United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

January 25, 2011

VIA EMAIL (rule-comments@sec.gov)

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: Advisers to Hedge Funds and Other Private Funds Registration Requirements and Related Exemptions for Foreign Private Advisers and Advisers to Venture Capital Funds, File Nos. S7-36-10 and S7-37-10

Dear Ms. Murphy:

The purpose of this letter is express support for, and offer strengthening suggestions to, the proposed rules issued by the Securities and Exchange Commission ("Commission") to require advisers to hedge funds and other private funds to register with the Commission,[1] subject to some modest exemptions.[2] The proposed rules would strengthen the oversight of previously unregistered investment advisers, including larger funds whose activities may pose systemic risks to the U.S. financial system. The rules would also require investment advisers to provide additional information on the make up and activities of the funds they manage, enhancing transparency and assisting regulators in assessing risks posed by these funds and their potential impact on the U.S. economy.

Subcommittee Investigations. The U.S. Senate Permanent Subcommittee on Investigations, which I chair, has examined the activities of hedge funds, private equity funds, and venture capital funds in connection with several investigations over the years into tax evasion, money laundering, and the recent financial crisis.

In 2006, for example, the Subcommittee released a report and held hearings on six case studies showing how U.S. financial professionals, including investment advisers, bankers, lawyers, accountants, and others have used tax havens to help U.S. taxpayers dodge payment of U.S. taxes.[3] One of the case studies involved two brothers, Sam and Charles Wyly, who

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[1] Rules Implementing Amendments to the Investment Advisers Act of 1940, 75 Fed. Reg. 77052 (proposed Dec. 10, 2010).

[2] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, 75 Fed. Reg. 77190 (proposed Dec. 10, 2010).

[3] U.S. Senate Permanent Subcommittee on Investigations, "Tax Haven Abuses: The Enablers, The Tools and Secrecy," S.Hrg. 109-797 (Aug. 1, 2006).

established several hedge funds, private equity funds, and venture capital funds in the United States, and used those funds to bring millions of dollars in suspect offshore funds into the United States without having to meetany U.S. reporting obligations. The investigation found that the private funds used the offshore dollars to engage in a variety of business investments, and that the hedge funds engaged in business activities normally attributed to private equity or venture capital funds, and vice versa. In 2008, the Subcommittee released a report and held a hearing showing how some hedge funds were using financial institutions to set up complex derivative and stock lending transactions to avoid payment of U.S. taxes on U.S. stock dividends, in part by conducting transactions and moving funds through foreign jurisdictions.[4] Over the course of the last two years, the Subcommittee has conducted an extensive investigation and held a series of hearings delving into key causes of the financial crisis. This investigation has examined, in part, activities undertaken by hedge funds in the buying and selling of complex structured finance products, including residential mortgage-backed securities, collateral debt obligations, credit default swaps, and ABX Index trades.

In conducting these investigations, the Subcommittee often found it difficult to obtain basic information about private funds that were engaging in a range of activities in U.S. financial markets, including the identity of the fund's key investment advisers, the ownership structure of the fund, its size, and primary business activities. The proposed rules will go a long way toward addressing the current lack of transparency regarding the ownership, size, and activities of large private funds active in U.S. financial markets.

Dodd-Frank Act. In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to "promote the financial stability of the United States by improving accountability and transparency in the financial system."[5] The Dodd-Frank Act's investment adviser provisions, some of which these proposed rules seek to implement, are intended to strengthen the ability of the Commission to oversee the activities of previously unregistered advisors of large private funds, assess the systemic risks posed by these funds, and protect investors, while allowing for some reasonable exemptions.

Background. Traditionally, the term "hedge fund" has not been used in the federal securities laws, and there have previously been various different interpretations of what it means.[6] For the purposes of this letter, the term "hedge funds" is meant to broadly include private investment funds in which investors have agreed to pool their money under the control of an investment manager who is typically paid a management fee and a portion of the fund's profits. Hedge funds are distinguished from other funds in that they are typically open only to "qualified purchasers"—a term used to refer to sophisticated investors like pensions funds and wealthy individuals. The previous argument for allowing these funds to operate outside of the Commission's general regulation and oversight was that their investors were generally more

[4] U.S. Senate Permanent Subcommittee on Investigations, "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends," S.Hrg. 110-778 (Sept. 11, 2008).
[5] Dodd-Frank Act, Pub. L. 111-203, 124 Stat. 1376, preamble (2010).
[6] *See, e.g.*, SEC Roundtable on Hedge Funds (May 13, 2003) (comments of David A. Vaughan).

experienced than the general public, and that these investors needed fewer government protections.

Hedge funds have since become so large and so entrenched in U.S. financial markets, however, that their actions can significantly impact market prices, damage other market participants, and even endanger the U.S. financial system and economy as a whole.[7] In addition, because hedge funds now manage billions of dollars for pension plans, insurance companies, university endowments, and municipalities, their actions can and do affect those sectors. Further, many large U.S. banks sponsor or manage their own hedge funds, using them to invest client funds as well as their own proprietary funds, raising questions about the possible impact of hedge funds on the banking sector.[8] Because hedge funds often engage in high risk investing, as they did in the subprime mortgage market, their actions can also increase the general level of risk present in U.S. markets with potentially disastrous results.[9]

In 2004, the Commission sought to enhance regulation of hedge funds by issuing a rule under the Investment Advisors Act of 1940, requiring their registration, only to have the rule struck down by a federal court.[10] The Dodd-Frank Act has since provided the Commission with clear authority to require the registration and oversee the activities of hedge funds and other private funds.

SEC Registration. To enable the Commission to exercise greater authority over hedge funds and other private funds, the Dodd-Frank Act repealed the "private adviser exemption" contained in section 203(b)(3) of the Investment Advisers Act of 1940.[11] Historically, many hedge fund advisers have relied upon that exemption to avoid registration under the Investment Advisers Act as well as meaningful oversight by the Commission.[12] Congress's explicit purpose in repealing the exemption was to require advisers to private funds to register.[13] At the same time, the Dodd-Frank Act exempted certain private fund advisers from the registration requirement, including advisers with assets under management in the United States of less than

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[7] *See, e.g.*, Roger Lowenstein, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (Random House 2000) (detailing how the hedge fund Long-Term Capital Management failed, and nearly collapsed the U.S. financial system).

[8] *See, e.g.*, Raj Date, *Test Case on the Charles*, CAMBRIDGE WINTER CENTER (2010) (detailing how State Street Bank bailed out funds it managed for $2.5 billion, but then needed several billion in emergency bailouts from the Federal government, including $2 billion in TARP funds; *see also* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1032-34 (2009).

[9] *See, e.g.*, Viral V. Acharya and Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REVIEW 195, 199-204 (2009) (citing proprietary holdings of asset-backed securities as one of the primary drivers of accumulated risk leading to the financial crisis).

[10] *Goldstein v. Sec. and Exch. Comm'n*, 451 F.3d 873 (D.C. Cir. 2006).

[11] Dodd-Frank Act, § 403.

[12] *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, 75 Fed. Reg. 77190 (proposed Dec. 10, 2010).

[13] *See, e.g.*, S. Rep. No. 111-176, at 71-3 (2010).

$150 million,[14] certain "foreign private advisers," andadvisers who solely advise "venture capital funds," as that term is to be defined by Commission rules.[15]

The proposed rules would strengthen Commission oversight of large hedge funds and other private funds by requiring their advisers to register with the Commission and disclose basic information about their activities and the funds they manage, including the number and types of investors in the fund; the size of the fund using both gross and net asset measurements; and the extent of leverage the fund employs.[16] Advisers would also be required to disclose information about their ownership structure, business affiliates, and certain "gatekeepers" that perform critical functions for either the advisers or the funds, including the identity of their auditors, prime brokers, document custodians, administrators, and marketers.[17] The advisers would also have to disclose their disciplinary history.[18] This information would be provided on the Commission's existing Form ADV and made accessible at no cost using the Commission's Investment Adviser Public Disclosure (IAPD) system.[19]

Increasing transparency by requiring the registration of investment advisers and allowing access to that information will help investors, regulators, and policymakers deepen their understanding of individual investment advisers and their funds. The data should be of particular use to the Financial Stability Oversight Council and the newly-created Office of Financial Research in their efforts to identify, measure, and monitor systemic risk. It should also assist law enforcement in gaining a quick understanding of specific investment advisers, their funds, and their investors. Increased transparency may also inhibit the ability of criminals to use these private funds to evade the payment of U.S. taxes, launder money, or commit other crimes.

Exemptions. In addition to establishing the disclosure obligations of hedge funds and other private funds, the proposed rules provide measures to carry out the exemptions included in the Dodd-Frank Act, including for foreign private advisers and advisers to venture capital funds. Because advisers and funds may seek to circumvent the registration requirement by qualifying under one of these exemptions, it is important for the proposed rules to hew closely to the statute, provide bright line rules on who qualifies for a registration exemption, and avoid vague or ambiguous language.

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[14] Dodd-Frank Act, § 408.
[15] Dodd-Frank Act, § 407.
[16] Rules Implementing Amendments to the Investment Advisers Act of 1940, at 77076.
[17] Id., at 77076.
[18] Id., at 77076.
[19] *See, e.g.*, Rules Implementing Amendments to the Investment Advisers Act of 1940, at 77076.

Foreign Private Advisers. The proposed rules seek to implement the Dodd-Frank Act's limited exemption for a "foreign private adviser,"[20] which it defined to be:

> any investment adviser who—
> (A) has no place of business in the United States;
> (B) has, in total, fewer than 15 clients and investors in the Unites States in private funds advised by the investment adviser;
> (C) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this title; and
> (D) neither—
> (i) holds itself out generally to the public in the United States as an investment adviser; nor
> (ii) acts as—
> (I) an investment adviser to any investment company registered under the Investment Company Act of 1940; or
> (II) a company that has elected to be a business development company pursuant to section 54 of the Investment Company Act of 1940 …, and has not withdrawn its election.[21]

The proposed rules would effectively implement the statutory provisions. One key issue involves determining who is counted as a "client" or "investor" of the foreign private adviser so that the statute's 15-client limit is not circumvented. The proposed rules would generally follow the existing Investment Advisers Act Rule 203(b)(3)-1, by allowing an adviser to count family members and related trusts as a single "client."[22] Similarly, corporations or other legal entities with the same shareholders, partners, limited partners, or beneficiaries could generally be counted as a single "client."[23] However, the rules would also make it clear that a foreign private adviser could not combine all of its U.S. clients into a single fund or corporation and then treat all of them as one client. The proposed rules would prevent that evasion of the 15-client threshhold by defining the term "investor," to be "any person who would be included in determining the number of beneficial owners" of a private fund under Section 3(c)(1) of the

[20] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, at 77210 (explaining how the proposed rules are intended to implement the new private fund adviser exemption created by Section 403 of the Dodd-Frank Act).
[21] Dodd-Frank Act, § 402 (adding the term "foreign private adviser" to the definitions under Section 202(a)(30) of the Investment Company Act of 1940).
[22] See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, at 77210.
[23] Id., at 77210-11.

Investment Company Act.[24] Collectively, these provisions should prevent foreign advisers from aggregating U.S. investors into nominal omnibus accounts as a way to avoid hitting the 15 investor threshhold.

In a change from Rule 203(b)(3)-1, the proposed rules would not distinguish between advisers whose principal places of business are inside or outside of the United States, in large part because the statute clearly states that an adviser invoking this exemption must have "no place of business in the United States."[25] This regulatory provision is essential to ensuring that U.S.-based advisers are unable to avoid the registration requirement by claiming to qualify as "foreign private advisers."

In its 2008 investigation, the Subcommittee took testimony from three large hedge funds that were incorporated in the Cayman Islands, but active in U.S. financial markets.[26] All three testified that they had no physical offices or employees in the foreign jurisdiction, and that all of their employees operated from locations in the United States.[27] Those hedge funds, and their advisers, are exactly the type of investment advisers to which the Dodd-Frank Act's registration requirements are intended to apply; none should be able to use the foreign private adviser's exemption to evade registration. As currently drafted, the proposed rules would correctly apply the registration requirements to those hedge funds.

Venture Capital Funds. The proposed rules also seek to implement the Dodd-Frank Act's exemption created for private fund advisers who solely advise "venture capital funds."[28]

As an initial matter, a variety of advisers or funds are likely to try to seek refuge from the registration requirement by urging an overbroad interpretation of the term "venture capital fund." How the term is defined may have significance for not only the registration requirement, but also other securities, tax, and anti-money laundering laws and regulations.[29] It is important for the Commission to define the term narrowly to ensure that only venture capital funds, and not other types of private funds, are able to avoid the new mandatory registration requirement.

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[24] Id., at 77211. Importantly, other persons may also qualify as investors, including "knowledgeable employees" and certain persons related to them, as well as beneficial owners of short-term paper issued by the private fund. Id., at 77211-12 and n.238.

[25] *See* id., at 77210, n.228.

[26] U.S. Senate Permanent Subcommittee on Investigations, "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends," S.Hrg. 110-778 (Sept. 11, 2008).

[27] Id. at 25-27.

[28] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, at 77192.

[29] *See, e.g.*, Financial Stability Oversight Council, *Study and Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, 62 (January 2011) (suggesting that regulators consider exempting venture capital funds from the restrictions on proprietary trading and relationships with private funds imposed by Section 619 of the Dodd-Frank Act).

The Commission's proposed rules set forth the criteria that must be met for a fund to qualify as a "venture capital fund."[30] They define a "venture capital fund" as:

> a private fund that: (i) invests in equity securities of private companies in order to provide operating and business expansion capital (i.e., "qualifying portfolio companies" ...) and at least 80 percent of each company's securities owned by the fund were acquired directly from the qualifying portfolio company; (ii) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (iii) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; and (vi) is not registered under the Investment Company Act and has not elected to be treated as a [business development company].[31]

Although lengthy and detailed, the proposed definition captures the essence of venture capital firms whose mission is to encourage the development and expansion of new businesses. The proposed definition uses an existing definition of "equity security," taken from Section 3(a)(11) of the Securities Exchange Act of 1934 and Rule 3a11-1, to ensure that venture capital funds may hold all types of equity interests.[32] The proposed definition also reflects that, immediately prior and subsequent to making venture capital investments, the funds will likely have relatively significant cash positions.[33]

The proposed definition also correctly attempts to distinguish a venture capital fund from a leveraged buyout fund by defining a "qualified portfolio company" in such a way that it would exclude companies that may "borrow, issue debt obligations or otherwise incur leverage in connection with the venture capital fund's investments."[34] Although somewhat confusing, this exclusion, in conjunction with the ownership requirement under clause (i), should ensure that advisers to leveraged buyout funds are not exempted from the mandatory disclosure obligation.

The definition also correctly requires qualifying funds to advertise themselves to investors as a venture capital fund, and properly excludes business development companies.

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[30] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, at 77193.
[31] Id., at 77193.
[32] Id., at 77196.
[33] Id., at 77196-97.
[34] Id., at 77197.

The Commission should consider strengthening the proposed definition by requiring funds seeking to rely on the venture capital fund exemption to disclose the intended duration of their investments, such as "lock up" periods for investors. Funds without such "lock up" periods, or which do not make investments typical of venture capital funds, should be examined to determine whether they are simply attempting to avoid the registration requirement. The Commission may also want to add an anti-evasion provision to the proposed registration rule to ensure that funds are not undertaking deceptive actions to circumvent the registration requirement. Such deceptions could include setting up sub-advisory relationships or distributing assets among a family of funds or among a group of affiliated investment advisers.

The proposed rules would also require advisers to funds with less than $150 million in assets under management in the U.S. and advisers of "venture capital funds" to provide the Commission with reports and keep records, as the Commission deems appropriate.[35] These essential disclosures and record-keeping requirements would aid the Commission in ensuring compliance with the registration provisions and should be adopted.

Thank you for this opportunity to comment on the proposed rules.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations

[35] Id., at 77191-92. The proposed disclosure obligations for these exempted advisors are a subset of the information that the Commission is proposing registered advisers provide, including: (1) identifying information for the adviser, (2) details regarding other business activities that the adviser and its affiliates are engaged in; and (3) the disciplinary history of the adviser and its employees. The Commission has proposed that the reports filed by exempt advisers be made publicly available on the Commission's IAPD system. Rules Implementing Amendments to the Investment Advisers Act of 1940, at 77061-77063.