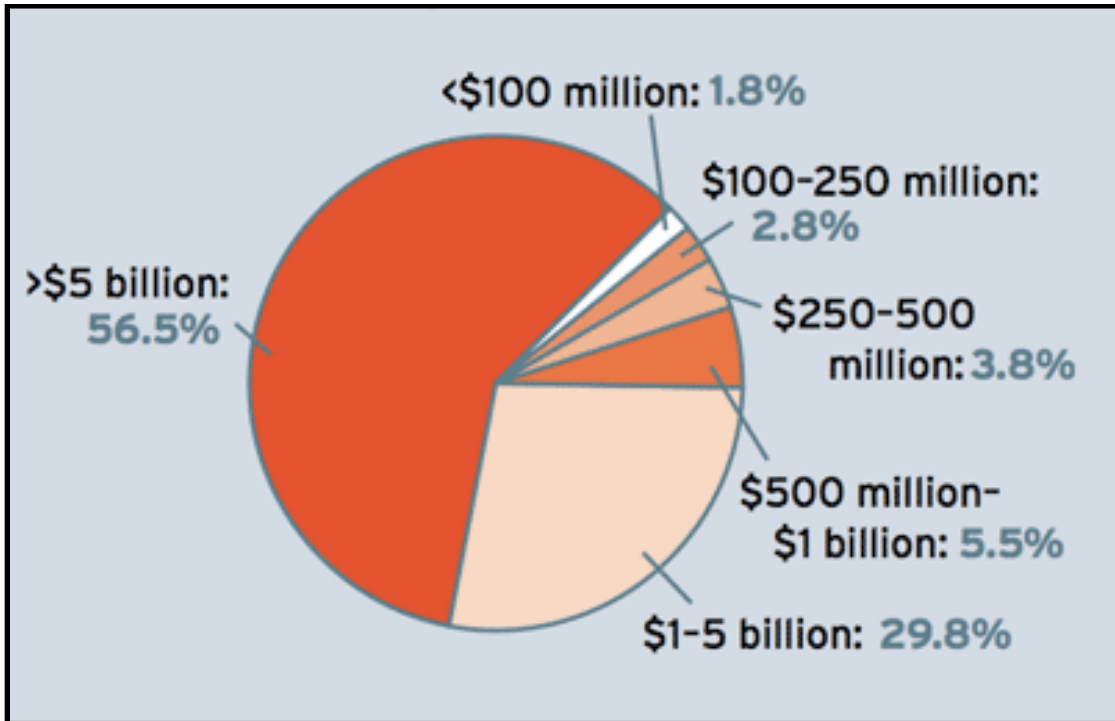
This chart shows that hedge funds manage approximately 1.1% of the assets of all major financial institutions.



Source: Michael R. King and Phillip Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks* (October 2008), available by registration at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1297188 & http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1297188.

Appendix III: Percentage of Total Number of Hedge Funds Meeting Certain Assets Under Management Thresholds

This chart illustrates that hedge funds with Assets Under Management of \$500 million or less represent less than 10% of the assets in the hedge fund industry. Taken together with Appendix II, hedge funds with Assets Under Management of \$500 million or less constitute less than 0.1% of the assets of major financial institutions. Thus, these funds do not pose a significant amount of systemic risk.



Source: Hedge Fund Research, Inc. Available by subscription at: <http://www.hedgefundresearch.com>

Appendix IV: Hedge Fund Trading Volume as Percentage of Total Market Segment

This chart shows that although hedge funds make up only a small fraction of managed assets of major financial institutions, they comprise a large percentage of the trading activity of certain markets and investments.

| Shares of Hedge Fund Trading in US Markets | |
|--|----|
| | % |
| Cash equities | 30 |
| Credit Derivatives (plain vanilla) | 60 |
| Credit Derivatives (structured) | 33 |
| Emerging Mkt Bonds | 45 |
| Distressed debt | 47 |
| Leveraged loan trading | 33 |
| High Yield bond trading | 25 |

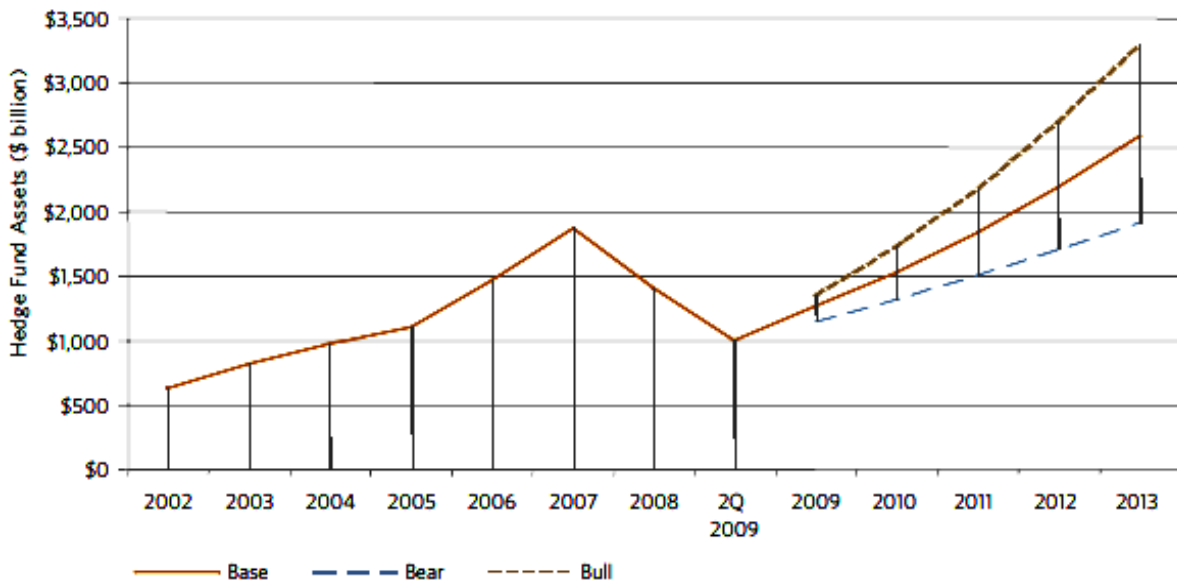
Source: Greenwich Associates, as reported in *The Financial Times*.

Appendix V: Projected Growth of Assets Under Management in the Hedge Fund Industry

This chart illustrates the projected growth of the hedge fund industry with regard to hedge fund Assets Under Management. Industry growth tends to correlate with growth of the individual entities within that industry. Accordingly, without establishing disincentives to private funds from greatly expanding their asset-base, each entity within the hedge fund industry will become larger and more systemically vital to the economy.

Exhibit 18: Projected Hedge Fund Assets by Scenario

December 2002 through December 2013



Source: Hedge Fund Research, The Bank of New York Mellon and Casey Quirk Analysis 2009