January 3, 2007

Re: *Accredited Investors*. File No. S7-25-06
A Better Solution than the SEC's Proposal to Increase Net Worth Requirement for Hedge Fund Investors.

Dear Commissioners:

Regulation is good if it promotes stable and efficient financial markets. However, if a regulation is poorly designed, it can have unintended negative consequences. The SEC proposal, *supposedly to address the occasional hedge fund blowups and fraud that might hurt less sophisticated investors*, to increase the minimum net-worth requirements for investing in hedge funds will have such unintended consequences. If approved, this regulation will impede the sophisticated upper middle class investor attempting to become wealthy, prevent promising portfolio managers from following their entrepreneurial dreams, drive many hedge funds offshore to the benefit of foreign investors at the expense of Americans, and most importantly, cause financial markets to become less stable and more inefficient by concentrating investments in a limited number of large investment companies.

The battle between the SEC and the hedge fund industry over regulation can be resolved in a more positive manner. Using today's online collaboration tools, there is a relatively simple way to achieve the SEC's objectives of gathering information on the hedge fund industry, preventing fraud and systemic financial risk while also meeting the hedge fund industry's objective of minimal government interference, all without imposing costly regulatory and reporting requirements.

The SEC and the hedge fund industry are in agreement that well-publicized inflated-return fraud cases as well as blow-ups due to overly concentrated portfolios are not good for the industry or financial markets.

The SEC could quickly detect and often fully prevent frauds by hedge funds that report inflated returns or asset sizes with an intent to deceive unwitting investors, and identify potential blowups involving poorly constructed portfolios with overly concentrated holdings. Instead of requiring hedge funds to register with the SEC and expending extensive resources by sending SEC auditors to examine numerous hedge funds, the SEC should gather its information from the most reliable source – the prime brokers. In order to control their own financial risk, prime brokers invest in highly sophisticated information technology to monitor their hedge fund clients. Virtually all legitimate hedge funds use prime brokers.

The SEC has the resources to audit and monitor all prime brokers but not all hedge funds. Unlike most hedge funds, prime brokers have the resources to handle SEC audits and comply with the reporting requirements. The SEC should gather information on all hedge funds regardless of size, but it should not put smaller hedge funds at a disadvantage relative to large hedge funds that can more easily comply with SEC regulations. Having the prime brokers do the reporting to the SEC is the most efficient method for the SEC, hedge fund managers, and the economy.

I suggest that each prime broker send the SEC all individual hedge fund client information within a reasonable time, for as long as the fund is open to new investments. This reporting exemption for hedge funds that are closed to new investments is needed to prevent them lobbying against the proposal. However, if such a fund later decided to open up to new investment again, the prime broker must then report on all the missing time periods.

Information sent to the SEC should only consist of (1) the legal name of the fund, (2) tax identification number, (3) type of fund such as long/short equity, (4) number of securities, (5) quarterly gross returns before fees, (6) dollar value of the fund, and (7) the largest individual security holding as a percentage of the portfolio's aggregate marketable securities (excluding ETFs and other diversified index products). For hard-to-price securities such as those in side pockets, the prime broker should report only the number of securities and not the returns or dollar value.

The information should be published on the SEC website at no cost to the public. Gross performance after trading expenses but before management and performance fees should be used because funds have different fee structures. This information would be very useful in detecting fraud. An investor can quickly see if a hedge fund manager's marketing material or fund statement makes claims substantially different from the data posted on the SEC website. For example, after-fee net performance should not be greater than the upper bound gross performance posted on the SEC website.

I hope the SEC adopts a low-cost transparency-based approach to address fraud and portfolio blowup problems instead of the proposed increase in net worth requirement that in the end will only let the rich become richer.

Sincerely,

James Kan, CFA
Chief Investment Officer