

Mr Jonathan D. Katz,
Secretary,
United States Securities and Exchange Commission,
450 Fifth Street, N.W.,
Washington, D.C. 20549-0609,
U.S.A.

By courier and e-mail

15th September, 2004

Dear Mr Katz,

The Proposed New Rule to Require Registration Under the Advisers Act of Certain Hedge Fund Advisers

A. Introduction

The Alternative Investment Management Association Limited ("AIMA") is writing this letter to convey the concerns of its membership with respect to the proposed new rule and associated rule amendments to require registration under the Investment Advisers Act of 1940 (the "Act" or the "Advisers Act") of certain hedge fund advisers (the "Proposed Rule") contained in Proposing Release No. IA-2266 (the "Release"). This follows our submission of 22nd March 2004 (the "March Submission") to the Securities and Exchange Commission (the "Commission" or "SEC") on the Staff Report of September 2003 on the Implications of the Growth of Hedge Funds (the "Report"). A copy of the March Submission is attached.

AIMA was established in the United Kingdom ("UK") in 1990 as a direct result of the growing importance of alternative investments in global investment management. It is a not-for-profit educational and research body that represents practitioners and institutional investors in hedge fund, futures fund and currency fund management, including managers, prime brokers, administrators, lawyers and accountants.

AIMA's global membership comprises some 700 members in 43 countries, of whom approximately 15 per cent are based in the United States ("U.S."). In addition to the U.S., AIMA has significant and active members' groups (comprising, in total, approximately 55 per cent of the total membership) in the UK and most European jurisdictions, including France, Ireland, Italy, Luxembourg, Germany, the Netherlands and Switzerland; it also has chapters in Australia, Canada, Hong Kong/China, Japan, Singapore and South Africa.

AIMA works closely with regulators around the world and other interested parties in order better to promote the responsible use of alternative investments. AIMA provides regulators with complimentary copies of educational material produced by it or on its behalf. In addition to both formal and informal discussions with regulators, whenever those appear useful and helpful, AIMA frequently responds on behalf of its members to consultation processes initiated by regulators. Examples of regulatory initiatives and material undertaken or published by AIMA are the following:-

- (a) Second International Regulatory Forum (June 2003), which regulators from 11 jurisdictions attended and to which the Commission was invited;
- (b) Guide to Sound Practices for European Hedge Fund Managers (September 2002);
- (c) Guide to Sound Practices for Administrators (September 2004);

- (d) A series of Due Diligence Questionnaires for use both by investors in reviewing managers and managers reviewing other parties involved in hedge funds; and
- (e) The AIMA Journal, published five times a year and consisting solely of educational material.

A "Guide to Sound Practices for Fund Directors" and a paper on net asset value calculation and pricing, "Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry", are examples of material soon to be published by AIMA.

We wish to express support for the Commission's concerns to learn about the hedge fund industry and we also applaud your recognition of the importance of the industry and of protecting U.S. residents from fraud and other dangers. We are sympathetic to your initiative to provide for limited application of the proposed general registration requirement for certain offshore investment advisers.

AIMA does not usually involve itself in lobbying activities in the U.S., but the potential impact of the Proposed Rule on those of our members who are "offshore advisers"¹ is such that we are asked by them to comment on the proposals contained in the Release on their behalf. Almost all offshore advisers have U.S. investors in their funds, and so the consequences to them of any implementation of the Proposed Rule are significant.

We should point out that, as was the case with the March Submission, we have not commented on the Proposed Rule as it affects our U.S. hedge fund adviser members, whether or not registered as investment advisers, nor have we considered any Investment Company Act of 1940 issues. In that context, we wish to remind the Commission that between 80 and 90 per cent of AIMA's investment manager and adviser members are already regulated in their home jurisdictions, including the U.S. It is, in fact, generally a prerequisite of membership of AIMA that an investment manager/adviser, which is subject to regulation in its own jurisdiction, is regulated accordingly.

It is also the case that AIMA's manager members are generally required by law to be registered and regulated by their home regulator, regardless of the amount of assets under their management or number of investors; even £1 or €1 of an investor's money will render a manager subject to regulation by, for example, the UK's Financial Services Authority (FSA), Ireland's Irish Financial Services Regulatory Authority (IFSRA) and the Ontario Securities Commission (OSC).

This submission has been prepared by the Council and other members of AIMA in conjunction with Wilmer Cutler Pickering Hale and Dorr LLP² and has been approved by the Council of AIMA on behalf of its membership worldwide. We represent a broad range of investment adviser members, some of whose views may differ, to varying degrees, from those expressed in this submission.

We have used the same terminology as the SEC has used in the Release, including the terms "Advisers Act", "hedge funds" and "private funds", unless we have specifically provided otherwise, and paragraph, footnote and page number references are to those in the Release.

B. Summary

AIMA maintains the position it stated in the March Submission, namely that the Commission should exclude from the ambit of the Proposed Rule offshore advisers who are subject to regulation in their own jurisdictions, so that they will not be subject to any requirement to register under the Advisers Act, subject to appropriate safeguards to prevent circumvention and abuse.

In addition, we have addressed the specific issues the SEC has raised with respect to offshore advisers, and where relevant we have repeated arguments made in the March Submission.

C. Submission

¹ I.e. hedge fund investment managers and advisers whose principal place of business is not in the U.S. and who do not advise or manage assets of funds registered under the Investment Company Act of 1940.

² This submission is without prejudice to, and distinct from, the submission made to the Commission by that firm on 10th September 2004.

1. The General Proposition: Registration of Hedge Fund Advisers under the Advisers Act.

The Commission requested (in Section III of the Release) general requests for comments, and accordingly we have set out below our own general comments on the Release and the Proposed Rule which sets out relevant extracts from the Release and the Appendix.

Fraud

One of the reasons the Commission cites for proposing registration is the deterrence and early discovery of fraud. Paragraph 2 on page 24 states that registration will give the SEC authority to conduct examinations of a registered investment adviser's hedge fund activities. Under English law, and (as far as we are aware) under the laws of many other jurisdictions, the SEC as a foreign regulatory authority is not empowered to conduct examinations inside those jurisdictions. Further, the SEC's examination resources are likely to be even more stretched if they have to make examinations outside the U.S. Additional substantial costs would also be incurred. (See section v on page 66 and paragraph C1(c)(i) of our March Submission).

The anti-fraud laws will apply to persons meeting the definition of "investment adviser", regardless of whether they are registered under the Advisers Act. As a result, the Proposed Rule is not necessary to deter or "police" fraudulent behaviour by offshore advisers vis-a-vis U.S. clients. It is also true that where hedge funds are sold in the US, the funds themselves are subject to the anti-fraud provisions of the Investment Company Act of 1940 and the Securities Exchange Act of 1934; in addition, the sales personnel are subject to the anti-fraud provisions of the 1934 Act.

We would also refer to the fact that, in the majority of the offshore jurisdictions where private funds are established by offshore advisers, there is a requirement for annual audits, independent valuations and, in most cases, independent custody of assets. In addition, the investment advisers themselves will be required to lodge audited annual financial statements with their local regulator, unlike U.S. private firms which may not require an audit.

SEC powers of examination

The Release states that registration will permit the SEC to screen individuals associated with an investment adviser and to deny registration if they have been convicted of a felony or have a disciplinary record subjecting them to disqualification (section 3, page 28). It also states that registration would require hedge fund advisers to adopt policies and procedures designed to prevent violations of the Advisers Act and to designate a chief compliance officer. (See section 3 on page 28 and section 4 on page 29). It is our view that offshore advisers which are already subject to regulation outside the U.S. will already be subject to equivalent requirements so the imposition of further regulatory requirements is unnecessary. (See paragraphs C1(a) and (c) of the March Submission).

If the SEC were to have the power to make examinations, we anticipate that your already strained resources would be further severely stretched. Having regard to how hedge funds are structured and that they operate in varied ways, sometimes with subtle variations, from jurisdiction to jurisdiction, we submit that the local regulators, who are in constant contact with local industry practitioners, including industry service providers, are in a better position to regulate and perform such examinations. As such, we do not consider that the Proposed Rule would add anything to improve on the overall regulatory framework under which the offshore adviser operates and it would not afford any additional protection to U.S. investors in funds managed by an offshore adviser. We suggest that the SEC might achieve its aim of learning more about the global hedge fund industry by continued co-operation and sharing of knowledge between regulators, thereby establishing deeper working relationships without treading on the toes of local regulators. Regulation should and does evolve in response to current practices in all of the various major jurisdictions.

Burden of registration / costs

The SEC states that it is seeking to impose only minimal additional burdens on hedge fund advisers (section 6, page 31). For the reasons outlined in the March Submission (paragraph C1(a)), this is unlikely to be the case where offshore advisers are concerned since registration will result in duplicative and/or possibly conflicting regulation, for example in relation to anti-money laundering and record keeping requirements.

In Section IV of the Release the Commission discusses the cost-benefit analysis. In addition to the SEC's fees, it has been estimated by the SEC itself that professional costs of registration would be in the order of U.S.\$20,000 and administrative costs would be approximately U.S.\$25,000. Whilst these figures may be higher for a U.S. hedge fund adviser who needs to be fully compliant with the Advisers Act, nevertheless this cost is in our view an unnecessary burden on offshore advisers who are already regulated and who already bear the direct and indirect costs of compliance with the rules and regulations of their local regulator. We cannot see a corresponding benefit to investors in having dual regulation and thus we cannot see the costs, both direct and indirect, of U.S. regulation as being other than an unnecessary addition to the existing regulatory burden of offshore advisers.

The extent of the additional burden on offshore advisers will largely depend on the size of the adviser, its existing structure and resources which would need to be diverted. The AIMA membership represents a broad array of advisers; some have dedicated in house legal and compliance resources, while others outsource this function to varying extents or totally. It is, therefore, very difficult for us to indicate accurately likely additional costs which advisers would incur without more time to consult our broader membership³. We would request that the Commission allow the industry further time to consider all implications, including costs, of requiring offshore investment advisers to register.

However, advisers would presumably, at the very minimum, need to reconsider all operational and compliance agreements for any specific regulatory conflicts (as mentioned in the March Submission). In addition, U.S. legal experts would need to be engaged to provide suitable and training and advice to the individuals tasked with compliance. An ongoing regulatory and educational burden would be placed on the designated compliance officer, who would need to be an "expert" and keep up to date with the legal requirements in both the local jurisdiction and the U.S. This may place an unreasonable burden on that individual and reduce effectiveness, especially in respect of medium sized and smaller firms.

2. The Proposals for Offshore Advisers

We have commented below and in the Appendix, which contains relevant extracts from the Release, on the specific questions raised by the Commission in respect of offshore advisers.

In paragraph 3(c) on page 43 reference is made to the fact that the Commission does not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of an offshore adviser, cross-referring in footnote 131 to the Unibanco letter.

Further, it is stated on page 44 that an offshore adviser to an offshore fund may treat the fund (and not the fund's investors) as its client for all purposes under the Advisers Act, other than (i) determining the availability of the private adviser exemption, and (ii) those provisions prohibiting fraud. We note that this will be the case with offshore advisers of offshore funds and we welcome that limitation.

We understand, therefore, that, among other rules, in those circumstances the following provisions of the Advisers Act would not apply to an offshore adviser:-

- (a) the brochure rule (Rule 204-3);
- (b) the code of ethics (Rule 204-1);
- (c) the custody rules (Rule 206(4)-2);
- (d) the cash solicitation rules (Rule 206(4)-3);
- (e) policy on proxy voting (Rule 206(4)-6); and
- (f) the adoption and implementation of policies and procedures to prevent violations of the Advisers Act (Rule 206(4)-7),

each as enunciated in Section VI of the Release.

³ One of our members has indicated that the total additional administration cost would require around 25% of a compliance professional's time (e.g. £20 -25,000 (or approximately \$40,000) per annum) . On top of this, the offshore manager would need to bear the cost of lawyers advising on registration, as noted in the Release. Local lawyers would also need to advise on compatibility with local law.

It is not clear, however, whether the “qualified client” rules (subject to the grandfathering provisions abstracted in the Appendix) would apply to offshore advisers of offshore funds and, for the reasons set out in the March Submission, we request that such a requirement is not imposed on offshore advisers for the reasons specified there (see paragraph C2(e)).

In addition, in accordance with footnote 134 of the Release and the application of the Unibanco letter referenced therein, the record keeping rules under the Advisers Act would appear to apply to offshore advisers. We are concerned that these record keeping requirements may impose additional obligations on offshore advisers beyond those they have in order to comply with their own local regulator’s rules. Indeed, Rule 204-2 covers a detailed and comprehensive list of items to be recorded, in substance and range more prescriptive and wider than the records to be kept by, for example, a UK manager regulated by the FSA.

D. Conclusion

To conclude, for the reasons set out above and in the Appendix, we still do not believe that it is necessary or desirable to require offshore advisers to register under the Advisers Act if they are subject to regulation in their local jurisdiction. If the Commission does maintain its current position that there should be limited registration for offshore advisers, then the issues we have outlined concerning the detailed implications of even the limited registration prescribed by the Release remain, and we urge the Commission to consider the real concerns our members have in that regard, as expressed in this submission.

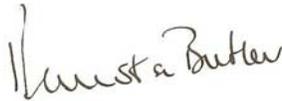
As we did with the March submission, we propose to draw the attention of regulators in other jurisdictions to this submission on behalf of our members and to provide copies to those regulatory authorities.

AIMA will be happy to discuss any aspect of this submission or to provide any further information requested. Any communication with AIMA in respect of this submission should be addressed to Florence Lombard, Executive Director (florence@aima.org) and Mary Richardson, Associate Director, Regulatory and Legal (mary@aima.org).

Yours faithfully,



Christopher Fawcett
Chairman



Dermot Butler
Deputy Chairman

Appendix 1: Extract from the Release

Appendix 1

Extract from the Release

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.

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 Commission. 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). Hedge fund advisers with assets under management between \$25 and \$30 million would be eligible, but not required, to register with the Commission.

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?

In addition to our overriding submission made in paragraph B of our submission, we would emphasise that the regulators in the UK, Ireland and Canada (as examples) require investment managers to be authorised before they can manage a single unit of currency of third party client money.

Subject to that, footnote 126 on page 41 seems to suggest that, whilst U.S. investment advisers would only have to register if they had assets under management of U.S. \$25 million or above, non-U.S. investment advisers would have to register, whatever the level of their assets under management. In our opinion this would be unfair and offshore advisers should be treated on an equivalent basis both in terms of the \$25 million threshold and the \$25 to \$30 million registration eligibility criteria.

We would add that, under the current regime in the U.S., there are some exceptions from the rule that small advisers (who are generally subject to local state regulation) cannot register with the Commission. Advisers operating from Wyoming (the only state that does not regulate advisers) MUST register with the Commission, regardless of assets under their management. It seems unfair that an offshore adviser who IS regulated in its own jurisdiction should be treated the same as an UNREGULATED U.S. (Wyoming) adviser.

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. Hedge fund advisers would be required to count the investors in the registered fund as clients. 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 investing in hedge funds. Are its terms clear?

Again, we would suggest that offshore advisers subject to a significant degree of regulation in their own jurisdictions should not be required to register in these circumstances. Many such advisers already manage funds which may include (for instance) regulated European funds or pension funds amongst their investors.

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

We have no comment.

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. 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.

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?

We believe that there should be a threshold for assets attributable to U.S. residents. For example, an offshore adviser managing an offshore fund with U.S. \$100 million of assets but with only U.S. \$10 million attributable to U.S. investors would, if those investors exceeded 14 in number, be subject to registration as proposed by the Commission. There are equivalent threshold exemptions in the rules of, for example, the CFTC where there is a relatively low threshold of U.S. interest. We would therefore propose that the threshold be 25% held by U.S. investors and that, where the threshold is lower, the offshore adviser would not need to register or, in the case of a registered offshore adviser where the threshold drops below that amount, it would have the option of deregistering.

Nevertheless, we maintain that offshore advisers subject to the appropriate degree of local regulation should be exempt from any requirement to register, regardless of the extent of assets managed by them attributable to U.S. investors.

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

See our comment in C1 of our submission.

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. 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.

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

This depends on the scope of "public offering". It is not clear, for example, whether this is intended to "catch" Dublin-listed funds or closed-end offshore funds listed in London. Such funds are subject to detailed listing rules which would merit their consideration under any such exemption.

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

The proposal distinguishes between non-U.S. advisers to offshore publicly offered funds and non-U.S. advisers to offshore private funds (paragraph b on page 42). This is a false distinction for offshore advisers since they will be subject to the same regulations, whatever the nature of the vehicle whose assets they manage.

We presume that the reason for the exception for advisers to offshore publicly offered funds is that the Commission feels that such a fund will be properly and suitably regulated in the offshore jurisdiction in which it is established. If that is so, then the implication is that the Commission recognises and accepts that the regulation related to publicly offered mutual funds meets, equals or exceeds the regulation required by the Commission and, therefore, that there is no need for further regulation by it. This accords with our essential contention that, where a hedge fund manager - or any other properly regulated entity - is regulated by an equivalent regulator, duplication of registration and regulation should be avoided.

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

As this exemption is designed for offshore advisers, on behalf of whom we have made this submission, the question of evasion does not arise.

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?

What constitutes a “public offering” will depend upon the laws of the relevant jurisdiction. Under EU law, there is a common set of conditions for determining whether or not an offering is made public, although each member state’s law may impose a more restrictive determination. In addition, many countries have separate rules governing collective investment schemes such as hedge funds. It may therefore be possible for an offshore adviser to make a public offering of a hedge fund in which U.S. residents are investors and thus fall within the ambit of this exemption, which we welcome and support.

However, it is generally the case that an offshore adviser, in most of the major jurisdictions where hedge fund managers are active, will be subject to significant local regulation, regardless of the public or private character of the funds it manages.

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. 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 U.S. clients. 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. 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)). Such an adviser would register with U.S., 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. We request comment on this provision.

Is this exception a reasonable limitation on the extraterritorial application of the Advisers Act?

The statements (paragraph c on page 43) that the SEC is proposing to limit the extraterritorial application of the Advisers Act and not to apply most of the substantive provisions to the non-U.S. clients of an offshore adviser are welcomed by AIMA (and see paragraph C2 of our submission).

This proposal states that the intention is to permit an offshore investment 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)) (by which we understand that it could have up to 14 fund clients inclusive without having to look through to the underlying investors) and (ii) those provisions prohibiting fraud (section 206 (1) and 206(2)).

In our view this limitation of the application of the Advisers Act should extend to an offshore adviser to a fund which is onshore in the U.S. We refer again to our March Submission where we referred to the vast majority of offshore advisers being regulated in their home jurisdiction, irrespective of the nature of the vehicle whose assets they manage. For this reason, and given that the de minimis requirements as postulated by the Commission apply to an offshore fund the entirety of whose investors are U.S. persons,

<p>we do not believe U.S. onshore funds, such as limited partnerships, should be treated any differently from offshore funds. For this reason we submit that the exception should be extended further to cover any fund managed by an offshore adviser.</p>
<p><i>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 directly. Are there other means of evading the requirements of the Act that ought to concern us?</i></p>
<p>One way of avoiding this, if registration is to be required, may be to use an appropriate degree of local regulation as the criterion for exemption.</p>
<p><i>Would it be sufficient to warn advisers seeking to circumvent the substantive provisions of the rule of the potential applicability of section 208(d)?</i></p>
<p><i>We have no comment.</i></p>
<p><i>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? If so, what should be the appropriate threshold?</i></p>
<p>In our comments to the first question we address this possibility. Again, for the reasons expressed there, we do not believe there should be a limit on the number of U.S. resident investors in the fund managed or advised by the offshore adviser.</p>

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

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. Hedge funds typically offer their investors liquidity access following an initial "lock-up" period, and thus most hedge fund advisers would be included within the rules. This "redeemability" requirement would, however, exclude persons who advise private equity funds, venture capital funds, 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 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, 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, 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.

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. Like the Treasury Department, we have tried to keep the definition simple, and provide a "bright line" indicator of when an adviser must look though 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:

<p><i>Should we narrow the rule? If so, how?</i></p>
<p>Listed hedge funds will typically have an initial lock-up of around six months. Two years might be too long and might "catch" some private equity funds.</p>
<p><i>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?</i></p>
<p>Any comment is beyond AIMA's remit. Although similar in some respects, the private equity market is a separate market.</p>
<p><i>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?</i></p>
<p>It is unlikely that any additional distinguishing feature that is included would serve to reduce or alter the ultimate impact of the proposal.</p>
<p><i>Is two years an appropriate time period for redemptions? If not, should it be longer or shorter, and why?</i></p>

Although listed hedge funds will, typically, have an initial lock-up of around six months, it is unlikely that any shortened period would make a difference to AIMA's members generally.

As stated above, two years might be too long and might "catch" some private equity funds.

Are there any other circumstances prompting redemptions that need to be excepted from the two-year test?

Any such test would need to "carve out" redemptions arising from reorganizations/mergers of funds, redemptions on default (for instance, in meeting a drawdown request in a typical private equity fund) and redemptions for regulatory reasons.

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. New paragraph (b)(6) would make it clear that advisers cannot rely on paragraph (a)(2)(i) with respect to private funds.

F. Amendments to Rule 204-2 [Record Keeping]

We are proposing to provide relief from a record keeping 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. The supporting records must be retained for a period of five years after the performance information is last used. 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 record keeping rule to the extent that those records are incomplete or otherwise do not meet the requirements of rule 204-2. Once a hedge fund adviser has registered with us, of course, it must comply with our record keeping 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 record keeping rules?

Regulated offshore advisers are commonly subject to requirements on performance claims, as on other matters, that they are fair, clear and not misleading and do not contain any material mis-statements of facts or material omissions. We understand that offshore advisers, even where most of the substantive provisions of the Advisers Act are not applied per C. above, would be subject to the record keeping requirements of the Advisers Act. Accordingly, see our comment in paragraph C2 of our submission.

In the UK, every manager regulated by the FSA is required to retain documents relating to financial promotions of any kind for three years and, if it relates to a life policy or pension contract, for six years.

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. 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?

Many funds established outside the U.S. do not have a separate general partner and are directly managed or advised by an offshore adviser. However, others often do have a local manager interposed between the fund and the offshore adviser. Where the offshore adviser is subject to local regulation, we do not believe that it should be appropriate for the SEC to have powers relating to affiliated entities unless those entities perform part of an investment management or advisory function in relation to the fund in question. In addition, for offshore advisers this should only cover funds which have the requisite number of U.S. resident investors.

Are there other entities we should include?

No.

G. Amendments to Rule 205-3 [Qualified Clients]

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. 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. 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," 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. 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 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:

<p><i>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?</i></p>
<p>Yes, it is appropriate. See also our view expressed in paragraph C2 of the submission.</p> <p>In the UK, FSA-authorized entities are in any event subject to extensive "know your customer", suitability and non-excessive fees requirements under the FSA's Conduct of Business rules.</p>
<p><i>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?</i></p>
<p>As above. Also current investors should be instructed in their dealings with an offshore adviser.</p>
<p><i>Are there other exceptions or exemptions we should create?</i></p>
<p>As above.</p>

H. Amendments to Rule 206(4)-2 [Adviser Custody Rule]

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. 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. 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.

We request comments on the proposed amendments.

<p><i>Is the 180-day period too long?</i></p>

As we understand it, we believe this rule would not apply to an offshore adviser's non-U.S. client funds, and so have not commented.
<i>Would a 150-day period achieve the same goal?</i>
<i>Should we keep the 120-day requirement for non-fund of hedge funds advisers?</i>
We suggest that 150 days would be a better period; the difficulty stems from an audit management problem, rather than from the fund itself. We would suggest it is appropriate to recognize this difficulty and give a limited concession by means of a slightly longer period.

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 7 B. of Part 1A and Section 7 B. 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.

<i>Are any other changes needed to Form ADV in connection with registering hedge fund advisers?</i>
We do not see any provision for an offshore adviser to indicate its status as such, so would suggest that that be changed.
We have seen the Submission of Bryan Cave and are generally supportive of the reporting proposals advanced there if the Commission remains minded to require offshore advisers to register.

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.

<i>Would six months be sufficient?</i>
No, for the reasons set out below.
<i>Would hedge fund advisers require as long as one year?</i>

Non-U.S. investment advisers should be given as long as possible to take advice as to the requirement to become registered and, where that is necessary, to understand the implications of that and put the necessary arrangements in place. We would suggest that the compliance period for registration be a minimum of one year from the date of promulgation of the rule change.



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Mr Jonathan D. Katz,
Secretary,
United States Securities and Exchange Commission,
450 Fifth Street, N.W.,
Washington, D.C. 20549-0609.
USA

By mail and e-mail

22nd March, 2004

Dear Mr Katz,

Staff Report to the United States Securities and Exchange Commission of September 2003 on the Implications of the Growth of Hedge Funds

A. Introduction

The Alternative Investment Management Association Limited ("AIMA") is writing this letter to convey the concerns of its membership with respect to the Staff Report to the United States Securities and Exchange Commission (the "Commission" or "SEC") of September 2003 on the Implications of the Growth of Hedge Funds (the "Report").

AIMA was established in the United Kingdom ("UK") in 1990 as a direct result of the growing importance of alternative investments in global investment management. It is a not-for-profit educational and research body that represents practitioners and institutional investors in hedge fund, futures fund and currency fund management, including managers, prime brokers, administrators, lawyers and accountants.

AIMA's global membership comprises some 680 members in 43 countries, of whom approximately 15 per cent are based in the United States ("US"). In addition to the US, AIMA has significant and active members' groups (comprising, in total, approximately 55 per cent of the total membership) in the UK and most European jurisdictions, including France, Ireland, Italy, Luxembourg, Germany, the Netherlands and Switzerland; it also has chapters in Australia, Canada, Hong Kong/China, Japan, Singapore and South Africa.

AIMA works closely with regulators and interested parties in order better to promote the responsible use of alternative investments. AIMA provides regulators with complimentary copies of educational material produced by it or on its behalf and frequently responds on behalf of its members to consultation processes initiated by regulators. Examples of regulatory initiatives and material undertaken or published by AIMA are the following:-

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- (a) Second International Regulatory Forum (June 2003), which regulators from 11 jurisdictions attended and to which the Commission was invited;
- (b) Guide to Sound Practices for European Hedge Fund Managers (September 2002);
- (c) A series of Due Diligence Questionnaires for use by investors in reviewing managers and other parties involved in hedge funds; and
- (d) The AIMA Journal, published five times a year and consisting solely of educational material.

A "Guide to Sound Practices for Administrators" and research on NAV calculation and pricing are examples of material soon to be published by AIMA.

AIMA does not usually involve itself in lobbying activities in the US, but the potential impact of the extension of US investment adviser registration to hedge fund managers, potentially including non-US managers (see footnote 301 to the Report, an edited extract of which appears at footnote 5 in Appendix 2, at A), and related measures by the Commission is such that we believe that we should comment on the proposals contained in the Report on their behalf.

Our members who would specifically be affected by this proposal, were it to be implemented, are hedge fund investment managers and advisers who do not have a place of business in the US and who do not advise or manage assets of funds registered under the Investment Company Act of 1940 ("non-US hedge fund advisers")¹. Almost all non-US hedge fund advisers have US investors in their funds, and so the consequences for them of the proposals in the Report are significant.

We should point out that we have not commented on the proposals as they affect our *US* hedge fund adviser members, whether or not registered as investment advisers, nor have we considered any Investment Company Act of 1940 issues. In that context it is illustrative to note that between 80 and 90 per cent of AIMA's investment manager and adviser members are already regulated in their home jurisdiction, including the US. It is, in fact, generally a prerequisite of membership of AIMA that an investment manager/adviser who is subject to regulation in its own jurisdiction is so regulated.

This submission has been prepared by the Council and other members of AIMA in conjunction with Wilmer Cutler Pickering and has been approved by the Council of AIMA on behalf of its membership worldwide.

We have used the same terminology as in the Report, including "hedge funds", unless we have specifically provided otherwise.

B. Summary

AIMA's position with regard to the Report is that the Commission should exclude non-US hedge fund advisers who are subject to adequate local regulation from any requirement to register under the Advisers Act, subject to appropriate safeguards to prevent circumvention and abuse described in C below.

¹ For the purposes of this definition, managing or operating a fund established in the US does not constitute having a place of business in the US.



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C. Submission

In order to support and explain our submission, we have extracted from the Report the summary of the requirements the Advisers Act imposes on registered advisers (Appendix 1), and relevant staff recommendations (Appendix 2), namely the recommendations (i) to require hedge fund advisers to register as investment advisers under the Advisers Act (the "Registration Recommendation"), and (ii) for advisers to provide investors with a

brochure specifically designed for hedge funds (the "Brochure Recommendation"). We have not considered the other proposals contained in the Report as these do not affect non-US hedge fund advisers.

As we inferred above, many non-US hedge fund advisers are required to be regulated in their home jurisdiction and, to shed light on the requirements of two typical regulators, we have summarised the requirements of the UK Financial Services Authority ("FSA") regulation in Appendix 3 (a) and the Irish Financial Services Regulatory Authority ("IFSRA") in Appendix 3 (b).

1. Extra-Territoriality and the Registration and Brochure Proposals

(a) *The Registration Recommendation*

On the issue of the Registration Recommendation (see Appendix 2 A), we do not question the right of the Commission to determine the structure and extent of regulation in the US, nor for it specifically to determine what level of regulation is appropriate for US hedge fund advisers. However, it is our view that hedge fund advisers and managers should only be subject to the regulatory regime which applies in their place of establishment and operation, recognising, however, that issues relating to the marketing of interests in their fund should be dealt with separately and are appropriate for regulation by the regulatory authority in each country where investors are sought. Not least among the arguments in favour of this proposition is the need to avoid:

- (i) conflicting and irreconcilable regulations from two or more regulators covering the same ground; and
- (ii) a duplication of regulation in relation to authorisation, rule compliance, investigations, discipline and enforcement.

In fact many hedge fund advisers already need to comply with the rules and regulations of three regulators: that of their place of incorporation and operation (e.g. the UK); that of the place of establishment of the fund itself (e.g. Ireland, Bermuda or the Cayman Islands), albeit at a low level in some jurisdictions; and, where the fund is listed, the rules of the relevant stock exchange (see C. 1. (b) below). However, these requirements are normally complementary, and do not bring the sort of problems which would follow if US regulations were additionally required. We have expanded on these problems in C.1(c) below.

It is instructive to note that in most relevant countries, including, inter alia, the UK and Ireland, qualification for regulation depends on where the business activity is carried on, not where investors and other clients are based. In addition, the obligation to be registered is triggered by the provision of investment services, irrespective of the number of clients, unlike in the US. Many hedge fund advisers start with only one fund.

Therefore, because most non-US hedge fund advisers are regulated in their home country, we submit that those who are resident in a jurisdiction whose regulatory regime provides for adequate regulation of hedge fund advisers (a "relevant jurisdiction") should be excluded from the Registration Recommendation and any requirement to register imposed by the Commission pursuant to it, irrespective of the number of US investors in any fund managed or advised by them. This would also deal with any concern about US hedge fund advisers emigrating outside the US: if they go to a relevant jurisdiction, they will still be subject to appropriate regulatory scrutiny and, if they do not, they will be caught by the registration requirement.

It is also our view that where a non-US hedge fund adviser which is not regulated in a relevant jurisdiction is approached by a US investor on an unsolicited basis, that US investor should not be counted in the number of investors used to determine the requirement to register.

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The Report notes (see footnote 5 in Appendix 2) that "at least one hedge fund consultant has suggested that advisers foregoing US investors is unlikely to occur". In our view this *is* likely when non-US hedge fund advisers weigh up the alternative of the cost and encumbrance of Commission registration, with the undesirable result that US investors will be denied the opportunity to invest in non-US funds.

It might also be considered unreasonable to require an adviser/manager to register when he would, for example, then be prohibited from acting for a non-US retail fund of funds if that fund of funds were registered in an appropriate jurisdiction (for example, Ireland).

(b) *The Brochure Recommendation*

Concerning the Brochure Recommendation (see Appendix 2 B), an offering memorandum for a non-US hedge fund is required to be produced by the hedge fund itself, whether under local prospectus laws or under stock exchange requirements. A Brochure would duplicate the information required to be disclosed in the offering memorandum or private placement memorandum ("PPM"). In the UK, hedge fund managers are regulated by the FSA, which requires that promotional and other documentation comply with certain form and content requirements, including a requirement that such documentation must be clear, fair and not misleading.

We would submit that the Brochure Recommendation should not apply to non-US hedge fund advisers who are regulated in a relevant jurisdiction and that, where an adviser is required to produce a Brochure but is only advising one or two hedge funds, the PPM for those funds should satisfy the Brochure requirement.

In addition, many funds offered for sale in Europe and elsewhere obtain a stock exchange listing, such as on the Irish Stock Exchange. The rules of those exchanges generally require disclosure about:

- (i) conflicts of interest;
- (ii) valuation of securities;
- (iii) lock-up periods;
- (iv) risk disclosures; and
- (v) many other matters not specifically referred to in the Report, but relevant in the context of this particular proposal.

Indeed, these disclosures are made in any properly drafted PPM, whether a fund is listed or not.

With regard to the valuation of securities, in the US most of the hedge fund scandals there have been as a result of fraud or misrepresentation of the value of the fund in an environment where valuation is self-administered. However, in Europe and elsewhere in the world, it is standard practice, if not a requirement, that an independent third party administrator be appointed to value securities, verify fund prices and calculate NAV; at the least, such an independent administrator will follow a consistent valuation model. Consequently, the disclosure concerns of the Commission outlined in Appendix 2 B are in most cases met and often exceeded by a requirement for an independent administrator.

(c) *Issues Arising from Conflicting Regulations*

Complex issues arise where there is dual regulation of an investment adviser. In C.1.(a) above we alluded to these issues which are expanded on below. We have addressed the issue of where a UK hedge fund adviser would be regulated both by the SEC and the FSA but similar issues would arise for a non-US hedge fund adviser based in any other relevant jurisdiction.

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(i) *Investigations and enforcement*

Investigations: The UK Financial Services and Markets Act 2000 ("FSMA") enables the FSA to exercise its investigation powers to require information from UK authorised firms and their staff, including documents, when they are asked to do so at the request of an overseas regulator. Where a request comes from a regulator outside the EU (e.g. from the Commission), the FSA will take into account whether the overseas regulator, in this case the SEC, corresponds in giving assistance when the FSA requests it, whether the case concerns a breach of law or other requirement which has a close parallel in the UK or involves the assertion of a jurisdiction not recognised by the UK, the seriousness of the case and its importance to persons in the UK and whether it is otherwise in the public interest to assist.

Under the multilateral IOSCO memorandum of understanding of May 2002 ("MOU") entered into between, among others, the FSA and the SEC, regulators agreed (i) to provide one another with documents in their own files at the request of their counterpart, and (ii) to require the production of documents such as those necessary to reconstruct securities and derivatives transactions identified either by the requesting authority or by any other person who might possess the relevant information. The information and documents will be gathered in accordance with the procedures applicable in the jurisdiction of the requested authority and by individuals designated by the requesting authority, although a representative of the requesting authority may be present if local law permits. There are restrictions on the use of material. It is doubtful if the FSA could exercise their powers to assist the SEC in relation to persons who are not UK authorised persons.

Enforcement: In terms of enforcement, the position is more complicated. It is a generally recognised principle of English law that the English courts have no jurisdiction to entertain actions for the enforcement either directly or indirectly of criminal, revenue or other public laws of foreign states. This applies not only to criminal enforcement but also civil enforcement. It would seem difficult therefore for the SEC to seek enforcement of a fine outside the United States. Complex questions arise as to whether compensation orders obtained by regulators can be enforced across borders.

It would not generally be open to the FSA to seek to bring enforcement proceedings in relation to breaches of US securities laws imposed by the SEC unless the same conduct breached the FSA's own principles and rules. As a general proposition, the FSA is only entitled to bring proceedings to address contraventions of relevant requirements imposed under FSMA and other UK legislation referred to in it. The lesson drawn from the above is that overlapping regulation throws up complex international regulatory issues over respective jurisdictions, and SEC regulation of non-US hedge fund advisers would not guarantee SEC automatic access to those advisers or enable the SEC effectively to enforce its own regulations against them. This undermines some of the arguments put forward by the Commission by way of benefits of mandatory registration (see for example C.2.(f) below).

(ii) *Specific regulatory conflicts*

Were a non-US hedge fund adviser required to be regulated both by the Commission and its local regulator, specific compliance conflicts would arise, for example in the following areas, and by comparison with a UK regulated hedge fund adviser :-

- (aa) for a UK hedge fund adviser, FSA regulations require it to allocate trades on a fair and timely basis, and this does not square with equivalent US provisions;
- (bb) the Advisers Acts imposes specific requirements for contracts as does the UK FSA, but these may conflict;
- (cc) the Advisers Act imposes limitations on performance fees and non-refundable fees, which do not find their counterpart under FSA rules;
- (dd) both the SEC and the FSA have advertising content and marketing requirements which do not match;

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- (ee) compliance manuals would need to be carefully drafted to ensure that both SEC and local regulatory requirements are met. This is a difficult enough task for large international groups and is an unnecessary burden on small non-US hedge fund advisers who employ a handful of staff and who may not employ compliance professionals; it would also require them to address the conflicting requirements of dual regulation;
- (ff) in the UK, soft commission and bundled brokerage arrangements are under scrutiny by FSA and the soft dollar rules are being reviewed in the US by Congress and others. The requirements on both sides of the Atlantic are not the same; and
- (gg) other SEC regulations and requirements of the Advisers Act, for example which require best execution without the ability to contract out of that requirement, as is possible in the UK, and proxy voting rules, where there is no UK equivalent. Further areas of conflict and overlap are evident as we consider some of the arguments put forward by the staff in favour of their recommendations.

2. Concerning Specific Arguments Propounded by the Report

In Appendices 1 and 2, we have extracted from the Report certain arguments put forward by the Commission for the regulation of hedge fund advisers, and dealing with the consequences of regulation. These are summarised below, accompanied by our comments.

(a) *Disclosure*

The Commission refers to the fact that registered investment advisers must keep current a Form ADV and provide a disclosure statement. Non-US hedge fund advisers who are regulated are subject to similar and, in many cases, more onerous disclosure requirements concerning themselves and their funds in their home jurisdictions. Registering as investment advisers would be an additional, unnecessary and potentially costly burden for them.

Also, disclosure to the Commission brings with it publication on the SEC website of basic information, including ownership interests of 25 per cent or more of the adviser. Information supplied to the FSA, on the other hand, remains confidential, save as to the identity only of approved persons and their controlled functions, and the firm's permitted activities. This disclosure does not extend to ownership and control.

In Appendix 3(a), we have described the components of the UK FSA application process and ongoing compliance obligations in order to emphasise the level of regulatory processes and requirements for a UK regulated hedge fund manager, in contrast to the less onerous US investment adviser registration requirements, and the same with respect to Irish regulated hedge fund managers in Appendix 3(b). We submit that this demonstrates that there is no benefit in UK or Irish regulated hedge fund managers complying with such registration requirements. We also submit that this should apply to non-US hedge fund managers regulated in other relevant jurisdictions (see C.1.(a) above) such as all other EU jurisdictions.

(b) *Books and Records*

Similarly non-US hedge fund advisers maintain records under existing local regulatory requirements, including for anti-money laundering purposes.

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(c) *Custody Arrangements*

Many non-US hedge funds appoint a third party custodian, although many funds use a prime broker as their de facto custodian; a custodian may also be a requirement of many stock exchanges where hedge fund interests are listed. A fund of funds, however, need not appoint a custodian of the interests which it holds in underlying funds, although it will retain a payment bank, which will act as de facto custodian for cash balances. However, in certain jurisdictions where funds are domiciled (e.g., Ireland) a custodian will always be required.

(d) *Fraud Issues*

The Commission states that the Advisers Act will prohibit advisers from defrauding a client. In almost every jurisdiction there are anti-fraud provisions, generally arising as a matter of general law. Simply having an entity regulated does not necessarily act as a panacea against fraud.

(e) *Minimum Investment Requirements*

The Commission points out that registration under the Advisers Act would increase the minimum investment required for direct investment in certain hedge funds because registered advisers are generally prohibited from charging performance fees unless investors have US\$750,000 invested with the advisor or have a net worth of US\$1.5 million. To impose this restriction on non-US hedge fund advisers would effectively constitute a trade barrier. Most European based hedge fund managers impose an initial investment limit of somewhere between US\$100,000 and US\$500,000 and many individual investors with a net worth of lower than US\$1.5 million are permitted to invest in funds under local regulatory regimes considered appropriate by the local regulator and legislator. We believe that no similar requirements are imposed by the regulators in the major (non-US) jurisdictions.

(f) *Benefits of Mandatory Registration*

In Appendix 2, we outline what the Commission considers to be the benefits of mandatory registration, including the proposition that registration of hedge fund advisers would serve as a deterrent to fraud (see also (d) above). In addition it is said that this would provide the Commission with examination authority and foster strong compliance practices. As we have indicated above, these extensive compliance obligations are already imposed on non-US hedge fund advisers in most major jurisdictions and have been for some time.

It is mentioned that registration of US hedge fund advisers would provide the Commission with important information about a section of the US financial system that is growing in significance. Whilst regulation of US hedge fund advisers would help to provide this information, nothing would be added to that knowledge by regulating non-US hedge fund advisers.

We note that the Commission discusses concerns about the consequences of regulation, including the cost. Adding a US level of regulation would be onerous and would not produce any benefits beyond those already resulting from existing regulation.

As an example in the context of costs, we would point out that, in Ireland, all resident administrators acting for an onshore or off-shore fund (whether Irish or non-Irish) are regulated. If the Registration Recommendation proceeds, such administrators may then also be required to ensure compliance of the funds with the Commission's rules. Clearly, this would mean additional costs passed onto the fund.

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D. Conclusion

To conclude, for the reasons set out above, we do not believe it necessary or desirable for the Commission to regulate non-US hedge fund advisers who are more than adequately regulated in their home countries. In addition, as a practical matter, we believe that the Commission staff would be stretched to regulate US hedge fund advisers without the burden of inspecting overseas firms. For this reason we have suggested a workable alternative.

AIMA invites the Commission to discuss and clarify the operations of non-US hedge fund advisers in the context of this submission. As the Report's proposals would affect managers and other entities regulated and domiciled or operating in numerous other jurisdictions, we propose to draw the attention of regulators in those other jurisdictions to the submission on behalf of our members and to provide copies to those regulatory authorities.

AIMA will be happy to discuss any aspect of this submission or to provide any further information requested. Any communication with AIMA in respect of this submission should be addressed to Florence Lombard, Executive Director (Florence@aima.org) and Mary Richardson, Legal and Regulatory Associate (mary@aima.org).

Yours sincerely,

Christopher Fawcett
Chairman

Dermot Butler
Deputy Chairman

Appendices:

1. Hedge Fund Advisers and the Investment Advisers Act of 1940
2. Relevant Staff Recommendations
3. (a) Regulation by the UK Financial Services Authority (FSA)
(b) Regulation by the Irish Financial Services Regulatory Authority (IFSRA)

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Appendix 1

Hedge Fund Advisers and the Investment Advisers Act of 1940²

1. Virtually all hedge fund advisers meet the definition of “investment adviser” under the Advisers Act under which investment advisers must register with the Commission and comply with the provisions of that Act and Commission rules. Specifically:-
 - (a) Registered investment advisers must keep current a Form ADV that is filed with the Commission and provide a disclosure statement that includes the information disclosed on Part II of Form ADV to clients. These disclosures provide both the Commission and investors with current information about the adviser’s business practices and disciplinary history, among other things.
 - (b) Registered advisers must maintain books and records and submit to periodic examinations by the Commission’s staff. Effective Commission oversight could lead to earlier detection of actual or potential misconduct, help to deter fraud and encourage a culture of compliance and controls.
 - (c) Advisers registered with the Commission must comply with requirements relating to safeguarding client assets that are in the adviser’s custody, and requiring that clients be told of an adviser’s adverse financial condition.
 - (d) Registered investment advisers must inform clients of their proxy voting practices.
 - (e) The Advisers Act prohibits investment advisers from defrauding their clients.
2. Many hedge fund advisers, however, avoid registering with the Commission by relying on the Advisers Act’s *de minimis* exemption under Section 203(b) of that Act. That section excludes from registration investment advisers that have had fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered investment company. For purposes of Section 203(b), current Commission rules provide that investment advisers may count a “legal organisation”, such as a hedge fund, as a single client. Thus, an adviser may manage up to 14 hedge funds before being required to register with the Commission as an investment adviser, so long as it satisfies the “no holding out” condition. Investment advisers that are exempt from registration nevertheless are subject to the antifraud provisions of the Advisers Act.

A number of hedge fund advisers, however, do register as investment advisers under the Advisers Act. Some are required to register because they have 15 or more advisory clients, or they advise one or more registered investment companies, and therefore are ineligible for the *de minimis* exemption. Others have registered with the Commission voluntarily because their investors demand it or for competitive reasons.

Registration of hedge fund advisers under the Advisers Act would effectively increase the minimum investment requirement for direct investments in certain hedge funds because registered advisers are generally prohibited from charging performance fees unless investors have \$750,000 invested with the adviser or have a net worth of \$1.5 million.
3. Registered investment advisers are not required to indicate whether they manage hedge funds. They are also not required to state the amount of hedge fund assets under their management. Importantly, Advisers Act registration would not impede the manner in which a hedge fund adviser invests or operates a hedge fund. Registration would not place restrictions on a hedge fund adviser’s ability to trade securities, use leverage, sell securities short or enter into derivative transactions. Registration would also not require the disclosure of hedge fund proprietary trading strategies and portfolio positions, nor would it result in the public identification of the hedge fund’s investors.

² This is an edited extract from Part III D of the Report.



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Appendix 2

Relevant Staff Recommendations

A. The Commission Should Consider Requiring Hedge Fund Advisers to Register as Investment Advisers under the Advisers Act, Taking into Account Whether the Benefits Outweigh the Burdens of Registration

We recommend that the Commission consider amending Rule 203(b)(3)-1 under the Advisers Act to require hedge fund advisers to “look through” any hedge funds that they manage and count each separate investor as a client. By amending Rule 203(b)(3)-1 to redefine “client,” the Commission would shift the regulatory emphasis away from counting the number of hedge funds advised by the investment adviser and refocus it so that it reflects a determination of whether an investment adviser is of a size to merit federal regulation. In our view, the result of the recommendation to amend Rule 203(b)(3)-1 would be consistent with the underlying purpose of Section 203(b)(3), which was designed to exempt advisers whose advisory business is so limited that it does not warrant federal attention. We also recommend that the Commission consider incorporating into any such amendment a threshold for Commission registration based upon the aggregate amount of assets managed by the hedge fund adviser.³

During the course of the staff’s investigation of hedge funds, we also questioned whether mandating registration of investment advisers to hedge funds would impede the operations or investment activities of hedge fund advisers. No one identified any provision of the Advisers Act or Commission rules that, if applied to hedge fund advisers, would have this result⁴. Although industry participants had mixed reactions to mandatory registration of hedge fund advisers⁵, many hedge fund advisers register voluntarily. This belies any notion that registration of hedge fund advisers is detrimental to a hedge fund’s legitimate investment activities.

Registration under the Advisers Act represents the least intrusive form of regulation available to address many of the concerns identified in this Report. Our recommendation that hedge fund advisers register with the Commission under the Advisers Act would not result in any changes with respect to those advisers’ ability to effectuate their investment strategies. Registration would not place any restrictions on hedge fund advisers’ ability to trade securities, use leverage, sell securities short or enter into derivatives transactions. Nor would registration under the Act require the disclosure of any proprietary trading strategy. In addition, registration would not result in hedge funds and hedge fund advisers being subject to any additional portfolio disclosure requirements.

Our recommendation would not result in hedge funds having to register the offerings of their interests with the Commission, nor would it require that they modify their organisational structures. Advisers would be able to maintain their existing lock-up and repurchase schedules. Adviser registration would not result in public disclosure of the identities of advisers’ clients. Finally, registration would not restrict the amount of fees that hedge fund advisers may charge hedge funds, although an adviser to a hedge fund relying on Section 3(c)(1) of the Investment Company Act would be permitted to charge that fund a performance fee only if each of the investors in the fund are qualified clients under Rule 205-3 under the Advisers Act.

³ Such a threshold would maintain the registration exemption for advisers to very small hedge funds whose investors are likely to have personal relationships with the hedge fund adviser. It would also be consistent with the approach taken by Congress ... to divide oversight of advisers between the states (for advisers with less than \$25 million in assets under management) and the Commission (for advisers with assets under management of \$25 million or more). We note, however, that even with such a threshold, our recommendation would require most hedge fund advisers to register under the Advisers Act.

⁴ One author has suggested that the European approach to regulating hedge fund advisers has benefited the industry by establishing minimum standards of practice in which investors can have some confidence. Neil Wilson, *Why Regulation Can Be Good*, Absolute Return (Apr. 2003). (UK regulation of hedge fund advisers has not impeded growth, and encourages advisers to build professional operations before launching funds; many of the firms deterred by regulation probably should not be managing hedge funds).

⁵ A few Roundtable panellists suggested that if the Commission requires mandatory registration for most hedge funds advisers, some of those advisers would move their operations to jurisdictions that did not have such requirements. We believe that such concerns are unwarranted. A hedge fund adviser could not avoid application of the Advisers Act simply by moving its office to a non-US location. In fact, an adviser moving offshore would be required to register if more than 14 US investors owned interests in the hedge fund. See Rule 203(b)(3)-1(b)(5) under the Advisers Act. At least one hedge fund consultant has suggested that advisers foregoing US investors is unlikely to occur.

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1. *Benefits of Mandatory Registration*

- (a) Registration of hedge fund advisers would serve as a deterrent to fraud.
- (b) Registration of hedge fund advisers would provide the Commission with examination authority and foster strong compliance practices.
- (c) Registration would provide the Commission with important information about a segment of the US financial system that is growing in significance.
- (d) Mandatory registration would effectively raise the standards for direct investments in hedge funds.

2. *Concerns about Mandatory Regulations*

We recognise that adviser registration will impose additional costs on hedge fund advisers that are not already registered with the Commission. Nevertheless, we believe that the benefits of adviser registration outlined in this Report outweigh the additional costs that would be imposed on unregistered hedge fund advisers. There are three types of costs associated with registering: (1) electronic filing, which costs \$1100 the first year and \$550 each year thereafter; (2) recordkeeping systems meeting the requirements of the Advisers Act, which are typically provided by the hedge fund's prime broker and thus, in many cases, would involve no additional costs; and (3) ongoing costs related to regulatory compliance. Most of these latter costs are attributable to compliance with the Act's antifraud provisions to which unregistered advisers already are subject and thus should be incurred regardless of whether the adviser is registered under the Act. In connection with any rulemaking, the staff would prepare a more complete analysis of the costs and benefits or requiring hedge fund advisers to register under the Advisers Act.

We are also mindful that the Commission's resources available to examine advisers are limited. Thus, we recommend that any rule the Commission adopts requiring advisers to count clients by "looking through" the hedge fund limit the number of new registrants by distinguishing between hedge funds and other investment vehicles that do not register under the Investment Company Act in reliance on Section 3(c)(1) or 3(c)(7). These other investment vehicles include venture capital funds, private equity funds and structured financing vehicles.

B. **The Commission Should Consider Revising its Regulations Under the Advisers Act to Require Advisers to Provide a Brochure Specifically Designed for Hedge Funds**

We recommend that the Commission consider revising its rules to require that hedge fund advisers file with the Commission and deliver to investors a disclosure statement tailored to meet the needs of hedge fund investors. Disclosure could be in the form of a brochure and would prescribe minimum requirements for basic disclosure information provided to investors and prospective investors. The Commission could require, for example, disclosure about various conflicts of interest, what risk management measures the adviser performs, how the adviser values securities held by hedge funds (and the extent to which that valuation will be determined independently) and what lock-up periods may apply to an investor's investment in hedge funds managed by the adviser. Although hedge fund investors may already receive some of the information in the fund's PPM, we would propose that the Commission require that this information be disclosed in the "hedge fund brochure" - the brochure having the added benefit of requiring the adviser to update its disclosures periodically and make that information available to investors on an ongoing basis. Moreover, these disclosures could be useful to other clients of the adviser in identifying conflicts of interests on the part of the adviser.

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Appendix 3 (a)

Regulation by the UK Financial Services Authority (FSA)

A. Application Process

In the United Kingdom, hedge fund managers and advisers are required to be regulated by the Financial Services Authority ("FSA"). That process begins with an application for regulation by the FSA which comprises the following forms and disclosure and other requirements:-

1. *Core details form*

The applicant is required to specify its legal form and group structure, the names of its senior management and all persons who will carry out certain "controlled functions", as well as general information on its history. Information is also provided on the proposed regulated activities to be undertaken. In the case of a hedge fund manager, that would include investment management and advice.

2. *Regulatory business plan*

The business plan, in narrative form, sets out detailed information on the business to be undertaken and should disclose the personnel involved in internal controls and outsourcing arrangements that may be put in place.

3. *Compliance form*

As a regulated FSA firm the hedge fund manager/adviser will need to have compliance procedures in place recorded in its compliance manual covering compliance arrangements, including details of the compliance department's reporting lines and procedures on personal account dealings and anti-money laundering procedures.

The compliance manual is supplied with the application.

4. *Systems*

Through this form the applicant demonstrates to the FSA that it has appropriate systems in place to fulfill its regulatory obligations, including effective back-office facilities and information on its IT systems. In addition, the applicant's auditors are required to sign off this form.

5. *Financial resources*

All UK FSA regulated firms are subject to financial resources requirements and financial reporting and this form, signed off by the applicant's auditors, discloses financial information about the applicant.

6. *Additional forms*

Under the FSA regime, each FSA regulated firm must demonstrate that its controllers (generally speaking those who own ten per cent or more of its share capital, or who have other rights of influence over the applicant) are suitable persons to be controllers of a regulated firm. Those individuals with responsibility for conducting the business of the firm, as well as senior officers, are all designated as "approved persons" and must satisfy FSA of their fitness and propriety to conduct those roles.



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B. Ongoing Compliance

1. *General Ongoing Compliance*

Those responsible for compliance need to discharge overarching ongoing obligations, as well as a number of specific requirements. As a general proposition, a firm's systems and controls, as well as the apportionment and discharge of responsibilities by senior management, should be maintained, and firms should be mindful on an ongoing basis of their obligations under the FSA's Principles for Businesses, including the obligation to keep the FSA informed of anything it would reasonably expect to hear about. This involves, to a considerable degree, keeping up with legislative and regulatory developments and changes. On a more detailed level, compliance officers or their delegates are required to make a number of regular reports to the FSA (including close links, controllers and complaints) in addition to financial reports made by the firm. They are also required to make sure all those arriving and departing from the firm are appropriately registered for approved person purposes where necessary. Training and competence obligations need to be met, including ensuring that relevant staff have passed approved examinations where necessary. Anti-money laundering measures, including verification of identity, will need to be in place and acted upon, and staff must receive regular anti-money laundering training. In all of these areas, compliance officers need to be mindful of the FSA's record keeping obligations.

2. *Financial Resources*

Regulation by the FSA entails ongoing compliance with its prudential regime, including the maintenance of specified levels of financial resources. Broadly, this requires a regulated firm to maintain certain levels of financial resources, determined according to the type of business it conducts.

For a hedge fund adviser which does not hold client money or trade for its own account, its financial resources requirement is its "own funds" requirement of 50,000 Euros and its "liquid capital" requirement, calculable as a fraction of its annual audited expenditure.

3. *Fees*

Annual fees levied by the FSA are calculated according to the firm's business and the fee block it falls into by reference to that business. Fees are usually made up of a base levy calculated in part by reference to funds under management, to which a multiplier is applied (which can, for certain firms, be derived from the number of approved persons it houses). In our experience, these annual fees are not usually considered onerous by larger and/or more profitable firms, but there are, in most circumstances, other ongoing compliance costs, including legal fees and auditors' fees generated as a result of the need to make regular financial reports to the FSA and maintain effective compliance.



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Appendix 3 (b)

Regulation by the Irish Financial Services Regulatory Authority (IFSRA)

1. Application Process

In Ireland, hedge fund investment managers and advisers are regulated and supervised by IFSRA under the Investment Intermediaries Act, 1995 (the "IIA"). Hedge fund investment managers who propose to operate in or from Ireland are required to apply for authorisation under Section 10 of the IIA. The process involves the submission of a very detailed business plan to IFSRA including the information and disclosure requirements set out below.

2. Legal Form and Group Structure

An applicant is required to submit details of its legal form and a copy of its constitutive documents and IFSRA must be satisfied with the documentation.

IFSRA will also look closely at the group structure of the applicant in order to be satisfied that the organisation of the applicant's business structure is such that it is capable of being adequately supervised. IFSRA will seek details of the activities of group companies, information on their regulatory status and the extent of interaction between companies within the group. Group audited accounts will also be required.

3. Capital Adequacy Requirements

All firms regulated by IFSRA under the IIA must comply with minimum capital adequacy requirements. Capital adequacy requirements are prescribed depending on the nature of the proposed business and the minimum capital level for hedge fund managers is either €125,000 or €730,000, depending on the activities engaged in.

The business plan submitted with the application must also include detailed financial projections covering a period of three years in order to allow IFSRA assess the financial viability of the applicant.

4. Integrity of Directors and Key Personnel

A key part of the approval process involves a due diligence exercise on key personnel and IFSRA thoroughly assesses the probity and competence of the directors and key personnel of the applicant. A detailed questionnaire needs to be submitted by each director and key individuals and references must be submitted.

5. Control and Qualifying Shareholders

Under the application procedure, IFSRA must be satisfied as to the suitability of the applicants' qualifying shareholders. Qualifying shareholders are those who directly or indirectly hold 10% or more of the voting rights or who would have the power to control or exercise a significant influence over the applicant. IFSRA will "look through" any direct and indirect shareholder to identify all persons who are in a position to control or influence the applicant so that all beneficial shareholders are identified. The information required includes detailed questionnaires, details of that shareholders' regulatory status, most recent audited accounts and information on proposed interaction with the applicant.

6. Organisational structure

IFSRA also requires the applicant to submit details of the organisational structure of the applicant's proposed operations. Essential to this are details of its internal controls, its proposed activities, the risk management process of the firm, and details of how it conducts business with third parties. IFSRA will also review copies of the operational and procedures manuals and documentary details of transactions with third parties e.g. sample

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customer documentation and promotional material. In this way, IFSRA checks that the firm has appropriate systems in place to comply with its regulatory obligations.

Evidence that the head office of the hedge fund manager is in Ireland and proof that the central management and control of the operation is in the state will also be required. This is essential to facilitate effective supervision by IFSRA.

7. Ongoing Compliance

Hedge fund managers approved under the IIA are required to comply with a regulatory regime supervised by IFSRA. Firms are required to provide regular details to IFSRA of their internal procedures and controls. In addition, they are required to submit copies of their audited annual accounts.

All investment managers regulated in Ireland are required to comply with a very comprehensive Code of Conduct set down by IFSRA. The Code of Conduct sets out requirements covering such areas as clients' *best interests*, soft commissions, conflicts of interest, KYC rules, excessive dealing, etc. There are also extensive safekeeping of client money rules. In addition, investment managers are required to comply with Irish anti-money laundering legislation.

8. Supervisory Powers

IFSRA has wide reaching statutory powers which enable it to effectively carry out its functions. IFSRA may refuse an application for authorisation, it may revoke an existing authorisation, impose conditions on and issue directions to an authorised firm. IFSRA also has extensive powers to enter premises and require and retain documentation. An Inspector can also be appointed by IFSRA to investigate and report on an authorised firm's business and activities.

9. Investor Compensation Scheme

Firms regulated by IFSRA under the IIA are required to contribute to an investor compensation fund operated by the Investor Compensation Company Limited. This is a statutory based compensation scheme established for clients of authorised investment firms who are eligible for compensation. This is a pooled fund made up of contributions from all authorised firms.

10. Additional Regulation

Hedge fund managers established in Ireland will also be subject to the full spectrum of corporate and other non-financial legislation including data privacy legislation, consumer protection and advertising standards legislation.

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