



## MANAGED FUNDS ASSOCIATION

### THE SEC'S REGISTRATION PROPOSAL: THE PUBLIC COMMENTARY—A SUMMARY

On July 14, 2004, the Securities and Exchange Commission (SEC or Commission) held an open meeting proposing a major regulatory amendment to the existing legal framework governing the hedge fund industry. The proposed rule would require all hedge fund advisers to register as investment advisers with the Commission (SEC Proposal). Once the SEC Proposal was published in the Federal Register on July 28<sup>th</sup>, the SEC held a brief comment period open until September 15<sup>th</sup>, although a few letters were submitted after that date. The SEC received 156 letters as of October 13<sup>th</sup>, 124 of which were either for or against the proposal.<sup>1</sup> The overwhelming number of the **124 comment letters** that took a position *opposed* the SEC Proposal as summarized below:

- **91 letters** submitted were **AGAINST** the proposal (**73%**)
- **33 letters** submitted were in **FAVOR** of the proposal (**27%**)

Many of the comment letters opposing the SEC Proposal provided solid and well-developed reasons why the SEC should not move forward to adopt this proposed rule. Those who oppose this proposal include not only major hedge fund groups, industry participants, the leading trade association representing this industry and top legal professionals and law firms who represent hedge fund managers, but also major business groups such as the U.S. Chamber of Commerce. It should be noted that the majority of the letters in favor of the proposal rarely exceeded one page and often contained anecdotal support or baseless claims about the industry. Many such respondents were individuals with no apparent connection to the industry or no prior experience in hedge fund investing. Coincidentally, the chief proponent of the SEC Proposal is a trade association which represents the mutual fund industry—a key competitor of the hedge fund industry.

It should be noted that many commentators provided alternatives to the SEC Proposal that, to our knowledge, the Commission has yet to consider. In light of the division within the Commission, the lack of support by the President's Working Group on Financial Markets (PWG), and the fact that no public policy case has been made to support the proposed rule, the SEC should at the very least consider these alternatives. While the industry does not necessarily endorse these alternatives, they could serve as a starting point to balance the desire of the Commission to obtain comprehensive information about the hedge fund industry without moving towards further *unnecessary* regulation of a successful and growing industry and negatively impacting the global marketplace.

In the pages that follow, we have summarized the arguments made by both opponents and proponents of the SEC Proposal and some of the alternatives presented.

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<sup>1</sup> It should be noted that 32 letters *neither* favored nor opposed the proposal, rather they requested clarification on certain points in the SEC Proposal.

## **Summary of Arguments Against the SEC Proposal**

The following arguments were raised in the 91 letters to the Commission in opposition to the SEC Proposal:

- **SEC Does Not Have the Legal Authority to Proceed**
  - Certain commentators argue that the SEC is exceeding the powers granted to it by Congress in redefining the term “client” under Section 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act).<sup>2</sup>
  - “The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.”<sup>3</sup>
  - Congress has made clear since adoption of the Advisers Act that a hedge fund counts as a single client under the current private adviser exemption.
- **Appropriate Regulatory Framework Already Exists**
  - All investment advisers are already subject to the anti-fraud and anti-manipulation provisions of the Advisers Act.
  - There is a comprehensive body of Federal regulations and required filings applicable to hedge funds and hedge fund managers.<sup>4</sup>
- **No Evidence of Retailization found by SEC**
  - The SEC found no evidence of the “retailization” of the industry.<sup>5</sup>
  - “Fund of hedge funds” products with lower investment minimums that are offered to the public are fully-registered with the SEC and subject to the full panoply of SEC regulations.
- **Proposal Goes Beyond Mere Registration to Impede Industry Growth**
  - Imposes actual and opportunity costs for these businesses, many of them small, start-up ventures.<sup>6</sup>
  - Although the SEC claims that its proposal is not aimed to govern the activities of the funds themselves, this new regime will hurt hedge fund investors and capital markets by impeding entrepreneurial efforts that characterize the industry’s diversity and innovation.
- **Mandatory Registration Would Divert Scarce SEC Resources**
  - Enormous SEC resources would be expended to reach a relatively small number of investors (a few hundred thousand) who are wealthy and/or sophisticated individuals and institutions.
  - Currently, the SEC has only 495 employees responsible for examining 8,000 mutual funds with about 91 million investors, managing \$7 trillion..<sup>7</sup> The SEC

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<sup>2</sup> See, e.g., Letters of Chamber of Commerce of the United States of America dated September 15, 2004; Willkie Farr & Gallagher LLP dated September 13, 2004; Wilmer Cutler Pickering Hale and Dorr LLP dated September 8, 2004; and Managed Funds Association dated October 12, 2004.

<sup>3</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976).

<sup>4</sup> See Managed Funds Association, *2003 Sound Practices for Hedge Fund Managers*, Appendix II.

<sup>5</sup> Staff Report to the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Funds*, at page 80.

<sup>6</sup> See Letter by Managed Funds Association dated September 15, 2004. Even a letter in support of the SEC Proposal by Investment Counsel Association of America dated September 14, 2004, agrees that the costs are substantial.

has not made clear that the agency would have the needed expertise to monitor thousands more hedge fund advisers.

### **Summary of Alternatives to the SEC Proposal**

Numerous alternatives have been proposed to the Commission including:

- **Commission Registry<sup>8</sup> and Certification<sup>9</sup>**
  - Amend Rule 203(b)(3)-1, in its current form, to state that any hedge fund adviser relying on this registration exemption must also file with the SEC in a central “registry” an annual report or notification containing information that the Commission deems necessary or appropriate within 90 days of the end of the hedge fund adviser’s fiscal year.
  - Annual report to include among other items: the name of adviser, affiliates and funds managed; address of principal place of business; names of people who retain voting and investment control over investments held by the funds; name of person responsible for compliance; and gross assets and net assets under management by adviser.
  - Hedge fund advisers would certify that: No executive officer or member of the governing board of, or holder of a 10% or greater equity interest in, the adviser is a person that would respond “yes” to one or more questions on Item 11 of Form ADV<sup>10</sup>, among other items.
- **Increased Information Sharing Among Regulators<sup>11</sup>**
  - Members of the PWG should evaluate the information about the hedge fund industry currently available to them and determine how this information can be shared among its respective agencies.
- **Increased Regulation D Standards<sup>12</sup>**
  - Accredited investor standards set forth in Rule 501 of Regulation D should be raised so that the monetary thresholds reflect the inflation in wealth and incomes since 1982 or by imposing a similar enhanced accredited investor standard under the Advisers Act for hedge fund investors.

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<sup>7</sup> Testimony of William H. Donaldson, Chairman, SEC, Before the Subcommittee on Commerce, Justice and State, the Judiciary, and Related Agencies, Committee on Appropriations, U.S. House of Representatives, “Fiscal 2005 Appropriations Request for the U.S. Securities and Exchange Commission,” dated March 31, 2004.

<sup>8</sup> See, e.g., Letters of Committee on Federal Regulation of Securities, Task Force on Hedge Fund Regulation, Section of Business Law, American Bar Association dated September 28, 2004; Schulte Roth & Zabel LLP dated September 15, 2004; Chamber of Commerce of the United States of America dated September 15, 2004; Kynikos Associates dated September 15, 2004; and Bryan Cave LLP dated August 16, 2004.

<sup>9</sup> See, e.g., Letters of Chamber of Commerce of the United States of America dated September 15, 2004; Seward & Kissel LLP dated September 15, 2004; Davis Polk & Wardwell dated September 15, 2004; Willkie Farr & Gallagher LLP dated September 13, 2004; and Managed Funds Association dated September 15, 2004.

<sup>10</sup> Questions on Item 11 to Form ADV ask managers several questions about any past criminal activity and violations of government regulations, particularly related to investment activity, among other things.

<sup>11</sup> See, e.g., Letters of The Financial Services Roundtable dated September 15, 2004; Tudor Investment Corporation dated September 15, 2004; Committee on Futures Regulation of the Association of the Bar of the City of New York dated September 15, 2004; Amaranth Advisers dated September 15, 2004; Kynikos Associates dated September 15, 2004; Katten Muchin Zavis Rosenman dated September 14, 2004; National Futures Association dated September 14, 2004; and Managed Funds Association dated September 15, 2004.

<sup>12</sup> See, e.g., Letters of Managed Funds Association dated September 15, 2004; International Swaps and Derivatives Association, Inc. (ISDA) dated September 15, 2004; Tudor Investment Corporation dated September 15, 2004; Committee on Futures Regulation of the Association of the Bar of the City of New York dated September 15, 2004; Kynikos Associates dated September 15, 2004; and Katten Muchin Zavis Rosenman dated September 14, 2004.

- **Submitting to Special Calls**<sup>13</sup>
  - Hedge fund advisers relying on a registration exemption could be required to provide, upon “special call” by the Commission under limited circumstances, certain information related to its business that the Commission may determine appropriate to enforce the anti-fraud and anti-manipulation provisions of the U.S. securities laws.
- **Audit and Financial Statements**<sup>14</sup>
  - Annual audit conducted by an accounting firm independent from the hedge fund manager under the SEC’s auditor independence rules.
  - Investors to receive annual audited financial statements and quarterly unaudited financial statements.
- **Suspicious Activity Reports (“SARs”)**<sup>15</sup>
  - SARs are required by the Financial Crimes Enforcement Network of the Treasury Department. They are prepared by broker-dealers, banks and other financial institutions and can be amended to include reporting of illegal activity by hedge funds and their advisers. Information contained in these amended forms could then be made available to the Commission.
- **Educational Seminars**<sup>16</sup>
  - Hedge fund advisers could receive training on a bi-annual basis with respect to, among other things, securities laws, fiduciary obligations and compliance procedures. Hedge fund advisers that are not registered under the Advisers Act could be required to certify, in a manner consistent with new certification requirements under the Sarbanes-Oxley Act of 2002, that key employees thereof have attended a seminar.

### **Arguments by Those Who Favor the Proposal**

The following bullet points summarize the reasons why (the few) supporters<sup>17</sup> of the SEC Proposal are in favor of the rule, and why these arguments are not supported by the facts:

- **Would Provide Commission with Information It Does Not Have**
  - Supporters of this argument ignore the fact that hedge funds and their managers are subject to a plethora of Federal regulations.
  - If this information were shared among various regulators, the SEC would have substantial information about hedge fund activities.<sup>18</sup>

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<sup>13</sup> See, e.g., Letter of Managed Funds Association dated September 15, 2004.

<sup>14</sup> See, e.g., Letters of Kynikos Associates dated September 15, 2004 and Willkie Farr & Gallagher LLP dated September 13, 2004.

<sup>15</sup> See, e.g., Letter of Bryan Cave LLP dated August 16, 2004.

<sup>16</sup> See, e.g., Letter of Bryan Cave LLP dated August 16, 2004.

<sup>17</sup> See, e.g., Letters by Investment Company Institute dated September 15, 2004; Investment Counsel Association of America dated September 14, 2004; and Investment Management Consultants Association dated September 14, 2004.

<sup>18</sup> See Footnote 7 herein.

- **Would Enable the Commission to Address Systemic Risk Concerns**
  - Commentators who favor the proposed mandatory registration of hedge fund advisers argue that the SEC must have “reliable, current and complete information” about the industry to “monitor the activities” of hedge funds.<sup>19</sup>
  - Concerns about systemic risk are not solely within the purview of the SEC, but rather of the broader PWG which in the past has determined that direct regulation of hedge funds was not warranted.<sup>20</sup>
  
- **Would Protect Pensioners**
  - Another rationale for supporting the proposal involves the protection of pensioners;<sup>21</sup> however, a substantial body of law administered and enforced by the U.S. Department of Labor (ERISA) and state regulatory agencies exists to govern pensions.
  
- **Would Help Detect and Prevent Fraud**
  - Supporters of the proposal believe that the SEC would be able to detect fraudulent activities; however, the SEC was not able to deter or prevent fraud in the highly regulated mutual fund industry as uncovered in 2003.
  - Of the 46 enforcement cases brought by the SEC against hedge funds in the last five years, the typical case involved an adviser that was either too small to be subject to the SEC Proposal or was already registered with the SEC, or an adviser that evaded SEC regulations.<sup>22</sup>
  - Registration would not help investors determine which advisers are qualified,<sup>23</sup> which creates a “moral hazard” for the Commission.
  
- **Registration Is Not “Overly Burdensome”**
  - Supporters of the proposal point to the fact that many hedge fund advisers are already registered with the Commission and these advisers do not feel that registration impedes their trading strategies.
  - On the contrary, mandatory registration would likely be a “first step” towards increased regulation. As Federal Reserve Chairman Alan Greenspan suggested:

*“[S]hould registration fail to achieve the intended objectives, pressure may become irresistible to expand the SEC’s regulatory reach from hedge fund advisers to hedge funds themselves.”<sup>24</sup>*

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<sup>19</sup> Letter by Investment Company Institute dated September 15, 2004 at page 2.

<sup>20</sup> See President’s Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long Term Capital Management*, at 42.

<sup>21</sup> See, e.g., Letters of New Jersey State Investment Council dated September 17, 2004; and the Ohio Public Employees Retirement System dated August 6, 2004 (though not invested in hedge funds).

<sup>22</sup> See Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to SEC Proposal at p. 100.

<sup>23</sup> See, e.g., Letter of Committee on Federal Regulation of Securities, Task Force on Hedge Fund Regulation, Section of Business Law, American Bar Association dated September 28, 2004 at page 3.

<sup>24</sup> *The Federal Reserve’s Second Monetary Policy Report to Congress for 2004*, Hearing before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate dated July 20, 2004 (response to question from Senator Crapo).