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

Re:  File No. S7-30-04; Release Nos. IA-2266
Registration Under the Advisers Act of Certain Hedge Fund Advisers

Dear Mr. Katz:

The North American Securities Administrators Association, Inc. (NASAA)\(^1\) hereby submits comments regarding the above-referenced rule and amendments. The proposal would require advisers to certain private investment pools ("hedge funds") to register with the Commission under the Investment Advisers Act of 1940 ("Advisers Act").

NASAA commends the Commission for proposing to regulate hedge fund advisers in a manner that we believe will provide greater transparency to investors while not overburdening the hedge fund industry. Requiring the registration of hedge fund advisers will ultimately result in the establishment of operational controls and other safeguards that will serve to protect investors.

State securities regulators are instituting an ever-rising number of investigations and enforcement actions regarding hedge funds, their managers, and advisers. State regulators are also encountering a growing number of hedge funds whose investors are of average means, not high net worth individuals. An increasing number of pension funds and other ERISA plans are investing substantial amounts into these investment vehicles. State regulators have also noted significant growth in the assets managed by hedge fund advisers who are registered with the states, finding a number of state registered investment advisers managing hedge funds with assets over $30 million.

\(^1\) The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.
Moreover, state securities regulators have noted that hedge funds are expanding beyond their historical, market-related investments into additional areas such as insurance. This expansion of the scope of the hedge fund industry and increased flow of assets to this arena argue in favor of additional regulatory oversight and monitoring of hedge fund advisers, including advisers to funds of funds.

NASAA previously responded to requests for comments on hedge fund regulation on July 8 and December 4, 2003, under File No. 4-476. Our positions have not changed in light of the Commission’s new proposal. NASAA is of the continuing belief that the Commission should require registration of hedge fund investment managers or advisers. As we stated in our previous comments of July 8, 2003, many states require hedge fund advisers to register as investment advisers and require that they be subject to the same standards of examination as other investment advisers.

The Commission’s rulemaking proposal is extensive. Therefore, NASAA will take this opportunity to provide comments on specific aspects of the Commission’s proposal.

**Definition of “Private Fund”**

As a threshold matter, NASAA is troubled that the Commission’s proposal does not specifically define “hedge fund.” We understand that the Commission is seeking to have a definition that is consistent with the USA PATRIOT Act. We also understand the Commission’s reluctance to define the term based on investment strategy, since hedge fund strategies are continuously evolving. However, NASAA feels that the definition of “Private Fund” is ineffective at distinguishing hedge funds from private equity, venture capital and commodity pools. The proposed rule would create a sub-category of hedge fund under the classification of a “Private Fund.”

NASAA agrees with the Commission’s rationale that a two-year lock up period is a trademark of the types of private funds that the Commission wishes to exclude from the rule. While NASAA does not find that the two year redemption period is inappropriate for distinguishing private equity funds and venture capital funds from hedge funds, we believe that using this time frame as one of the benchmarks for registration will encourage many 3(c)(1) and 3(c)(7) funds to incorporate a minimum two year lock up period in order to escape the registration requirement.

Rather than attempting to define what a hedge fund is not, NASAA recommends that the Commission make “hedge fund” a specifically defined term. NASAA will take this opportunity to put forward an alternate proposal for consideration.

**The “actively traded” test**

A clearly distinguishing factor that differentiates private equity and venture capital funds from hedge funds is that the managers of the former do not, in the traditional sense, “actively trade” the securities held in the fund. As such, NASAA appreciates the
Commission’s reluctance to place the managers of private equity funds and venture capital funds under the purview of the Advisers Act. Hedge fund managers, by definition, must “actively trade” a large portion of the securities held in the fund (or its underlying investments). Therefore, “active trading” by the manager is a distinguishing characteristic of hedge funds. While recognizing that defining “actively traded” is challenging, NASAA suggests that “60% of the value of the securities held by the fund, or its underlying investments during the last calendar year” could serve as a point of reference for future refinements.

NASAA would also recommend that the Commission reconsider the third prong of the definition of “Private Fund”. While it is true that decisions to invest in a hedge fund may be based on the continued investment expertise and skills of the adviser, NASAA believes that this ought not be a basis in determining what constitutes an interest in a private fund. One fundamental difficulty with this proposal is that the adviser is usually an entity. Although the portfolio manager may have a certain level of training, it is the traders, economists, and those individuals who develop the quantitative analysis programs that, for all intents and purposes, are making the trading decisions.

**Proposed rule 203(b)(3)-2**

NASAA strongly believes that a “look through” approach, subject to a definition of a hedge fund, is good for investor protection by bringing these advisers under the oversight of the Commission. NASAA believes that the Commission’s proposal is clear and concise, making it simple for advisers to determine the number of clients that they have for purposes of Section 203(b)(3). We note that various states and other jurisdictions now look through investment vehicles to count the number of investors as clients, rather than looking only to the fund itself. This practice has assisted investors in obtaining material disclosures regarding fund advisers, including any prior disciplinary action, conflicts of interest, and information on affiliated entities and individuals.

In connection with proposed rule 203(b)(3)-2, the Commission has requested comment on the applicability of the current minimum asset thresholds to hedge fund advisers. NASAA believes that such threshold should be raised to $50,000,000. Because state securities regulators have significant experience regulating investment advisers at or below $30,000,000 in assets under management, including hedge funds, NASAA believes the states are situated to assume regulatory responsibility under a higher asset threshold.

**Proposed amendments to rule 204-2**

NASAA strongly recommends that the Commission expressly prohibit the use of all unsubstantiated past performance claims. Therefore, NASAA would recommend that the Commission reconsider proposed Transition Rule 204-2(3)(ii). We would also note that the proposed Transition Rule appears to be in conflict with the spirit of the anti-fraud provision (Section 206 of the Advisers Act) that calls for substantiation of performance claims in advertisements through books and records required to be maintained by the
adviser. Additionally, the proposed Transition Rule may place private fund advisers who have kept adequate books and records on performance advertising at a competitive disadvantage vis-à-vis advisers who would be allowed to continue making performance claims for which they do not have adequate supporting documentation in their books and records.

**Proposed amendments to Rule 205-3**

The Commission proposes to amend Rule 205-3 to exempt certain non-qualified investors from meeting the qualified client rule requirement. As a general proposition, NASAA does not object to a “grandfather” provision that would allow existing investors to maintain their existing contracts in full force and effect following the effective date of the Rule. We understand that such a provision would prevent voiding a pre-existing performance-based fee agreement between the adviser and a client who no longer meets qualification requirements. However, NASAA strongly urges the Commission to raise the requirements of the definition of “qualified client” found in Rule 205 – 3 under the Advisers Act.

NASAA believes that, for purposes of the Advisers Act, "qualified client" should be defined in the same manner as the term “qualified purchaser” is defined under Section 2(A)(51)(A)(i) of the Investment Company Act of 1940 (‘40 Act) as to individuals. A person is a "qualified purchaser" if, under the '40 Act, the person owns a certain dollar amount of investments. Congress set the level at $5 million for natural persons.

NASAA considers the '40 Act definition of “qualified purchaser” to be appropriate for a natural person in this context because it sets the threshold sufficiently high that there is a reasonable probability that the investors included in the definition would be better able to assume the risks associated with investing in hedge funds.

NASAA is concerned that investors who became hedge fund clients, even though they did not meet the minimum assets-under-management threshold of the “qualified client” standard of the Advisers Act, receive protection going forward. NASAA agrees that hedge fund advisers that charge performance-based fees should not be able to seek additional funds from current clients who do not meet the “qualified client” standard. NASAA believes that, at a minimum, the Commission should require hedge fund advisers to notify pre-existing clients who are charged performance-based fees, but do not meet the “qualified client” standard, to explain to the client the importance of the change in the standard with regard to performance-based fees and to provide an immediate “opt-out” provision.

We believe that the proposed Rule, with our recommendations, will allow hedge fund advisers to continue collecting performance-based fees from existing clients. NASAA, however, is concerned by the potential the proposed Rule has for the unintended consequence of a last minute effort by unscrupulous hedge fund advisers to solicit additional unaccredited investors or unqualified clients, or increase the current asset base of pre-existing clients, before the effective date of the Rule in order to maintain these
clients as investors in their funds. To that end, NASAA recommends that hedge fund advisers be required to give both clients and potential clients adequate disclosures, in plain English, describing the fee arrangements, including the fact that not all hedge fund advisers charge performance-based fees.

**Amendments to Form ADV**

The Commission has asked whether any other changes are needed to the Form ADV in connection with the registration of hedge fund advisers. Changes to item #7B of Form ADV, Part 1A, and section #7B of Schedule D, would require advisers to “Private Funds,” as defined in the proposed Rule, to identify themselves as hedge fund advisers. We support these amendments.

However, the Commission has not proposed amendments to item #5C (Clients) or #5F (Assets Under Management) to reflect revisions proposed to Rules 275.203(b)(3)-1 (definition of “client” of an investment adviser) and 275.203(b)(3) (definition of “client” for certain private funds). NASAA recommends that the Commission amend these items on Form ADV to provide additional disclosure concerning the nature of the clients and the amount of assets under management. This will allow for more effective monitoring of the funds. This would also permit a more statistically accurate count of clients of investment advisers and private fund advisers.

NASAA also urges the Commission to require hedge fund-specific disclosures on the Form ADV, Part 2, since this document is given to both investors and investment advisory clients. This would be consistent with the recommendation in the staff report on the “Implications of the Growth of Hedge Funds” that the Commission should consider mandating that advisers provide a brochure that is specifically designed for hedge funds. This brochure disclosure should be mandatory, while giving the fund adviser the option of having a separate hedge fund brochure, or prominently including the disclosure within a brochure that the adviser uses to describe other services.

**Costs of compliance**

The Commission has asked whether increased compliance costs that the new Rules would impose on hedge fund advisers should be a consideration in whether to adopt them. NASAA’s response is that these are exactly the entities that are most in need of securities regulation. Investments in hedge funds are approaching one trillion dollars. We know of no other circumstances where a substantial segment of an industry has been allowed to escape the most basic of securities regulations.

Requiring Commission registration of hedge fund advisers will result in a great benefit to investors. Investor confidence will be increased knowing that there is greater transparency and accountability, supported by governmental examinations and enforcement. Hedge funds will also derive benefit from the increased investor confidence. Hedge fund advisers are not being asked to comply with rules beyond those that already apply to other investment advisers.
We do not contend that requiring hedge fund managers to register with the Commission will eliminate all hedge fund fraud, but it will certainly discourage those with prior disciplinary problems, or who are not fully qualified, from entering the marketplace. Investors in hedge funds should have the same opportunity as those participating in other investments to examine the backgrounds of those who seek to manage their money.

Thank you for your consideration of these views. Should you have questions about these comments, please feel free to contact, Theodore A. Miles, Director of the District of Columbia Securities Bureau and Chair of NASAA’s Investment Adviser Section, Tanya Solov, Director of the Illinois Securities Department and Chair of NASAA’s Broker-Dealer Section, or Rex A. Staples, NASAA’s General Counsel.

Sincerely,

Franklin L. Widmann

Franklin L. Widmann
NASAA President and
Chief, New Jersey Bureau of Securities