• Mandatory registration will not fill SEC information gaps – but will significantly increase industry and Commission burdens.

• According to the SEC itself, in its 1992 report on the hedge fund industry:
  o “The purpose of regulation is to protect investors, not to simplify investigations.”
  o “The potential need to obtain information from hedge funds for enforcement purposes would not seem to be an adequate reason for registration.”

• According the President’s Working Group on Financial Markets (of which the SEC is a member), in its 1999 report on the hedge fund industry: “Requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity.”

Retailization: A Non-Issue

• The 2003 SEC Staff Hedge Fund Report found no retailization and no significant increase in fraud -- consistent with the SEC’s May 2003 roundtable (at which 60 panelists, including federal, state, and foreign regulators, securities professionals, and academics testified). Nonetheless, the staff recommended registering hedge fund advisers.

• In any event, adjustments to eligibility criteria for accredited investors – established over 20 years ago, in 1982 -- would address concerns about potential retailization much more directly than would hedge fund adviser registration.

• Furthermore, if the SEC can demonstrate that publicly offered funds of funds pose real undisclosed risks to retail investors, the SEC should consider whether the problem can be addressed by reversing past regulatory actions that have permitted these funds of funds to be publicly offered. In addition, it should be noted that funds of funds are already subject to the fully panoply of protections afforded by SEC regulation.

• Although the Commission itself admits that it “has not uncovered evidence of significant numbers of retail investors investing directly in hedge funds” ... “nevertheless, the increased number of retail investors qualifying as accredited investors raises our concern that hedge funds and broker-dealers might begin to seek out these investors as a new source of capital for hedge funds.” If, as the Commission suggests, there is an excess of investor dollars waiting to flow into hedge funds, then it is unclear why hedge funds would need seek out retail investors. (See From Alpha to Omega; Hedge Funds, The Economist, July 17, 2004: Many of the oldest and best-known hedge funds will not accept any new money [because] for many trading strategies ... there is a limit to the amount of money that can be moved around cheaply and briskly. While punting large amounts on the highly liquid foreign-exchange or government-bond markets is easy, betting on illiquid corporate bonds or shares is far harder. And the larger the amounts, the more expensive the bets are.)

• But perhaps most importantly, the Commission would be providing a false sense of security -- suggesting to the marketplace that, through registration, hedge funds have been “bathed in sunlight.”

Fraud: Where’s the Beef?

• The SEC has brought 46 enforcement actions in the past five years in which hedge fund advisers have defrauded investors or used a hedge fund to defraud others. By comparison, the SEC
initiated approximately 2,600 enforcement actions during this same time period. As the SEC’s 2003 Hedge Fund Report states, there is “no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity.”

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

- Eight of these 46 cases involved hedge fund advisers who were already registered with the Commission. These 8 cases, however, do not justify the proposed rulemaking. Most involved valuation problems, which have been notoriously difficult for the SEC to detect even if the adviser is registered. In addition, only perfectly timed inspections would have improved the Commission’s detection of the frauds at issue. With respect to all advisers, registered or unregistered, tips from knowledgeable insiders or third parties are often the key to discovering the fraud. Indeed, tips pointed us to the fraud in 7 of the 8 remaining cases. So it follows that increasing the quantity and quality of tips would have far more impact than would registration.

- Even ignoring this, theses 46 cases suggest that the typical hedge fund fraud is perpetrated by an adviser that is too small to be registered with the SEC, was registered already with the SEC, or evaded registration requirements. Registration would therefore not add to the SEC’s ability to combat these types of fraud. Importantly, the very recitation of these fraud cases illustrates the fact that hedge fund advisers are subject to anti-fraud provisions regardless of their registration status.

- Moreover, there is no correlation between registration and fraud. Again, as the SEC’s own Hedge Fund Report states, “both registered and unregistered investment advisers have engaged in fraud.”

- It should be remembered too that unregistered hedge funds are already subject to a variety of rules and regulations that create the necessity to have a sound compliance program. These include anti-fraud provisions and insider trading prohibitions under US securities laws, reporting requirements designed to increase market transparency (e.g., Form 13G, Section 16), and anti-money laundering regulations.

- To substantiate requiring registration, the Commission points to the recent market timing and late trading scandal in the investment industry, in which some hedge funds were implicated. The Commission posits that had examiners been inspecting hedge funds, they would have found these abuses sooner. But mutual funds and their advisers are registered, and examiners were inspecting the mutual funds involved in the scandals and did not find these abuses. The SEC should revisit its oversight methods rather than looking for more entities to inspect.

- Worse yet, the proposal states that the staff has identified up to 40 hedge funds that have been involved in the SEC’s late trading and market timing actions. The reliance on this information to substantiate the proposal is unwarranted however, as the Commission never counted the number of hedge fund advisers, the entities it proposes to register.
• The Commission speaks ominously of the fact that certain hedge fund managers are active traders, but this just indicates their important role in providing liquidity. If well-meaning but ineffective regulation inhibits hedge funds from performing their important function of lubricating our financial system, it could have an injurious effect upon our economy. As Alan Greenspan testified before the US Senate in February of this year: “The value that these institutions have is to create a very significant amount of liquidity in our system, and I think that while they have a reputation for being a sort of peculiar type of financial group, I think they’ve been very helpful to the liquidity, and hence the international flexibility, of our financial system.”

• The Commission also expresses concern about an increase in hedge fund investment by universities, endowments, foundations, and other charitable organizations because 'losses resulting from hedge fund investments, as with any other investment loss, may affect the entities' ability to satisfy their obligations to their beneficiaries or pursue other intended purposes.” Laudable as this concern is, we I personally attest, these organizations hire experienced money managers to invest their money in a way that maximizes the ability of those organizations to carry out their objectives.

Opportunity Costs: the Law of Unintended Consequences

• While it is far from certain that registration will reduce investor fraud losses, it is certain that investors will bear the cost of the additional regulations. In the age-old spirit of *caveat emptor*, hedge fund investors will continue to do their own research to supplement government-mandated information. In fact, both the Secretary of the Treasury and Chairman of the Federal Reserve agree that “information and disclosure requirements should be designed to provide investors with real value rather merely serving to increase costs and decrease returns.” It should be noted that the information currently obtained by investors as part of their due diligence procedures and through private placement memoranda is far more valuable than the information that could be provided by way of a prescriptive, one-size-fits-all document.

• The Commission estimates filing fees of approximately $1,000 in the first year and approximately $500 subsequently. In addition, the Commission estimates average initial compliance costs of $20,000 in professional fees and $25,000 in internal costs including staff time. As with any disclosure document, the Form ADV can serve as the basis for litigation against an adviser, so they are prepared with great care and often costly legal advice. These various costs equate to one administrative assistant’s salary for one year – illustrating that ill-conceived regulations have genuine human consequences.

• It is worth noting here the words of the dissenting Commissioners: Registration “Proponents tend to paint the proposed approach as little more than a notice filing approach. We suspect that many advisers already regulated under the Advisers Act would not share that view.”

• The Commission downplays the complexities involved in registering as an investment adviser. While the burden of this first step is likely to exceed the Commission’s expectations, future, more substantive regulation may bring even higher costs. In fact, tellingly, the Commission has characterized this proposal as “a modest first step.” This begs the question of what this is a first step towards. In the words of Alan Greenspan, in his previously mentioned testimony before the Senate: “I grant you that registering advisers in and of itself is not a problem. The question is: ‘What is the purpose of that unless you’re going to go further?’ And therefore I feel uncomfortable about that issue.”
• As the SEC casts about for the information it needs, hedge fund advisers may face repeated, ad-hoc requests for paper and electronic documents. Such an approach cannot be deemed, in the Commission’s words, to be “modest.”

• In fact, the burdens of registration might lead some advisers to relocate off-shore, making existing regulation less effective, and driving a significant portion of the economy out of the country.
  
  o In the words of Alan Greenspan: “Most hedge funds are only a short step from cyberspace. Any direct regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction … If the funds move abroad, our oversight will diminish.”

  o And in the words of William McDonough, President of the Federal Reserve Bank of New York: “The reality is that imposing direct regulation on hedge fund entities that are chartered in the major industrialized countries would likely result in the movement of all operations offshore.”

  o And finally, in the words of James Newsome, Commissioner of the Commodity Futures Trading Commission: “I believe that heavy-handed regulation will certainly drive business off the shores of the United States.”

• The burdens associated with mandatory registration could stifle innovation and deter certain money managers from entering the industry. The imposition of such a regulatory scheme could impair the development of the innovative and adaptive investment strategies that have contributed to the success of the hedge fund industry – and cause advisers to manage their businesses to meet SEC expectations rather than to develop strategies that contribute to market efficiency.

• The Commission also ignores the costs of its own proposal to the SEC itself. The SEC does not have unlimited resources, and those that are devoted to regulating hedge fund advisers are resources that could be otherwise have been devoted to other, possibly higher, priorities.
  
  o Mandatory registration would be inconsistent with longstanding public policy that sophisticated investors do not require the protections provided by the regulations applicable to transactions involving unsophisticated market participants.

  o Almost laughably, former SEC Chairman Arthur Levitt testified in 1996 that SEC inspections had become so infrequent for lack of resources that small advisers were inspected, on average, once every 44 years.

  o Wouldn’t investors be better served if the SEC were to devote resources to more effective regulation of mutual funds, the investment of choice for over 90 million Americans? Or should the SEC devote those resources to hedge funds, whose direct investors are limited to large institutions and about 200,000 sophisticated, high-net-worth individuals?

• Observes one commentator: “Regulatory action aimed at eliminating every vestige of fraud in a given market would place such a heavy and costly burden of compliance upon issuers that investors would be safe but unable to achieve any meaningful return on their investments. The regulatory agency would also incur a high cost of enforcement. Carried to its logical end, investor protection as a sole reason for regulation, without also granting markets the freedom to reward those who take risk, ironically keeps investors safe and yet fails to fully protect the investors’ sole interest in investing in the first instance: to achieve the highest return commensurate with their individual tolerance for risk.”
Unfounded Concerns ... Continued

- The proposing release cites an increase in pension investments and hedge funds from $13 billion to $72 billion since 1997. This amount represents approximately one percent of the total amount invested in all US private and public pension plans. Despite this, the Commission assumes that pension plan participants' financial well-being depends on its protection.

- One wonders whether the proposed two year lock-up will simply cause hedge fund advisers to lengthen their redemption periods, which would not in any way benefit investors.

- The Commission points to valuation as one of the problems that the proposed rulemaking would address. If valuation concerns are motivating the push for hedge fund registration, the same concerns should then have been expressed about private equity and venture capital funds.

- The Commission cites a recent study finding valuation problems in hedge funds, and notes that "the authors attribute these failures, in part, to a lack of regulatory oversight." This is wrong. The article in question does not call for enhanced government regulation, but for more rigorous internal valuation procedures with adequate managerial supervision and, when necessary, utilization of third-party pricing services.

Superior Alternatives

- In the unlikely event that the data point to specific problems with hedge funds, the SEC could still work with prime brokers, which are already registered with the SEC, to develop solutions. The proposal does not even ask any questions about the role that prime brokers can play, even though prime brokers have already helped the SEC to identify instances of fraudulent activity at some hedge funds.

- Promoting prudent due diligence, valuation, and risk management practices among hedge fund counterparties and creditors would go a long way toward achieving SEC objectives without the burdens and pitfalls of mandatory registration.

- Some suggest that hedge funds have an unfair advantage over mutual funds. But this is not the only area in which the Commission permits a mix of unregistered and registered products in order to enhance investors’ options without compromising investor protection.

- The SEC should also review the vast array of data that it and other government agencies already receive. The SEC can glean additional information from investor complaints, examinations of prime brokers, registered hedge fund advisers, and hedge fund enforcement cases. Another source of information may be hedge fund filings under the USA Patriot Act.

- Crucially, hedge fund advisers can decide to register and, if registration is important to investors, the market will reward registered advisers.

- Lastly, it bears mentioning that enforcement of existing regulations serves as its own deterrent. White-collar criminals being publicly made to do serious prison time gives pause to others with criminal intent.

In closing, one can hardly take comfort from the fact only 3 of 5 Commissioners voted in favor of the proposal. In fact, dissenting opinions by Commissioners are uncommon: only 10 dissenting opinions have been published since the SEC was established in 1933. Nor is it likely that the Commission will determine within this sixty-day comment window what it really needs to know. As an observer of the hedge fund community, I concur with the dissenting opinion in opposing a proposal that “papers over the weaknesses of the approach it puts forward, overstates its purported benefits, and ignores the possibility that viable, and indeed preferable, alternative approaches may exist.”