



# Federal Register

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**Wednesday,  
July 28, 2004**

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**Part III**

## **Securities and Exchange Commission**

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**17 CFR Parts 275 and 279**

**Registration Under the Advisers Act of  
Certain Hedge Fund Advisers; Proposed  
Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 275 and 279

[Release No. IA-2266; File No. S7-30-04]

RIN 3235-AJ25

### Registration Under the Advisers Act of Certain Hedge Fund Advisers

**AGENCY:** Securities and Exchange Commission (the "Commission").

**ACTION:** Proposed rule.

**SUMMARY:** The Commission is proposing for comment a new rule and rule amendments under the Investment Advisers Act of 1940. The proposed new rule and amendments would require advisers to certain private investment pools ("hedge funds") to register with the Commission under the Advisers Act. The rule and rule amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets.

**DATES:** Comments should be received on or before September 15, 2004.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-30-04 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File Number S7-30-04. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying

information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Vivien Liu, Senior Counsel, Jamey Basham, Branch Chief, or Jennifer L. Sawin, Assistant Director, at 202-942-0719 or [IArules@sec.gov](mailto:IArules@sec.gov), Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0506.

**SUPPLEMENTARY INFORMATION:** The Commission is requesting public comment on proposed new rule 203(b)(3)-2 [17 CFR 275.203(b)(3)-2], proposed amendments to rules 203(b)(3)-1 [17 CFR 275.203(b)(3)-1], 204-2 [17 CFR 275.204-2], 205-3 [17 CFR 275.205-3], and 206(4)-2 [17 CFR 275.206(4)-2],<sup>1</sup> and Form ADV [17 CFR 279.1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (the "Advisers Act" or "Act").

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#### I. Background

The Commission regulates the nation's money managers under the Investment Advisers Act of 1940. These include investment advisers to mutual funds, pension funds, private funds, corporations, trusts, endowments, charities, as well as advisers to individuals and families. The approximately 8,000 investment advisers registered with us under the

<sup>1</sup> Unless otherwise noted, when we refer to rules 203(b)(3)-1, 204-2, 205-3, 206(4)-2, or any paragraph of the rules, we are referring to 17 CFR 275.203(b)(3)-1, 275.204-2, 275.205-3, and 275.206(4)-2 of the Code of Federal Regulations in which the rules are published.

Advisers Act manage more than \$23 trillion of client assets.<sup>2</sup>

Advisers registered with us engage in a wide variety of asset management styles. They represent perhaps every different view and approach to managing money, including indexing, quantitative analysis, and numerous styles of fundamental analysis. Some assemble simple portfolios of stocks and bonds. Others employ sophisticated hedging strategies that seek to reduce volatility or other risks. Still others use futures contracts or derivatives to leverage client holdings in hopes that, by assuming greater risk, they will capture greater profits. Some manage cash holdings that provide safety and liquidity for a portion of client portfolios while others help clients speculate in distressed securities, options, merger arbitrage or other risky investment strategies. Many do not manage money at all but, instead, provide financial planning services.

The clients of these advisers include small investors and the largest of national and international financial institutions. A number of advisers registered with us manage client portfolios through mutual funds or other collective investment vehicles organized as corporations, trusts, limited partnerships or limited liability companies.<sup>3</sup> Many advise only individual accounts,<sup>4</sup> while others report to us that they advise only institutional or high net worth individuals.<sup>5</sup>

There may be few areas of the financial services industry more diverse than the Commission's registered investment advisers.<sup>6</sup> Yet the Advisers Act accommodates them all. Instead of prescribing a set of detailed rules, the Act contains a few basic requirements,

<sup>2</sup> Based on information filed with us on Form ADV, the adviser registration form, as of May 1, 2004, investment advisers registered with the Commission managed approximately \$21 trillion in discretionary accounts and managed an additional \$2.3 trillion on a non-discretionary basis.

<sup>3</sup> Based on information filed with us on Form ADV as of May 1, 2004, 1,483 or 18 percent of advisers registered with us managed one or more investment companies and 1,912 or 23 percent of advisers registered with us managed other types of pooled investment vehicles.

<sup>4</sup> Based on information filed with us on Form ADV as of May 1, 2004, 672 or 8 percent of advisers registered with us managed individual accounts only.

<sup>5</sup> Based on information filed with us on Form ADV as of May 1, 2004.

<sup>6</sup> In addition to varying substantially in their approach to money management and their clientele, these investment advisers also vary widely in their organizational size. Our data indicate that the sizes of the 8,275 advisers registered with us range from 1 employee to exceeding 1,000 employees, with 4,132 having 1-5 employees and 96 having more than 1,000 employees.

such as registration with the Commission, maintenance of business records, and delivery of a disclosure statement (“brochure”). Most significant is a provision of the Act that prohibits advisers from defrauding their clients, a provision that the Supreme Court has construed as imposing on advisers a fiduciary obligation to their clients.<sup>7</sup> This fiduciary duty requires advisers to manage their clients’ portfolios in the best interest of clients, but not in any prescribed manner. A number of obligations to clients flow from this fiduciary duty, including the duty to fully disclose any conflicts the adviser has with clients,<sup>8</sup> to seek best execution for client transactions,<sup>9</sup> and to have a reasonable basis for client recommendations.<sup>10</sup>

Not all advisers must register with the Commission. The Act exempts an adviser from registration if it (i) has had fewer than fifteen clients during the preceding 12 months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to any registered investment company.<sup>11</sup> Advisers taking advantage of this “private adviser exemption” must nonetheless comply with the Act’s antifraud provisions,<sup>12</sup> but do not file registration forms with us identifying who they are, do not have to maintain business records in accordance with our rules, do not have to adopt or implement compliance programs or codes of ethics, and are not subject to

Commission oversight. We lack authority to conduct regular examinations of advisers exempt from the Act’s registration requirements.<sup>13</sup>

There is no legislative history that explains why the private adviser exemption was enacted. We do know, however, that it was not intended to exempt advisers to wealthy or sophisticated clients. They were the primary clients of many advisers in 1940 when the provision was included in the Act.<sup>14</sup> While provisions of the Securities Act (and its rules) provide exemptions from registration under that Act for securities transactions with persons, including institutions, that have such knowledge and experience that they are considered capable of fending for themselves and thus do not need the protections of the applicable registration provisions,<sup>15</sup> the Advisers Act does not. When a client—even one who is highly sophisticated in financial matters—seeks the services of an investment adviser, he acknowledges he needs the assistance of an expert. The client may be unfamiliar with investing or the type of strategy employed by the adviser, or may simply not have the time to manage his financial affairs. The Advisers Act is intended to protect all types of investors who have entrusted their assets to a professional investment adviser. Today, thirty-nine percent of advisers registered with us report that they advise only institutional and wealthy clients.<sup>16</sup>

The private adviser exemption appears to reflect Congress’ view that there is no federal interest in regulating advisers with only a small number of clients, many of whom are likely to be friends and family members.<sup>17</sup> Today,

however, a growing number of investment advisers take advantage of the private adviser exemption to operate large investment advisory firms without Commission oversight. Instead of managing client money directly, these advisers pool client assets by creating limited partnerships, business trusts or corporations in which clients invest. Because our rules generally have permitted advisers to count each partnership, trust or corporation as a single client, many of these advisers have been able to avoid our oversight even though they manage large amounts of client assets and, indirectly, have a large number of clients.<sup>18</sup>

One significant group of these advisers provides investment advice through a type of pooled investment vehicle commonly known as a “hedge fund.” There is no statutory or regulatory definition of hedge fund, although many have several characteristics in common. Hedge funds are organized by professional investment managers who frequently have a significant stake in the funds they manage and receive a management fee that includes a substantial share of the performance of the fund.<sup>19</sup> Advisers organize and operate hedge funds in a manner that avoids regulation as mutual funds under the Investment Company

owned by a limited number of investors likely to be drawn from persons with personal, familial, or similar ties, do not rise to the level of federal interest. See *Investment Trusts and Investment Companies: Hearings on S.3580 before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong. 3d. Sess. 179 (1940).

<sup>18</sup> Rule 203(b)(3)–1(a)(2)(i) generally permits a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to be counted as a single client. Rule 203(b)(3)–1(b)(3) states that “[a] limited partnership is a client of any general partner or other person acting as investment adviser to the partnership.”

<sup>19</sup> See William Fung and David A. Hsieh, *A Primer on Hedge Funds*, *Journal of Empirical Finance* 6 (1999), at 310; David W. Frederick, Institute of Certified Financial Planners, *Hedge Funds: Only the Wealthy Need Apply*, Jan. 30, 1998, at [http://www.yourretirement.com/fidquest\\_22.htm](http://www.yourretirement.com/fidquest_22.htm) (visited on May 20, 2004); Roy Kouwenberg, Erasmus University Rotterdam & William T. Ziemba, Sauder School of Business, Vancouver and Swiss Banking Institute, University of Zurich, *Incentives and Risk Taking in Hedge Funds*, July 17, 2003, at <http://www.few.eur.nl/few/people/kouwenberg/incentives3.pdf> (visited on May 20, 2004). Not all hedge funds, however, are managed by legitimate investment professionals. See *SEC v. Ryan J. Fontaine and Simpleton Holdings Corporation a/k/a Signature Investments Hedge Fund*, Litigation Release No. 18254 (July 28, 2003) (22 year-old college student purportedly acted as Signature’s portfolio manager and made numerous false claims to investors and prospective investors).

<sup>7</sup> See *SEC v. Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180 (1963) (“*Capital Gains*”). See also *Transamerica Mortgage Advisors, Inc., (TAMA) v. Lewis*, 444 U.S. 11 (1979); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 471, n 11 (1977).

<sup>8</sup> See *Capital Gains*, *supra* note 7, at 191–194.

<sup>9</sup> See *In the Matter of Kidder, Peabody & Co., Incorporated, Edward B. Goodnow*, Investment Advisers Act Release No. 232 (Oct. 16, 1968); *In the Matter of Mark Bailey & Co., and Mark Bailey*, Investment Advisers Act Release No. 1105 (Feb. 24, 1988); *In the Matter of Jamison, Eaton & Wood, Inc.*, Investment Advisers Act Release No. 2129 (May 15, 2003).

<sup>10</sup> See *supra* note 9.

<sup>11</sup> Section 203(b)(3) [15 U.S.C. 80b–3(b)(3)]. The Act also provides several other registration exemptions, which have much more limited application. Registration exemptions are provided to advisers that have only intrastate business and do not give advice on exchange-listed securities (section 203(b)(1) [15 U.S.C. 80b–3(b)(1)]); to advisers whose only clients are insurance companies (section 203(b)(2) [15 U.S.C. 80b–3(b)(2)]); to charitable organizations and their officials (section 203(b)(4) [15 U.S.C. 80b–3(b)(4)]); to church plans (section 203(b)(5) [15 U.S.C. 80b–3(b)(5)]); and to commodity trading advisers registered with the Commodity Futures Trading Commission (“CFTC”) whose business does not consist primarily of acting as investment advisers (section 203(b)(6) [15 U.S.C. 80b–3(b)(6)]).

<sup>12</sup> They are also subject to antifraud provisions of other federal securities laws, including rule 10b–5 under the Securities Exchange Act of 1934 [17 CFR 240.10b–5].

<sup>13</sup> Section 204 of the Advisers Act [15 U.S.C. 80b–4] authorizes the Commission to conduct examinations of all records of investment advisers. Advisers exempted from registration pursuant to section 203(b) of the Act [15 U.S.C. 80b–3(b)] are specifically excluded from being subject to these examinations.

<sup>14</sup> The Commission’s 1939 Investment Trust study to Congress, which preceded enactment of the Advisers Act, found that the average size of individual clients’ accounts managed by advisers surveyed in 1936 was \$281,000, which equals \$3.8 million in today’s value. Individual clients represented about 83 percent of these advisers’ client base. See SEC, *Investment Trusts and Investment Companies*, H.R. Doc. No. 279, 76th Cong., 1st Sess., pt. 2 at 8–9 (1940).

<sup>15</sup> See e.g., sections 4(2) and 4(6) of the Securities Act of 1933 [15 U.S.C. 77d(2) and 77d(6)] and Regulation D [17 CFR 230.501 et seq.] and rule 144A [17 CFR 230.144A]; *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

<sup>16</sup> Based on information filed with us on Form ADV as of June 30, 2004.

<sup>17</sup> The legislative history of section 3(c)(1) of the Investment Company Act of 1940 [15 U.S.C. 80a–3(c)(1)], a parallel section to section 203(b)(3) that was enacted at the same time, reflects Congress’ view that privately placed investment companies,

Act of 1940, and they do not make public offerings of their securities.<sup>20</sup>

Hedge funds were originally designed to invest in equity securities and use leverage and short selling to “hedge” the portfolio’s exposure to movements of the equity markets.<sup>21</sup> Today, however, advisers to hedge funds utilize a wide variety of investment strategies and techniques designed to maximize the returns for investors in the hedge funds they sponsor.<sup>22</sup> Many are very active traders of securities.<sup>23</sup>

The Commission has long been concerned about hedge funds and their managers, and the impact their investment activities can have on investors and the securities markets. As early as 1969, the Commission investigated hedge funds, responding to their rapid growth and concerns about their use of trading techniques such as leverage and short selling.<sup>24</sup> In 1971 we conducted an economic study of institutional investors in which we described the activities of hedge funds, noted the serious conflicts of interest that hedge fund advisers have, and noted their growth.<sup>25</sup> In 1992, in response to a Congressional inquiry, the Commission developed and provided to Congress detailed information about the regulatory treatment of hedge funds under the federal securities laws.<sup>26</sup> Seven years later we participated in the President’s Working Group on Financial Markets in the wake of the near-collapse of Long Term Capital Management, Inc., (“LTCM”).<sup>27</sup> LTCM was a large, highly

leveraged hedge fund the unraveling of which threatened the stability of international capital markets.<sup>28</sup> Recently, our staff assisted officials of the Treasury Department to prepare proposed rules that would require hedge funds to implement anti-money laundering programs.<sup>29</sup>

In 2002, we requested that our staff again examine the activities of hedge funds and hedge fund advisers. First, we were aware that the number and size of hedge funds were rapidly growing and that this growth could have broad consequences for the securities markets for which we are responsible. Second, we were bringing a growing number of enforcement cases in which hedge fund advisers defrauded hedge fund investors, who typically were able to recover few of their assets. Third, we were concerned that the activities of hedge funds today might affect a broader group of persons than the relatively few wealthy individuals and families who had historically invested in hedge funds.<sup>30</sup> We directed the staff to develop information for us on a number of related topics, and advise us whether we should exercise greater regulatory authority over the hedge fund industry.

In connection with the staff investigation, we held a Hedge Fund Roundtable on May 14 and 15, 2003, and invited a broad spectrum of hedge fund industry participants to participate. Information developed at the Roundtable, and a large number of additional submissions we subsequently received from interested persons, contributed greatly to the staff’s investigation and our understanding of hedge funds and hedge fund advisers.<sup>31</sup>

In September 2003, the staff published a report entitled *Implications of the Growth of Hedge Funds*.<sup>32</sup> The 2003 Staff Hedge Fund Report describes in detail the operation of hedge funds

*President’s Working Group on Financial Markets*, by representatives from the Commission, the Treasury Department, the Federal Reserve and the Commodity Futures Trading Commission (Apr. 1999) (“PWG LTCM Report”).

<sup>28</sup> *Id.*

<sup>29</sup> See *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, Department of the Treasury Release [67 FR 60617 (Sept. 26, 2002)].

<sup>30</sup> See Douglas W. Hawes, *Hedge Funds—Investment Clubs for the Rich*, *The Business Lawyer* (Jan. 1968).

<sup>31</sup> Transcripts of the Roundtable participants’ presentations and comments submitted in connection with the Roundtable are available at <http://www.sec.gov/spotlight/hedgefunds.htm>.

<sup>32</sup> *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission*, (“2003 Staff Hedge Fund Report”), available at <http://www.sec.gov/spotlight/hedgefunds.htm>.

and raises a number of important public policy concerns. The report focused on investor protection concerns raised by the growth of hedge funds. In contrast, the principal focus of the President’s Working Group’s 1999 report was the stability of financial markets and the exposure of banks and other financial institutions to the counterparty risks of dealing with highly leveraged entities such as the LTCM hedge fund. Because the two reports had different purposes, the recommendations of the two reports are also quite different. The 2003 Staff Hedge Fund Report confirmed and further developed several of our concerns regarding hedge funds and hedge fund advisers.

### A. Growth of Hedge Funds

Since 1993, the estimated assets in U.S. hedge funds have increased fifteenfold to at least \$795 billion,<sup>33</sup> and the number of hedge funds has increased more than fivefold to 7,000.<sup>34</sup> Although hedge funds remain a relatively small portion of the U.S. financial markets,<sup>35</sup> the rate of growth of hedge funds has been substantially greater than that of other sectors,<sup>36</sup> and

<sup>33</sup> The estimated total assets of hedge funds in the U.S. were \$50 billion in January 1993. See Charles J. Gradante, *Comments of Hennessee Group LLC for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds, May 14–15, 2003* at 5 (available at <http://www.sec.gov/spotlight/hedgefunds/hedge-parts.htm>). The Hennessee Group recently reported that total hedge fund assets in the U.S. have reached \$795 billion. See Testimony of Charles J. Gradante, Managing Principal, the Hennessee Group LLC, Before the Senate Committee on Banking, Housing, and Urban Affairs, available at [http://banking.senate.gov/\\_files/gradante.pdf](http://banking.senate.gov/_files/gradante.pdf) (visited on July 20, 2004). Hedge Fund Research, a research/consulting firm, recently put the figure at \$800 billion. See Forbes News Release, *Hedge Funds Are Robbing Investors, According to Forbes*, May 5, 2004, available at [www.forbesinc.com/newsroom/releases/editorial/Forbes052404.doc](http://www.forbesinc.com/newsroom/releases/editorial/Forbes052404.doc) (visited on May 20, 2004). Moreover, data indicated that the rate of new money invested in hedge funds may be accelerating. See *Fund Briefs*, Pensions and Investments (Mar. 22, 2004) (TASS estimates that the total amount of hedge fund inflows for 2003 was 4 times the amount of inflows for 2002). Industry experts predict world’s total hedge fund assets may grow to \$2–4 trillion by the end of the decade. See *Is Two Trillion Dollars Too Little?* AIMA Journal (June 2004).

<sup>34</sup> The estimated total number of hedge funds in the U.S. grew from 1,100 in January 1993 to 5,700 in January 2003. See Charles J. Gradante, *Comments for the Roundtable on Hedge Funds*, *supra* note 33. The Hennessee Group recently reported that total number of hedge funds has grown to 7,000. See Testimony of Charles J. Gradante, *supra* note 33.

<sup>35</sup> For example, the total market value of corporate equities in the U.S. stock market at the end of 2003 was \$15,497.9 billion. See Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States—Flows and Outstandings*, First Quarter 2004.

<sup>36</sup> During the same period (1993–2003), the number of mutual fund portfolios barely doubled and their assets increased by 2.5 times; assets of insurance companies and commercial banks

<sup>20</sup> See sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 [15 U.S.C. 80a–3(c)(1) and 3(c)(7)].

<sup>21</sup> See Carol J. Loomis, *Hard Times Come To The Hedge Funds*, *Fortune* (Jan. 1970) at 10.

<sup>22</sup> Bernstein Wealth Management Research, *Hedge Fund Myths and Realities* (Oct. 2002) at 3 (“[H]edge funds vary in many ways, including the broad array of strategies they employ, the manager’s skill at implementing those strategies and the risks they take \* \* \*”).

<sup>23</sup> Ted Caldwell, *Introduction: The Model for Superior Performance*, in HEDGE FUNDS, INVESTMENT AND PORTFOLIO STRATEGIES FOR THE INSTITUTIONAL INVESTORS, (Jess Lederman & Robert A. Klein eds., 1995); Julie Rohrer, *The Red-Hot World of Julian Robertson*, *Institutional Investor*, May 1986, at 86.

<sup>24</sup> See *The 35th Annual Report*, Securities and Exchange Commission (1969), at 18.

<sup>25</sup> SEC, *Institutional Investor Study Report*, H.R. Doc. No. 92–64, 92 Cong., 2d Sess., p. xv.

<sup>26</sup> See *Letter from Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives* (June 12, 1992), available at SEC’s public reference room under file no. S7–30–04. See also *Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management of the U.S. Securities and Exchange Commission (May 1992).

<sup>27</sup> See *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management—Report of the*

hedge fund assets have been projected to grow to over a trillion dollars by the end of 2004.<sup>37</sup> In addition, hedge funds play a growing role in our securities markets as large and frequent traders of securities. One recent article portrayed a single hedge fund manager as responsible for an average of five percent of the daily trading volume of the New York Stock Exchange.<sup>38</sup> Another reported hedge funds dominate the market for convertible bonds.<sup>39</sup>

### B. Growth in Hedge Fund Fraud

The growth in hedge funds has been accompanied by a substantial and troubling growth in the number of our hedge fund fraud enforcement cases. In the last five years, the Commission has brought 46 cases in which we have asserted that hedge fund advisers have defrauded hedge fund investors or used the fund to defraud others in amounts our staff estimates to exceed \$1 billion. These frauds involved advisers that:

- For years grossly overstated the performance of their hedge funds to investors who were actually incurring tens or hundreds of millions of dollars in losses on their investments in the funds;<sup>40</sup>

doubled; and deposits of commercial banks barely doubled. Sources: *ICI Factbook 2003* and “Trends in Mutual Fund Investing, January 2004” at [www.ici.org](http://www.ici.org); Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States—Flows and Outstandings*, First Quarter 2004; Federal Reserve Statistical Release H.8, *Assets and Liabilities of Commercial Banks in the United States*, Dec. 1993 through Dec. 2003.

<sup>37</sup> The total asset inflows into hedge funds for 2003 reached \$72.2 billion according to TASS Research. See *Tremont's TASS Research Reports Record \$72.2 Billion in Net Inflow for 2003, Record Fourth Quarter Inflow of \$26.8 Billion*, Feb. 19, 2004, available at [http://www.tremontinvestment.com/tass\\_estimate\\_021904.htm](http://www.tremontinvestment.com/tass_estimate_021904.htm) (visited on May 20, 2004). Hedge Fund Research, an alternative investments research and consulting firm, predicts that investors will put \$100 billion into hedge funds in 2004. See Neil Weinberg and Bernard Condon, *The Sleaziest Show on Earth*, *Forbes* (May 24, 2004), at 110. Financial Research Corp., a financial research firm, predicts the hedge fund industry will reach \$1 trillion by year-end. See Hanna Shaw Grove and Russ Alan Prince, *Let Us In*, Registered Rep. (Mar. 2004).

<sup>38</sup> Marcia Vickers, *The Most Powerful Trader On Wall Street You've Never Heard Of*, *BusinessWeek* (July 21, 2003), at 66.

<sup>39</sup> See Henny Sender, *Hedge Funds Skid on Convertible Bonds*, *The Wall St. J.*, June 30, 2004, at C4 (hedge funds account for about 95% of all trading in convertible bonds).

<sup>40</sup> *SEC v. Edward Thomas Jung, et al.*, Litigation Release No. 17417 (Mar. 15, 2002) (Commission found unregistered adviser caused investor losses of approximately \$20 million); *SEC v. David M. Mobley, Sr., et al.*, Litigation Release No. 18150 (May 20, 2003) (Commission found unregistered adviser caused investor losses of approximately \$60 million); *SEC v. Michael W. Berger, Manhattan Capital Management Inc.*, Litigation Release No. 17230 (Nov. 13, 2001) (Commission obtained judgment in case against unregistered adviser who

- Caused hedge funds to pay unnecessary and undisclosed commissions;<sup>41</sup> and

- Used parallel unregistered advisory firms and hedge funds as vehicles to misappropriate client assets.<sup>42</sup>

Since the staff report, a new species of hedge fund fraud has been uncovered. Advisers to hedge funds have been key participants in the recent scandals involving mutual fund late trading and inappropriate market timing.<sup>43</sup> Many of our enforcement cases

caused investor losses of approximately \$400 million). We have also filed civil actions alleging the same types of fraud. *SEC v. Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC*, Litigation Release No. 18247 (July 23, 2003) (charging unregistered hedge fund adviser with manipulating thinly-traded portfolio securities to fraudulently inflate fund values by hundreds of millions of dollars); *SEC v. Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla*, Litigation Release No. 16770 (Oct. 17, 2000) (charging unregistered hedge fund adviser with misappropriating millions of dollars in client assets). See also *SEC v. Beacon Hill Asset Management LLC, et al.*, Litigation Release No. 18745A (June 16, 2004) (charging unregistered hedge fund adviser with understating losses by hundreds of millions of dollars for at least three months, and causing the hedge fund to purchase securities from the adviser's managed account clients at inflated prices to prop up the performance of the managed accounts; principals of the adviser were also charged with causing the hedge fund to trade with the principals' personal account at erroneous prices that benefited the principals).

<sup>41</sup> *In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses*, Investment Advisers Act Release No. 2038 (June 20, 2002) (registered adviser caused its hedge funds to pay nearly \$2 million in unnecessary and undisclosed commission costs, above markups already paid, to broker that had no role in executing trades, as reward for referring investors to the hedge funds).

<sup>42</sup> *SEC v. Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17487 (Apr. 24, 2002), Litigation Release No. 17981 (Feb. 11, 2003) (principal of registered adviser who, after becoming aware of Commission investigation of its misappropriation of client assets, established a hedge fund and parallel unregistered advisory firm to continue the fraud).

<sup>43</sup> We recently sanctioned persons charged with late trading of mutual fund shares on behalf of groups of hedge funds, and against mutual fund advisers or principals for permitting hedge funds' market timing. *In the Matter of Banc One Investment Advisers Corporation and Mark A. Beeson*, Investment Advisers Act Release No. 2254 (June 29, 2004) (Commission found that investment adviser permitted hedge fund manager to time the adviser's mutual funds, contrary to the funds' prospectuses; helped arrange financing for the timing trades; failed to disclose the timing arrangements; and provided the hedge fund manager with nonpublic portfolio information); *In the Matter of Pilgrim Baxter & Associates, Ltd.*, Investment Advisers Act Release No. 2251 (June 21, 2004) (Commission found that mutual fund adviser permitted a hedge fund, in which one of its executives had a substantial financial interest, to engage in repeated short-term trading of several mutual funds and that one of its executives provided nonpublic portfolio information to a broker-dealer, which passed it on to its customers); *In the Matter of Strong Capital Management, Inc.*, Investment Advisers Act Release No. 2239 (May 20, 2004) (Commission found that adviser disclosed

involved hedge funds that sought to exploit mutual fund investors for their own gain. Some entered into arrangements with mutual fund advisers under which the advisers waived restrictions on market timing in return for receipt of “sticky assets” from the hedge fund, *i.e.*, placement of other assets in other funds managed by the mutual fund adviser. Others sought ways to avoid detection by mutual fund personnel by conspiring with intermediaries to conceal the identity of the hedge funds. While our investigation is ongoing, the frequency

material nonpublic information about mutual fund portfolio holdings to hedge fund, and permitted own chairman and hedge fund to engage in undisclosed market timing of mutual funds managed by adviser); *SEC v. Security Trust Co., N.A.*, Litigation Release No. 18653 (Apr. 1, 2004) (consent to judgment by trust company charged with accepting late trades from several hedge funds over at least a three-year period); *In the Matter of Stephen B. Markovitz*, Administrative Proceedings Release No. 33-8298 (Oct. 2, 2003) (Commission found that Markovitz engaged in late trading on behalf of hedge funds spanning four years). See also *In the Matter of Alliance Capital Management, L.P.*, Investment Advisers Act Release No. 2205 (Dec. 18, 2003) (Commission found that investment adviser permitted known market timers, including at least one hedge fund, to market time its mutual funds, in exchange for the timers' investments in Alliance's investment vehicles); *In the Matter of James Patrick Connelly, Jr.*, Investment Advisers Act Release No. 2183 (Oct. 16, 2003) (Commission found that vice chairman of mutual fund adviser permitted market timing by hedge funds).

We are continuing to pursue several similar cases. To date, we have instituted seven enforcement actions (in addition to the seven settled actions discussed above). See *SEC v. PIMCO Advisors Fund Management, LLC*, Litigation Release No. 18697 (May 6, 2004) (alleging that mutual fund adviser entered into a market timing arrangement permitting over 100 mutual fund market timing transactions by a hedge fund); *SEC v. Columbia Management Advisors, Inc.*, Litigation Release No. 18590 (Feb. 24, 2004) (alleging mutual fund adviser entered into arrangements allowing hedge funds to engage in market timing transactions in nine funds, including one aimed at young investors); *SEC v. Mutuals.com, Inc.*, Litigation Release No. 18489 (Dec. 4, 2003) (alleging that dually registered broker-dealer and investment adviser, three of its executives, and two affiliated broker-dealers assisted hedge fund brokerage customers in carrying out and concealing thousands of market timing trades and illegal late trades in shares of hundreds of mutual funds); *SEC v. Invesco Funds Group*, Litigation Release No. 18482 (Dec. 2, 2003) (alleging that mutual fund adviser, with approval of its president and chief executive officer, entered into market timing arrangements with hedge funds); *SEC v. Druffner*, Litigation Release No. 18444 (Nov. 4, 2003) (alleging that five brokers, with the assistance of their branch office manager, evaded attempts to restrict their trading and assisted several hedge funds in conducting thousands of market timing trades in numerous mutual funds); *In re Sihpol*, Securities Exchange Act Release No. 48493 (Sept. 16, 2003) (charging former broker with playing a key role in enabling hedge fund customers to engage in late trading in mutual fund shares over a three-year period). See also *In the Matter of Paul A. Flynn*, Securities Exchange Act Release No. 49177 (Feb. 3, 2004) (alleging Flynn assisted numerous hedge funds in obtaining bank financing to fund late trading and deceptive market timing of mutual fund shares).

with which hedge funds appear in these cases and continue to turn up in the investigations is alarming. Our staff counts as many as forty different hedge funds involved in these cases, including hedge funds managed by Canary Investment Management, LLC.<sup>44</sup>

In a lawsuit against Canary, the New York Attorney General has alleged that Canary obtained its late trading and market timing “capacity” from mutual fund managers and intermediaries.<sup>45</sup> In return, Canary often would leave millions of dollars in the fund managers’ selected funds on a long-term basis as “sticky assets.”<sup>46</sup> Canary borrowed from the parent companies of the fund managers or intermediaries to finance its late trading and market timing schemes. As a result, Canary reaped tens of millions of dollars in profits from these schemes,<sup>47</sup> the fund managers collected lucrative management fees from the “sticky assets,” the intermediaries received huge commissions,<sup>48</sup> and parent companies of the fund managers or intermediaries acting as lenders earned interest at a significant premium, while long-term investors in the mutual funds targeted by Canary lost tens of millions of dollars.<sup>49</sup>

### C. “Retailization” of Hedge Funds

The third development of significant concern is the growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds. Hedge fund investors are no longer limited to the very wealthy. We note three developments that we have observed that contribute to our concern.

First, some hedge funds today are expanding their marketing activities to attract investors who may not previously have participated in these types of risky investments.<sup>50</sup> Many

hedge funds maintain very high minimum requirements, and many of the hedge fund participants at our Roundtable expressed no interest in attracting “retail investors.” Our staff observed, however, that many hedge funds’ minimum investment requirements have decreased over time.<sup>51</sup> In developed markets outside the United States, hedge funds have sought to market themselves to smaller investors, and we can expect similar market pressures to develop in the United States as more hedge funds enter our markets.<sup>52</sup>

Bryant Quinn and Temma Ehrenfeld, *The Street’s Latest Lure: Some One Is Going to Mint Money With the New Hedge Funds For Smaller Investors*, Newsweek (May 26, 2003). See also two recent articles discussing hedge funds in publications for physicians. John J. Grande, *Alternative Investment Strategies Can Offer Significant ROI*, Ophthalmology Times (May 15, 2002); Leslie Kane, *Where to Put Your Money: Four Experts Tell Whether You Should Expect Happy Days for Stocks, and How to Invest Your Money*, Medical Economics (Jan. 9, 2004).

<sup>51</sup> See *supra* note 32, at 81.

<sup>52</sup> Any sales in the United States would, of course, be subject to the registration requirements of the Securities Act, and the hedge fund itself may be subject to the Investment Company Act, unless exemptions were available. The UK recently introduced a new type of vehicle which will be available only to sophisticated investors, but will still be authorized by the FSA, as a “half way house” between retail funds (fully regulated) and wholly unregulated funds. See Financial Services Authority, *The CIS Sourcebook—A New Approach, Feedback on CP185 and Made Text*, Mar. 2004, available at [www.fsa.gov.uk/pubs/policy/04\\_07.pdf](http://www.fsa.gov.uk/pubs/policy/04_07.pdf) (visited on May 11, 2004). Starting Jan. 2004, funds of hedge funds may sell their shares to smaller investors in Germany subject to certain regulations and procedures. See Silvia Ascarelli and David Reilly, *Hedge Funds Are Coming to the Masses*, The Wall St. J., Apr. 15, 2004; EU Financial Services Group Briefing, Wilmer, Cutler & Pickering, *Hedge Funds in Germany—German Parliament Opens the Market for Alternative Investment Products*, Dec. 5, 2003, available at <http://www.wilmer.com/pubs/results.aspx?iPractice> (visited on May 11, 2004). Since April 2003, funds of hedge funds may sell their shares to smaller investors in France, subject to certain regulations and procedures. See Commission des Operations de Bourse (France), *Regulating Alternative Multi-Management Investments*, News Release (Apr. 1, 2003) (available in File No. S7-30-04); Alain Gauvin and Guillaume Eliet, Capital Markets Dept., Coudert Freres, *Regulating Alternative Multi-Management Investments*, 2003, available at <http://www.coudert.com> (visited on May 17, 2004). In Ireland, funds of hedge funds may sell their shares to smaller investors subject to certain regulations and procedures. See Matheson Ormsby Prentice, *Establishing a Hedge Fund in Ireland*, 2003, available at <http://www.mop.ie/fileupload/publications> (visited on May 17, 2004). In Asia, both Hong Kong and Singapore permit authorized hedge funds to sell their shares to investors subject to certain minimum subscription thresholds and regulations. See Donald E. Lacey, Jr., *Democratizing the Hedge Fund: Considering the Advent of Retail Hedge Funds*, Apr. 2003, (International Finance Seminar at Harvard Law School), available at [http://www.law.harvard.edu/programs/pifs/pdfs/donald\\_lacey.pdf](http://www.law.harvard.edu/programs/pifs/pdfs/donald_lacey.pdf) (visited on May 17, 2004); Matthew Harrison, *Fund Management in Hong Kong and Singapore*, CSU Research and Policy, Jan. 6,

Second, the development of “funds of hedge funds” has made hedge funds more broadly available to investors.<sup>53</sup> Today there are 40 registered funds of hedge funds that offer or plan to offer their shares publicly.<sup>54</sup> Most funds of hedge funds are today offered only to institutional investors, but there are no limitations on the public offering of these funds.

Finally, and perhaps most significantly, in the last few years, a growing number of public and private pension funds,<sup>55</sup> as well as universities, endowments, foundations, and other charitable organizations, have begun to invest in hedge funds or have increased their allocations to hedge funds.<sup>56</sup> Press

2003. In South Africa, regulators and trade associations recently issued a joint discussion paper to develop an acceptable regulated environment in which existing and new hedge funds can operate (including consideration of whether to permit certain hedge fund products to be marketed to the public). See The Financial Services Board, Association of Collective Investments and Alternative Investment Management Association, *The Regulatory Position of Hedge Funds in South Africa—A Joint Discussion Paper* (Mar. 9, 2004). See also Carla Fiford, *South African Hedge Fund Industry Grows by Stealth*, AIMA Journal (Feb. 2004).

<sup>53</sup> *The Street’s Latest Lure: Some One Is Going to Mint Money With the New Hedge Funds For Smaller Investors*, *supra* note 50; *Going Mainstream*, *supra* note 50; Jessica Toonkel, *Firms Take Pause Before Launching Hedge Funds of Funds for Mass Affluent; Hold Your Horses! Fund Action* (Apr. 21, 2003); Michael P. Malloy and Jim Strangroom, *Registered Funds of Hedge Funds*, MFA Reporter (2002); *Fool’s Gold*, The Economist (Sept. 1, 2001); Kimberly Hill, *Investors Need Help With Hedge Funds*, Fundfire, May 14, 2004.

<sup>54</sup> An additional 47 funds of hedge funds are registered with the Commission as investment companies but can be sold only through private offerings. The Commission does not have data on the number of additional funds of hedge funds that exist but are not registered with the Commission.

<sup>55</sup> According to Greenwich Associates, about 20 percent of corporate and public plans in the United States were investing in hedge funds in 2002, up from 15 percent in 2001. See BIM Alternative Investments SGR, *Odd Blend May Be a Match*, available at [http://www.bimalternativesgr.it/italiano/hedge\\_funds/news/2003/20030624\\_ticker\\_magazine](http://www.bimalternativesgr.it/italiano/hedge_funds/news/2003/20030624_ticker_magazine) (visited on May 18, 2004); RMF Investment Management, RMF Investment Letter, available at [http://www.rmfcf.com/rmf\\_investment\\_letter\\_june\\_2003.pdf](http://www.rmfcf.com/rmf_investment_letter_june_2003.pdf) (visited on May 18, 2004). Hennessee Group data indicate that pensions’ investments in hedge funds increased from \$13 billion in 1997 to \$72 billion in 2004. See Testimony of Charles J. Gradante, *supra* note 33. See also *Hedge Funds Gaining Acceptance Among Pension Funds*, Morningstar Web site, June 27, 2003; Chris Clair, *‘Unprecedented Pressure’: Public Plans Race to Embrace Hedge Funds; This Time They Are Leading, Not Following, Their Corporate Counterparts*, Pensions and Investments, July 8, 2002, at 2; *Alaska Pension Allocates to Hedge Fund*, Alternative Investment News, July 1, 2004 (the Alaska State Pension Investment Board has chosen three firms to manage its first \$300 million hedge fund allocation).

<sup>56</sup> Median strategic allocation to hedge funds by endowments and foundations was 11 percent in 2001, 10 percent in 2003 and forecast at 12.3 percent in 2005. See Goldman Sachs International

<sup>44</sup> Because the advisers to these hedge funds were unregistered, our examination staff had no opportunity to review their trading activities in the mutual funds.

<sup>45</sup> See State of New York Complaint Against Canary Capital Partners, LLC, Canary Investment Management, LLC, Canary Capital Partners, LTD and Edward J. Stern, Sept. 3, 2003, available at [www.oag.state.ny.us/press/2003/sep/canary\\_complaint.pdf](http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf) (visited on May 26, 2004).

<sup>46</sup> *Id.*

<sup>47</sup> See, e.g., *SEC v. Security Trust Co., N.A.*, *supra* note 43 (as a result of its late trading and market timing assisted by Security Trust Co., Canary realized a profit of \$85 million).

<sup>48</sup> See, e.g., *SEC v. Security Trust Co., N.A.*, *supra* note 43 (Security Trust Co. received over \$5.8 million in direct compensation from Canary).

<sup>49</sup> See *supra* note 45.

<sup>50</sup> See Harriet Johnson Brackey, *New Class of Hedge Funds Reaches Beyond the Wealthy*, San Jose Mercury News, Mar. 23, 2003; Pam Black, *Going Mainstream*, Registered Rep. (Mar. 1, 2004); *Let Us In*, Registered Rep., *supra* note 37; Jane

reports indicate that more of these institutions have also recently begun to consider these alternative investments.<sup>57</sup> Hedge funds are thus today being purchased by entities that are not traditional hedge fund investors, including pension plans that have

and Russell Investment Group, *Report on Alternative Investing by Tax-Exempt Organizations 2003*, available at [http://www.russell.com/II/Research\\_and\\_Resources/Informative\\_Articles/Goldman\\_Russell\\_Survey.asp](http://www.russell.com/II/Research_and_Resources/Informative_Articles/Goldman_Russell_Survey.asp) (visited on May 18, 2004). Lewis Knox, *The Hedge Fund: Institutional Money is Swelling the Coffers of the World's Largest Hedge Fund Managers*, 28 *Institutional Investor* (International Edition) 53 (June 1, 2003); Dan Neel, *Michigan Preps For Hedge, Real Estate*, *Investment Management Weekly*, Apr. 28, 2003; *Virginia Exposure Soars to 60%*, *Financial News* (Daily), Apr. 27, 2003 (University of Virginia has invested 50 percent of its portfolio in hedge funds, and plans to increase its exposure to 60 percent of its total portfolio); Chris Clair, *Allocation Goal: 25%—UTIMCO Joins Billion-Dollar Hedge Fund Club*, *Pensions and Investments*, Apr. 14, 2003, at 3; Chidem Kurdas, *Hedge Funds Continue to Gain in Endowments' Alternative Investments*, *HedgeWorld Daily News*, Apr. 7, 2003; *Behind the Money Section; University of Wisconsin Searching for Hedge Funds*, 4 *Alternative Investment News*, Feb. 1, 2003, at 20 (\$300 million University of Wisconsin endowment will allocate up to 10 percent, or \$25–30 million, to a fund of funds manager); *Baylor University; Inside The Buyside; Increases Hedge Fund Activity by \$20–25 Million*, 4 *Alternative Investment News*, Feb. 1, 2003 at 6; Susan L. Barreto, *Hedge Funds Become Saving Grace for Endowments in Tough Times*, *HedgeWorld Daily News*, Apr. 4, 2002.

<sup>57</sup> *Philly to Embrace Hedge Funds*, *Alternative Investment News*, June 21, 2004 (the \$4.1 billion City of Philadelphia Board of Pension & Retirement system has carved out a 5 percent allocation to hedge funds—its first to the asset class); *Texas Plan to Search for Hedge Funds*, 6 *Alternative Investment News*, June 2004, at 6 (\$1.5 billion San Antonio Fire and Police Retirement Fund expects to carve out a \$75 million allocation to hedge funds); *Updated Searches Section*, 6 *Alternative Investment News*, June 2004, at 12 (Illinois State Board of Investment will issue an RFP in early fall for four funds of hedge funds to handle between \$500–550 million for the pension plans under its oversight); *Auburn to Seek Alternatives Managers*, *Alternative Investment News*, June 10, 2004 (Auburn University will hire a few funds of hedge funds firms to fill its newly-created 20 percent allocation to absolute return strategies); *US Pension Plan Looks to Hedge Fund*, *Financial Times* (London), June 26, 2003, at Global Investing 21 (Virginia Retirement System plans to invest \$1 billion in hedge funds); *NYC Fund Eyes Maiden Hedge Fund of Funds Investment*, 4 *Alternative Investments*, June 1, 2003, at 19 (Manhattan & Bronx Surface Transit Operating Authority Retirement Fund considers investment in hedge funds); *Florida Plan to Search for Funds of Funds*, 4 *Alternative Investment News*, Apr. 1, 2003, at 19 (Gainesville, Florida General Employees Pension Plan searches for hedge fund manager); *Indiana University Eyeing Single-Manager Hedge Funds*, 6 *Foundation & Money Management*, Mar. 1, 2003, at 1; *Kern County Seeks Hedge Funds*, 4 *Alternative Investment News*, Mar. 1, 2003, at 19 (\$1.5 billion Kern County, California Employees Retirement Association will make a maiden foray into hedge funds with a \$45 million search for multiple managers); *MassPRIM to Consider Hedge Funds in Review*, 4 *Alternative Investment News*, Feb. 1, 2003, at 19 (\$27 billion Massachusetts Pension Reserves Investment Management Board is considering adding its first hedge funds this year).

millions of beneficiaries. As a result of the participation by these entities in hedge funds, as well as other sophisticated investment strategies, the assets of these entities are exposed to the risks of the hedge fund. Losses resulting from hedge fund investments, as with any other investment loss, may affect the entities' ability to satisfy their obligations to their beneficiaries or pursue other intended purposes.

## II. Discussion

### A. Need for Regulatory Action

Our responsibilities to protect investors and the nation's securities markets do not permit us to ignore these developments. Our current regulatory program for hedge funds and hedge fund advisers is inadequate—it relies almost entirely on enforcement actions brought after the fraud has occurred and investor assets are gone.<sup>58</sup> We have no oversight program that would provide us with the ability to deter or detect fraud by unregistered hedge fund advisers at an early stage. We lack basic information about hedge fund advisers and the hedge fund industry, and must rely on third party data that often conflict and may be unreliable.<sup>59</sup>

<sup>58</sup> Robert Lenzner and Michael Maiello, *The Money Vanishes*, *Forbes*, Aug. 6, 2001 at 70 (“What does it mean to say that hedge funds are unregulated? It means that if there is mischief, the Securities and Exchange Commission will find out about it too late.”).

<sup>59</sup> William Fung and David Hsieh, *Measuring the Market Impact of Hedge Funds*, 7 *Journal of Empirical Finance* 1 (2000) (“There are varying estimates of the size of the hedge fund industry.”); *Hedge-matics: How Many Funds Exist?* *The Wall St. J.*, May 22, 2003, at C5 (“Just how big is the hedge-fund industry? This simple question has been debated because the data on hedge funds are spotty.”); *Letter from Craig S. Tyle, General Counsel of the Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission*, July 2, 2003, available at [www.ici.org](http://www.ici.org) (visited on Feb. 10, 2004) (“There is currently no universal database that contains records of all hedge funds, both those currently operating and those that have ceased operating.”); Gaurav S. Amin and Harry M. Kat, *Hedge Fund Performance 1990–2000: Do the “Money Machines” Really Add Value?*, 38 *Journal of Financial and Quantitative Analysis* 2 (June 1, 2003) (“Due to its private nature, it is difficult to estimate the current size of the hedge fund industry.”). *See also* Bing Liang, *Hedge Funds: The Living and the Dead*, 35 *Journal of Financial and Quantitative Analysis* 309–326 (2000) (study of statistical inconsistencies in two major hedge fund databases, noting hedge funds “are basically not regulated. They report their fund information only on a voluntary basis. Therefore, the reliability of hedge fund data is an open question and is critical for hedge fund research and the investment community.”); Harry M. Kat, *10 Things That Investors Should Know About Hedge Funds*, *Institutional Investor* (Spring 2003) (noting that hedge fund databases are of low quality, that each database covers only a subset of the hedge fund universe, that all present survivorship bias, and that researchers attempting to analyze the hedge fund industry or fund performance may perceive matters very differently depending on the database or index they use).

Hedge fund growth and the evolution of hedge fund ownership have resulted in both more significant and broader market and investor protection concerns, and have convinced us that we should consider taking steps to provide for greater oversight of hedge fund advisers. As the 2003 Staff Hedge Fund Report outlines, numerous institutions on which individual investors, savers, and pensioners depend today have a substantial exposure to the risks of hedge funds and the activities of hedge fund advisers. One survey reports that pension fund exposure to hedge funds has grown from \$13 billion in 1997 to \$72 billion today, an increase of 450 percent.<sup>60</sup> Hardly a week passes in which industry publications do not announce a decision by a public pension plan, endowment, foundation or other charitable organization to invest in hedge funds.<sup>61</sup> The growing demand for hedge funds has resulted in asymmetries of information: even institutional investors are often unable to acquire information on an ongoing basis about the hedge fund adviser, its operations and conflicts.<sup>62</sup>

The recent rapid growth of hedge fund investments also concerns us because of its potential impact on the behavior of hedge fund advisers. As substantial inflows chase absolute returns, hedge fund managers will have powerful incentives to pursue riskier strategies in order to generate substantial absolute returns under all market conditions. The capacity of hedge fund advisers to generate large absolute returns is limited because the use of similar financial strategies by other hedge fund advisers narrows spreads and decreases profitability.<sup>63</sup>

<sup>60</sup> *See supra* note 55.

<sup>61</sup> *See supra* notes 55–57.

<sup>62</sup> *See* Roundtable Transcript of May 14 at 167–70 (statement of David Swensen) (private placement memoranda as disclosure documents are “not particularly useful”); Roundtable Transcript of May 15 at 190 (statement of Sandra Manzke) (“[I]t would make my life a lot easier to have mandated disclosures \* \* \* [I]t’s very difficult to get answers out of managers, and they hold all the keys right now. If you want to get into a good fund, and you ask some difficult questions, you may not get that answer. Sure, there is a lot of access, to get online and do background checks, and hire firms \* \* \* But that’s expensive. And can the retail investor do it? No. Firms like ours, we spend a lot of money, we have a lot more people working for us now to uncover these types of situations.”).

<sup>63</sup> *See* David Reilly, *Hot Hedge Fund Vega Grapples With Growth: Global/Macro Style of Investing May Provide Room to Maneuver, But a Door Is Closed to New Cash*, *The Wall St. J.*, June 4, 2004, at C1 (as hedge funds’ assets explode, difficulties in finding winning strategies raises the specter of diminished returns and concentrations of investment risk that are difficult to unwind in a crisis); Mara Der Hovanesian, *Will Hedge Funds Be*

We are also concerned that some hedge fund advisers may be pursuing strategies that may be inconsistent with disclosures provided regarding the advisers, or may be improper or unlawful, as we have seen with hedge funds pursuing late trading and market timing strategies.

Hedge funds present unique risks to the securities markets and investors that concern us and should concern all market participants. Unregistered hedge fund advisers operate largely in the shadows, with little oversight, are subject to the pressures of performance fee arrangements,<sup>64</sup> and in many cases are expected to generate positive returns even in down markets. While these conditions can stimulate a tremendous amount of investment creativity and profit, they are also a perfect medium for the germination and growth of frauds. As we have seen, hedge fund advisers are capable of serious transgressions that can harm ordinary citizens who in many cases are now their ultimate beneficiaries.

Our concern is and must be the protection of investors and the suppression of fraud. But we must also recognize the important role that hedge funds play in our markets. Hedge funds contribute to market efficiency and liquidity.<sup>65</sup> They play an important role in allocating investment risks by serving as counterparties to investors who seek to hedge risks.<sup>66</sup> They provide their investors with greater diversification of risk by offering them exposure uncorrelated with market movements.<sup>67</sup> Therefore, in evaluating alternative

*Overrun By All The Traffic?*, BusinessWeek, Mar. 11, 2002 (some hedge fund strategies are becoming less effective as the capacity of managers to generate high absolute returns diminishes when investment portfolios are too large). See also Alexander M. Ineichen, ABSOLUTE RETURNS (2003) at 47 (falling barriers to entry for new hedge fund advisers are causing a dilution of the talent pool, making adviser selection more difficult).

<sup>64</sup> See William Goetzmann, *et al.*, *High-Water Marks and Hedge Fund Management Contracts*, Yale International Center for Finance (Apr. 18, 2001).

<sup>65</sup> “[M]any of the things which [hedge funds] do \* \* \* tend to refine the pricing system in the United States and elsewhere. And it is that really exceptional and increasingly sophisticated pricing system which is one of the reasons why the use of capital in this country is so efficient \* \* \* there is an economic value here which we should not merely dismiss \* \* \*. I do think it is important to remember that [hedge funds] \* \* \* by what they do, they do make a contribution to this country.” Testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, Before the House Committee on Banking and Finance (Oct. 1, 1998).

<sup>66</sup> See *A Primer on Hedge Funds*, *supra* note 19. See also PWG LTCM Report, *supra* note 27; 2003 Staff Hedge Fund Report, *supra* note 32, at 4.

<sup>67</sup> See *A Primer on Hedge Funds*, *supra* note 19. See also PWG LTCM Report, *supra* note 27; 2003 Staff Hedge Fund Report, *supra* note 32, at 4.

courses we might take, we have paid particular attention to the extent to which our actions might encumber the operation of hedge funds and thus damage the very markets we seek to protect.

#### *B. Matters Considered by the Commission*

We are proposing a new rule the effect of which would be to require hedge fund advisers to register under the Advisers Act. Registration under the Act would address several of our concerns described above while imposing only minimal burdens on hedge fund advisers.

##### 1. Census Information

Hedge fund adviser registration would provide the Commission with important information about this growing segment of the U.S. financial system. Collecting information about the nation’s investment advisers has been one aim of the Advisers Act since it was enacted in 1940.<sup>68</sup> However, just as data on *all* advisers was lacking before 1940, today there are no comprehensive data on hedge fund advisers currently available.<sup>69</sup> We have only limited indirect information about these firms and their trading practices, and we are hampered in our ability to develop regulatory policy regarding hedge fund advisers and their funds. Registering hedge fund advisers would permit us to collect information about the number of hedge funds that advisers manage, the amount of assets in hedge funds, the number of employees and types of clients these advisers have, other business activities they conduct, and the identity of persons that control or are affiliated with the firm.<sup>70</sup>

Although there may be other piecemeal sources for some of the information the Commission would obtain when a hedge fund adviser files Form ADV, much of the information is not readily available without substantial forensic efforts on the part of our staff.

<sup>68</sup> Although the primary objective of the Advisers Act is the protection of advisory clients, the Act also serves as “a continuing census of the Nation’s investment advisers.” H.R. Rep. No. 1760, 86th Cong., 2d Sess. 2 (1960). In 1940, Congress noted that it was difficult to ascertain the number of investment advisers in operation or the amount of funds under their influence and control. H.R. Rep. No. 1775, 76th Cong., 3d Sess. 21 (1940).

<sup>69</sup> See 2003 Staff Hedge Fund Report, *supra* note 32.

<sup>70</sup> Much of this information is currently collected from hedge fund advisers that are registered with the Commission. A registered adviser that is the general partner of a hedge fund must report that it advises a “pooled vehicle” in response to Item 5.D (6) of Part 1A of Form ADV, list each pooled vehicle on Schedule D (Section 7.B.) and disclose the amount of assets in the fund and the minimum amount of capital investment per investor.

We need information that is reliable, current, and complete, and we need it in a format easily susceptible to analysis by our staff.

##### 2. Deterrence and Early Discovery of Fraud

Registration under the Advisers Act gives us authority to conduct examinations of the adviser’s hedge fund activities.<sup>71</sup> Our examinations permit us to identify compliance problems at an early stage, identify practices that may be harmful to investors, and provide a deterrent to unlawful conduct.<sup>72</sup> They are a key part of our investor protection program.

The prospect of an SEC examination increases the risk of getting caught, and thus will deter wrongdoers.<sup>73</sup> 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. Each of these operational areas presents a greater opportunity for misconduct if it is not open to examination. Our examinations bring limited sunlight to advisory activities that are kept from sight from clients for competitive and other reasons. Examinations may be a particularly appropriate form of sunlight because of the highly proprietary nature of many hedge fund advisers’ activities.<sup>74</sup>

<sup>71</sup> See *supra* note 13.

<sup>72</sup> Other protections of the Advisers Act would also act as deterrents to unlawful conduct by serving as a check on the advisers’ control of assets in funds they advise and contribute to the protection of investors in those funds. Our custody rule, for example, requires the adviser to maintain fund assets with a qualified custodian. See rule 206(4)–2 under the Advisers Act.

<sup>73</sup> The facts of the action against Stevin R. Hoover and Hoover Capital Management, Inc. are instructive on this question. See *SEC v. Hoover and Hoover Capital Management, Inc.*, (Second Amended Complaint of the SEC), (available at [www.sec.gov/litigation/complr17487.htm](http://www.sec.gov/litigation/complr17487.htm)). Hoover was involved in a scheme to defraud clients of his advisory firm by, among other things, misappropriating assets and overbilling expenses. When Hoover became aware that the Commission staff was investigating his firm, he established a separate, unregistered advisory firm and perpetuated his fraud through use of a hedge fund he created and controlled.

<sup>74</sup> We are not proposing to require, nor have we ever required, investment advisers to disclose their clients’ securities positions. Indeed, we recently declined requests to require advisers to publicly disclose how they voted client proxies out of a concern that they would thereby divulge client securities positions. *Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) [68 FR 6585 (Feb. 7, 2003)]. The Advisers Act requires us to maintain as confidential information obtained by our examiners in the

Examination of hedge fund advisers should serve the same deterrent role that it does with respect to other types of advisers.<sup>75</sup> There is nothing unique about hedge fund advisers or the types of frauds they have committed that suggests that our examination program would not or could not play the same effective role. The fraud actions we have brought against unregistered hedge fund advisers have been similar to the types of fraud actions we have brought against other types of advisers, including misappropriation of assets,<sup>76</sup> portfolio pumping,<sup>77</sup> misrepresentation of portfolio performance,<sup>78</sup> falsification of experience, credentials and past returns,<sup>79</sup> misleading disclosure

course of an examination. See sections 210(b) and 210A of the Act. [15 U.S.C. 80b-210(b) and 210A].

<sup>75</sup> Of course, we are not suggesting our examination program would reduce investment risks. Our examination program is designed to uncover poor controls and to deter and expose misconduct. It is not designed to evaluate advisers' investment and trading strategies or to prevent losses that may result from legitimate investment risks.

<sup>76</sup> *SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee*, Litigation Release No. 18216 (July 7, 2003); *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. David M. Mobley, Sr., et al.*, supra note 40; *SEC v. Vestron Financial Corp., et al.*, Litigation Release No. 18065 (Apr. 2, 2003); *SEC v. Hoover and Hoover Capital Management, Inc.*, supra note 42; *SEC v. Beacon Hill Asset Management LLC, et al.*, supra note 40; *SEC v. House Asset Management, L.L.C., House Edge, L.P., Paul J. House, and Brandon R. Moore*, Litigation Release No. 17583 (June 24, 2002); *SEC v. Edward Thomas Jung, et al.*, supra note 40; *SEC v. Evelyn Litwok & Dalia Eilat*, Litigation Release No. 16843 (Dec. 27, 2000); *SEC v. Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla*, supra note 40.

<sup>77</sup> *SEC v. Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC*, supra note 40; *SEC v. Burton G. Friedlander*, Litigation Rel. No. 18426 (Oct. 24, 2003).

<sup>78</sup> *In the Matter of Samer M. El Bizri and Bizri Capital Partners, Inc.*, Admin Proc. File No. 3-11521 (June 16, 2004); *SEC v. Millennium Capital Hedge Fund*, Litigation Release No. 18362 (Sept. 25, 2003); *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, supra note 76; *SEC v. David M. Mobley, Sr., et al.*, supra note 40; *SEC v. Hoover and Hoover Capital Management, Inc.*, supra note 42; *SEC v. Beacon Hill Asset Management LLC, et al.*, supra note 40; *SEC v. Edward Thomas Jung, et al.*, supra note 40; *SEC v. Michael W. Berger, Manhattan Capital Management Inc.*, supra note 40; *In the Matter of Charles K. Seavey and Alexander Lushtak*, Investment Advisers Act Release No. 1968 (Aug. 15, 2001); *In the Matter of Michael T. Higgins*, Investment Advisers Act Release No. 1947 (June 1, 2001); *SEC v. Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla*, supra note 40.

<sup>79</sup> *SEC v. J. Scott Eskind*, Litigation Release No. 18558 (Jan. 29, 2004); *SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee*, supra note 76; *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, supra note 76; *SEC v. Vestron Financial Corp., et al.*, supra note 76; *SEC v. House Asset Management, L.L.C., House Edge, L.P., Paul J.*

regarding claimed trading strategies<sup>80</sup> and improper valuation of assets.<sup>81</sup>

We have also charged registered hedge fund advisers with other types of fraud, including: misallocating favorable investment opportunities to a hedge fund, to the detriment of the adviser's other clients, *In the Matter of Nevis Capital Management, LLC, David R. Wilmerding, III and Jon C. Baker*, Investment Advisers Act Release No. 2214 (Feb. 9, 2004); misallocating investment opportunities to the personal account of a hedge fund adviser, to the detriment of the hedge fund, *In the Matter of Zion Capital Management LLC, and Ricky A. Lang*, Investment Advisers Act Release No. 2200 (Dec. 11, 2003); usurping a profitable, low-risk investment opportunity available to a hedge fund and taking it for the personal benefit of a hedge fund adviser, *SEC v. Schwendiman Partners, LLC, Gary Schwendiman, and Todd G. Schwendiman*, Investment Advisers Act Release No. 2043 (July 11, 2002); and causing hedge funds to pay commissions to a broker that had no role in executing trades, as reward for referring investors to the adviser's hedge funds, *In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses*, supra note 41. We have no reason to believe that unregistered advisers may not be perpetrating the same types of frauds, beyond our detection.

Improper valuation of hedge fund assets by hedge fund advisers is a matter of serious concern to us. A recent study of hedge funds identified valuation problems as playing a primary or contributing role in 35 percent of hedge fund failures, and fraud as the underlying cause for more than half of them.<sup>82</sup> The authors attribute these

*House, and Brandon R. Moore*, supra note 76; *SEC v. Evelyn Litwok & Dalia Eilat*, supra note 76; *SEC v. Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla*, supra note 40.

<sup>80</sup> *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, supra note 76; *SEC v. David M. Mobley, Sr., et al.*, supra note 40; *SEC v. Edward Thomas Jung, et al.*, supra note 40; *SEC v. Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla*, supra note 40.

<sup>81</sup> *SEC v. Global Money Management, L.P.*, Litigation Release No. 18666 (Apr. 12, 2004); *SEC v. Burton G. Friedlander*, supra note 77; *SEC v. Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC*, supra note 40; *SEC v. David M. Mobley, Sr., et al.*, supra note 40; *SEC v. Beacon Hill Asset Management LLC, et al.*, supra note 40; *SEC v. Edward Thomas Jung, et al.*, supra note 40; *In the Matter of Charles K. Seavey and Alexander Lushtak*, supra note 78; *In the Matter of Michael T. Higgins*, supra note 78.

<sup>82</sup> Christopher Kundro and Stuart Feffer, *Valuation Issues and Operational Risk in Hedge*

failures, in part, to a lack of regulatory oversight: "Put these natural, inherent difficulties in pricing complex or illiquid investments [in which hedge funds invest] together with a powerful financial incentive [on the part of the adviser] to show (or hide weak) performance, and then situate these factors in an environment with minimal regulatory oversight, or without strict discipline and internal controls (still far too typical in the hedge fund industry), and there is potential for trouble."<sup>83</sup>

Valuation problems arise in many cases when hedge fund advisers overstate assets in order to cover trading losses or to "buy time" until performance improves.<sup>84</sup> Registered investment advisers are not required to follow any particular valuation methodology, but our examiners consider whether the adviser's procedures for valuing the managed assets are effective, whether the adviser's actual practices in valuing client assets follow the procedures they have established, and how the adviser discloses, mitigates and manages the conflicts of interest that can arise with respect to valuation.<sup>85</sup>

### 3. Keeping Unfit Persons From Using Hedge Funds To Perpetrate Frauds

Registration with the Commission permits us to screen individuals associated with the adviser, and to deny registration if they have been convicted of a felony or had a disciplinary record subjecting them to disqualification.<sup>86</sup>

*Funds*, Capco White Paper (Dec. 2003) (valuation problems played a role in 35 percent of studied hedge fund failures, and 57 percent of those valuation problems were caused by fraud or misrepresentation) (available at <http://www.capco.com/pdf/j10art06.pdf>) (visited on July 12, 2004). See also *Proceed With Caution*, Investment Adviser, Apr. 12, 2004 ("Unreliable pricing of securities in a hedge fund manager's portfolio remains the single most significant cause of blow-ups in the industry \* \* \*"); Mara Der Hovanesian, *Hedge Fund Values: Stop the Fudging*, *BusinessWeek*, May 10, 2004, at 106.

<sup>83</sup> Kundro & Feffer, supra note 82 at 4.

<sup>84</sup> See, e.g., *SEC v. Michael W. Berger, Manhattan Capital Management Inc.*, supra note 40; *SEC v. Edward Thomas Jung, et al.*, supra note 40.

<sup>85</sup> *Examinations of Investment Companies and Investment Advisers*, SEC Staff Report (Mar. 2004) at 19, available at <http://www.sec.gov/news/extra/apx-ts031004lar.pdf>. One simple check our examiners perform is to determine the extent to which the sale price of fund securities deviates substantially from the price at which the securities are valued.

<sup>86</sup> See, e.g., *SEC v. J. Scott Eskind*, supra note 79 (Eskind, already barred by the Commission from association with any investment adviser, raised more than \$3 million from investors for a purported hedge fund, and simply misappropriated it); *SEC v. Sanjay Saxena*, Litigation Release No. 16206 (July 8, 1999) (Saxena, already barred by the Commission from the securities industry, defrauded fund investors of approximately \$700,000). Item 11 of

Continued

Several of the hedge fund frauds appear to have been perpetrated by unscrupulous persons using the hedge fund as a vehicle to defraud investors. These persons appear to never have intended to establish a legitimate hedge fund, but used the allure of a hedge fund to attract their “marks.”<sup>87</sup>

We are concerned that these individuals may have been attracted to hedge funds because they could operate without regulatory scrutiny of their past activities. Our lack of oversight may have contributed to the belief that their frauds would not be exposed. Our ability to screen individuals and, in some cases, to block their entrance into the advisory profession should serve to discourage unscrupulous persons from using hedge funds as vehicles for fraud.<sup>88</sup>

#### 4. Adoption of Compliance Controls

Registration under the Advisers Act would require hedge fund advisers to adopt policies and procedures designed to prevent violation of the Advisers Act, and to designate a chief compliance officer.<sup>89</sup> Because our examination staff resources are limited, we cannot be at the office of every adviser at all times. Compliance officers serve as the front line watch for violations of securities

Part 1 of Form ADV requires applicants for registration as an investment adviser to report felonies and other disciplinary events occurring during the last 10 years. Section 203(c)(2) of the Advisers Act [15 U.S.C. 80b-3(c)(2)] permits the Commission, after notice and opportunity for a hearing, to deny registration to an adviser that is subject to disqualification under Section 203(e) [15 U.S.C. 80b-3(e)]. The Commission's screening does not rely exclusively on an applicant's self-reporting of violations; our staff checks applicants against a large database of securities violators to determine whether there are any unreported disciplinary events.

<sup>87</sup> *SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee*, supra note 76 (defendants raised nearly half a million dollars, the majority of which were simply misappropriated by Jean Pierre); *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, supra note 76 (Chabot raised over \$1.2 million for an alleged hedge fund but did not buy any stocks or other securities with the funds, instead using the money for his personal expenses).

<sup>88</sup> We acknowledge that many new sponsors of hedge funds may not have \$25 million of assets under management and thus may not be required to register with us. See section 203A(a)(1) of the Act [15 U.S.C. 80b-3a(a)(1)] (prohibiting certain advisers having less than \$25 million from registering with the Commission). It is likely that if we adopt this rule, prospective investors will insist that hedge fund advisers be registered with the Commission. These advisers will apply for registration pursuant to our rule 203A-2(d) [17 CFR 275.203A-2(d)], which permits an adviser with less than \$25 million of assets under management to register with us if the adviser has a reasonable expectation that it will be eligible to register within 120 days.

<sup>89</sup> Rule 206(4)-7 [17 CFR 275.206(4)-7].

laws, and provide protection against conflicts of interests.

Hedge fund advisers have substantial conflicts of interest, both with their hedge funds and with their investors. These conflicts arise from management strategies, fee structures, use of fund brokerage and other aspects of hedge fund management. To protect against the adverse consequences of these conflicts, a hedge fund adviser must make compliance considerations a part of its business plan. While the 2003 Hedge Fund Staff Report indicated that many unregistered hedge fund managers had strong compliance controls, others had very informal procedures that appeared to be inadequate for the amount of assets under their management.<sup>90</sup> Application of our recent rule requiring more formalized compliance policies administered by an employee designated as a chief compliance officer should serve to better protect hedge fund investors.<sup>91</sup>

#### 5. Limitation on Retailization

Registration under the Advisers Act would have the salutary effect of requiring all direct investors in most hedge funds to meet minimum standards of rule 205-3 under the Advisers Act.<sup>92</sup> Rule 205-3 requires that each investor generally have a net worth of at least \$1.5 million or have at least \$750,000 of assets under management with the adviser.<sup>93</sup> Many hedge fund advisers will rely on rule 205-3 to continue charging a “performance fee” to the funds they manage.

#### 6. Imposition of Minimal Burdens

While it furthers these five important objectives, registration under the Advisers Act would meet another important objective of the Commission

<sup>90</sup> See section VII.A.1.b. of the 2003 Staff Hedge Fund Report, supra note 32.

<sup>91</sup> See *Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)].

<sup>92</sup> Most hedge fund advisers charge performance fees. Rule 205-3 permits registered investment advisers to charge performance fees only to “qualified clients” that have a net worth of at least \$1.5 million or have at least \$750,000 of assets under management with the adviser.

<sup>93</sup> Hedge funds in the United States are generally organized to avoid regulation under the Investment Company Act by qualifying for an exemption under section 3(c)(1) or 3(c)(7) of that Act. There are no performance fee restrictions on 3(c)(7) funds, but each investor in the fund must be a “qualified purchaser,” which for natural persons generally means having investments of at least \$5 million. See section 2(a)(51) of the Investment Company Act [15 U.S.C. 80a-2(a)(51)]. Rule 205-3 requires that each advisory client subject to a performance fee have \$1.5 million in net worth or \$750,000 under management with the investment adviser, and requires advisers to 3(c)(1) funds to consider each investor as a client.

by imposing only minimal additional burdens on hedge fund advisers. As we discussed above, the Act does not require or prohibit an adviser to follow any particular investment strategies, nor does it require or prohibit specific investments. Its most significant provision, which requires full disclosure of conflicts of interest and prohibits fraud against clients, applies regardless of whether the adviser is registered under the Act.<sup>94</sup>

Many advisers registered with us today currently advise hedge funds,<sup>95</sup> and none has reported to us that registration made their hedge funds less competitive with other hedge funds.<sup>96</sup> Although some panelists on our Roundtable argued against requiring hedge fund advisers to register under the Act, none identified any impediment under the Advisers Act to managing a hedge fund.<sup>97</sup> Thus, registration under the Advisers Act should not interfere with the important functions that hedge funds play in our financial markets.

We request comment on the burdens our proposal would impose, and whether those burdens could be alleviated in some manner that also meets our objectives in proposing these rules.

<sup>94</sup> The antifraud prohibitions of section 206 [15 U.S.C. 80b-6], including provisions restricting an adviser's ability to engage in principal trades and agency cross-transactions with clients, apply to any investment adviser that makes use of the mails or any means of interstate commerce. In contrast, section 204 (authorizing the Commission to require advisers to issue reports and maintain books and records) applies to all advisers other than those specifically exempted from registration by section 203(b) of the Act.

<sup>95</sup> Our data show that as of May 1, 2004 1,912 advisers reported in their Form ADVs that they provide advice to pooled investment vehicles other than investment companies, pension and profit sharing plans. Our staff's inspection experience indicates that a large percentage of these pools are hedge funds or funds of hedge funds.

<sup>96</sup> Five of the ten world's largest hedge fund managers (ranked by total assets under management) are currently registered with us. See *The Hedge Fund 100*, Institutional Investor (May 2004).

<sup>97</sup> In the past, hedge fund industry participants cited the restrictions on registered advisers charging performance-based compensation in section 205(a)(1) of the Act [15 U.S.C. 80b-5(a)(1)] as being incompatible with the operation of hedge funds. See *Hard Times Come to the Hedge Funds*, supra note 21; Lawrence J. Berkowitz, *Regulation of Hedge Funds*, 2 Rev. of Securities Reg. (Jan. 17, 1969). In 1998, however, the Commission eliminated this concern by adopting amendments to rule 205-3. *Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Investment Advisers Act Release No. 1731 (July 15, 1998) [63 FR 39022 (July 21, 1998)]. No hedge fund industry participant with whom our staff spoke indicated that section 205 or the qualified client criteria in rule 205-3 present any concerns to hedge funds. See Section II. G. of this Release.

- Many hedge fund advisers voluntarily register under the Advisers Act in order to meet client needs or requirements.<sup>98</sup> We infer from these decisions that, in practice, advisers do not consider registration burdensome. Is this inference warranted?

- We specifically request comment from hedge fund advisers that are registered under the Act. Do they believe that registration has imposed undue burdens on them? Has registration impaired their ability to compete for investors with other hedge fund managers? Has registration affected their choices of management strategies or investments?

- Recently, we amended our rule governing the safekeeping of client assets by advisers that have custody of those assets.<sup>99</sup> Those rule amendments specifically accommodated the needs of hedge fund advisers,<sup>100</sup> which usually have custody of client assets.<sup>101</sup> Are there similar accommodations that could be made to other of our rules or forms that might make them work better for hedge fund advisers? Are there changes that should be made to our other rules or forms to tailor them to advisers to hedge funds? Should we further narrow or expand any of them when applied to hedge fund advisers? If so, how?

- Some have suggested that hedge fund advisers may move their operations offshore, *i.e.*, to other countries, in order to avoid registration under the Advisers Act.<sup>102</sup> Is that a likely result? Under the proposed rule, which we describe below, an adviser would not only have to persuade valuable employees to live abroad, it would also have to forgo capital from U.S. investors.<sup>103</sup>

<sup>98</sup> See Jeff Benjamin, *Oversight Concerns Aren't Registering With Hedge Funds*, InvestmentNews, Apr. 19, 2004 (between 30 percent and 50 percent of all U.S.-based hedge fund managers are already registered as investment advisers).

<sup>99</sup> See *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2176 (Sept. 25, 2003) [68 FR 56692 (Oct. 1, 2003)].

<sup>100</sup> See rule 206(4)–2(b)(3). We are proposing additional amendments to accommodate advisers to funds of hedge funds. See Section II. H. of this Release.

<sup>101</sup> Our custody rule makes it clear that an adviser acting as general partner to a pooled investment vehicle it manages has custody of the pool's assets. Rule 206(4)–2(c)(1)(iii).

<sup>102</sup> See *Letter from John G. Gaine, Managed Funds Association, to William Donaldson, Chairman, U.S. Securities and Exchange Commission* (Nov. 21, 2003), available in File No. S7–30–04. Managed Funds Association raised the concern that “the burdens associated with mandatory registration might lead certain hedge fund advisers to relocate offshore, making existing regulation less effective.”

<sup>103</sup> Under rule 203(b)(3)–1(b)(5), an adviser with its principal place of business in another country

- Many of the advisers registered with us are smaller firms with less than \$50 million of assets under management.<sup>104</sup> Many of them are likely to have markedly less cash flow than hedge fund advisers, many of which have a substantial amount of assets under management and charge a customary fee of one to two percent of assets plus 20 percent of gains.<sup>105</sup> We infer from this that the Advisers Act does not impose an undue burden on smaller advisory firms, and that hedge fund advisers are in a position to bear that burden. Is our inference warranted? We request comment on this question particularly from smaller firms such as financial planners.

## 7. CFTC Regulation

Some have argued that registering hedge fund advisers under the Advisers Act is unnecessary because many may already be registered with the Commodity Futures Trading Commission (“CFTC”) as commodity pool operators (“CPOs”) and examined by the National Futures Association (“NFA”), a self-regulatory organization.<sup>106</sup> These examinations, however, necessarily focus more on the area of futures trading—that is, the activities of most concern to the CFTC and NFA.<sup>107</sup> Moreover, the CFTC is withdrawing its oversight of certain hedge fund advisers. The CFTC recently adopted rules that may permit most hedge fund advisers to now avoid

must count each U.S. client to determine whether it is eligible for the private adviser exemption. Thus, under the proposed rule, a hedge fund adviser could not admit more than 14 U.S. residents into its hedge funds. At least one hedge fund consultant has suggested that for this reason hedge fund advisers are unlikely to move offshore. Ron Orol, *Firmly Rooted*, Daily Deal, July 14, 2003 (citing Arthur Bell of Arthur Bell & Associates as stating that U.S. investors would be “virtually impossible to replace”).

<sup>104</sup> As of May 1, 2004, of the 8,275 advisers registered with the Commission, 2,640 reported on their Form ADV that they were managing less than \$50 million in client assets.

<sup>105</sup> See 2003 Staff Hedge Fund Report, *supra* note 32, at ix.

<sup>106</sup> Roundtable Transcript of May 14 at 279 (statement of Anthony Artabane, Partner, Pricewaterhouse Coopers, LLP) (regulation should not be overlapping); Roundtable Transcript of May 15 at 144 (statement of Patrick J. McCarty, General Counsel, Commodity Futures Trading Commission) (to the extent the hedge fund adviser is registered with CFTC as a CPO or CTA, there is no need for SEC registration), and 231 (statement of Armando Belly, General Counsel, Soros Fund Management, LLC) (SEC registration is not worthwhile if the firm is already registered with the CFTC).

<sup>107</sup> Roundtable Transcript of May 15 at 236–37 (statement of Jane Thorpe that “NFA certainly has the ability to go in and inspect vehicles that may not directly be trading in futures but based on a risk-based approach is going to focus on those areas that obviously it has the most and we have the most interest in.”).

registering as CPOs or commodity trading advisors (“CTAs”).<sup>108</sup> New entrants to the industry have an opportunity to structure their activities so as to avoid CFTC registration, and existing hedge fund advisers may deregister with the CFTC.<sup>109</sup>

## 8. Proper Administration of the Advisers Act

As we discussed above, many hedge fund advisers currently avoid registration under the Advisers Act by qualifying for the “private adviser” exemption that section 203(b)(3) provides to advisers that have had fourteen or fewer clients during the preceding twelve months and that do not hold themselves out generally to the public as investment advisers. The Act does not define the term “client,” and for many years it was unclear whether the Act required an adviser that served as a general partner to a limited partnership holding investment securities to count each limited partner as a client, because the pooled investment vehicle served primarily as a vehicle through which the adviser/general partner provided investment advice.<sup>110</sup> If advisers to hedge funds

<sup>108</sup> *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisers; Past Performance Issues* (Aug. 1, 2003) [68 FR 47221 (Aug. 8, 2003)] (“CFTC 2003 Exemptive Release”) (adopting new rule 4.13(a)(3), which exempts CPOs from registration if the pool is sold only to accredited investors and engages in limited trading of commodity interests, new rule 4.13(a)(4), which exempts CPOs from registration if the pool is offered only to persons reasonably believed to be “qualified eligible persons,” and new rule 4.14(a)(10), which exempts CTAs who during the preceding 12 months provide advice to fewer than 15 legal entities).

<sup>109</sup> See Susan Ervin, *Downsizing Commodity Pool Regulation: The CFTC's New Initiative*, Futures Industry 36 (May/June 2003) (The CFTC has embarked upon a fundamental change in its regulatory program, which would free very sizable portions of the industry from CFTC regulation. Many new entrants would not need to register with the CFTC and many currently registered persons may elect to withdraw from registration.).

We are not, however, seeking to require Advisers Act registration of hedge fund advisers whose business consists primarily of advising others with respect to investments in futures. Hedge fund advisers that are registered as CTAs with the CFTC may qualify for a separate exemption from SEC registration if their business does not consist primarily of acting as an investment adviser. See section 203(b)(6) of the Advisers Act.

<sup>110</sup> See Robert C. Hacker and Ronald D. Rotunda, *SEC Registration of Private Partnerships after Abrahamson v. Fleschner*, 78 Colum. L. Rev. 1471, 1478 (1978). It was also unclear whether the general partner was an adviser who gave advice to “others” within the meaning of section 202(a)(11) of the Act. That issue was resolved by the Second Circuit in *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978), which held that general partners of limited partnerships investing in securities were investment advisers.

were viewed as providing investment advice to one client—the fund—then they would not be required to register under the Act (assuming they advised no more than fourteen funds and did not hold themselves out to the public as investment advisers). If they were viewed as advising each partner of a partnership having more than fourteen partners, they would be required to register (assuming no other exemption were available).

In 1985, the Commission addressed this issue by adopting rule 203(b)(3)–1, which permits an adviser to treat a limited partnership as the “client” for purposes of the private adviser exemption if, among other things, the advice provided to the limited partnership is based on the investment objectives of the partnership rather than those of the various limited partners.<sup>111</sup> When we adopted rule 203(b)(3)–1, we concluded that when an adviser manages a group of client accounts on the basis of the investment objectives of the pool, it would be appropriate to view the pool (rather than each participant in the pool) as the client.<sup>112</sup>

The Second Circuit originally characterized the individual limited partners as the “clients” of the general partner, (1976–77) Fed. Sec. L. Rep. (CCH) ¶ 95,889, at 91,282 n. 16, but later withdrew this characterization, 568 F. 2d at 872 n. 16, leaving unanswered the issue of whether the partnership, or each of the partners, should be counted as a client. See *Definition of “Client” of an Investment Adviser for Certain Purposes Relating to Limited Partnerships*, Investment Advisers Act Release No. 956 (Feb. 25, 1985) [50 FR 8740 (Mar. 5 1985)]. See also Hacker and Rotunda, *supra*, at 1484.

<sup>111</sup> See *Definition of “Client” of an Investment Adviser for Certain Purposes Relating to Limited Partnerships*, Investment Advisers Act Release No. 983 (July 12, 1985) [50 FR 29206 (July 18, 1985)]. In 1997, we expanded the rule to cover other types of legal entities that advisers use to pool client assets. See *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)]. Under rule 203(b)(3)–1(a)(2)(i), an investment adviser may count a legal organization as a single client so long as the investment advice is provided based on the objectives of the legal organization rather than the individual investment objectives of any owner of the legal organization.

<sup>112</sup> See *Definition of “Client” of an Investment Adviser for Certain Purposes Relating to Limited Partnerships*, *supra* note 111. In other circumstances, we look through pools to the investors themselves in specifying advisers’ obligations under the Advisers Act. See, e.g., rule 205–3(b) (requiring each investor in a private investment company to meet qualified client criteria if the adviser charges the private investment company a performance fee); rule 206(4)–2(a)(3)(iii) (requiring that custody account statements for funds and securities of limited partnerships for which the adviser acts as general partner be delivered to each limited partner); *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Investment Advisers Act Release No. 1862 (Apr. 5, 2000) [65 FR 20524 (Apr. 17, 2000)] at n.117 and accompanying text (clarifying that an adviser acting as general partner of a limited partnership must provide Form ADV disclosures to each limited partner).

We acknowledged, however, that a different approach could be followed.<sup>113</sup>

But since 1985, circumstances have changed. Hedge fund assets have continued to grow,<sup>114</sup> the number of hedge funds has increased, the types of investors have changed and funds of hedge funds have emerged. Moreover, this growth has occurred in an environment where hedge fund advisers have not been required to register. Commensurate with this growth, fraud in the hedge fund industry has increased. It is clear that the implications of our 1985 decision have also grown. Today, advisers to hedge funds manage multiple hedge funds having hundreds of investors, and tens of millions of dollars of assets, without registering with the Commission. We are concerned that rule 203(b)(3)–1 may no longer be consistent with the underlying purposes of section 203(b)(3), which, as we noted above, seems intended to exempt from registration advisers that have only a few clients and whose clients are likely to be friends, associates or family members.<sup>115</sup>

In 1996, Congress amended the Advisers Act to allocate regulatory responsibility over advisers between the SEC and state regulatory authorities.<sup>116</sup> In doing so, Congress established a

<sup>113</sup> See *Definition of “Client” of an Investment Adviser for Certain Purposes Relating to Limited Partnerships*, *supra* note 111. Until recently, the CFTC interpreted a similar provision of the Commodities Exchange Act (“CEA”) to require a commodity trading advisor to register by “looking through” a client that was not a natural person, e.g., a limited partnership, to count the number of participants. Section 4m(1) of the CEA provides an exemption from registration for a commodity trading advisor that has not furnished commodity trading advice to more than 15 persons during the preceding 12 months and does not hold itself out to the public as a commodity trading advisor. When queried about its interpretation of “person” in the context of non-natural persons, the CFTC historically took the position that a commodity trading advisor providing advice to such entities would look through and count the individual participants for purposes of tabulating the number of persons it advises. See, e.g., CFTC Interpretive Letter 95–39 (Dec. 5, 1994) (each partner in a limited partnership counts as a person) and CFTC Interpretive Letter 96–43 (May 15, 1996) (each shareholder in a corporation counts as a person). In 2003, the CFTC adopted new rule 4.14(a)(10) [17 CFR 4.14(a)(10)] that reversed its look-through interpretation by permitting commodity trading advisors to count legal entities, such as corporations or limited partnerships, as a single person. The rule is patterned after Advisers Act rule 203(b)(3)–1, and in the adopting release the CFTC confirmed that “it intends to follow interpretations of rule 203(b)(3)–1 issued by the SEC and its staff.” See CFTC 2003 Exemptive Release, *supra* note 91.

<sup>114</sup> See *supra* notes 33 and 34.

<sup>115</sup> See *supra* note 17.

<sup>116</sup> Pub. L. No. 104–290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code). Hedge fund advisers that avail themselves of the registration exemption under section 203(b)(3) may nevertheless be required to register as investment advisers with one or more states.

threshold for federal interest in advisers by requiring advisers to register with the Commission (unless they were otherwise exempt) if they have more than \$25 million of assets under management.<sup>117</sup> While such a later amendment of the Act would not serve to expand or contract the scope of section 203(b)(3),<sup>118</sup> we believe it should inform our administration of the section. In this regard, rule 203(b)(3)–1 may provide too broad a safe harbor in light of the 1996 Congressional determination that there is a federal interest in the oversight of advisers that manage significant amounts of client assets.

In suggesting this conclusion, we are mindful of section 208(d) of the Act, which prohibits advisers from doing indirectly, or through or by another person, what they are prohibited from doing directly.<sup>119</sup> Rule 203(b)(3)–1 may thus be viewed to permit advisers to manage assets for more than fourteen clients “through or by” a hedge fund and remain unregistered.

### C. Proposed Rule 203(b)(3)–2

Proposed rule 203(b)(3)–2 would require investment advisers to count each owner of a “private fund” as a client for purposes of determining the availability of the private adviser exemption of section 203(b)(3) of the Act. As a result, an adviser to a “private fund,” which is defined in the rule and discussed below, could no longer rely on the private adviser exemption if the adviser, during the course of the preceding twelve months, advised a private fund that had more than fourteen investors. And an adviser that advised individual clients directly would have to count those clients together with the investors in any private fund it advised in determining its total number of clients.

### 1. Minimum Assets Under Management

The new rule would not alter the minimum assets under management that an investment adviser must have in order to be eligible to register with the

<sup>117</sup> Section 203A of the Advisers Act [15 U.S.C. 80b–3A].

<sup>118</sup> See *Capital Gains*, *supra* note 7, at 286–87 (declining to narrow construction of the Advisers Act as adopted in 1940 by reference to amendments enacted in 1960, stating “[o]pinions attributed to a Congress twenty years after the event cannot be considered evidence of the Congress of 1940.” (internal citations omitted)).

<sup>119</sup> 15 U.S.C. 80b–8(d). We note that neither the Advisers Act nor the Commission’s 1985 release (see *supra* note 111), in our view, should be construed to provide an exemption for an adviser with greater than 14 clients merely because the adviser did not provide individualized advice to each of those clients.

Commission.<sup>120</sup> Thus, hedge fund advisers with assets under management of less than \$25 million would continue generally not to be eligible for Commission registration (unless they also advise a registered investment company or qualify for registration under one of our exemptive rules).<sup>121</sup> Hedge fund advisers with assets under management between \$25 and \$30 million would be eligible, but not required, to register with the Commission.<sup>122</sup>

- We request comment on the applicability of the minimum asset thresholds to hedge fund advisers. Should they be higher? Should they be lower given that some of the frauds we have uncovered involved hedge fund advisers that never had \$25 million of assets under management?<sup>123</sup>

## 2. Funds of Hedge Funds

The new rule would contain a special provision for advisers to hedge funds in which a registered investment company invests.<sup>124</sup> Hedge fund advisers would be required to count the investors in the registered fund as clients.<sup>125</sup> Without this provision, a hedge fund adviser could provide its services to thousands of mutual fund investors through fourteen or fewer mutual funds, each of which could invest in the private fund, and each of which would count as a single client.

- We request comment on our “look through” approach with respect to registered investment companies

<sup>120</sup> See section 203A(a)(1)(A). The National Securities Markets Improvement Act of 1996 amended the Advisers Act to divide the responsibility for regulating investment advisers between the Commission and the state securities authorities. Section 203A of the Advisers Act effects this division by generally prohibiting investment advisers from registering with us unless they have at least \$25 million of assets under management or advise a registered investment company, and preempting most state regulatory requirements with respect to SEC-registered advisers. See Pub. L. 104–290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

<sup>121</sup> See rule 203A–2 [17 CFR 275.203A–2].

<sup>122</sup> See rule 203A–1 [17 CFR 275.203A–1].

<sup>123</sup> See *Securities and Exchange Commission v. J. Scott Eskin, Lorus Investments, Inc., and Capital Management Fund, Limited Partnership*, supra note 79; *SEC v. Hoover and Hoover Capital Management, Inc.*, supra note 42.

<sup>124</sup> Proposed rule 203(b)(3)–2(b).

<sup>125</sup> An adviser to a fund underlying an unregistered fund of hedge funds would also count the investors in the top-tier fund as clients. However, where the top-tier fund is itself a “private fund” under the rule, the general provisions of the rule would compel looking through the top-tier fund and no special provision is needed. Our proposal would not require the adviser to the underlying fund to receive information as to the precise number or identities of the top-tier investors—it would be sufficient if the adviser to the top-tier fund confirms to the underlying adviser that the top-tier fund has more than 14 owners.

investing in hedge funds. Are its terms clear?

- Have we provided detailed enough guidance on how advisers should count clients? Or, are there points on which further guidance is needed?

## 3. Offshore Advisers

a. *Counting Clients of Offshore Advisers.* The proposal would require hedge fund advisers located offshore to look through the funds they manage, whether or not those funds are also located offshore, and count investors that are U.S. residents as clients. An adviser to any hedge fund that, in the course of the previous twelve months, has more than fourteen investors (or other advisory clients) that are U.S. residents would generally have to register under the Advisers Act.<sup>126</sup> Offshore advisers to hedge funds would, therefore, be treated in the same manner as any other type of offshore adviser providing advice to U.S. residents.<sup>127</sup>

- Should offshore advisers be required to look through their offshore funds only if assets attributable to U.S. residents comprise more than a threshold percentage? If we impose a threshold, what should it be? Should the threshold apply to the cumulative assets of all offshore funds advised by the offshore adviser?

- Would registration present difficulties for offshore advisers because of conflicts with the laws of their home jurisdiction?<sup>128</sup> Approximately 350 non-U.S. advisers are currently

<sup>126</sup> Rule 203(b)(3)–1(b)(5) (adviser with principal place of business not in the United States need count only clients that are U.S. residents). The offshore adviser would not have to register, however, if it were eligible for some other exemption from registration. Absent the availability of an exemption, offshore advisers would be required to register regardless of the amount of assets managed by the adviser because the \$25 million threshold does not apply to an adviser that does not have its principal place of business in the United States. See *Rules Implementing Amendments to the Investment Advisers Act of 1940*, supra note 111, at section II.E.

<sup>127</sup> See supra note 126.

<sup>128</sup> According to one law firm’s analysis, registration under the Advisers Act would have little impact on most non-U.S. hedge fund managers: “For unregistered non-U.S. investment managers, it is likely that the impact will be less significant because in most jurisdictions where hedge fund managers are concentrated, including, for example, London, Paris and Frankfurt and other European Union jurisdictions, management of third party assets is generally an activity which requires registration with local regulators and ongoing compliance with minimum operational standards, regardless of the number of ‘clients’ for whom these services are provided. It is likely therefore that most major non-U.S. hedge fund managers that will be affected by the SEC’s recommendations will already be complying in their home jurisdictions with broadly similar requirements to those the Staff now seeks to impose.” See Shearman & Sterling, *SEC Report: Implications of the Growth of Hedge Funds*, Jan. 2004, available in File No. S7–30–04.

registered with us, and we are unaware of any conflicts that create problems for those dual registrants. Do offshore hedge fund advisers present different concerns or face different burdens? If so, what are they and how should we address them?

b. *Advisers to Offshore Publicly Offered Funds.* We do not want to require advisers to offshore publicly offered mutual funds or closed-end funds to register with us simply because more than fourteen of their investors are now resident in the United States.<sup>129</sup> Therefore, we have included in the proposed rule an exception to the definition of “private fund” for a company that has its principal office and place of business outside the United States, makes a public offering of its securities outside the United States, and is regulated as a public investment company under the laws of a country other than the United States.<sup>130</sup>

- Is the scope of this exception too broad or too narrow?

- Are there any other types of companies or entities that need to be included in the exception?

- Is there a significant concern that some hedge fund advisers would seek to use this exception to evade the requirements of the Act?

- Hedge funds may be offered publicly in some countries. Would our proposed rule exempt these hedge funds from the definition of “private fund”? Should it?

c. *Advisers to Offshore Private Funds.* We are also proposing to limit the extraterritorial application of the Advisers Act that would otherwise occur as a result of these amendments. We do not apply most of the substantive provisions of the Act to the non-U.S. clients of an offshore adviser.<sup>131</sup> As a result, offshore advisers registered with us must, for example, comply with our rules regarding the safekeeping of client assets only with respect to assets of their

<sup>129</sup> Section 7(d) of the Investment Company Act [15 U.S.C. 80a–7(d)] generally prohibits an unregistered foreign investment company from publicly offering its securities in the United States. That provision does not preclude unregistered foreign investment companies from making private offerings in the United States. *Resale of Restricted Securities*, Investment Company Act Release No. 17452 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)]. Nor does it prevent U.S. persons from being shareholders of foreign investment companies as a result of, for example, relocating to the United States. See, e.g., *Investment Funds Institute of Canada*, SEC Staff No-Action Letter (Mar. 4, 1996).

<sup>130</sup> 130 Proposed rule 203(b)(3)–2(d)(3).

<sup>131</sup> This policy was first set forth in a staff letter from our Division of Investment Management, in which Division staff stated that they would not recommend to the Commission enforcement action against an offshore fund adviser under such circumstances. See *Uniao de Banco de Brasileiros S.A.*, SEC Staff No-Action Letter (July 28, 1992) (“Unibanco letter”).

U.S. clients.<sup>132</sup> If those client assets are pooled and held, for example, in a hedge fund, our custody rule would, as a practical matter, require the adviser to meet many of the requirements of the rule with respect to all assets of the fund even if most of the fund investors are not U.S. residents.

It is not uncommon for U.S. investors to acquire interests in an offshore hedge fund that has few connections to the United States other than the investors (or the securities in which they invest). The laws governing such a fund would likely be those of the country in which it is organized or those of the country in which the adviser has its principal place of business. U.S. investors in such a fund generally would not have reasons to expect the full protection of the U.S. securities laws.<sup>133</sup> Moreover, as a practical matter, they may be precluded from an investment opportunity in offshore funds if their participation resulted in the full application of the Advisers Act and our rules.

Therefore, we propose to permit an offshore adviser to an offshore fund to treat the fund as its client (and not the investors) for all purposes under the Act, other than (i) determining the availability of the private adviser exemption (section 203(b)(3)), and (ii) those provisions prohibiting fraud (sections 206(1) and 206(2)).<sup>134</sup> Such an adviser would register with us, but because the fund would not be a U.S. client, most of the substantive provisions of the Advisers Act would not apply to the adviser's dealings with the fund or other of its non-U.S. clients.<sup>135</sup> We request comment on this provision.

- Is this exception a reasonable limitation on the extraterritorial application of the Advisers Act?
- Is there a significant concern that some U.S. hedge fund advisers would seek to use this exception to evade the requirements of the Act? An unregistered adviser could not establish a shell subsidiary in a foreign country through which to manage offshore hedge funds without violating section 208(d) of the Act, which prohibits any person from doing indirectly, or through or by any other person, anything it would be unlawful for the person to do

<sup>132</sup> Rule 206(4)–2.

<sup>133</sup> See *Offshore Offers and Sales*, Securities Act Release No. 6863 (Apr. 24, 1990) [55 FR 18306 (May 2, 1990)].

<sup>134</sup> Proposed rule 203(b)(3)–2(c). Because the fund would not be a U.S. client of the adviser, the substantive provisions of the Act generally would not apply to the adviser's dealings with the fund under general principles first outlined in the Unibanco letter, *supra* note 131.

<sup>135</sup> See *supra* note 134.

directly.<sup>136</sup> Are there other means of evading the requirements of the Act that ought to concern us?

- Would it be sufficient to warn advisers seeking to circumvent the substantive provisions of the rule of the potential applicability of section 208(d)?
- As proposed, this exception would apply to an offshore adviser that advised an offshore hedge fund owned entirely by U.S. residents. Should we apply the substantive provisions of the Act to such an adviser? Should the exception be available to advisers only with respect to private funds owned primarily by non-U.S. residents?<sup>137</sup> If so, what should be the appropriate threshold?

#### D. Definition of “Private Fund”

Advisers have many types of clients, some of which may be legal organizations such as trusts, partnerships, or corporations that have beneficial owners, *e.g.*, beneficiaries, limited partners, or shareholders. It would not serve the purpose of this regulatory initiative or of the Act if we were to require advisers to “look through” each and every business or other legal organization they advised for purposes of determining the availability of the “private adviser” exemption. To identify those legal organizations whose advisers would be required to look through, the rule would contain a definition of “private fund.”

Our rule would define a “private fund” by reference to three characteristics shared by virtually all hedge funds. First, the private fund would be limited to a company that would be subject to regulation under the Investment Company Act of 1940 (the “Investment Company Act”) but for the exception provided in either section 3(c)(1) (a “3(c)(1) fund”) or section 3(c)(7) (a “3(c)(7) fund”) of such Act.<sup>138</sup> By limiting the scope of the look-through provision to those entities relying on these two sections of the Investment Company Act, we would exclude advisers to most business organizations, including insurance

<sup>136</sup> See *supra* note 119. See also *Richard Ellis, Inc.*, SEC Staff No-Action Letter (Sept. 17, 1981).

<sup>137</sup> See, *e.g.*, rule 14d–1(c)(1) [17 CFR 240.14(d)(c)(1)] (exempting securities of foreign private issuers from most provisions of the Securities Exchange Act of 1934 [15 U.S.C. 77a–77aa] and rules governing tender offers when U.S. security holders hold 10 percent or less of the subject securities).

<sup>138</sup> Proposed rule 203(b)(3)–2(d)(1)(i). Section 3(c)(1) exempts issuers with fewer than 100 shareholders from the definition of “investment company” under the Investment Company Act and section 3(c)(7) exempts issuers whose shareholders are exclusively “qualified purchasers” from that definition. See section 3(c)(1) and section 3(c)(7) of the Investment Company Act.

companies, broker-dealers, and banks, and include advisers to many types of pooled investment vehicles investing in securities, including hedge funds.<sup>139</sup>

Second, a company would be a private fund only if it permits investors to redeem their interests in the fund (*i.e.*, sell them back to the fund) within two years of purchasing them.<sup>140</sup> Hedge funds typically offer their investors liquidity access following an initial “lock-up” period,<sup>141</sup> and thus most hedge fund advisers would be included within the rules. This “redeemability” requirement would, however, exclude persons who advise private equity funds,<sup>142</sup> venture capital funds,<sup>143</sup> and similar funds that require investors to make long-term commitments of capital. These funds are similar to hedge funds in some respects, but we have not encountered significant enforcement problems with advisers with respect to their management of these types of

<sup>139</sup> It would also exclude, of course, advisers to registered investment companies. This exclusion would, however, have no effect on these advisers, which are not eligible for the private adviser exemption. See section 203(b)(3).

<sup>140</sup> Proposed rule 203(b)(3)–2(d)(1)(ii). Private equity and venture capital funds may offer redemption rights under extraordinary circumstances. These extraordinary redemptions do not change the basic character of the investment pool into a hedge fund. Accordingly, an investment pool could offer redemption rights in extraordinary and unforeseeable situations, such as an owner's death or total disability, or circumstances that make it illegal or impractical for the investor to continue to own the interest in the fund, without becoming a “private fund” under the new rule. Proposed rule 203(b)(3)–2(d)(2)(i). The proposed new rule would also provide an exception to the two-year redemption test for interests acquired with reinvested dividends. Proposed rule 203(b)(3)–2(d)(2)(ii). The two-year redemption test would apply to each investment in the fund, not only the investor's initial investment, and could be used on a “first in, first out” basis.

<sup>141</sup> Hedge funds often offer semi-annual, quarterly, or monthly liquidity terms to their investors. We understand that, because liquidity is important to hedge fund investors, some hedge fund advisers offer certain investors “side letter agreements” to provide shorter liquidity terms than other investors in the same fund may receive. See Alexander M. Ineichen, *Funds of Hedge Funds: Industry Overview*, 4 J. WEALTH MGMT. 47 (Mar. 22, 2002).

<sup>142</sup> Private equity funds concentrate their investments in unregistered (and typically illiquid) securities. Private equity investors typically commit to invest a certain amount of money with the fund over the life of the fund, and make their contributions in response to “capital calls” from the fund's general partner. Private equity funds offer little, if any, opportunity for investors to redeem their investments.

<sup>143</sup> Venture capital funds are generally organized to invest in the start-up or early stages of a company. Venture capital funds have the same features that distinguish private equity funds generally from hedge funds, such as capital contributions over the life of the fund and long-term nature of the investment. A venture capital fund typically seeks to liquidate its investment once the value of the company increases above the value of the investment.

funds. In contrast, the Commission has developed a substantial record of frauds associated with hedge funds. A key element of hedge fund advisers' fraud in most of our recent enforcement cases has been the advisers' misrepresentation of their funds' performance to current investors,<sup>144</sup> which in some cases was used to induce a false sense of security for investors when they might otherwise have exercised their redemption rights. Because hedge funds are where we have seen a recent growth in fraud enforcement actions, that is where we propose to focus our examination resources at this time.

In addition, as the staff discussed in its 2003 Staff Hedge Fund Report, private equity funds typically are long-term investments providing for liquidation at the end of a term specified in the fund's governing documents. They provide for little or no opportunity for investors to redeem their investments,<sup>145</sup> and moreover typically require investors to commit to invest an amount of money over the life of the fund, and make contributions in response to "capital calls." Periodic redemption rights offered by hedge funds, however, provide the hedge fund investors with a level of liquidity that allows the investor to withdraw a portion of his or her assets, controlled by the adviser, or to terminate the relationship with the hedge fund adviser and choose a new adviser. Given the association between these redeemability features and potential abuses that could harm investors in the fund, this element of the private fund definition will help promote the purposes of the Act.

Third, interests in a private fund would be based on the ongoing investment advisory skills, ability or expertise of the investment adviser. In deciding whether to invest in a particular hedge fund, the adviser's history, experience, past performance with this or other client accounts, strategies, and disciplinary record, are likely important to investors, who rely on the adviser for the success of their investment. In that regard, hedge fund advisers emphasize the record of the manager and often provide prospective investors with information about the adviser and individual manager. This

reliance by hedge fund investors implicates the need for the protections that the Advisers Act offers.<sup>146</sup>

Our approach to defining the scope of rule 203(b)(3)-2 is similar to that taken recently by the Department of Treasury in defining the scope of its proposed rule requiring "private investment companies" to adopt anti-money laundering programs.<sup>147</sup> Like the Treasury Department, we have tried to keep the definition simple, and provide a "bright line" indicator of when an adviser must look through a client that is a legal organization. We have avoided alternative approaches that would turn on the nature of the investments made by the pooled investment vehicle because we do not want registration concerns to affect investment decisions of the adviser.

We request comment on the proposal:

- Should we narrow the rule? If so, how?
- Should "private fund" include private equity, venture capital, and other investment pools that are not hedge funds? If so, how should we broaden the rule?
- Do the three characteristics used in the rule effectively distinguish hedge funds from these other types of funds? If not, what specific tests should apply?
- Is two years an appropriate time period for redemptions? If not, should it be longer or shorter, and why?
- Are there any other circumstances prompting redemptions that need to be excepted from the two-year test?

#### E. Amendments to Rule 203(b)(3)-1

We propose to amend rule 203(b)(3)-1 to clarify that investment advisers may not count hedge funds as single clients under that safe harbor. As discussed earlier, many hedge fund advisers have avoided Advisers Act registration by relying on paragraph (a)(2)(i) of this rule, which permits advisers to count a legal organization, rather than its owners, as a single client.<sup>148</sup> New paragraph (b)(6) would make it clear that advisers cannot rely on paragraph (a)(2)(i) with respect to private funds.<sup>149</sup>

#### F. Amendments to Rule 204-2

We are proposing to provide relief from a recordkeeping requirement for

hedge fund advisers that would be required to register with us under new rule 203(b)(3)-2. Under our rules, a registered investment adviser that makes claims concerning its performance "track record" must keep documentation supporting those performance claims.<sup>150</sup> The supporting records must be retained for a period of five years after the performance information is last used.<sup>151</sup> Thus, if a registered adviser promotes its 20-year performance record in 2004, it must continue to keep its supporting records for its 1984 performance through 2009—five years after the last time that 1984 performance is included.

While it is important for our examiners to be able to substantiate an adviser's performance claims, we recognize that hedge fund advisers, like other investment firms, need to communicate their performance history to their clients and prospective clients. We question, however, whether advisers that were not previously subject to our rules will necessarily have retained adequate records from prior periods. It is not our intention to put these new registrants at a competitive disadvantage in promoting the returns they have earned, in some instances over many years. Accordingly, we would require these new registrants to retain whatever records they do have that support the performance they earned prior to their registration with us, but would excuse them from our recordkeeping rule to the extent that those records are incomplete or otherwise do not meet the

<sup>150</sup> Rule 204-2(a)(16) requires registered investment advisers to make and keep "[a]ll accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser); *provided, however*, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph."

<sup>151</sup> Rule 204-2(e)(3) specifies the retention period: "Books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this rule shall be maintained and preserved in an easily accessible place for a period of not less than five years, the first two years in an appropriate office of the investment adviser, from the end of the fiscal year during which the investment adviser last published or otherwise disseminated, directly or indirectly, the notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication."

<sup>144</sup> See, e.g., *SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee*, Litigation Release No. 17303 (Jan. 10, 2002) and *supra* note 76; *In the Matter of Michael T. Higgins*, *supra* note 78; *SEC v. David M. Mobley, Sr., et al.*, Investment Advisers Act Release No. 2131 (May 20, 2003); *SEC v. Michael W. Berger, Manhattan Capital Management Inc.*, *supra* note 40; *SEC v. Todd Hansen and Nicholas Lobue*, Litigation Release No. 17299 (Jan. 9, 2002).

<sup>145</sup> See *supra* note 142.

<sup>146</sup> It is worth noting in this regard that section 203(b)(3) of the Advisers Act specifically excludes an adviser from relying on the exemption, even if it has fewer than 15 clients, if it holds itself out generally to the public as an investment adviser.

<sup>147</sup> See *supra* note 29.

<sup>148</sup> Rule 203(b)(3)-1(a)(2)(i).

<sup>149</sup> We are also proposing non-substantive changes to the wording of the preliminary note and paragraphs (a) (General), (a)(2)(i), (b)(1), (2), (3), (4) and (5), and (c) of rule 203(b)(3)-1 to clarify those sections.

requirements of rule 204–2. Once a hedge fund adviser has registered with us, of course, it must comply with our recordkeeping rule going forward.

We ask comment on this aspect of our proposal.

- Is this exemption necessary? Or, do hedge fund advisers already routinely retain documents substantiating their performance claims that comply with our recordkeeping rules?

We are also proposing an amendment to rule 204–2 clarifying that, for purposes of section 204 of the Advisers Act, the books and records of a hedge fund adviser registered with us include records of the private funds for which the adviser acts as general partner, managing member, or in a similar capacity.<sup>152</sup> Section 204 of the Act generally subjects records of investment advisers to examination by the Commission. To determine whether a hedge fund adviser is meeting its fiduciary obligations to a private fund under the Advisers Act and rules, our examiners require access to all records relating to the adviser's activities with respect to the fund, including records relating to the adviser's service as the fund's general partner. The general partners effectively control all the operations and assets of the hedge fund. Because many hedge fund advisers establish a separate special purpose vehicle to be named as the fund's general partner, the proposed amendment would also cover private funds for which a related person of the adviser (as defined in Form ADV) acts as general partner, managing member, or in a similar capacity.

We ask comment on this aspect of our proposal.

- Is the scope of this provision too narrow or too broad?
- Are there other entities we should include?

#### G. Amendments to Rule 205–3

We are proposing to amend rule 205–3 under the Advisers Act to avoid requiring certain hedge fund investors to divest their current interests in the funds. Most hedge fund advisers charge a fee based on their fund's capital gains or appreciation—a “performance fee.” Rule 205–3 permits registered investment advisers to charge performance fees only to “qualified clients,” and requires the adviser to a 3(c)(1) fund to look through the fund to determine whether all investors are qualified clients.<sup>153</sup> Generally, to be a

qualified client of a registered investment adviser an investor must place at least \$750,000 under that adviser's management or have a net worth of \$1.5 million.<sup>154</sup> While many hedge fund advisers place these or even more stringent requirements on the investors in their funds, not all do so. Some hedge funds are marketed to “accredited investors,”<sup>155</sup> and some may permit a small number of non-accredited investors.

Accordingly, there may be some small number of investors in hedge funds that are not qualified clients. It may, therefore, be against our current rules for the adviser to continue receiving a performance fee from some current investors.<sup>156</sup> While we would require hedge fund advisers to comply with our performance fee rules going forward, we do not believe it is necessary to disrupt existing arrangements with persons who have already invested in the hedge fund. Our proposed amendment to 205–3 would allow a hedge fund's current

[15 U.S.C. 80b–5(a)]. Registered advisers are not prohibited from charging performance fees to 3(c)(7) funds, section 205(b)(4) [15 U.S.C. 80b–5(b)(4)], investors in which must all be “qualified purchasers.” See *supra* note 93.

<sup>154</sup> A “qualified client” under rule 205–3 is: (i) A natural person who or a company that immediately after entering into the contract has at least \$750,000 under the management of the investment adviser; (ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either: (A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$1,500,000 at the time the contract is entered into; or (B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(51)(A)) at the time the contract is entered into; or (iii) A natural person who immediately prior to entering into the contract is: (A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

<sup>155</sup> Regulation D under the Securities Act provides that an accredited investor includes certain institutional investors as well as any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000 or who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

<sup>156</sup> In the absence of relief, the registered adviser would have to either force the non-qualified client out of the fund or restructure its fee so that the non-qualified client is not paying the performance-based component of the fee.

investors who are not qualified clients to retain their existing investment in that fund, and to add to that account. It would not give them an exemption to open new investment accounts in that hedge fund or other hedge funds.

We request comment on this aspect of our proposal:

- Is it appropriate to create this exemption for current investors? If not, should we require that investors who are not qualified clients exit the hedge funds, or should we require that they be carved out of paying the performance fee?

- Is the scope of the exemption appropriate? If it is too narrow, should we permit current investors to open new accounts or invest in other hedge funds managed by the same adviser? Alternatively, if it is too broad, should we prohibit current investors from adding to their investment?

- Are there other exceptions or exemptions we should create?

#### H. Amendments to Rule 206(4)–2

We propose to amend rule 206(4)–2, the adviser custody rule, to accommodate advisers to funds of hedge funds. Our custody rule makes it clear that an adviser acting as general partner to a pooled investment vehicle it manages has custody of the pool's assets.<sup>157</sup> Under the rule, advisers to pooled investment vehicles, including hedge funds, may satisfy their obligation to deliver custody account information to investors by distributing the pool's audited financial statements to investors within 120 days of the pool's fiscal year-end.<sup>158</sup> Some advisers to funds of hedge funds have encountered difficulty in obtaining completion of their fund audits prior to completion of the audits for the underlying funds in which they invest, and as a practical matter will be prevented from complying with the 120-day deadline. We propose to extend the period for pooled investment vehicles to distribute their audited financial statements to their investors from 120 days to 180 days, so that advisers to funds of hedge funds may comply with the rule.<sup>159</sup>

We request comments on the proposed amendments.

- Is the 180-day period too long?
- Would a 150-day period achieve the same goal?

<sup>157</sup> Rule 206(4)–2(c)(1)(iii).

<sup>158</sup> Rule 206(4)–2(b)(3).

<sup>159</sup> Until the Commission takes action on this proposed amendment, the Division of Investment Management will not recommend that the Commission take any enforcement action against an adviser to a fund of funds that acts in accordance with the proposed amendment.

<sup>152</sup> Proposed rule 204–2(l).

<sup>153</sup> Rule 205–3(a) and (b). Rule 205–3 permits registered advisers to charge performance fees that would otherwise be prohibited by section 205(a).

- Should we keep the 120-day requirement for non-fund of hedge funds advisers?

#### I. Amendments to Form ADV

We propose to amend Form ADV to identify advisers to hedge funds. The current Form ADV collects information about advisers to pooled investment vehicles without distinguishing hedge fund advisers from other advisers. We would amend Item 7B. of Part 1A and Section 7B. of Schedule D to require advisers to “private funds” as defined in the proposed rule to identify themselves as hedge fund advisers in Part 1A and Schedule D of Form ADV. We request comment on this aspect of our proposal.

- Are any other changes needed to Form ADV in connection with registering hedge fund advisers?

#### J. Compliance Period

We request comment on the length of time hedge fund advisers would need in order to register and revise their compliance systems so as to meet the requirements under the Advisers Act. Although many hedge fund advisers may be able to transition easily, we recognize that some firms may need to develop control policies and procedures in a number of areas.

- Would six months be sufficient?
- Would hedge fund advisers require as long as one year?

### III. General Request for Comment

The Commission requests comment on the rule and amendments proposed in this Release, suggestions for other additions to the rule and amendments, and comment on other matters that might have an effect on the proposals contained in this Release. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the potential impact of the proposed rule and amendments on the economy on an annual basis. Commenters should provide empirical data to support their views.

### IV. Cost-Benefit Analysis

We are sensitive to the costs and benefits that result from our rules. Proposed rule 203(b)(3)–2 would require certain hedge fund advisers to register with us under the Investment Advisers Act of 1940. We are also proposing related recordkeeping and performance fee amendments to facilitate a smooth transition for hedge fund advisers, and amendments to the custody rule designed to facilitate a smooth transition particularly for advisers to funds of hedge funds. We have identified certain costs and benefits,

which are discussed below, that may result from the proposed rule and amendments. We request comment on the costs and benefits of the proposed rule and amendments. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs and benefits.

#### A. Benefits

##### 1. Benefits To Hedge Fund Investors

As discussed above in this Release, our proposal to require hedge fund advisers to register under the Advisers Act would benefit hedge fund investors, though these benefits are difficult to quantify.

(a) *Deter fraud and curtail losses.* Our oversight may prevent or diminish losses hedge fund investors would otherwise experience as a result of hedge fund advisers’ fraud. Registration would allow us to conduct regular examinations of hedge fund advisers, and our examinations provide a strong deterrent to advisers’ fraud, identify practices that may harm investors, and lead to earlier discovery of fraud that does occur.<sup>160</sup> Registration would also permit us to screen individuals seeking to advise hedge funds, and to deny entry to those with a history of disciplinary problems.<sup>161</sup>

In the last five years, the Commission has brought 46 enforcement cases in which we assert hedge fund advisers have defrauded hedge fund investors or used the fund to defraud others. While 3 of these frauds were detected in time to prevent investor losses, this was the exception rather than the rule.<sup>162</sup> In 35 of these cases, our staff estimates potential investor losses aggregate approximately \$1.1 billion.<sup>163</sup> Staff

<sup>160</sup> See Section II.B.2 of this Release.

<sup>161</sup> See Section II.B.3 of this Release.

<sup>162</sup> *SEC v. EPG Global Private Equity Fund*, Litigation Release No. 18577 (Feb. 17, 2004); *SEC v. Millennium Capital Hedge Fund, L.P.*, *Millennium Capital Group, LLC*, and *Andreas F. Zybelle*, Litigation Release No. 18362 (Sept. 25, 2003); *In the Matter of John Christopher McCamey and Sierra Equity Partners, LP*, Securities Exchange Act Release No. 48917 (June 18, 2003).

<sup>163</sup> *In the Matter of Samer M. El Bizri and Bizri Capital Partners, Inc.*, supra note 78; *SEC v. Daniel D. Dyer and Oxbow Capital Partners, LLC*, Litigation Release No. 18719 (May 19, 2004); *SEC v. J. Robert Dobbins, Dobbins Capital Corp.*, *Dobbins Offshore Capital LLC*, *Dobbins Partners, L.P.*, and *Dobbins Offshore, Ltd.*, Litigation Release No. 18634 (Mar. 23, 2004); *SEC v. Patrollers Capital Fund and Franklin S. Marone*, Litigation Release No. 18601 (Feb. 27, 2004); *SEC v. Darren Silverman and Matthew Brenner*, Litigation Release No. 18597 (Feb. 25, 2004); *In the Matter of Nevis Capital Management, LLC*, *David R. Wilmerding, III* and *Jon C. Baker*, supra note 80; *In the Matter of Robert T. Littell and Wilfred Meckel*, Investment Advisers Act Release No. 2203 (Dec. 15, 2003); *SEC v. Koji Goto*, Litigation Release No. 18456 (Nov. 14, 2003); *SEC*

cannot at this time estimate the amount of losses in the remaining eight cases.<sup>164</sup> We are concerned that individuals have targeted hedge fund investors and chosen hedge funds as a vehicle for fraud because these individuals could operate their funds without regulatory scrutiny of their activities. Only eight of the 46 cases involve investment advisers registered with the Commission, with over \$75.7 million in estimated aggregate investor losses.<sup>165</sup> The

*v. John F. Turant, Jr.*, *Russ R. Luciano*, *JTI Group Fund, LP*, *J.T. Investment Group, Inc.*, *Evergreen Investment Group, LP*, and *New Resource Investment Group, Inc.*, Litigation Release No. 18351 (Sept. 15, 2003); *SEC v. Michael Batterman, Randall B. Batterman III, and Dynasty Fund, Ltd.*, et al., Litigation Release No. 18299 (Aug. 20, 2003); *SEC v. Ryan J. Fontaine and Simpleton Holdings Corporation a/k/a Signature Investments Hedge Fund*, supra note 19; *In the Matter of Ascend Capital, LLC*, *Malcolm P. Fairbairn*, and *Emily Wang Fairbairn*, Investment Advisers Act Release No. 2150 (July 17, 2003); *SEC v. Beacon Hill Asset Management LLC*, et al., supra note 40; *SEC v. J. Scott Eskind, Lorus Investments, Inc.*, and *Capital Management Fund, Limited Partnership*, supra note 79; *SEC v. Michael L. Smirlock and LASER Advisers, Inc.*, Litigation Release No. 17630 (July 24, 2002); *SEC v. Schwendiman Partners, LLC*, *Gary Schwendiman*, and *Todd G. Schwendiman*, supra note 80; *SEC v. Von Christopher Cummings, Paramount Financial Partners, L.P.*, *Paramount Capital Management, LLC*, *John A. Ryan*, *Kevin L. Grandy* and *James Curtis Conley*, Litigation Release No. 17598 (July 3, 2002); *SEC v. House Asset Management, L.L.C.*, *House Edge, L.P.*, *Paul J. House*, and *Brandon R. Moore*, supra note 76; *In the Matter of Portfolio Advisory Services, LLC* and *Cedd L. Moses*, supra note 41; *SEC v. Jean Baptiste Jean Pierre*, *Gabriel Tols Pearce* and *Darius L. Lee*, supra note 76; *In the Matter of Zion Capital Management LLC*, and *Ricky A. Lang*, supra note 80; *SEC v. Peter W. Chabot*, *Chabot Investments, Inc.*, *Sirens Synergy and the Synergy Fund*, supra note 76; *SEC v. Vestron Financial Corp.*, et al., supra note 76; *SEC v. Edward Thomas Jung*, et al., supra note 40; *SEC v. Burton G. Friedlander*, supra note 77; *SEC v. Hoover and Hoover Capital Management, Inc.*, supra note 42; *SEC v. Evelyn Litwok & Dalia Eilat*, supra note 76; *SEC v. Ashbury Capital Partners, L.P.*, *Ashbury Capital Management, L.L.C.*, and *Mark Yagalla*, supra note 40; *SEC v. James S. Saltzman*, Litigation Release No. 17158 (Sept. 27, 2001); *In the Matter of Stephen V. Burns*, Investment Advisers Act Release No. 1910 (Nov. 17, 2002); *In the Matter of Michael T. Higgins*, supra note 78; *SEC v. David M. Mobley, Sr.*, et al., supra note 40; *SEC v. Michael W. Berger*, *Manhattan Capital Management Inc.*, supra note 78; *In the Matter of Charles K. Seavey and Alexander Lushtak*, supra note 78; *SEC v. Todd Hansen and Nicholas Lobue*, supra note 144.

<sup>164</sup> *SEC v. Global Money Management, LP*, *LF Global Investments, LLC*, and *Marvin I. Friedman*, Litigation Release No. 18666 (Apr. 12, 2004); *SEC v. KS Advisors, Inc.* et al., Litigation Release No. 18600 (Feb. 27, 2004); *In the Matter of Alliance Capital Management, L.P.*, supra note 43; *SEC v. Edward J. Strafacci*, Litigation Release No. 18432 (Oct. 29, 2003); *In the Matter of Stephen B. Markovitz*, supra note 43; *Michael Lauer*, *Lancer Management Group II, LLC*, supra note 40; *In the Matter of Martin W. Smith and World Securities, Inc.*, Investment Advisers Act Release No. 2124 (Apr. 18, 2003); *SEC v. Platinum Investment Corp.* et al., Litigation Release No. 17643 (July 31, 2002).

<sup>165</sup> *In the Matter of Alliance Capital Management, L.P.*, supra note 43; *SEC v. Michael L. Smirlock*,

remaining 38 cases involve advisers that were not registered with us, with over \$1 billion in estimated aggregate investor losses.<sup>166</sup> While our regulatory oversight cannot guarantee hedge fund investors will never be defrauded, our oversight should reduce investor losses.<sup>167</sup>

(b) *Provide basic information about hedge fund advisers.* Form ADV information that hedge fund advisers would file in registering would aid hedge fund investors in evaluating potential managers.<sup>168</sup> Filing Form ADV would require hedge fund advisers to disclose information about their business, affiliates and owners, and disciplinary history. Many investors currently lack good access to this information about their hedge fund managers.<sup>169</sup> Although the information hedge fund advisers would provide on their Form ADV filings and to comply with our rules cannot substitute for an investor's due diligence, it would aid investors by providing a publicly accessible foundation of basic information.<sup>170</sup>

(c) *Improve compliance controls.* Hedge fund investors would benefit from their advisers' improved compliance controls. Once registered, hedge fund advisers would be required

*supra* note 163; *SEC v. Edward J. Strafaci*, *supra* note 164; *In the Matter of Nevis Capital Management*, *supra* note 80; *In the Matter of Martin W. Smith and World Securities, Inc.*, *supra* note 164; *SEC v. Schwendiman Partners, LLC, Gary Schwendiman, and Todd G. Schwendiman*, *supra* note 80; *In the Matter of Portfolio Advisory Services, LLC and Cedric L. Moses*, *supra* note 41; *In the Matter of Zion Capital Management LLC, and Ricky A. Lang*, *supra* note 80. Staff cannot estimate the amount of losses in 3 of these cases at this time.

<sup>166</sup> Staff cannot estimate the amount of losses in 5 of these cases at this time.

<sup>167</sup> This benefit may be particularly important to hedge fund investors in an environment where there is excess demand for hedge funds. As substantial inflows chase absolute returns, average hedge fund risk can be expected to increase as hedge fund advisers compete for investment opportunities. This pressure may give hedge fund advisers incentives to engage in strategies that may not be consistent with the funds' disclosure or may be unlawful. *See supra* note 63 and accompanying text. In the absence of Commission oversight as a deterrent, these incentives may tempt hedge fund advisers to engage in fraud.

<sup>168</sup> *See supra* note 62 and accompanying text.

<sup>169</sup> *Id.*

<sup>170</sup> Participants at our Hedge Fund Roundtable last year spoke of the difficulty and costs that investors face in obtaining information from hedge fund advisers. Roundtable Transcript, May 15 (statement of Sandra Mancke) ("[I]t's very difficult to get answers out of managers, and they hold all the keys right now. If you want to get into a good fund, and you ask some difficult questions, you may not get that answer. Sure, there is a lot of access, to get online and do background checks, and hire firms \* \* \*. But that's expensive. And can the retail investor do it? No. Firms like ours, we spend a lot of money, we have a lot more people working for us now to uncover these types of situations.")

to have comprehensive compliance procedures and to designate a chief compliance officer.<sup>171</sup> Specific procedures governing proxy voting<sup>172</sup> and a code of ethics including requirements for personal securities reporting would also be required.<sup>173</sup> In addition, our examinations and the obligation to commit to a program of compliance controls foster adherence to a culture of compliance by advisers.<sup>174</sup> These compliance measures are the first line of defense in protecting investors against breaches of an adviser's fiduciary duties under the Act.

## 2. Benefits to Mutual Fund Investors

Mutual fund investors would benefit from hedge fund adviser registration to the extent that Commission oversight deters hedge funds and their advisers from illegal conduct that exploits mutual funds. Many of the market timers and illegal late traders involved in recent mutual fund scandals have been hedge funds.<sup>175</sup> The 46 enforcement cases discussed earlier do not include 12 other actions we have brought to date against persons charged with late trading of mutual fund shares on behalf of hedge fund groups, and against mutual fund advisers or principals for permitting hedge funds to market time mutual funds contrary to the mutual funds' prospectus disclosure.<sup>176</sup> Hedge fund advisers reaped huge profits for their funds over an extended period while costing our nation's retail mutual fund investors hundreds of millions of dollars.<sup>177</sup>

## 3. Benefits to Other Investors and Markets

Other investors, and markets, would benefit from hedge fund adviser registration to the extent that SEC oversight eliminates opportunities for hedge funds and their advisers to engage in other types of unlawful conduct in the securities markets. The mutual fund scandals have shown us that hedge fund advisers' improper or illegal activities can cause harm beyond the hedge funds' own investors. There may be other fraudulent activities by hedge fund advisers of which we are unaware because we cannot examine these advisers regularly.<sup>178</sup> Adviser

<sup>171</sup> *See* Section II.B.4 of this Release.

<sup>172</sup> Rule 206(4)-6 [17 CFR 275.206(4)-6].

<sup>173</sup> Rule 204A-1 [17 CFR 275.204A-1].

<sup>174</sup> *See* Section II.B.2 of this Release.

<sup>175</sup> *See supra* note 43.

<sup>176</sup> *Id.*

<sup>177</sup> *Id.*

<sup>178</sup> *See, e.g., Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC, supra* note 40 (Commission complaint asserting unregistered hedge fund adviser manipulated the

registration, as discussed above, would lead to earlier discovery of fraudulent activities and thus would enhance protections to all investors in the securities markets.

## 4. Benefits to Regulatory Policy

Registration of hedge fund advisers would benefit all investors and market participants by providing us and other policy makers with better data. Better data would help us to form and frame appropriate regulatory policies regarding the hedge fund industry and its advisers, and to evaluate the effect of our policies and programs on this sector. We have limited information about hedge fund advisers and the hedge fund industry, and much of what we do have is indirect information extrapolated from other data. This hampers our ability to develop regulatory policy for the protection of hedge fund investors and investors in general.<sup>179</sup> Hedge fund adviser registration would provide the Congress, the Commission and other government agencies with important information about this rapidly growing segment of the U.S. financial system.<sup>180</sup>

## 5. Benefits to Hedge Fund Advisers

(a) *Curtail competitive disparities.* Mandatory registration would provide a level playing field for hedge fund advisers. Many hedge fund advisers have already registered with us,<sup>181</sup> and

market price of certain securities held by the hedge fund); *SEC v. Burton G. Friedlander*, *supra* note 77.

<sup>179</sup> *See* Section II.B.1. of this Release.

<sup>180</sup> In addition to the Commission, other federal and state government departments and agencies regulating the financial sectors of the country may need such information to form their regulatory policies. For example, the Commission was unable to provide the Department of Treasury with accurate information about the number of hedge funds for use in connection with its proposals to require hedge funds to adopt anti-money laundering programs. *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, *supra* note 29. Because there is no government source of information to identify or locate hedge funds, the Treasury Department proposed a rule under the USA Patriot Act that will require that hedge funds, among others, to file a brief notice with the Department with certain information about their operations. *Id.* at p. 60622. *See also The President's Working Group Study on Hedge Funds: Hearing Before the House Comm. on Banking and Financial Services, 106th Cong. (1999)*, p. 4 (statement of Representative John LaFalce, Member, House Comm. on Banking and Financial Services) ("The message of LTCM is not so much that the Federal Reserve set the stage for extricating very big and sophisticated principals and their lenders from a tight situation. The real message is that we can no longer doubt that we have a new powerful kind of financial institution in our midst, the hedge fund, and that we know very little about them."); PWG LTCM Report, *supra* note 27 at 1 ("[I]t is difficult to estimate precisely the size of the [hedge fund] industry \* \* \*").

<sup>181</sup> Many advisers to hedge funds are required to register with us because of other advisory business

have organized their compliance procedures under the Advisers Act. Unregistered hedge fund advisers, however, vary substantially in their compliance practices.<sup>182</sup> While many of them have adopted sound compliance practices, many others, against whom they and the registered advisers compete, have not allocated resources to implement an effective compliance infrastructure. Mandatory registration would ensure that all hedge fund advisers compete on the same basis in this regard.

(b) *Legitimize a growing and maturing industry.* As discussed above, the hedge fund industry has been growing at an extraordinary pace in the past decade.<sup>183</sup> Registration under the Advisers Act would bring hedge fund advisers to the same compliance level as other SEC-registered advisers, thus legitimizing a growing and maturing industry that is currently perceived as operating in the shadows. In addition, without appropriate regulatory oversight to check growing hedge fund fraud, investors' confidence in hedge fund advisers and the hedge fund industry could eventually erode.

#### B. Costs

Registration of hedge fund advisers under the Advisers Act would not impede hedge funds' operations. The Act does not prohibit any particular investment strategies, nor does it require or prohibit specific investments. Instead of imposing specific procedures on registrants, the Advisers Act is principally a disclosure statute that requires registrants to fully inform clients of conflicts so that those clients can determine whether to give their consent. For the same reasons, registering hedge fund advisers should not impair the ability of hedge funds to continue their important roles of providing price information and liquidity to our markets.<sup>184</sup> Registration, however, imposes certain additional costs as discussed below.

#### 1. Registration Costs

Hedge fund advisers would experience costs to register under the

they have. Still others have chosen to register with us because their investor clients require it. See Section II.B.6 of this Release. See also *supra* note 98.

<sup>182</sup> See Section VII.A.1.b. of the 2003 Staff Hedge Fund Report, *supra* note 32.

<sup>183</sup> See Section I. A. of this Release.

<sup>184</sup> See PGW LTCM Report *supra* note 27 at 2. The 2003 Staff Hedge Fund Report, also noted that hedge funds' trading brings price information to our securities markets, thus improving market efficiency, and hedge funds also provide liquidity to our capital markets. 2003 Staff Hedge Fund Report at 4, *supra* note 32.

Advisers Act, but these costs would not be high. In order to register, advisers are required to file Part 1 of Form ADV (the registration form for advisers) electronically through the Investment Adviser Registration Depository ("IARD") and pay initial filing fees and annual filing fees to the IARD system operator.<sup>185</sup> In addition to these filing fees, hedge fund advisers would also incur internal costs in connection with preparing Part 1, but these costs should be low because Form ADV readily accommodates registration by hedge fund advisers. Part 1 requires advisers to answer basic questions about their business, their affiliates and their owners, and Part 1 can be completed using information readily available to hedge fund advisers. Numerous hedge fund advisers have already registered with the Commission using Part 1, and none has reported to us that their business model presents any difficulty in using the form.<sup>186</sup> Advisers must also complete Part II of Form ADV and deliver a copy of Part II or a disclosure brochure containing the same information to clients.<sup>187</sup> Part II requires disclosure of certain conflicts of interest. We expect that hedge fund advisers would face relatively small internal costs in preparing a Part II, and would be likely to include their Part II information as part of their private placement memoranda for their hedge funds, reducing their overall costs even further.

#### 2. Compliance Infrastructure Costs

New hedge fund adviser registrants would also face costs to bring their operations into conformity with the Advisers Act and the rules under the Act, and these costs would vary substantially across advisory firms. Registered advisers are required to comply with rules under the Advisers Act such as the books and records rule,<sup>188</sup> the custody rule,<sup>189</sup> the proxy voting rule,<sup>190</sup> the compliance rule,<sup>191</sup>

<sup>185</sup> The initial filing fee for advisers with \$25 million to \$100 million of assets under management is \$800 and for advisers with \$100 million or more of assets under management is \$1,100. The annual filing fee for advisers with \$25 million to \$100 million of assets under management is \$400 and for advisers with more than \$100 million of assets under management is \$550. Available at [www.sec.gov/division/investment/iard/iardfee.shtml](http://www.sec.gov/division/investment/iard/iardfee.shtml).

<sup>186</sup> In fact, our proposal makes only one small change to Part 1, to better identify which advisers' pooled investment vehicles are hedge funds. See Section II. I. of this Release.

<sup>187</sup> See rule 204-3 [17 CFR 275.204-3], the brochure delivery rule.

<sup>188</sup> Rule 204-2.

<sup>189</sup> Rule 206(4)-2.

<sup>190</sup> Rule 206(4)-6.

<sup>191</sup> Rule 206(4)-7.

and the code of ethics rule.<sup>192</sup> Many unregistered hedge fund advisers have already built sound compliance infrastructure because their business compels it. These firms already have procedures designed to keep good records of all transactions, to keep their clients' assets safe, to provide fair and full disclosure of conflicts of interest, and to prevent their supervised persons from breaching fiduciary duties. These advisory firms would face little cost to modify their current compliance practices to comply with the Advisers Act rules. For other hedge fund advisers that have not yet established sound compliance programs, however, the costs would be higher.

Based on discussions with industry, we estimate the costs to establish the required compliance infrastructure would be \$20,000 in professional fees and \$25,000 in internal costs including staff time.<sup>193</sup> These estimates are averages. As stated above, the costs would likely be less for new registrants that have already established sound compliance practices and more for new registrants that do not yet have good compliance procedures. These costs should not represent a barrier to entry for new hedge fund advisers. More than 2,500 smaller advisory firms are currently registered with us.<sup>194</sup> These firms have absorbed these compliance costs, notwithstanding the fact that their revenues are likely to be smaller than those of a typical hedge fund adviser.<sup>195</sup>

#### V. Effects on Commission Examination Resources

The proposed rule would also increase the workload of the Commission's investment adviser examination program, which is operated by our Office of Compliance Inspections and Examinations ("OCIE"). OCIE's examination program already covers a number of advisers to hedge funds. These advisers have registered with the SEC, either because they advise non-hedge fund clients for whom registration is required, or because they

<sup>192</sup> Rule 204A-1.

<sup>193</sup> Our staff has estimated that between 690 and 1,260 hedge fund advisers would be new Advisers Act registrants under the proposed rules. See *infra* text following note 198. Aggregate start-up costs to establish required compliance infrastructure for all new registrants are therefore estimated to range from \$31 to \$57 million.

<sup>194</sup> As of May 1, 2004, 2,640 advisers registered with us reported that they were managing less than \$50 million in client assets. These advisers represent 32 percent of our registrant pool.

<sup>195</sup> In addition to asset-based investment management fees that are comparable to advisory fees charged by non-hedge fund advisory firms, hedge fund advisers also typically earn incentive compensation equaling 20 percent of the fund's net investment income.

perceive SEC registration to be necessary to their business model. The proposed rule would increase the number of SEC-registered advisers by some amount, and increase our examination workload correspondingly.

There are various options we could pursue to lessen the effect of this increase. Though OCIE's resources would be spread over an expanded pool of investment adviser registrants, we could develop risk assessment tools that enhance the efficiency of our examination program. In addition, we have recently adopted measures that require advisory personnel to be more accountable for the efficacy of compliance programs. By October of this year, advisers must comply with our new compliance rule, which requires all registered investment advisers to implement comprehensive policies and procedures for compliance with the Advisers Act, under the administration of a chief compliance officer.<sup>196</sup> As advisers improve their own compliance regimes, we expect our examination program will enjoy increased efficiencies. Another option would be to increase the current threshold for SEC registration from \$25 million of assets under management to a slightly higher amount, thereby reducing the number of smaller advisers overseen by the Commission (instead of state securities administrators). Or we could seek additional resources from Congress, if necessary.

Our ability to estimate the size of the increase in our workload has been hampered by the absence of any reliable and comprehensive database of hedge funds or advisers to hedge funds. Our staff tentatively estimates that the addition of new hedge fund advisers to our current registrant pool of 8,300 advisers could increase the total size of this pool by 8 to 15 percent.

Based on a review of the limited information available, our staff estimates that there are probably between 2,300 and 3,500 hedge fund advisers in the industry, advising approximately 7,000 funds.<sup>197</sup> After

<sup>196</sup> Rule 206(4)-7. See *Compliance Programs of Investment Companies and Investment Advisers*, *supra* note 91.

<sup>197</sup> Participants at our Hedge Fund Roundtable in May of 2003 estimated that there were approximately 6,000 hedge funds in operation at that time. 2003 Staff Hedge Fund Report, *supra* note 32 at n. 2. More recently, the Hennessee Group has estimated the total number of hedge funds at 7,000. See Testimony of Charles J. Gradante, *supra* note 33.

No similar estimates exist of the number of advisers managing these hedge funds. Many hedge fund advisers manage two or four funds (one or two management styles, with a U.S. and an off-shore version of each), while other smaller hedge fund advisers manage only one and some of the largest

examining various private databases of hedge fund information, staff further estimates that approximately 60 percent of these firms are likely to have at least \$25 million in assets under management, making them eligible to register with the Commission instead of the states. Staff further estimates that approximately 40 to 50 percent of those eligible advisers are already registered with the Commission, with registration rates likely to be higher for larger firms and lower for smaller firms.<sup>198</sup> Based on these estimates and assumptions:

- If the industry is comprised of approximately 2,300 hedge fund advisers, then approximately 1,380 are likely eligible to register with the Commission under the \$25 million registration threshold. Of these 1,380 firms, approximately 550 to 690 are likely already SEC-registered, and the proposed rule would result in 690 to 830 new registrants.

- If the industry is comprised of approximately 3,500 hedge fund advisers, then approximately 2,100 are likely eligible to register with the Commission under the \$25 million registration threshold. Of these 2,100 firms, approximately 840 to 1,050 are likely already SEC-registered, and the proposed rule would result in 1,050 to 1,260 new registrants.

We request comment on these estimates. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any alternative estimates.

## VI. Paperwork Reduction Act

Proposed rule 203(b)(3)-2 contains no new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 to 3520). The rules proposed to be amended contain several collection of information requirements, but the proposed amendments do not change the burden per response from that under the current rules. Proposed

advisers manage more than four. If, on average, each hedge fund advisory firm is managing approximately two to three funds, that equates to approximately 2,300 to 3,500 firms.

<sup>198</sup> In reaching this estimate, staff reviewed information contained in private databases of hedge fund information. Form ADV does not presently require SEC-registered advisers to indicate whether they advise hedge funds. As of April 2004, approximately 1,900 advisers, representing 23 percent of all SEC-registered advisers, indicated on their Form ADV that they advised "other pooled investment vehicles" as clients, and approximately 600 out of the 1,900 indicated these pooled investment vehicles represented 75 percent or more of their client base. While these "other pooled investment vehicles" include hedge funds, they also include a variety of other non-hedge fund pools, and therefore we cannot use these responses to estimate how many of these advisers manage hedge funds.

rule 203(b)(3)-2 would have the effect of requiring advisers to hedge funds to register with the Commission under the Advisers Act and would therefore increase the number of respondents under several existing collections of information, and, correspondingly, increase the annual aggregate burden under those existing collections of information. The Commission has submitted, to the Office of Management and Budget ("OMB") in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, the existing collections for information for which the annual aggregate burden would likely increase as a result of rule 203(b)(3)-2. The titles of the affected collections of information are: "Form ADV," "Form ADV-W and Rule 203-2," "Rule 203-3 and Form ADV-H," "Form ADV-NR," "Rule 204-2," "Rule 204-3," "Rule 204A-1," "Rule 206(4)-2, Custody of Funds or Securities of Clients by Investment Advisers," "Rule 206(4)-3," "Rule 206(4)-4," "Rule 206(4)-6," and "Rule 206(4)-7," all under the Advisers Act. The existing rules affected by rule 203(b)(3)-2 contain currently approved collection of information numbers under OMB control numbers 3235-0049, 3235-0313, 3235-0538, 3235-0240, 3235-0278, 3235-0047, 3235-0596, 3235-0241, 3253-0242, 3235-0345, 3235-0571 and 3235-0585, respectively. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. All of these collections of information are mandatory, and respondents in each case are investment advisers registered with us, except that (i) respondents to Form ADV are also investment advisers applying for registration with us; (ii) respondents to Form ADV-NR are non-resident general partners or managing agents of registered advisers; (iii) respondents to Rule 204A-1 include "access persons" of an adviser registered with us, who must submit reports of their personal trading to their advisory firms; (iv) respondents to Rule 206(4)-2 are only those SEC-registered advisers that have custody of clients' funds or securities; (v) respondents to Rule 206(4)-3 are advisers who pay cash fees to persons who solicit clients for the adviser; (vi) respondents to Rule 204(4)-4 are advisers with certain disciplinary histories or a financial condition that is reasonably likely to affect contractual commitments; and (vii) respondents to Rule 206(4)-6 are only those SEC-registered advisers that vote their clients' securities. Unless

otherwise noted below, responses are not kept confidential.

We cannot estimate with precision the number of hedge fund advisers that would be new registrants with the Commission under the Advisers Act if proposed rule 203(b)(3)-2 is adopted. As discussed earlier, our staff has estimated that between 690 and 1,260 hedge fund advisers would be new Advisers Act registrants under the proposed rules.<sup>199</sup> For purposes of estimating the increases in respondents to the existing collections of information, we have used the midpoint of this estimated range, or 975 new respondents. We request comment on the number of hedge fund advisers that would be subject to the proposed rule and to the applicable collections of information.

#### A. Form ADV

Form ADV is the investment adviser registration form. The collection of information under Form ADV is necessary to provide advisory clients, prospective clients, and the Commission with information about the adviser, its business, and its conflicts of interest. Rule 203-1 requires every person applying for investment adviser registration with the Commission to file Form ADV. Rule 204-1 requires each registered adviser to file amendments to Form ADV at least annually, and requires advisers to submit electronic filings through the IARD. This collection of information is found at 17 CFR 275.203-1, 275.204-1, and 279.1. The currently approved collection of information in Form ADV is 102,653 hours. We estimate that 975 new respondents would file one complete Form ADV and one amendment annually, and comply with Form ADV requirements relating to delivery of the code of ethics. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under Form ADV by 28,958 hours<sup>200</sup> for a total of 131,611 hours.

#### B. Form ADV-W and Rule 203-2

Rule 203-2 requires every person withdrawing from investment adviser registration with the Commission to file Form ADV-W. The collection of information is necessary to apprise the Commission of advisers who are no longer operating as registered advisers. This collection of information is found

at 17 CFR 275.203-2 and 17 CFR 279.2. The currently approved collection of information in Form ADV-W is 500 hours. We estimate that 975 hedge fund advisers that would be new registrants would withdraw from SEC registration at a rate of approximately 16 percent per year, the same rate as other registered advisers, and would file for partial and full withdrawals at the same rates as other registered advisers, with approximately half of the filings being full withdrawals and half being partial withdrawals. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under Form ADV-W and rule 203-2 by 78 hours<sup>201</sup> for a total of 578 hours.

#### C. Rule 203-3 and Form ADV-H

Rule 203-3 requires that advisers requesting either a temporary or continuing hardship exemption submit the request on Form ADV-H. An adviser requesting a temporary hardship exemption is required to file Form ADV-H, providing a brief explanation of the nature and extent of the temporary technical difficulties preventing it from submitting a required filing electronically. Form ADV-H requires an adviser requesting a continuing hardship exemption to indicate the reasons the adviser is unable to submit electronic filings without undue burden and expense. Continuing hardship exemptions are available only to advisers that are small entities. The collection of information is necessary to provide the Commission with information about the basis of the adviser's hardship. This collection of information is found at 17 CFR 275.203-3, and 279.3. The currently approved collection of information in Form ADV-H is 10 hours. We estimate that the approximately 975 hedge fund advisers that would be new registrants would file for temporary hardship exemptions at approximately 0.1 percent per year, the same rate as other registered advisers.<sup>202</sup> Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under Form ADV-H and rule 203-3 by 1 hour<sup>203</sup> for a total of 11 hours.

#### D. Form ADV-NR

Non-resident general partners or managing agents of SEC-registered investment advisers must make a one-time filing of Form ADV-NR with the

Commission. Form ADV-NR requires these non-resident general partners or managing agents to furnish us with a written irrevocable consent and power of attorney that designates the Commission as an agent for service of process, and that stipulates and agrees that any civil suit or action against such person may be commenced by service of process on the Commission. The collection of information is necessary for us to obtain appropriate consent to permit the Commission and other parties to bring actions against non-resident partners or agents for violations of the federal securities laws. This collection of information is found at 17 CFR 279.4. The currently approved collection of information in Form ADV-NR is 15 hours. We estimate that the approximately 975 hedge fund advisers that would be new registrants would make these filings at the same rate (0.2 percent) as other registered advisers. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under Form ADV-NR by 2 hours<sup>204</sup> for a total of 17 hours.

#### E. Rule 204-2

Rule 204-2 requires SEC-registered investment advisers to maintain copies of certain books and records relating to their advisory business. The collection of information under rule 204-2 is necessary for the Commission staff to use in its examination and oversight program. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.<sup>205</sup> The records that an adviser must keep in accordance with rule 204-2 must generally be retained for not less than five years.<sup>206</sup> This collection of information is found at 17 CFR 275.204-2. The currently approved collection of information for rule 204-2 is 1,537,884 hours, or 191.78 hours per registered adviser. We estimate that all 975 advisers that would be new registrants would maintain copies of records under the requirements of rule 204-2. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under rule 204-2 by 186,985.5 hours<sup>207</sup> for a total of 1,724,869.5 hours.

#### F. Rule 204-3

Rule 204-3, the "brochure rule," requires an investment adviser to

<sup>199</sup> See *supra* text following note 198.

<sup>200</sup> 975 filings of the complete form at 22.25 hours each, plus 975 amendments at 0.75 hours each, plus 6.7 hours for each of the 975 hedge fund advisers to deliver copies of their codes of ethics to 10 percent of their 670 clients annually who request it, at 0.1 hours per response.

<sup>201</sup> 156 filings (975 × 0.16), consisting of 78 full withdrawals at 0.75 hours each and 78 partial withdrawals at 0.25 hours each.

<sup>202</sup> We expect that no hedge fund advisers would be small advisers that would be eligible to file for a continuing hardship exemption.

<sup>203</sup> 1 filing (975 × 0.001) at 1 hour each.

<sup>204</sup> 2 filings (975 × 0.002) at 1 hour each.

<sup>205</sup> See section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

<sup>206</sup> See rule 204-2(e).

<sup>207</sup> 975 hedge fund advisers × 191.78 hours per adviser = 186,985.5 hours.

deliver or offer to prospective clients a disclosure statement containing specified information as to the business practices and background of the adviser. Rule 204-3 also requires that an investment adviser deliver, or offer, its brochure on an annual basis to existing clients in order to provide them with current information about the adviser. The collection of information is necessary to assist clients in determining whether to retain, or continue employing, the adviser. This collection of information is found at 17 CFR 275.204-3. The currently approved collection of information for rule 204-3 is 5,412,643 hours, or 694 hours per registered adviser, assuming each adviser has on average 670 clients. We estimate that all 975 advisers that would be new registrants would provide brochures to their clients as required by rule 204-3. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under rule 204-3 by 676,650 hours<sup>208</sup> for a total of 6,089,293 hours. We note that the average number of clients per adviser reflects a small number of advisers who have thousands of clients, while the typical SEC-registered adviser has approximately 76 clients. We ask comment on the number of clients of the average hedge fund adviser.

#### G. Rule 204A-1

Rule 204A-1 requires SEC-registered investment advisers to adopt codes of ethics setting forth standards of conduct expected of their advisory personnel and addressing conflicts that arise from personal securities trading by their personnel, and requiring advisers' "access persons" to report their personal securities transactions. The collection of information under rule 204A-1 is necessary to establish standards of business conduct for supervised persons of investment advisers and to facilitate investment advisers' efforts to prevent fraudulent personal trading by their supervised persons. This collection of information is found at 17 CFR 275.204A-1. The currently approved collection of information for rule 204A-1 is 945,841 hours, or 117.95 hours per registered adviser. We estimate that all 975 advisers that would be new registrants would adopt codes of ethics under the requirements of rule 204A-1 and require personal securities transaction reporting by their "access persons." Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under

<sup>208</sup> 975 hedge fund advisers times 694 hours per adviser.

rule 204A-1 by 115,001 hours<sup>209</sup> for a total of 1,060,842 hours.

#### H. Rule 206(4)-2

Rule 206(4)-2 requires advisers with custody of their clients' funds and securities to maintain controls designed to protect those assets from being lost, misused, misappropriated, or subjected to financial reverses of the adviser. The collection of information under rule 206(4)-2 is necessary to ensure that clients' funds and securities in the custody of advisers are safeguarded, and information contained in the collections is used by staff of the Commission in its enforcement, regulatory, and examination programs. This collection of information is found at 17 CFR 275.206(4)-2. The currently approved collection of information for rule 206(4)-2 is 72,113 hours. We estimate that all 975 hedge fund advisers that would be new registrants would have custody. We are proposing to amend rule 206(4)-2 to make it easier for hedge fund advisers to distribute audited financial statements to their investors annually in lieu of quarterly account statements sent by either the adviser or a qualified custodian and we estimate that all 975 new respondents would use this approach and would not be required to undergo an annual surprise examination. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under rule 206(4)-2 by 326,625 hours<sup>210</sup> for a total of 398,738 hours.

#### I. Rule 206(4)-3

Rule 206(4)-3 requires advisers who pay cash fees to persons who solicit clients for the adviser to observe certain procedures in connection with solicitation activity. The collection of information under rule 206(4)-3 is necessary to inform advisory clients about the nature of a solicitor's financial interest in the recommendation of an investment adviser, so the client may consider the solicitor's potential bias, and to protect investors against solicitation activities being carried out in a manner inconsistent with the adviser's fiduciary duties. This collection of information is found at 17 CFR 275.206(4)-3. The currently approved collection of information for rule 206(4)-3 is 10,982 hours. We estimate that approximately 20 percent of the 975 hedge fund advisers that would be new registrants would be subject to the cash solicitation rule, the

<sup>209</sup> 975 hedge fund advisers at 117.95 hours per adviser annually.

<sup>210</sup> 975 hedge fund advisers times 670 clients times 0.5 hours per annual financial statement distribution.

same rate as other registered advisers. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under rule 206(4)-3 by 1,373 hours<sup>211</sup> for a total of 12,355 hours.

#### J. Rule 206(4)-4

Rule 206(4)-4 requires registered investment advisers to disclose to clients and prospective clients certain disciplinary history or a financial condition that is reasonably likely to affect contractual commitments. This collection of information is necessary for clients and prospective clients in choosing an adviser or continuing to employ an adviser. This collection of information is found at 17 CFR 275.206(4)-4. The currently approved collection of information for rule 206(4)-4 is 10,118 hours. We estimate that approximately 17.3 percent of the 975 hedge fund advisers that would be new registrants would be subject to rule 206(4)-4, the same rate as other registered advisers. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under rule 206(4)-4 by 1,265 hours<sup>212</sup> for a total of 11,383 hours.

#### K. Rule 206(4)-6

Rule 206(4)-6 requires an investment adviser that votes client securities to adopt written policies reasonably designed to ensure that the adviser votes in the best interests of clients, and requires the adviser to disclose to clients information about those policies and procedures. This collection of information is necessary to permit advisory clients to assess their adviser's voting policies and procedures and to monitor the adviser's performance of its voting responsibilities. This collection of information is found at 17 CFR 275.206(4)-6. The currently approved collection of information for rule 206(4)-6 is 103,590 hours. We estimate that all 975 hedge fund advisers that would be new registrants would vote their clients' securities. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under rule 206(4)-6 by 16,283 hours<sup>213</sup> for a total of 119,873 hours.

<sup>211</sup> 195 respondents (975 × 0.2) at 7.04 hours annually per respondent.

<sup>212</sup> 169 respondents (975 × 0.173) at 7.5 hours annually per respondent.

<sup>213</sup> 975 hedge fund advisers would spend 10 hours each annually documenting their voting policies and procedures, and would provide copies of those policies and procedures to 10 percent of their 670 clients annually at 0.1 hours per response.

*L. Rule 206(4)-7*

Rule 206(4)-7 requires each registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, review those policies and procedures annually, and designate an individual to serve as chief compliance officer. This collection of information under rule 206(4)-7 is necessary to ensure that investment advisers maintain comprehensive internal programs that promote the advisers' compliance with the Advisers Act. This collection of information is found at 17 CFR 275.206(4)-7. The currently approved collection of information for rule 206(4)-7 is 623,200 hours, or 80 hours annually per registered adviser. We estimate all 975 advisers that would be new registrants would be required to maintain compliance programs under rule 206(4)-7. Accordingly, we estimate the proposal would increase the annual aggregate information collection burden under rule 206(4)-7 by 78,000 hours<sup>214</sup> for a total of 701,200 hours.

*M. Request for Comment*

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

- Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- Evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information;
- Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
- Determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, Washington, DC 20503, and also should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609 with reference to File No. S7-30-04. OMB is required to make a decision

concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives the comment within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-30-04, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549.

**VII. Effects on Competition, Efficiency and Capital Formation**

Section 202(c) of the Advisers Act mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>215</sup>

As discussed above, proposed rule 203(b)(3)-2 would, in effect, require hedge fund advisers to register with the Commission under the Advisers Act. The proposed rule is designed to provide the protection afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets. We are also proposing rule amendments that would facilitate hedge fund advisers' transition to registration and improve the Commission's ability to identify hedge fund advisers from information filed on their Form ADV. The proposed rule and rule amendments may indirectly increase efficiency for hedge fund investors. Hedge fund adviser registration would provide hedge fund investors and industry participants with better access to important basic information about hedge fund advisers and the hedge fund industry. This improved access may allow investors to investigate and select their advisers more efficiently.

We do not anticipate that the proposed rule would introduce any competitive disadvantages. The proposed rule may provide a level playing field with respect to advisers' compliance infrastructures. Many hedge fund advisers are already registered with us, either because their investors demand it or because they have other advisory business that requires them to register. These registered advisers must adopt compliance procedures under the Advisers Act and must provide certain safeguards to their clients, including

their hedge fund investors. While some unregistered hedge fund advisers have adopted sound comparable compliance procedures, others have not. Mandatory registration would require that all hedge fund advisers compete with each other and with other investment advisers on the same basis in this regard. The proposed amendment to rule 204-2 is designed to prevent newly-registered hedge fund advisers from being at a competitive disadvantage with respect to the promotion of their previous performance records, and the proposed amendment to rule 206(4)-2 is designed to allow advisers to funds of hedge funds to use the same approach under the adviser custody rule as do advisers to other pooled investment vehicles.

The proposed rule is unlikely to have a substantial effect on capital formation. To the extent that registration and the prospect of Commission examinations improves the compliance culture at hedge fund advisory firms, it may bolster investor confidence and investors may be more likely to entrust hedge fund advisers with their assets for investment. However, these assets may be diverted from other investments in the capital markets.

The Commission seeks comment regarding the impact of the proposed rules on efficiency, competition, and capital formation. Commenters are requested to provide empirical data to support their views.

**VIII. Regulatory Flexibility Act***A. Certification*

Pursuant to section 605(b) of the Regulatory Flexibility Act,<sup>216</sup> the Commission hereby certifies that proposed rule 203(b)(3)-2 and the proposed amendments to rules 203(b)(3)-1, 204-2, 205-3 and Form ADV would not, if adopted, have a significant economic impact on a substantial number of small entities. Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than \$25 million; (ii) did not have total assets of \$5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had \$5

<sup>214</sup> 975 hedge fund advisers at 80 hours annually.

<sup>215</sup> 15 U.S.C. 80b-2(c).

<sup>216</sup> 5 U.S.C. 605(b).

million or more on the last day of its most recent fiscal year.<sup>217</sup>

Proposed rule 203(b)(3)-2 and the amendment to rule 203(b)(3)-1 would remove a safe harbor and require certain advisers to private funds to register with the Commission under the Advisers Act by requiring them to count investors in the fund as clients for purposes of the Advisers Act “*de minimis*” exemption from registration. Notwithstanding the proposed rule, investment advisers with assets under management of less than \$25 million would remain generally ineligible for registration with the Commission under section 203A of the Advisers Act.<sup>218</sup> The proposed amendments to rules 204-2 and 205-3 would allow advisers affected by the proposed new rule to continue certain marketing practices and performance fees they now have in place. The proposed amendment to Form ADV would require advisers to private funds to identify themselves as such. No other entities would incur obligations from the proposed rules and amendments. Accordingly, the Commission certifies that proposed rule 203(b)(3)-2 and the proposed amendments to rules 203(b)(3)-1, 204-2, 205-3 and Form ADV would not have a significant economic impact on a substantial number of small entities.

The Commission requests written comments regarding this certification. The Commission requests that commenters describe the nature of any impact on small businesses and provide empirical data to support the extent of the impact.

#### B. Amendment to Rule 206(4)-2

The Commission has prepared the following Initial Regulatory Flexibility Analysis (“IRFA”) regarding the proposed amendment to rule 206(4)-2 in accordance with section 3(a) of the Regulatory Flexibility Act.<sup>219</sup>

##### 1. Reasons for Proposed Action

We propose to amend rule 206(4)-2, the adviser custody rule, to accommodate advisers to private funds of funds, including funds of hedge funds.<sup>220</sup> Under the rule, advisers to pooled investment vehicles may satisfy their obligation to deliver custody account information to investors by distributing the pool’s audited financial statements to investors within 120 days of the pool’s fiscal year-end.<sup>221</sup> Some advisers to private funds of funds

(including funds of hedge funds) have encountered difficulty in obtaining completion of their fund audits prior to completion of the audits for the underlying funds in which they invest, and as a practical matter will be prevented from complying with the 120-day deadline. We propose to extend the period for pooled investment vehicles to distribute their audited financial statements to their investors from 120 days to 180 days, so that advisers to funds of hedge funds may comply with the rule.

##### 2. Objectives and Legal Basis

The objective of the proposed amendment to rule 206(4)-2 is to make the rule requirements easier to comply with for advisers to private funds of funds such as funds of hedge funds. Section IX of this Release lists the statutory authority for the proposed amendment.

##### 3. Small Entities Subject To Rule

The Commission estimates that as of June 30, 2004,<sup>222</sup> approximately 490 SEC-registered investment advisers that would be affected by the amendment to the rule were small entities for purposes of the Advisers Act and the Regulatory Flexibility Act.<sup>223</sup>

##### 4. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendment would impose no new reporting, recordkeeping or other compliance requirements. To the contrary, the proposed amendment would provide all advisers, big or small, that advise pooled investment vehicles with the opportunity to reduce the burdens they incur complying with the present rule’s requirements to send pools’ audited financial statements to their investors within 120 days.

##### 5. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with the proposed amendment.

##### 6. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small

entities. In connection with the proposed rule, the Commission considered the following alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the amendment for such small entities.

The overall impact of the proposed amendment is to decrease regulatory burdens on advisers, and small advisers, as well as large ones, will benefit from the proposed rule. Moreover, the proposed amendment achieves the rule’s objectives through alternatives that are already consistent in large part with advisers’ current custodial practices. For these reasons, alternatives to the proposed amendment are unlikely to minimize any impact that the proposed rule may have on small entities. The 180-day rule cannot be further clarified, or improved by the use of a performance standard. Regarding exemption from coverage of the rule amendment, or any part thereof, for small entities, such an exemption would deprive small entities of the burden relief provided by the amendment.

##### 7. Solicitation of Comments

We encourage written comments on matters discussed in this IRFA. Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of the effect.

#### IX. Statutory Authority

We are proposing amendments to rule 203(b)(3)-1 and proposing rule 203(b)(3)-2 pursuant to our authority under sections 202(a)(17),<sup>224</sup> 203, 204, 206(4) and 211(a) of the Advisers Act.<sup>225</sup> Section 211(a) gives us authority to classify, by rule, persons and matters within our jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of our authority under the Act.<sup>226</sup>

We are proposing amendments to rule 204-2 pursuant to our authority under

<sup>217</sup> Rule 0-7(a) [17 CFR 275.0-7(a)]

<sup>218</sup> 15 U.S.C. 80b-3A.

<sup>219</sup> 5 U.S.C. 603(a).

<sup>220</sup> Rule 206(4)-2 [17 CFR 275.206(4)-2].

<sup>221</sup> Rule 206(4)-2(b)(3).

<sup>222</sup> This estimate is based on the information provided submitted by SEC-registered advisers in Form ADV, Part 1A [17 CFR 279.1].

<sup>223</sup> See Section VIII.A. of this Release for the definition of a small entity. Unlike the other rules and amendments the Commission is proposing today, the scope of the proposed amendment to rule 206(4)-2 is not limited to hedge fund advisers that would be subject to registration requirements under proposed rule 203(b)(3)-2.

<sup>224</sup> 15 U.S.C. 80b-2(a)(17).

<sup>225</sup> 15 U.S.C. 80b-3, 80b-4, 80b-6(4) and 80b-11(a).

<sup>226</sup> Section 211(a) also provides that “the Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission \* \* \*.”

sections 204, 206(4), and 211(a) of the Advisers Act.

We are proposing amendments to rule 205-3 pursuant to the authority set forth in section 205(e) and 206A of the Advisers Act.<sup>227</sup>

We are proposing amendments to rule 206(4)-2 pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act.

We are proposing amendments to Form ADV under section 19(a) of the Securities Act of 1933,<sup>228</sup> sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934,<sup>229</sup> section 319(a) of the Trust Indenture Act of 1939,<sup>230</sup> section 38(a) of the Investment Company Act of 1940,<sup>231</sup> and sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940.<sup>232</sup>

### Text of Proposed Rule, Rule Amendments and Form Amendments

#### List of Subjects in 17 CFR Parts 275 and 279

Investment Advisers, Reporting and recordkeeping requirements, Securities.

For reasons set forth in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

### PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The general authority citation for Part 275 is revised to read as follows:

**Authority:** 15 U.S.C. 80b-2(a)(11)(F), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Section 275.203(b)(3)-1 is revised to read as follows:

#### § 275.203(b)(3)-1 Definition of “client” of an investment adviser.

*Preliminary Note to § 275.203(b)(3)-1.* This section is a safe harbor and is not intended to specify the exclusive method for determining who may be deemed a single client for purposes of section 203(b)(3) of the Act. Under paragraph (b)(6) of this section, the safe harbor is not available with respect to private funds.

(a) *General.* You may deem the following to be a single client for purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)):

(1) A natural person, and:

(i) Any minor child of the natural person;

(ii) Any relative, spouse, or relative of the spouse of the natural person who has the same principal residence;

(iii) All accounts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries; and

(iv) All trusts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries;

(2) (i) A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to in paragraph (a)(1)(iv) of this section), or other legal organization (any of which are referred to hereinafter as a “legal organization”) to which you provide investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, other securityholders or beneficiaries (any of which are referred to hereinafter as an “owner”); and

(ii) Two or more legal organizations referred to in paragraph (a)(2)(i) of this section that have identical owners.

(b) *Special rules.* For purposes of this section:

(1) You must count an owner as a client if you provide investment advisory services to the owner separate and apart from the investment advisory services you provide to the legal organization, *provided, however*, that the determination that an owner is a client will not affect the applicability of this section with regard to any other owner;

(2) You are not required to count an owner as a client solely because you, on behalf of the legal organization, offer, promote, or sell interests in the legal organization to the owner, or report periodically to the owners as a group solely with respect to the performance of or plans for the legal organization’s assets or similar matters;

(3) A limited partnership or limited liability company is a client of any general partner, managing member or other person acting as investment adviser to the partnership or limited liability company;

(4) You are not required to count as a client any person for whom you provide investment advisory services without compensation;

(5) If you have your principal office and place of business outside of the United States, you are not required to count clients that are not United States residents, but if your principal office and place of business is in the United States, you must count all clients; and

(6) You may not rely on paragraph (a)(2)(i) of this section with respect to

any private fund as defined in § 275.203(b)(3)-2(d).

(c) *Holding out.* If you are relying on this section, you shall not be deemed to be holding yourself out generally to the public as an investment adviser, within the meaning of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)), solely because you participate in a non-public offering of interests in a limited partnership under the Securities Act of 1933.

3. Section 275.203(b)(3)-2 is added to read as follows:

#### § 275.203(b)(3)-2 Definition of “client” for certain private funds.

(a) For purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)), you must count the shareholders, limited partners, members, other securityholders or beneficiaries (any of which are referred to hereinafter as an “owner”) of a private fund as clients.

(b) If you provide investment advisory services to a private fund in which an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 to 80a-64) is, directly or indirectly, an owner, you must count the owners of that investment company as clients for purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)).

(c) If both you and the private fund have your principal offices and places of business outside the United States, you may treat the private fund as your client for all other purposes under the Act, other than sections 206(1) and 206(2) (15 U.S.C. 80b-6(1) and (2)).

(d)(1) A private fund is a company:

(i) That would be an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(a)) but for the exception provided from that definition by either section 3(c)(1) or section 3(c)(7) of such Act (15 U.S.C. 80a-3(c)(1) or (7));

(ii) That permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and

(iii) Interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

(2) Notwithstanding paragraph (d)(1) of this section, a company is not a private fund if it permits its owners to redeem their ownership interests within two years of the purchase of such interests only in the case of:

(i) Events you find after reasonable inquiry to be extraordinary and unforeseeable at the time the interest was issued; and

(ii) Interests acquired with reinvested dividends.

<sup>227</sup> 15 U.S.C. 80b-5(e) and 80b-6a.

<sup>228</sup> 15 U.S.C. 77s(a).

<sup>229</sup> 15 U.S.C. 78w(a) and 78bb(e)(2).

<sup>230</sup> 15 U.S.C. 77sss(a).

<sup>231</sup> 15 U.S.C. 78a-37(a).

<sup>232</sup> 15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a).

(3) Notwithstanding paragraph (d)(1) of this section, a company is not a private fund if it has its principal office and place of business outside the United States, makes a public offering of its securities in a country other than the United States, and is regulated as a public investment company under the laws of the country other than the United States.

4. Section 275.204-2 is amended by:

(a) Redesignating paragraph (e)(3) as (e)(3)(i); and

(b) Adding paragraphs (e)(3)(ii) and (l).

The additions read as follows:

**§ 275.204-2 Books and records to be maintained by investment advisers.**

\* \* \* \* \*

(e) \* \* \*

(3)(i) \* \* \*

(ii) *Transition rule.* If you are an investment adviser to a private fund as that term is defined in § 275.203(b)(3)-2, and you were exempt from registration under section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)) prior to [insert effective date of the final § 275.203(b)(3)-2], paragraph (e)(3)(i) of this section does not require you to maintain or preserve books and records that would otherwise be required to be maintained or preserved under the provisions of paragraph (a)(16) of this section to the extent those books and records pertain to the performance or rate of return of such private fund for any period ended prior to [insert effective date of the final § 275.203(b)(3)-2], provided that you were not registered with the Commission as an investment adviser during such period, and provided further that you continue to preserve any books and records in your possession that pertain to the performance or rate of return of such private fund for such period.

\* \* \* \* \*

(1) *Records of private funds.* If an investment adviser subject to paragraph (a) of this section advises a private fund (as defined in § 275.203(b)(3)-2(d)), and the adviser or any related person (as defined in Form ADV [17 CFR 279.1]) of the adviser acts as the private fund's general partner, managing member, or in a comparable capacity, the books and records of the private fund are records of the adviser for purposes of section 204 of the Act [15 U.S.C. 80b-4].

5. Section 275.205-3 is amended by redesignating paragraph (c) as (c)(1) and adding paragraph (c)(2) to read as follows:

**§ 275.205-3 Exemption from the compensation prohibition of section 205(a)(1) for registered investment advisers.**

\* \* \* \* \*

(c)(1) \* \* \*

(2) *Private funds.* If you are an investment adviser to a private investment company that is a private fund as that term is defined in § 275.203(b)(3)-2, and you were exempt from registration under section 203(b)(3) of the Act [15 U.S.C. 80b-3(b)(3)] prior to [insert effective date of the final § 275.203(b)(3)-2], paragraph (b) of this section will not apply to any equity owner of that company that was an equity owner of that company prior to [insert effective date of the final § 275.203(b)(3)-2].

\* \* \* \* \*

6. Section 275.206(4)-2 is amended by revising paragraph (b)(3) to read as:

**§ 275.206(4)-2 Custody of funds or securities of clients by investment advisers.**

\* \* \* \* \*

(b) \* \* \*

(3) *Limited partnerships subject to annual audit.* You are not required to comply with paragraph (a)(3) of this section with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit (as defined in section 2(d) of Article 1 of Regulation S-X (17 CFR 210.1-02(d)) at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 180 days of the end of its fiscal year; and

\* \* \* \* \*

**PART 279—FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940**

7. The authority citation for Part 279 continues to read as follows:

**Authority:** The Investment Advisers Act of 1940, 15 U.S.C. 80b-1, *et seq.*

8. Form ADV (referenced in § 279.1) is amended by:

a. In Part 1A, Item 7, revising Item 7B; and

b. In Schedule D, revising Section 7.B. The revisions read as follows:

**Note:** The text of Form ADV does not and this amendment will not appear in the Code of Federal Regulations.

Form ADV

\* \* \* \* \*

Part 1A

\* \* \* \* \*

Item 7 Financial Industry Affiliations

\* \* \* \* \*

B. Are you or any related person a general partner in an investment-related limited partnership or manager of an investment-related limited liability company, or do you advise any other "private fund," as defined under SEC rule 203(b)(3)-2?

Yes  No

If "yes," for each limited partnership, limited liability company, or (if applicable) private fund, complete Section 7.B. of Schedule D. If, however, you are an SEC-registered adviser and you have related persons that are *SEC-registered advisers* who are the general partners of limited partnerships or the managers of limited liability companies, you do not have to complete Section 7.B. of Schedule D with respect to those related advisers' limited partnerships or limited liability companies.

To use this alternative procedure, you must state in the Miscellaneous Section of Schedule D: (1) That you have related SEC-registered investment advisers that manage limited partnerships or limited liability companies that are not listed in Section 7.B. of your Schedule D; (2) that complete and accurate information about those limited partnerships or limited liability companies is available in Section 7.B. of Schedule D of the Form ADVs of your related SEC-registered advisers; and (3) whether your clients are solicited to invest in any of those limited partnerships or limited liability companies.

\* \* \* \* \*

Schedule D

\* \* \* \* \*

**SECTION 7.B. Limited Partnership or Other Private Fund Participation**

You must complete a separate Schedule D Page 4 for each limited partnership in which you or a related person is a general partner, each limited liability company for which you or a related person is a manager, and each other private fund that you advise.

Check only one box:

Add  Delete  Amend  
Name of Limited Partnership, Limited Liability Company, or other Private Fund:

\_\_\_\_\_  
Name of General Partner or Manager:

If you are registered or registering with the SEC, is this a "private fund" as defined under SEC rule 203(b)(3)-2?  
 Yes  No

Are your clients solicited to invest in the limited partnership, limited liability company or other private fund?

Yes  No

Approximately what percentage of your clients have invested in this limited partnership, limited liability company, or other private fund? \_\_\_\_\_%

Minimum investment commitment required of a limited partner, member, or other investor: \$ \_\_\_\_\_

Current value of the total assets of the limited partnership, limited liability company, or other private fund: \$ \_\_\_\_\_

Dated: July 20, 2004.

By the Commission.

**Jill M. Peterson,**

*Assistant Secretary.*

**Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to Proposing Release No. IA-2266; Proposed Registration Under the Advisers Act of Certain Hedge Fund Advisers**

The majority proposes a new rule and rule amendments under the Investment Advisers Act of 1940 that would require advisers to all hedge funds to register with the Commission.<sup>1</sup> We write jointly to dissent from this proposal. Our primary purpose in writing this dissent is to encourage commenters to respond to the issues discussed in the Proposing Release and to address the numerous issues that the release does not raise.

The majority proposes a solution to an ill-defined problem without having given proper consideration to viable alternative solutions in light of the limitations of our own capabilities. We acknowledge that the Commission does not know everything it would like to about hedge funds and hedge fund advisers. Mandatory registration of hedge fund advisers under the Advisers Act would not fill in these information gaps, but would significantly increase industry and Commission burdens. We are confident that there are other ways of obtaining information that would help us with our investor protection mission. However, before attempting a systematic collection of information, we must determine what information we want or need. We hope that commenters can provide us guidance about the types of useful information that would assist the Commission in discovering and deterring hedge fund fraud.

*Hedge Funds Have Long Been the Subject of SEC Study*

As the Proposing Release points out, the Commission has been studying hedge funds since the 1960s.<sup>2</sup> As recently as 1992, in

<sup>1</sup> The term "hedge fund" generally refers to an unregistered pooled investment, privately organized, not advertised, and administered by professional investment managers, whose securities are privately placed with wealthy individual and institutional investors. See generally *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission*, at 3 (available at <http://www.sec.gov/spotlight/hedgefunds.htm>) ("2003 Staff Hedge Fund Report").

<sup>2</sup> See Proposing Release, at n. 24 and accompanying text.

response to a Congressional inquiry, the Commission's staff discussed the "difficulties" that unregulated advisers pose to our enforcement efforts.<sup>3</sup> The report concluded "the Commission has substantial powers to obtain information for enforcement purposes, including the power to compel testimony and document production."<sup>4</sup> Further, the report noted that "the purpose of regulation is to protect investors, not to simplify investigations" and "the potential need to obtain information from hedge funds for enforcement purposes would not seem to be an adequate reason for registration."<sup>5</sup> Seven years later, the President's Working Group on Financial Markets, of which the Commission is a member, issued a report after the near collapse of Long Term Capital Management.<sup>6</sup> This report concluded "requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity."<sup>7</sup>

Last year, however, our staff, after conducting another study of the hedge fund industry, issued a report that recommended, among other things, that the Commission consider requiring hedge fund managers to register as investment advisers under the Advisers Act.<sup>8</sup> This report was the culmination of a study that the Commission authorized the staff to conduct in June 2002 in order to determine the necessity of new rules or legislation for hedge funds.<sup>9</sup> The Commission gave the staff subpoena power to ensure that it could obtain the information that it needed. Of particular concern was whether hedge funds were becoming "retailized" and whether the growth in hedge funds was accompanied by a disproportionate incidence of fraud.

The 2003 Staff Hedge Fund Report found no retailization and no significant increase in fraud. These conclusions were consistent

<sup>3</sup> See Letter from Richard C. Breeden, Chairman, SEC, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (June 12, 1992), transmitting Memorandum from William H. Heyman, Director, Division of Market Regulation, and Marianne K. Smythe, Director, Division of Investment Management, to Chairman Breeden, regarding Hedge Funds, at 10 (available at SEC's public reference room under file no. S7-30-04).

<sup>4</sup> *Id.* at 10.

<sup>5</sup> *Id.* at 10.

<sup>6</sup> See Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management—Report of the President's Working Group on Financial Markets, by representatives from the Commission, the Treasury Department, the Federal Reserve and the Commodity Futures Trading Commission (Apr. 1999) (available at: <http://www.treas.gov/press/releases/reports/hedfund.pdf>) ("PWG LTCM Report").

<sup>7</sup> *Id.* at B-16.

<sup>8</sup> 2003 Staff Hedge Fund Report, *supra* note 1.

<sup>9</sup> The objective of the study was to aid the Commission in determining whether regulatory or legislative changes were necessary to respond to the growth in hedge funds. Commission staff reviewed documents and information from 65 hedge fund advisers managing more than 650 different hedge funds, visited hedge fund advisers and prime brokers, and conducted a series of examinations of registered funds of hedge funds. See 2003 Staff Hedge Fund Report, *supra* note 1, at vii.

with the views expressed at the Commission's May 2003 roundtable, at which 60 panelists, including representatives of Federal, State and foreign government regulators, securities industry professionals, and academics testified. Notwithstanding these findings, the staff recommended registering hedge fund advisers. The Proposing Release fails to make a convincing case that this change from the President's Working Group position, supported by the Commission four years earlier, is warranted. It dismisses the conclusion in the PWG LTCM Report on the basis that the Report and the Proposing Release serve "different purposes."<sup>10</sup> Nonetheless, the Proposing Release cites as a concern underlying the proposed rulemaking the very anomalies and marketplace risks that were a central focus of the PWG LTCM Report.<sup>11</sup>

*Registration Will Not Reduce Enforcement Actions*

In support of its proposal, the majority cites Commission enforcement actions. First, it notes that the Commission has brought 46 enforcement actions in the past five years in which hedge fund advisers have defrauded hedge fund investors or used a hedge fund to defraud others. By comparison, the Commission initiated approximately 2,600 enforcement actions during fiscal years 1999 through 2003.<sup>12</sup> As the staff's 2003 Hedge Fund Report states, there is "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."<sup>13</sup>

Even assuming that the number of hedge fund cases is rising disproportionately, the nature of the cases suggests that registration of hedge fund advisers will not stem the increase. The 46 cases suggest that the typical "hedge fund" fraud is perpetrated by an adviser that is too small to be registered with the Commission, was registered already with the Commission, or evaded registration

<sup>10</sup> See Proposing Release at text following n. 32.

<sup>11</sup> See Proposing Release at text accompanying nn. 38 and 39. The majority speaks ominously of the fact that certain hedge fund managers are active traders, but this just indicates their important role in providing liquidity. See Proposing Release at n. 38 and accompanying text (citing Marcia Vickers, *The Most Powerful Trader on Wall Street You've Never Heard Of*, Business Week, July 21, 2003, at 66 (noting that SAC Capital Advisors "routinely accounts for as much as 3% of the New York Stock Exchange's average daily trading, plus up to 1% of the NASDAQ's"). Federal Reserve Chairman Alan Greenspan explained the important role hedge funds can play. Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing And Urban Affairs Committee (Feb. 12, 2004) ("Greenspan Testimony") ("The value that these institutions have is to create a very significant amount of liquidity in our system, and I think that while they have a reputation of being a sort of peculiar type of financial group, I think they've been very helpful to the liquidity and, hence, the international flexibility of our financial system.").

<sup>12</sup> See Securities and Exchange Commission, 2002 Annual Report at 2, and 2003 Annual Report at 17 (reporting number of civil injunctive actions and administrative proceedings initiated during fiscal years 1999 through 2003).

<sup>13</sup> See 2003 Staff Hedge Fund Report, *supra* note 1, at 73.

requirements.<sup>14</sup> Mandatory hedge fund adviser registration would not add to the Commission's ability to combat these types of fraud.<sup>15</sup> Importantly, the majority's recitation of these fraud cases illustrates the fact that hedge fund advisers are subject to the antifraud provisions regardless of their registration status.

To substantiate requiring registration, the majority also points to the recent market timing and late trading scandal in the investment company industry in which some hedge funds were implicated. The majority posits that had our examiners been inspecting the hedge funds, they would have found these abuses sooner. But mutual funds and their advisers *are* registered, and examiners were inspecting the mutual funds involved in the scandals and did not find the abuses. We have been and are continuing to punish fund advisers and their employees for orchestrating these schemes.<sup>16</sup> Although our enforcement actions have been targeted primarily at the regulated advisers of mutual funds, hedge fund advisers are also answerable—and will be punished—for their violations of the securities laws.<sup>17</sup> In addition

<sup>14</sup> Specifically, 8 of these 46 cases involve hedge fund advisers who were already registered with the Commission. In 5 of the 46 cases, the fund should have been registered under the Investment Company Act, so their advisers already should have been registered under current rules. In 20 of the 46 cases, the hedge funds were too small to be covered by the proposed rulemaking. In 2 cases, the fraud involved a principal of a registered broker-dealer or investment adviser, over whom we already had full regulatory oversight. Three of the 46 cases were garden-variety fraud designed to swindle investors, regardless of whether the vehicles were called hedge funds, venture capital funds, limited partnerships or prime banks. Registration might have deterred them from using the term "hedge fund," but would not have deterred the fraud itself.

<sup>15</sup> In only 8 of the 46 cases the existence of the rule might have increased in the Commission's oversight. These 8 cases, however, do not justify the proposed rulemaking. Most involve valuation problems, which have been notoriously difficult for us to detect even if the adviser is registered. In addition, only perfectly timed inspections would have improved the Commission's detection of the frauds at issue. With respect to all advisers, registered or unregistered, tips from knowledgeable insiders or third parties are often the key to discovering the fraud. Indeed, tips pointed us to the fraud in 7 of the 8 remaining cases.

<sup>16</sup> See, e.g., In the Matter of Alliance Capital Management, L.P., Investment Advisers Act Release No. 2205 (Dec. 18, 2003); In the Matter of Banc One Investment Advisors Corporation and Mark A. Beeson, Investment Advisers Act Release No. 2254 (June 29, 2004); In the Matter of James Patrick Connolly, Jr., Investment Advisers Act Release No. 2183 (Oct. 16, 2003); In the Matter of Pilgrim Baxter & Associates, Ltd., Investment Advisers Act Release No. 2251 (June 21, 2004); In the Matter of Strong Capital Management, Inc., Investment Advisers Act Release No. 2239 (May 20, 2004); *SEC v. Security Trust Co.*, N.A., Litigation Release No. 18653 (Apr. 1, 2004); In the Matter of Steven B. Markovitz, Release No. 33-8298 (Oct. 2, 2003).

<sup>17</sup> The Proposing Release states that the staff has identified up to 40 hedge funds that have been involved in the Commission's late trading and market timing actions. See Proposing Release at n. 44 and accompanying text. The reliance on this information to substantiate the proposal is unwarranted. The majority never counted the number of hedge fund advisers, the entities it proposes to register. We estimate that the number

to our enforcement actions, we have adopted certain regulatory measures<sup>18</sup> and are considering others to address any underlying, widespread problems.<sup>19</sup> We should revisit our oversight methods rather than looking for more entities to inspect. For example, had we reviewed mutual funds' flow data and understood how to extract the relevant information, we might have discerned these abusive practices.

#### *Form ADV Does Not Meet the Information "Needs" Articulated by the Majority*

The majority believes that the information that hedge fund advisers will provide on Form ADV could otherwise only be obtained through "substantial forensic efforts on the part of our staff."<sup>20</sup> Without considerable further amendment, information filed on Form ADV will not provide the details about hedge fund advisers that the majority suggests it needs to assist the Commission in addressing the concerns that the majority refers to in the release.<sup>21</sup> Part I of Form ADV yields little more than a census of name, address, and amount of assets under management. Part II of Form ADV, although more substantive, is unlikely to produce information that would prove useful to the Commission because hedge fund advisers will feel compelled to draft their disclosure to protect proprietary information. Perhaps it is proponents' realization that the Form ADV may not provide all the information they need that causes them to characterize the proposal to require hedge fund advisers to register as a modest first step. This begs the question of what this is a first step towards.<sup>22</sup>

#### *No Evidence of Significant Retailization*

The majority contends that the retailization of hedge funds is a growing problem. They assert that as more investors qualify as accredited investors, unsophisticated investors might be gaining inappropriate access to hedge funds. Adjustments to the eligibility criteria would address concerns about potential retailization more directly than hedge fund adviser registration.<sup>23</sup>

of advisers involved with these funds would have been approximately half. In addition, it is unclear at this point how many of the advisers to these 40 funds actually violated the securities laws.

<sup>18</sup> See, e.g., Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26418 (Apr. 16, 2004) [69 FR 22299 (Apr. 23, 2004)] and Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74713 (Dec. 24, 2003)].

<sup>19</sup> See, e.g., Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 11, 2003) [68 FR 70387 (Dec. 17, 2003)].

<sup>20</sup> See Proposing Release at text following n. 70.

<sup>21</sup> Form ADV and its instructions are available at <http://www.sec.gov/about/forms/formadv.pdf>.

<sup>22</sup> The staff recommended one possible next step. See 2003 Hedge Fund Staff Report, *supra* note 1, at 97 (recommending that Commission consider requiring advisers to provide a brochure specifically designed for hedge funds).

<sup>23</sup> This would directly address the staff's concern that although it "has not uncovered evidence of significant numbers of retail investors investing directly in hedge funds," "[n]evertheless, the increased number of retail investors qualifying as

The majority also points to indirect retailization through pension fund investments in hedge funds.<sup>24</sup> The proposing release cites an increase in pension investments and hedge funds from \$13 billion to \$72 billion since 1997.<sup>25</sup> This amount is approximately one percent of the total amount invested in private and public pension plans.<sup>26</sup> Despite the small portion of pension assets invested in hedge funds, the Proposing Release assumes that pension plan participants' financial well-being depends on Commission protection. Pension plan participants rely on professional money managers, who are fiduciaries of the pension plans, to evaluate investment options on behalf of the plan. Further, pension funds fall under either the oversight of either the Department of Labor or, in the case of public funds, state oversight.

Similarly, the majority points to creeping retailization through publicly-offered funds of hedge funds, noting that currently "there are 40 registered funds of hedge funds that offer or plan to offer their shares publicly."<sup>27</sup> However, these publicly-offered funds must be managed by a registered investment adviser and the fund must also comply with the more prescriptive provisions of the Investment Company Act. The Commission is able to examine registered advisers to registered funds of hedge funds as often as it deems appropriate. The Commission may ask for additional information from a registered adviser. It is therefore unclear how mandatory hedge fund adviser registration

accredited investors raises our concern that hedge funds and broker-dealers might begin to seek out these investors as a new source of capital for hedge funds." See 2003 Staff Hedge Fund Report, *supra* note 1, at 80-81. If, as the majority suggests, there are an excess of investor dollars waiting to flow into hedge funds, then it is unclear why hedge funds would need to look to retail investors. See *From Alpha to Omega; Hedge Funds*, ECONOMIST, July 17, 2004 ("[M]any of the oldest and best-known hedge funds will not accept any new money" because "[f]or many trading strategies \* \* \* there is a limit to the amount of money that can be moved around cheaply and briskly. While punting large amounts on the highly liquid foreign-exchange or government-bond markets is easy, betting on illiquid corporate bonds or shares is far harder. And the larger the amounts, the more expensive the bets are.").

<sup>24</sup> The majority also expresses concern about an increase in hedge fund investment by universities, endowments, foundations, and other charitable organizations because "[l]osses resulting from hedge fund investments, as with any other investment loss, may affect the entities' ability to satisfy their obligations to their beneficiaries or pursue other intended purposes." See Proposing Release at text following n. 57. We applaud the majority's concern for the nation's educational and charitable institutions, but these organizations hire experienced money managers to invest their money in a way that maximizes the ability of those organizations to carry out their objectives.

<sup>25</sup> See Proposing Release at text accompanying n. 60.

<sup>26</sup> See Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Flow of Funds Accounts of the United States* (June 10, 2004) (reporting for year 2003, \$4.21 trillion in private pension fund reserves and \$2.21 trillion in public pension fund reserves).

<sup>27</sup> See Proposing Release at text accompanying n. 54.

would be helpful in this context. However, if the Commission can demonstrate that publicly-offered funds of hedge funds pose real undisclosed risks to retail investors, the Commission could consider whether the problem can be addressed by reversing past regulatory actions that have permitted these funds of hedge funds to be publicly offered.

#### *Scope of the Proposed Rule*

The majority's proposal would reach fund advisers that advise "private funds," which it defines as funds that: (1) Would be subject to regulation under the Investment Company Act of 1940 but for the exception provided in either section 3(c)(1) or section 3(c)(7) of the Act; (2) permit investors to redeem their interests in the fund within two years of purchasing them; and (3) interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser. We question whether the two year lock-up will simply cause hedge fund advisers to lengthen their redemption periods, which would not benefit investors. Further, the majority points to valuation as one of the problems that the proposed rulemaking would address.<sup>28</sup> If valuation concerns are motivating the push for hedge fund registration, we should have the same concerns about private equity and venture capital funds.<sup>29</sup>

#### *Costs of Registration*

The proposing release seeks to minimize the burden of registration.<sup>30</sup> It downplays the complexities involved in registering as an investment adviser. Although proponents seem to believe that, even under the current

<sup>28</sup> The Proposing Release cites a recent study finding valuation problems in hedge funds, and noted that "the authors attribute these failures, in part, to a lack of regulatory oversight." See Proposing Release at n. 83 and accompanying text (citing Christopher Kundro and Stuart Feffer, *Valuation Issues and Operational Risk in Hedge Funds*, Capco White Paper (Dec. 2003)). The article does not call for enhanced government regulation, but for more rigorous internal valuation procedures with adequate managerial supervision and, when necessary, utilization of third-party pricing services. See *id.* at 8–9.

<sup>29</sup> Probate and taxation of investors' estates, financing transactions based on balance sheet assets, marketing to investors of follow-on funds, and secondary sales of investment interests all raise potential valuation issues for private equity and venture funds.

<sup>30</sup> The majority estimated filing fees of approximately \$1,000 in the first year and approximately \$500 subsequently. In addition, the majority estimated average initial compliance costs of \$20,000 in professional fees and \$25,000 in internal costs including staff time. See Proposing Release at Section IV.B. At the same time the majority characterizes the costs associated with hedge fund adviser registration as small, it contends that the proposal will level the playing field among hedge fund advisers. See Proposing Release at IV.A.5.a. A level playing field already exists; hedge fund advisers can decide to register and, if registration is important to investors, the market will reward registered advisers. Others suggest that hedge funds have an unfair advantage over mutual funds. This is not the only area in which the Commission permits a mix of unregistered and registered products in order to enhance investors' options without compromising investor protection. Rule 144A [17 CFR 230.144A] private offerings, for example, exist alongside public offerings.

regulatory regime, Advisers Act registration is the only choice for legitimate advisers,<sup>31</sup> there is no indication that advisers undertake the process of registration lightly.<sup>32</sup> While the burden of this first step is likely to exceed the majority's expectations, future, more substantive regulation may bring even higher costs, such as the stifling of hedge funds' ability to carry out their business.<sup>33</sup>

It is far from certain that the oversight afforded through registration under the Advisers Act will reduce hedge fund investor fraud losses. By contrast, it is certain that fund investors will bear the cost of the additional regulations.<sup>34</sup> The information collected on Form ADV will not be a sufficient basis for hedge fund advisers' investment decisions; hedge fund investors will continue to do their own research to supplement this information.

Even apart from the Form ADV discussion, the majority discounts the fact that

<sup>31</sup> Indeed, underlying this proposal is an apparent belief that advisers that are willing to register are better than those who do not. See William Donaldson, Chairman, Securities and Exchange Commission, Testimony before the Senate Banking Committee (July 18, 2004) ("I don't get much push back from people who are operating good funds," he said. "I don't get much push back from people who have nothing to hide.")

<sup>32</sup> Adviser registration already carries with it certain substantive requirements, including adherence to rule 206(4)–6 [17 CFR 275.206(4)–6], the proxy voting rule, and rule 206(4)–7 [17 CFR 275.206(4)–7], the compliance rule. More generally, as with any disclosure document, Forms ADV can serve as the basis for a litigation against an adviser, so they are prepared with great care and often costly legal advice.

<sup>33</sup> Federal Reserve Chairman Alan Greenspan warned of the likelihood of substantive regulation following registration. See Greenspan Testimony, *supra* note 11. ("I grant you that registering advisers in and of itself is not a problem. The question is: What is the purpose of that unless you're going to go further? And therefore I feel uncomfortable about that issue.")

<sup>34</sup> The majority argues that all investors, regardless of their wealth, deserve the protection of the Investment Advisers Act. See Proposing Release at nn. 15–17. Wealthy investors might not want or need the same level of protection. They often employ well-trained professionals to select investments appropriate for them. If they desire the comfort afforded by a more rigorous regulatory regime, they may select mutual funds or other investments managed by advisers registered with the Commission or rely on a registered investment adviser to invest their money for them. Thus, the majority should view the benefit of enhanced protection for wealthy investors against the costs, including limitations on their investment options and potentially higher fees. See, Erik J. Greupner, Comment, *Hedge Funds Are Headed Down-market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1578 (2003) ("[R]egulatory action aimed at eliminating every vestige of fraud in a given market would place such a heavy and costly burden of compliance upon issuers that investors would be safe but unable to achieve any meaningful return on their investments. The regulatory agency would also incur a high cost of enforcement. Carried to its logical end, investor protection as a sole reason for regulation, without also granting markets the freedom to reward those who take risk, ironically keeps investors safe and yet fails to fully protect the investors' sole interest in investing in the first instance: to achieve the highest return commensurate with their individual tolerance for risk.")

registration implies inspection. Effective inspection of all hedge fund advisers will require the Commission to invest substantial resources and expertise that it does not yet have. Targeted exams will not necessarily be less burdensome than routine exams either for the Commission or for those advisers inspected. If we fail to devote adequate resources and develop the necessary expertise to carry out effective risk-based examinations, we are providing a false sense of security by suggesting to the marketplace that, through registration, we have bathed hedge funds in "sunlight."

The majority ignores the opportunity costs of its proposal. The Commission does not have unlimited resources. Resources we devote to regulating hedge fund advisers are resources that we could be devoting to other, perhaps higher, priorities. It is abundantly clear from recent events that we have more work to do in other, more traditional, areas under our jurisdiction.<sup>35</sup> Would investors be better served if we devoted our additional resources to more effective regulation of mutual funds, the investment of choice for over ninety million Americans, as opposed to hedge funds, whose direct investors are limited to institutions and an estimated 200,000 sophisticated high net worth investors? The Commission is moving away from routine inspections and towards a risk-based inspections system. The majority views hedge fund advisers as ideal candidates for the risk-based approach.<sup>36</sup> As the Commission determines what it is looking for, hedge fund advisers may face repeated, ad-hoc requests for paper and electronic documents. Such an approach cannot be deemed to be "modest."

#### *The Commission Should Explore Alternative Approaches*

Before making this proposal, the Commission should have undertaken a study that complements the descriptive overview of

<sup>35</sup> The majority contends that hedge fund advisers fall within our traditional jurisdiction, but for the safe harbor provision in rule 203(b)(3)–1 [17 CFR 275.203(b)(3)–1] ("A limited partnership is a client of any general partner or other person acting as investment adviser to the partnership"). See Proposing Release at text accompanying n. 119. We disagree with the majority's suggestion that rule 203(b)(3)–1 conflicts with the spirit of section 208(d) of the Act, which prohibits a person from doing indirectly or through another person something that would be unlawful for the person to do directly. See Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. 956 (Feb 22, 1985) (when the Commission proposed rule 203(b)(3)–1, it explained that the rule's availability is limited "to situations where the general partner advises the partnership based on the investment objectives of the limited partners as a group" to "prevent a general partner, in contravention of section 208(d) of the Advisers Act, from using the partnership to do what it could not do directly itself, namely, provide individualized investment advice to 15 or more clients without registering as an investment adviser"). Hedge fund advisers provide advice to hedge fund investors as a group, not individually, and, therefore, they should not be deemed to be managing the assets of more than 14 persons in contravention of the Act.

<sup>36</sup> Absent clearly identified red flags, we are concerned that high performance will likely invite extra Commission scrutiny.

hedge funds provided by the 2003 Staff Hedge Fund Report and focuses on identifying the qualitative and quantitative information that would raise red flags and provide systematic data on hedge fund trends and practices. Although speed of implementation seems to be of great concern to the majority, the Commission can defer consideration of adoption of the proposal pending the completion of such an analysis.

This study would include a survey of hedge funds, hedge fund investors, prime brokers, bank lenders and auditors and other relevant sources. The Commission should also review the vast array of data that the Commission and other government agencies already receive.<sup>37</sup> The Commission can glean additional information from investor complaints, examinations of prime brokers and registered hedge fund advisers, and in hedge fund enforcement cases. Another source of information may be hedge funds' filings under the USA Patriot Act.<sup>38</sup> After completing such a study, we could consider whether to require hedge fund advisers to file periodically certain information, which we could then monitor for red flags and trends.<sup>39</sup>

If the data point us to specific problems with hedge funds, we may be able to work with prime brokers, which are already registered with the Commission, to develop solutions. The Proposing Release does not

<sup>37</sup> Systemic risk issues are properly addressed jointly with the Treasury and the Federal Reserve. As Federal Reserve Chairman Alan Greenspan has stated, hedge funds have "been very helpful to the liquidity and hence the international flexibility of our financial system." Greenspan testimony, *supra* note 11. If well-meaning, but ineffective regulation inhibits hedge funds from performing their important function of lubricating our financial system, it could have a negative effect on our economy. The Chairman of the CFTC has expressed a desire for cooperation across agencies. See CFTC Chairman James Newsome, *Financial Times*, 5 April 2004 ("But my concern is that before any regulatory agency drives specific rules, you have to remember that hedge funds run across multiple jurisdictions. So I would suggest that the [President's] working group is the appropriate mechanism because that group takes the broader context.").

<sup>38</sup> See Anti-Money Laundering Programs for Unregistered Investment Companies, 67 FR 60617 (Sept. 26, 2002) (proposing to require, among other things, that unregistered investment companies file a notice containing certain basic information with the Department of Treasury's Financial Crimes Enforcement Network).

<sup>39</sup> Proponents tend to paint the proposed approach as little more than a notice filing approach. We suspect that many advisers already regulated under the Advisers Act would not share that view.

even ask any questions about the role that prime brokers can play, even though prime brokers have already helped us to identify some fraudulent activity at hedge funds.

#### *Request for Comment*

We urge commenters to address the following questions and any other issues raised here and in the Proposing Release.

- What are the concerns with respect to hedge funds that we should be addressing through rulemaking?
- Would approaches other than hedge fund registration be effective in addressing the concerns raised by the majority? Should we, for example, adjust the eligibility criteria for hedge fund investors? If so, what should the revised criteria be? For example, should we devise another definition of "accredited investor" that differs from that we employ for Regulation D purposes? Would a notice filing and reporting regime be a better alternative to Advisers Act registration? Are there more effective ways of addressing valuation? What measures could we take to enlist prime brokers in identifying valuation problems, fraud, and other red flags at hedge funds?
- What effect will universal registration have on investor demand for hedge fund investment opportunities? Would the registration of all hedge fund advisers expand the universe of eligible hedge funds and encourage even more pension fund investment in hedge funds? Would universal registration lead to calls for a reduction in eligibility criteria for investors because of a belief that registration enhances safety?<sup>40</sup>
- Is there a justifiable basis for distinguishing between the advisers covered by the proposed rulemaking and advisers to venture capital and private equity funds?<sup>41</sup> Are there risks that are peculiar to hedge fund advisers?
- If the Commission adopts the proposal, should it include an exemption for advisers that are registered with another government agency, e.g., the Commodity Futures Trading Commission?
- Would the proposed rulemaking conflict with the securities laws' traditional view that

<sup>40</sup> As the Proposing Release points out, in some other countries, there is pressure to open up hedge funds, subject to certain regulations, to a wider range of investors. See Proposing Release at n. 52.

<sup>41</sup> The majority distinguishes them by noting that, despite similarities, "we have not encountered significant enforcement problems with advisers with respect to their management of these types of funds." See Proposing Release at text accompanying notes 142 through 144. The majority links the higher incidence of abuses to the relative ease with which hedge fund investments can be redeemed. See *id.* at text accompanying n. 145.

sophisticated investors do not need the full oversight of the Commission?<sup>42</sup>

- Is the information provided on Form ADV sufficient to address the majority's concerns about hedge funds? What effect would the availability of information on the Form ADV have on the costs investors incur in researching hedge funds? What effect would registration have on the due diligence performed by hedge fund investors and the professionals they hire?

- Are the majority's estimates of the costs of registration and the costs of maintaining a compliance program under rule 206(4)-2, and the costs of complying with other rules under the Advisers Act, accurate? What are the anticipated effects of this rule proposal on new entrants in the marketplace? Would fears about more substantive regulation of hedge fund activity, business models, and business practices drive hedge fund advisers offshore? What burdens will hedge fund advisers face in responding to targeted, time-sensitive document requests under the Commission's new risk-based approach to oversight of registrants? What costs would investors bear as a result of the proposed rulemaking (including any reduction in the number of hedge fund offerings)?

Although the proposal seems innocuous on its face, it may harm investors without helping us perform our role. We need to know more about hedge funds. Registration of hedge fund advisers is not the best way to learn more, and it is unlikely that the Commission will determine in the next sixty days what it needs to know. While we would not normally oppose issuing a rule proposal to solicit comment, we cannot support a proposing release that papers over the weaknesses of the approach it puts forward, overstates the purported benefits, and ignores the possibility that viable, and indeed preferable, alternative approaches may exist.

For all of the foregoing reasons, we respectfully dissent.

Cynthia A. Glassman,  
*Commissioner.*

Paul S. Atkins,  
*Commissioner.*

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<sup>42</sup> See, e.g., section 4(2) of the Securities Act of 1933 [15 U.S.C. 77d(2)], Regulation D [17 CFR 230.501-230.508] and rule 144A [17 CFR 230.144A] promulgated thereunder, and sections 3(c)(1) [15 U.S.C. 80a-3(c)(1)] and 3(c)(7) [15 U.S.C. 80a-3(c)(7)] of the Investment Company Act.