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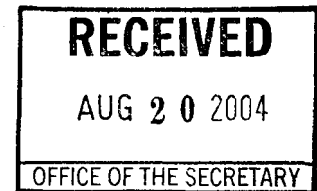
**MEMORANDUM**

August 20, 2004

To: S7-30-04  
From: Jennifer Sawin  
Jamey Basham  
Vivien Liu

**Re: Registration Under the Advisers Act of Certain Hedge Fund Advisers  
("Proposing Release")**

In connection with publishing the Proposing Release, we request that the following documents be included in File No. S7-30-04: (1) Chairman Richard C. Breeden's letter to Chairman Edward J. Markey dated Jun. 12, 1992; (2) Commission des Operations de Bourse (France) news release, *Regulating Alternative Multi-Management Investments*; (3) letter from John G. Gaine, President of Managed Funds Association, to Chairman William H. Donaldson dated Nov. 21, 2003; and (4) Shearman & Sterling's summary entitled *SEC Report: Implications of the Growth of Hedge Funds*. The Proposing Release cites these documents in footnotes 26, 52, 102 and 128, respectively.



57-30-04

Footnote 26 (HF Proposing Release)

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**SECURITIES AND EXCHANGE COMMISSION**

**Response to Letter from Chairman Markey concerning**

**HEDGE FUNDS**

**prepared by the Division of Market Regulation**  
**of the**  
**U.S. Securities and Exchange Commission**

JUNE 12, 1992

**made public by the Honorable Edward J. Markey**

*Handwritten: Trade ... to ... of ...*



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

THE CHAIRMAN

June 12, 1992

CHAIRMAN'S OFFICE  
MAILED

The Honorable Edward J. Markey  
Chairman  
Subcommittee on Telecommunications and Finance  
Committee on Energy and Commerce  
United States House of Representatives  
Washington, D.C. 20515

JUN 12 1992

Signed by: \_\_\_\_\_

Dear Chairman Markey:

This is in response to your letter of March 18, 1992 regarding hedge funds.

As you know, although the recent Joint Report on the Government Securities Markets discussed hedge funds, it did not make any legislative proposals regarding hedge funds. There does not appear, at the present time, to be any need for legislation specifically addressing hedge funds.

Investors in hedge funds are typically wealthy individuals. They are protected by the limits in the statutory exemptions on which hedge funds rely, as well as by the hedge funds' own limits on minimum investments. Since 1987, the Commission has apparently received no investor complaints and has instituted no enforcement actions against hedge funds. To the extent that additional information about the trading of hedge funds is necessary to understand any systemic effect of their trading, the large trader reporting system for equity securities, and the proposed large position reporting system for government securities, should be adequate.

The enclosed memorandum from the Commission's staff attempts to respond to your detailed questions. Please let us know if you require any additional information.

Sincerely yours,

Richard C. Breeden  
Chairman

Enclosure

MEMORANDUM

June 12, 1992

TO: Chairman Breeden

FROM: William H. Heyman, Director  
Division of Market Regulation

Marianne K. Smythe, Director  
Division of Investment Management

RE: Hedge Funds

This memorandum responds to a letter, dated March 18, 1992, from Chairman Markey of the House Subcommittee on Telecommunications and Finance, in which he requested that the Commission provide the Subcommittee with detailed information regarding the nature, and regulatory treatment, of certain private investment vehicles known as "hedge funds." The memorandum has been prepared in a report format that generally follows the order of the questions raised in Chairman Markey's letter.

At the present time, the Commission does not have a direct source of information regarding hedge fund activities and there is no public directory of hedge funds. Consequently, much of the information in this report was drawn from publicly available sources.

I. General Information Regarding Hedge Funds and their Growth

A. General Description. The term "hedge fund" is not defined or used in the federal securities laws, and it has no precise legal definition. Generally, however, the term is used to describe private investment vehicles that often engage in active trading of various types of securities and commodities, employing sophisticated investment techniques such as arbitrage, leveraging, and hedging.

The hedge fund vehicle emerged originally in the 1960s, particularly during the "bull market" of 1968-73, when private investment entities began using sophisticated hedging and arbitrage techniques to trade in the corporate equity markets. In the 1970s and 80s, the activities of hedge funds broadened into other financial instruments and activities. Currently, hedge funds are known to trade in the equities, government securities, commodities, financial futures, options, and foreign currency markets, as well as participate in merger and acquisition activities.

Hedge funds are generally organized as private limited partnerships that are exempt from regulation as investment companies (see discussion below). The general partner, who often

has a personal stake invested in the fund, is typically responsible for managing the fund and making investment decisions (or selecting who will make investment decisions). The limited partners are investors that purchase an interest in the partnership in return for which they receive a fixed percentage of the fund's profits. Participation in a hedge fund requires a substantial investment: investor must meet the fund's minimum capital investment amount, which ranges from \$250,000 to \$1 million.<sup>1/</sup> Investors also must be willing and able to tie their funds up for an extended period of time, as redemptions and transferability of partnership interests are limited. Accordingly, hedge fund investors typically are wealthy individuals or institutions.

Because hedge funds are structured as private investment companies, they have considerably more flexibility in trading and investment techniques than conventionally regulated investment companies that offer their shares to the public. Typically, hedge funds engage in aggressive trading strategies and are willing to take substantial risks with their investment capital. For example, hedge funds may take offsetting short and long positions in the same security (a typical hedge fund strategy), buy futures and options, invest in risky securities, trade on margin, and take heavily concentrated positions. Some invest in other pooled investment vehicles, some specialize in short selling or arbitrage, and some invest only in the securities of takeover targets or companies undergoing bankruptcy reorganization.

In contrast to registered investment companies, hedge fund managers are able to invest in any type of asset in any market with total flexibility, use many investment strategies at the same time, switch investment strategies quickly, and borrow money and or otherwise use leverage without being subject to investment company leverage limits. Furthermore, unlike registered investment companies, hedge funds are not required to disclose publicly their investments to shareholders.

Hedge fund managers generally are compensated based on fund performance. Some fund managers receive as compensation as much as 20% of any net profits made by the fund, although it recently has been reported that several funds have reduced this incentive fee to 10 or 15%. It has been argued that a high level of compensation, linked to the funds' profits, attracts the most talented investment managers.

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<sup>1/</sup> According to press reports, some hedge funds require only an initial investment of \$150,000; in contrast, at least one hedge fund reportedly requires an initial investment as high as \$10 million.

B. Statistics regarding Hedge Funds. As more fully described below, hedge funds generally are structured so that they are not subject to registration and reporting requirements under the federal securities laws.<sup>2/</sup> Consequently, the Commission does not have a direct source of information regarding hedge funds or their activities. In addition, other publicly available data regarding hedge funds is limited. For example, there is no public directory of hedge funds.<sup>3/</sup>

The Commission is, therefore, unable to provide the Subcommittee with comprehensive statistics regarding the number of hedge funds in existence, the size in terms of assets managed, the investors participating, the rates of return achieved, the degree of leverage used, or the positions maintained in particular instruments such as equities, commodities, government securities, or options.

Review of publicly-available information, however, provides some rough statistics regarding hedge funds and their activities. For example, recent press reports estimate that approximately 400 hedge funds are in existence, up from around 100 such funds during the mid-1980s. Based on public sources, we have prepared the attached list of 53 entities that have been identified in the press as hedge funds (see Appendix A attached).

Likewise, publicly available information regarding the total assets managed by hedge funds is available for only 17 funds; as of December 31, 1991, total assets for these 17 funds represented approximately \$130 billion. Based on the publicly available information regarding these 17 funds, the average fund asset size would appear to be in the range of \$75-\$150 million.<sup>4/</sup>

According to media reports, the number and asset size of hedge funds grew substantially during the bull market of the 1980s. Arguably, this growth parallels the emergence and proliferation of hedge funds that took place during the bull market of the 1960s. Not all funds, however, appear to want to grow: reportedly, a number of funds are not accepting additional investments at the present time. Some commentators speculate

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<sup>2/</sup> Of course, the antifraud provisions of the federal securities laws do apply to hedge funds whether or not the registration provisions apply.

<sup>3/</sup> According to media reports, there does exist a privately-published list of offshore funds. The staff, however, was unable to obtain a copy of this list.

<sup>4/</sup> Several funds, however, have total assets of more than \$1 billion each.

that fund performance is often inversely related to growth in assets. This may be, in part, because funds that become too large lose the ability to shift their investments rapidly.

Hedge funds are attractive investments for some investors because of the historically high returns on investments obtained by skilled hedge fund managers. For example, for the period 1987-1990, the median reported hedge fund return was 75.1% (compared with median mutual fund return of 36.1% and the S&P 500 "return" of 56.2%). Media sources recently have reported that some pension funds invest, or are considering investing, in hedge funds.<sup>5/</sup>

## II. Regulatory Treatment of Hedge Funds

Hedge funds claim various exemptions or exceptions from the registration requirements of the federal securities laws. As more fully described below, however, the Commission's proposed large trader information system should provide the Commission with access to relevant information regarding the issues raised by hedge fund activity in the equity securities market, without unduly burdening market participants.

In view of the impending large trader system, the staff believes that the existing registration requirements should not be altered to include hedge funds within their scope at this time. The regulatory programs for broker-dealers, investment companies, and investment advisers focus extensively on the protection of public investors. The regulatory issues potentially relevant to hedge funds, however, involve not so much the protection of the investors who invest in them -- typically high net worth individuals or institutions -- but the potential of these funds to affect the market due to their size and active market presence.

### A. Application of Registration Provisions to Hedge Funds

1. Securities Act of 1933. Investment interests in hedge fund limited partnerships generally are privately offered to wealthy individuals and institutions that are accredited investors and thus are not registered under the Securities Act of 1933 ("Securities Act"). Consequently, registration statements

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<sup>5/</sup> It appears that registered investment companies do not invest significant assets in hedge funds because of the anti-pyramiding provision contained in Section 12(d)(1)(A) of the Investment Company Act of 1940 (the "Investment Company Act"). That provision limits a registered investment company's ability to acquire the securities of any other investment company (including a hedge fund) to prevent excessive layering of fees.

for such offerings are not filed with the Commission, although private offering documents are presumably distributed to the limited partners.

The staff does not believe that there is any reason to treat private offerings of hedge fund investment interests, which are sold to wealthy individuals and institutions, differently from other private offerings under the Securities Act.

2. Investment Company Act of 1940. Most hedge funds fall within the definition of "investment company" found in Section 3(a) of the Investment Company Act. To avoid registration as an investment company under the Investment Company Act, however, hedge funds generally restrict participation to fewer than 100 persons in order to avail themselves of the so-called private investment company exception contained in Section 3(c)(1) of the Investment Company Act. Section 3(c)(1) provides an exception from the definition of "investment company" for any issuer whose outstanding securities are owned by not more than 100 persons, and which is not making and does not presently propose to make a public offering of its securities. The Commission staff looks to Section 4(2) of the Securities Act, and Rule 506 thereunder, in interpreting the private offering exception.

The legislative history of the Investment Company Act reveals that although Congress was informed that private investment companies could hold substantial amounts of assets, it nonetheless believed that these companies do not involve significant public interest and are not appropriate subjects for federal regulation, regardless of the amount or value of the securities they hold.<sup>6/</sup> Section 3(c)(1) thus reflects a Congressional determination that small groups of investors do not need the full panoply of investor protection that the Investment Company Act offers.<sup>7/</sup>

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<sup>6/</sup> Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. on Securities and Exchange of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 179 (1940) (statements of Senator Wagner and David Schenker, Chief Counsel, Investment Trust Study, Securities and Exchange Commission).

<sup>7/</sup> Similarly, the Commission believes that highly sophisticated investors deserve similar treatment under the Investment Company Act. Recently, the Commission forwarded to Congress the proposed Business Incentive Act of 1992, which was introduced in the House of Representatives as H.R. 4938 on April 9, 1992. The proposed legislation would, among other things, create a new "qualified purchaser" exception from  
(continued...)



3. Investment Advisers Act of 1940. The manager of a hedge fund generally would fall within the definition of "investment adviser" under Section 202(a)(11) of the Investment Advisers Act of 1940 (the "Advisers Act"). Many hedge fund managers, however, avail themselves of the small adviser exception from registration found in Section 203(b)(3) of the Advisers Act.

Section 203(b)(3) exempts from registration any adviser with fewer than 15 clients and who does not hold itself out to the public as an investment adviser. Rule 203(b)(3)-1, adopted in 1985 by the Commission, allows a general partner to count a limited partnership as a single client, rather than counting each limited partner, if the general partner provides investment advice to the partnership based on the investment objectives of the limited partnership. Under this rule, many managers and general partners of hedge funds are exempt from registering as investment advisers.

While those advisers are exempt from registration under the Advisers Act, however, they remain subject to the antifraud provisions of Section 206 of the Advisers Act. Further, registered and unregistered advisers that have custody or possession of client assets are required to comply with Rule 206(4)-2, the Advisers Act custody rule.

4. Securities Exchange Act of 1934. Hedge funds generally rely on the "trader" exception to the requirement that "dealers" register under Section 15(a) of the Securities Exchange Act of 1934 (the "Exchange Act").

Section 3(a)(5) of the Exchange Act defines "dealer" as "any person engaged in the business of buying or selling securities for his own account, through a broker or otherwise" as part of a regular business. The definition excludes "any person insofar as he buys or sells securities for his own account . . . but not as part of a regular business." Thus, an individual may trade for his or her own account with some frequency, without being considered a "dealer." A hedge fund trading for its own account would be in an analogous position.

The line between a trader and dealer depends upon the facts and circumstances. Obviously, at some point, a hedge fund could cross over the line and become a dealer subject to the registration requirement. The staff is not aware, however, of

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1/ (...continued)

regulation under the Investment Company Act for investment pools whose assets are held by an unlimited number of highly sophisticated investors.

any current cases of hedge funds operating as unregistered dealers.

B. Obtaining Information Regarding Hedge Funds

One current, and one proposed, Commission reporting requirement provide some information about the activities of hedge funds.

Section 13(f). Section 13(f) of the Exchange Act requires institutional investment managers exercising investment discretion with respect to accounts having \$100,000,000 or more in exchange-traded or NASDAQ-quoted securities ("Section 13(f) securities") on the last trading day of any month to file a Form 13F with the Commission. Generally, Form 13F requires disclosure, for all Section 13(f) securities, of the name of the issuer, the number of shares or principal amount, and the aggregate purchases and aggregate sales.

Information about hedge fund participation in the equity markets can be obtained by examining Form 13F filings for those entities known to be hedge funds, such as those listed in Appendix A. This information, however, is only required on a quarterly basis.

Large Trader Reporting System. As noted above, the staff believes that the Commission's proposed large trader reporting system will provide it with better ability to examine the activities of hedge funds in the event of large market movements, without unduly burdening the private market for investment.

The Market Reform Act of 1990 added to the Exchange Act Section 13(h), which provides the Commission with the authority to create a activity-based large trader reporting system. <sup>8/</sup> The purpose of the large trader reporting system is to assist the Commission in reviewing the trading activities of market professionals and other investors that engage in a substantial level or value of equity securities trading, as well as to monitor the effects on the equity securities markets of such trading activities. In drafting the legislation, Congress specifically indicated that hedge funds were to be considered "large traders" within the scope of Section 13(h) if their

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<sup>8/</sup> Section 13(h) was added to the Exchange Act to remedy difficulties encountered by the Commission during its attempts to reconstruct and analyze investor trading activity following the market breaks of October 1987 and 1989.

activities caused them to fit within the "large trader" definition.<sup>9/</sup>

Pursuant to Section 13(h), the Commission recently has proposed Rule 13h-1. As proposed, the rule calls for identification of large traders and broker-dealer record-keeping and reporting of large trader activities. A "large trader" would be defined as any person that effects aggregate transactions in publicly traded securities <sup>10/</sup> during a 24 hour period equal to or exceeding 100,000 shares, \$4 million total market value, or that constitute program trading.

Upon attaining "large trader" status, the person or entity would be required to file Form 13H with the Commission. Form 13H would contain identifying information concerning the large trader, including name, address, and telephone number; organization type; principal business or occupation; regulatory status; and descriptions of each trading account maintained by the large trader (including the account name and number, the broker-dealer maintaining the account, the name of the contact person for the account, and his or her telephone number.) Thereafter, large traders would be required to provide annual updates to Form 13H, within 45 days after the calendar year-end.

In addition to the filing of Form 13H, the proposed rule also calls for all broker-dealers that carry large trader accounts to maintain, and report to the Commission on request, records of large trader transactions in equity securities that exceed certain threshold levels to be determined by the Commission. Accordingly, whenever the Commission deems it necessary, it may request transaction information concerning specific equity securities transactions and specific large traders from broker-dealers.

As proposed, the large trader reporting system would include information regarding hedge funds that are large traders within its scope. Form 13H will provide the Commission with substantial information regarding the identity of such hedge funds, including descriptions and location of the trading accounts. In addition,

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<sup>9/</sup> See S. Rep. No. 300, 101st Cong., 2d Sess., at 73 (1990).

<sup>10/</sup> The term "publicly traded security" would include only equities, options on individual equities and options on an index of equity securities that are listed for trading on a national securities exchange or the National Association of Securities Dealers Automated Quotation System, National Market System ("NASDAQ/NMS"). The proposed rule would apply to all publicly traded securities traded in foreign or domestic over-the-counter markets and after-hours trading systems.

large traders that are partnerships would be required to describe the partnership, disclose the jurisdiction in which it is organized, and provide identifying information regarding the general partner (such as name, address, and telephone number). In addition, through a request for the large trader transaction records, the Commission will be able to review a hedge fund's activities in those publicly traded securities transactions within the scope of the large trading reporting system. Accordingly, the proposed system should provide the Commission with an opportunity to observe, analyze, and monitor the activities of hedge funds whose trading activities may pose potential systemic risk concerns.<sup>11/</sup>

Although the large trader reporting system will cover only publicly-traded equity securities and options, the large position reporting provision being discussed in the context of the reauthorization of the Government Securities Act would provide the Commission with the ability to obtain comparable information regarding large position activity in the government securities markets when specific need exists for such information, upon a finding by Treasury, in consultation with the Commission and the Board of Governors of the Federal Reserve, that market conditions warrant the collection of such information.

### III. Complaints regarding Hedge Funds

In responding to the Subcommittee's inquiry regarding the number of complaints regarding hedge fund activities, the Commission staff has searched its files based on the list contained in Appendix A. Since January 1, 1987, the Commission has received only three customer complaints relating to the activities of entities identified in Appendix A. It appears that all three complaints relate to the activities of affiliates of the hedge fund, such as its investment adviser or a public investment company, rather than the hedge fund itself.

### IV. Enforcement Actions relating to Hedge Funds

Since January 1, 1987, neither the Commission nor the self-regulatory organizations ("SROs") have instituted any actions involving potential violations of the federal securities laws by any of the entities listed in Appendix A, or their identifiable managers or associated persons. The Commission, of course, cannot confirm or deny whether its enforcement staff (or that of the SROs) is currently investigating any of these entities or individuals.

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<sup>11/</sup> The staff is currently reviewing public comments on the proposed large trader reporting system. See Securities Exchange Act Release No. 29593 (August 28, 1991) 56 FR 42550.

## V. Difficulties in Enforcement Matters

Even with respect to individuals and entities not registered with the Commission, the Commission has substantial powers to obtain information for enforcement purposes, including the power to compel testimony and document production. The Commission has even more extensive powers with respect to regulated entities, but the purpose of regulation is to protect investors, not to simplify investigations. The potential need to obtain information from hedge funds for enforcement purposes would thus not seem an adequate reason for registration or regulation of hedge funds.

## VI. Potential Systemic Risk Posed to the Financial Markets

Hedge funds have the potential to both increase and decrease liquidity in the markets in which they invest. By virtue of their substantial trading activities, the funds add depth to the markets in which they invest, thereby increasing liquidity. In addition, hedge funds can increase stability to the markets by maintaining their positions in times of declining market conditions. In contrast, other institutional investors may have position sizes that are limited by policy or agreement, or who cannot sustain the potential losses threatened by changing market conditions.

To the extent that the shifting by hedge funds of their sizable capital causes large price movements, these funds may reduce stability in the markets in which they invest. Many well-known funds, however, build in a cushion against unexpectedly large market movements, thereby reducing forced trading in a crisis with its resulting volatility. Furthermore, it also appears that some hedge fund managers employ a wide variety of trading strategies in order to limit the risks they pose to the markets.

As stated in the Joint Report on the Government Securities Markets, to date hedge fund managers appear to have adequately controlled their market risk, and their lending counterparties appear to consider them creditworthy.<sup>12/</sup> According to the Report, the use of leverage by hedge funds is usually implemented through collateralized transactions that would tend to mitigate the effect of a failure on counterparties. For example, repurchase agreements are collateralized by government securities, allowing the counterparties holding collateral

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<sup>12/</sup> Department of Treasury, Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission, Joint Report on the Government Securities Markets, at B-70, (January 1992).

securities to retain or sell them in the event of a failure of a hedge fund.

In addition, the margin rules of the Board of Governors of the Federal Reserve and the SROs protect registered broker-dealers, as well as the financial system as a whole, against losses resulting from customer defaults.<sup>13/</sup> Margin rules require the customer to provide collateral that varies depending on the market risk of the position and whether the position is hedged. For example, the margin requirements require more collateral when a position is not hedged. This is especially important because hedge funds may establish large trading positions, the risk of which are limited through hedging. Furthermore, large broker-dealers that have hedge funds as customers have credit committees that monitor their extensions of credit to counterparties and customers in order to protect their financial integrity.

As noted above, the Commission will be able to gain considerable information regarding hedge funds that are large traders in the equity markets as a result of its proposed large trader reporting system. Before additional legislation regarding hedge funds is considered on account of concerns regarding potential systemic risk, the staff believes that experience should first be gained with use of the information that will be available through the large trader system.

#### VII. Offshore Funds

An offshore fund is an investment company incorporated in a foreign country.<sup>14/</sup> As a result of certain regulatory requirements of resident foreign jurisdictions, these offshore funds are typically organized as corporations. An offshore fund often falls within one of two types: (1) a fund whose shares are typically sold to foreign investors and that invests in U.S. securities; and (2) a fund whose shares are sold to both U.S. and foreign investors, but which invests exclusively in foreign securities. Until recently, offshore funds trading in U.S. securities were more common. Presently, however, offshore funds investing exclusively in foreign securities are becoming the predominant offshore vehicle. The growth in these foreign securities funds may be attributed to heightened interest on the part of U.S. investors in the international markets.

It is estimated that approximately 3,000 offshore funds are in existence representing approximately \$250 billion in

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<sup>13/</sup> In addition, transactions on commodity exchanges are subject to margin and mark-to-market rules.

<sup>14/</sup> Offshore funds may or may not be considered "hedge funds," however.

assets.<sup>15/</sup> A large portion of these funds' portfolios are invested in U.S. securities. Many of these offshore funds are managed by well-known U.S. investment advisers. These funds are typically organized by individuals who operate U.S. hedge funds, individuals who are affiliated with regulated U.S. financial institutions, or foreign institutions.

To date, the Commission has entered into Memoranda of Understanding ("MOUs") for the exchange of information with nine countries.<sup>16/</sup> These MOUs generally provide the Commission with the ability to obtain foreign-based information regarding the activities of persons and entities conducting securities business within the scope of the United States securities laws, including offshore funds.

The Subcommittee has asked the staff to identify the extent to which the Commission has MOUs with countries in which offshore hedge funds are organized. While the staff has not been able to obtain any exhaustive list identifying offshore hedge funds, it appears that many are located in jurisdictions such as the Netherlands Antilles, a country with whom there is no MOU. On the other hand, as regards offshore funds' transactions in United States markets, the Commission has the ability to obtain all relevant books, records and testimony concerning the subject transactions directly from the brokers involved, without regard to whether the transactions may have emanated from abroad.

#### VIII. Hedge Fund Participation in the IPO Market

According to market participants, hedge funds regularly participate in the distributions by broker-dealers of initial public stock offerings ("IPOs").

The Commission does not specifically monitor the trading activities of hedge funds in the IPO market. Based on conversations with market participants, however, the staff understands that hedge funds may engage in a practice called "flipping." Flipping involves the purchase of IPO securities, and the subsequent immediate sale of the securities back to the underwriting syndicate. In addition to seeking profits from these transactions, hedge funds have been known to flip IPO

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<sup>15/</sup> Julie Rohrer, "The Offshore Fund Bonanza", Institutional Investor, January 1992, at 4.

<sup>16/</sup> To date, the Commission has entered into MOUs with the following nine countries: Japan, Canada, Brazil, the Netherlands, France, Mexico, Norway, the United Kingdom, and Argentina. In addition, the Commission has information-sharing agreements with: Italy, Hungary, Sweden, Costa Rica, and Indonesia.

securities in an effort to generate broker-dealer "credits" and thereby obtain "soft dollars" or free research. Recently, we understand the level of flipping has decreased, as broker-dealers have strongly discouraged all entities, including hedge fund clients, from engaging in this practice.

In its Free-Riding and Withholding Interpretation, the NASD sets forth NASD members' duties with regard to their members' participation in IPOs. Specifically, this Interpretation makes it inconsistent with the just and equitable principles of trade, and a violation of Article III, Section 1 of the Association's Rules of Fair Practice, for members or persons associated with members to fail to make available to the public at the public offering price any IPO securities that are trading at a premium in the secondary market ("hot issues"), whenever such secondary trading begins.<sup>17/</sup> The purpose of this Interpretation is to prevent NASD members or any persons associated with members from artificially raising the prices of these "hot issue" securities through failure to make bona fide public distributions.

The Interpretation specifies the conditions under which NASD members may continue to hold any securities acquired in an IPO; sell the securities to officers, directors, general partners, employees or any other associated persons of the member; sell the securities to finders or fiduciaries of the managing underwriter; sell the securities to a bank, savings and loan institution, insurance company, registered investment company, registered investment advisory firm or any other institutional type account; sell the securities to any other broker/dealer; sell the securities to any domestic bank or domestic branch of a foreign bank, or trust company; and finally, the conditions under which the member may sell the securities to a foreign broker/dealer or foreign bank.

The Interpretation specifically states that members may not sell these "hot issue" securities to the account of any investment partnership or corporation, domestic or foreign, (except companies registered under the Investment Company Act of 1940) including but not limited to, hedge funds, investment clubs, and other similar accounts unless no relationship exists between the proposed account and both the underwriting group and the company whose securities are being offered. Accordingly, before a member may execute a transaction with an investment partnership or other similar account, the member must obtain from the account a list of names and business connections of all

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<sup>17/</sup> NASD Rules of Fair Practice, Article III, Sec. 1, NASD Securities Dealers Manual (CCH ¶2151.06).



persons having any beneficial interest in the account.<sup>18/</sup> In the event that any person so listed is associated with the underwriting group or the company whose securities are being offered, then the fund or account is thereby prohibited from hot issue trading. Alternatively, the NASD member may obtain, prior to the execution of the transaction, a legal opinion from counsel stating that no person with a beneficial interest in the account is a restricted person under the Interpretation, and that in connection with the opinion, the counsel reviewed the Interpretation, a list of all persons with a beneficial interest in the account and such persons' business connections, and any such other necessary information.

#### IX. Conclusion

The staff does not believe that the existing registration schemes--which focus on investor protection--should be altered to include hedge funds. To the extent that further information is needed, the Commission's proposed large trader information system should provide the Commission with access to information that is more tailored to systemic risk concerns, without unduly burdening private investors. Similarly, the proposed large position reporting provision contained in the H.R. 3927, the Government Securities Reform Act, would provide the Commission with the ability to obtain comparable information regarding large position activity in the government securities markets in circumstances when market conditions exist that warrant the collection of such information, upon a finding to that effect to be made by the Treasury, after consultation with the Commission and the Board of Governors of the Federal Reserve.

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<sup>18/</sup> The term beneficial interest includes not only ownership interests, but every type of direct financial interest, including without limitation, management fees based on the performance of the account.

Russell Private Partnerships  
SP Investors NV  
Select Capital Strategies  
ShareVest  
SoGen International  
Southgate Partners  
Steinhardt Partners  
Tamarisk Fund  
Tiger Fund  
Tudor Investment Corp  
Ursus Partners  
West Highland Partners  
Zweig DiMenna Partners

\* Names and entities for this list were taken from recent media articles from newspapers and periodicals.

57-30-04

Footnote 52 (HF Proposing Release)



PUBLIC RELATIONS DIVISION

## NEWS RELEASE

### REGULATING ALTERNATIVE MULTI-MANAGEMENT INVESTMENTS

PARIS, 3 April 2003 Investment management strategies seeking to deliver absolute returns, uncorrelated with a benchmark index, have developed only marginally in France. They are not widely distributed and account for only limited amounts under management. Recently however, amid difficult market conditions, demand for these products has grown, mirroring the international development of hedge funds. These management strategies are generally referred to as "alternative investments", although the term has no standard international definition and its substance varies significantly.

In France, alternative investments primarily consist of alternative funds of funds, i.e. French funds invested in offshore funds, or French funds with a specialist bias, such as futures or options. It is therefore necessary to establish a precise legal framework that can be applied to an activity which France has tolerated for almost a decade.

Investment management companies that choose French or foreign funds relying on complex management techniques must follow due diligence procedures, which need to be formalised and included in a special **programme of operations** (for discretionary management and collective investment funds). Furthermore, investors must be informed of the special characteristics of such products and techniques through the marketing programme and appropriate informational materials. In order for them to make an informed decision about a particular product, prospective fund subscribers and discretionary clients must be clearly informed, by means of the fund prospectus, discretionary mandate and any promotional literature, of the type of investment involved and the specific risks inherent in it.

Following several months of industry-wide discussions, the Commission des Opérations de Bourse (COB) recently adopted a series of positions. These are spelled out in a decision statement<sup>1</sup> that establishes a framework for contributing to the development of alternative investment activity and ensuring proper security. The main rules are now as follows:

- Management companies managing a fund or mandate invested in an alternative fund must update their programme of operations<sup>1</sup> accordingly. (Companies seeking authorisation to carry on this activity must submit this amended programme beforehand.)
- General purpose funds with **less than 10 per cent of their assets** invested in alternative funds must update their prospectus accordingly (and the management company must update its programme of operations).

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<sup>1</sup> The decision statement and special programme of operations are available on the COB website at <http://www.cob.fr>.

- o General purpose funds with **more than 10 per cent** of their assets invested in alternative funds must update their prospectus. Management companies must supplement their programme of operations with a **marketing programme**. (For newly formed funds, these documents must be submitted to the COB as a prerequisite for authorisation.)

The COB will review programmes of operations to ensure that management companies have the necessary skills and resources to manage these products.

Existing regulations will be adapted to cover alternative investment funds – notably via the creation of a new classification: "funds invested in alternative funds" – in 2003. This will be part of an overall regulatory overhaul aimed at taking into account the issues dealt with by the COB (e.g. the working group on management fees and charges, chaired by Philippe Adhémar) as well as new European directives.

In addition, discussions are still underway with the French Investment Management Association, AFG, with a view to approving a code of professional conduct for market participants involved in alternative investment strategies.

These discussions will be extended, in collaboration with the industry as a whole, to determine the best arrangements for implementing direct alternative strategies in funds organised under French law.

S7-30-04

Footnote 102

(CHF Proposing Release)



## MANAGED FUNDS ASSOCIATION

VIA FEDERAL EXPRESS

November 21, 2003

The Honorable William H. Donaldson  
Chairman  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549-0506

Re: Staff Report to the Commission entitled  
*Implications of the Growth of Hedge Funds*

Dear Chairman Donaldson:

Managed Funds Association (MFA) is pleased to provide its views and comments on the recommendations made by the staff of the Securities and Exchange Commission (the "Commission") in its report entitled *Implications of the Growth of Hedge Funds* (the "Staff Report").

*About MFA.* MFA is the primary US-based membership organization dedicated to serving the needs and representing the interests of hedge funds and alternative investment vehicles globally. MFA has more than 700 members representing a significant portion of the estimated \$700 billion in assets managed by the industry. Since its inception in 1991, MFA has provided leadership to the alternative investment industry in government relations, communications, media relations and education to members and investors.

*Purpose of Letter.* MFA commends Commission staff for having produced a highly professional and informative report on the hedge fund industry. In addition, MFA applauds the Staff Report's recognition of the market price efficiencies and enhanced liquidity that hedge funds provide to financial markets, as well as the staff's acknowledgement of the numerous regulatory requirements to which hedge funds are currently subject.

MFA also strongly endorses the efforts by the Commission and its staff to address any investor protection issues that may be presented by the increasing interest of retail investors in hedge fund investments while preserving the recognized benefits that hedge funds bring to the global financial markets and the investment community as a whole. Although the staff found no evidence of significant numbers of retail investors investing in hedge funds, MFA believes that the staff's concerns have merit to the extent that registered funds of hedge funds ("FOHFs") are offered to retail investors at some point in the future.<sup>1</sup> It is important to recognize, however, that these vehicles are not hedge funds. Whereas hedge funds are not registered pursuant to the Investment Company Act of 1940 and are sold exclusively in private placements to sophisticated institutional investors and wealthy individuals, FOHFs are registered with the Commission as investment companies and are sold in registered public offerings, and their advisers are registered under the Investment Advisers Act. Consequently, FOHFs are subject to the full panoply of protections afforded by Commission registration and regulation, and the Commission should exercise its authority and judgment to address investor protection issues that may be presented by these registrants.

In the comments below MFA identifies the principal grounds for the positions it holds with respect to those recommendations that directly affect the hedge fund industry and MFA's constituents. While MFA supports some of the recommendations contained in the Staff Report, MFA believes that certain other recommendations are not justified by the Staff Report's findings and would have adverse consequences not only for the hedge fund industry and its investors, but also for the ability of the Commission to fulfill its traditional public mandate: protecting retail investors.

## **MFA's Response to Staff Recommendations to the Commission**

### ***I. MFA Opposes Requiring Registration of All Hedge Fund Advisers as Investment Advisers***

The Staff Report states that the Commission should consider requiring hedge fund advisers to register as investment advisers under the Investment Advisers Act of 1940, taking into account whether the benefits of mandatory registration would outweigh its burdens. Having assessed the potential benefits of mandatory registration cited by the staff against the associated burdens and costs, MFA maintains that mandatory registration of all hedge fund advisers under the Investment Advisers Act of 1940 is not merited and would have adverse consequences for the hedge fund industry as well as financial markets and investors more generally, as discussed in detail below. Most importantly, as discussed below, MFA submits that mandatory registration would require the Commission to devote staff and funding to overseeing hedge fund advisers dealing

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<sup>1</sup> MFA also believes that the staff's concerns regarding the increased number of investors qualifying as accredited investors are valid and, as discussed below, MFA would support increasing the standards applicable to accredited investors so as to alleviate these concerns.

exclusively with sophisticated investors that neither seek nor require the protections that may be afforded by investment adviser registration and therefore would inappropriately divert the Commission's limited resources away from protecting retail investors.

***A. Mandatory Registration Is Unlikely to Yield the Benefits Cited by the Staff***

The Staff Report lists several potential benefits as justification for mandatory registration of hedge fund advisers. MFA believes that the purported benefits are either unlikely to be realized or will be immaterial in value for the reasons discussed below.

***1. There is no evidence that mandatory registration would be a meaningful deterrent to fraud.***

The Staff Report recognizes that “[t]here is no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity.” Furthermore, based on the Commission’s recent enforcement cases, the Staff Report itself acknowledges that “both registered and unregistered investment advisers have engaged in fraud.”<sup>2</sup> Nonetheless, the Staff Report argues that “the prospect of Commission examination serves as a deterrent to fraud and other misconduct.”

MFA is not aware of any evidence indicating that unregistered hedge fund advisers, despite lower levels of Commission oversight, engage in a disproportionately larger incidence of fraud as compared to registered investment advisers. In fact, many of the Commission’s enforcement actions alleging hedge fund fraud were brought against registered investment advisers.<sup>3</sup> MFA therefore believes that the premise that the absence of regulation increases the likelihood of fraud is without foundation and that mandatory registration will not serve as a meaningful deterrent to fraud. Furthermore, MFA maintains that the regulatory framework currently in place is adequate to enable the Enforcement Division at the Commission and state regulators to investigate and prosecute hedge fund fraud cases to the fullest extent under the securities laws (including criminal referrals).

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<sup>2</sup> Staff Report at page 74.

<sup>3</sup> See, e.g., *SEC v. Edward J. Strafaci*, 03 CV 8524 (CSH) (S.D.N.Y.), Litigation Release No. 18432 (October 29, 2003) (in which Strafaci is charged with fraud in the valuation of four funds, three of which were registered with the Commission as broker-dealers and all of which were allegedly managed by Lipper & Company, L.P., a investment adviser registered with the Commission, or an affiliate); *SEC v. Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17981 (Feb. 11, 2003); *SEC v. Beacon Hill Asset Management LLC*, Litigation Release No. 17831 (November 7, 2002); *SEC v. Michael L. Smirlock and LASER Advisers, Inc.*, Litigation Release No. 17630 (July 24, 2002); *In the Matter of William F. Branston*, Advisers Act Release No. 2040 (June 26, 2002); *In the Matter of Abraham and Sons Capital, Inc. and Brett G. Brubaker*, Advisers Act Release No. 1956 (July 31, 2001). See also Yuka Hayashi, *Alliance Disclosure Suggests Settlement Being Worked Out*, Dow Jones Newswires (Nov. 17, 2003) (regarding Commission notice of possible enforcement action against Alliance Capital Management L.P.).

2. *Sound compliance practices may be fostered through more effective, and less costly, means.*

The Staff Report contends that mandatory registration of hedge fund advisers would lead hedge fund advisers to adopt a “culture of compliance” and that the “the prospect of a staff compliance examination will serve to support business decisions to allocate resources necessary to ensure the implementation of strong compliance controls and the satisfaction of hedge fund advisers’ fiduciary responsibilities to their clients.”

MFA believes that this recommendation ignores the fact that unregistered hedge fund advisers are already subject to a variety of rules and regulations<sup>4</sup> that create the necessity to have a sound compliance program. For example, hedge fund advisers, regardless of whether they are registered with the Commission as an investment adviser, are subject to the following:

- **Anti-Fraud Provisions and Insider Trading Prohibitions under the U.S. Securities Laws.** All hedge funds and their advisers are subject to the broad anti-fraud and anti-manipulation provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisers Act which prohibit fraud in connection with the offer, sale and purchase of securities and in connection with the advisory relationship. In addition hedge fund managers are subject to the U.S. securities laws’ prohibitions on insider trading. These provisions and the related rules and regulations create the need to have explicit trading and valuation policies and procedures to avoid liability.
- **CFTC Regulation.** A substantial majority of the large hedge fund advisers that are not registered with the Commission are registered with the Commodity Futures Trading Commission (the “CFTC”) as commodity trading advisers and/or commodity pool operators and are therefore subject to the CFTC’s registration, reporting and recordkeeping requirements, as well as periodic on-site audits by the National Futures Association (“NFA”) for purposes of determining their general compliance with applicable CFTC and NFA rules.
- **NASD Regulation.** A number of hedge fund advisers have affiliates or funds that are registered as broker-dealers and regulated by NASDR, which administers a comprehensive compliance regime. In addition broker-dealers that sell interests in hedge funds are subject to the requirements of NASD rules.
- **Reporting Requirements.** As with other market participants, hedge funds are required to comply with certain reporting requirements designed to increase market transparency, including

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<sup>4</sup> See Appendix II to MFA’s 2003 *Sound Practices for Hedge Fund Managers*.



various Commission equity ownership and portfolio reporting requirements, large position and other reporting requirements of the Treasury Department and the Federal Reserve in connection with government securities and foreign exchange transactions, and the CFTC large trader reporting system.

- **Anti-Money Laundering Regulations.** U.S. hedge funds (and hedge funds with a U.S. nexus) will be required to comply with certain key provisions of the *USA PATRIOT Act* once final rules are promulgated with respect to hedge funds. MFA has published *Preliminary Guidance*, as well as an *Update* to this document, on developing anti-money laundering programs in order to prepare hedge funds for complying with these requirements

As a result, it is MFA's position that every hedge fund adviser, whether it is registered with the Commission or not, already has a need to establish a "culture of compliance." The Staff Report acknowledges that "many unregistered hedge fund advisers already have adopted sound compliance practices." Consequently, MFA does not believe that an additional layer of regulation is necessary to promote sound compliance practices. Rather, MFA believes that there exist more productive and less costly means of achieving this objective, many of which are already in place, such as:

- *Rigorous enforcement of the anti-fraud rules and other regulations to which hedge fund advisers are already subject.* MFA believes that the threat of criminal and civil enforcement action with respect to breaches of the regulations to which hedge fund advisers are currently subject serves as compelling motivation for the adoption of a sound compliance program.
- *Promotion of prudent due diligence, valuation and risk management practices among hedge fund counterparties and creditors.* Following the near-collapse of Long-Term Capital Management ("LTCM") in 1998, the President's Working Group on Financial Markets (the "President's Working Group") issued a report containing risk management and other recommendations with respect to the hedge fund industry. According to the Staff Report, the Commission staff has found that many brokerage firms have responded favorably to the President's Working Group recommendations. In addition many banks and brokers have embraced the recommendations made by the Counterparty Risk Management Policy Group ("CRMPG") for credit risk management in respect of hedge fund counterparties.

MFA believes that the procedures voluntarily adopted by the markets to reduce counterparty credit risk have produced important benefits for both hedge funds and their counterparties. MFA also believes that the due diligence processes performed by prime

brokers, counterparties and other hedge fund creditors, together with those undertaken by investors, have led many hedge fund advisers to implement enhanced business and compliance practices. In addition valuation processes have been significantly enhanced by the third party price discovery provided through the bilateral exchange of collateral between counterparties to repurchase agreements, over-the-counter derivatives and other financial instruments.

- *Promotion of sound practices for use by hedge fund advisers.* The Staff Report itself observes that “[t]he use of best practices can be an effective means of addressing issues that arise in the hedge fund industry.”<sup>5</sup> MFA has undertaken to foster sound compliance practices among both registered and unregistered investment advisers by publishing its *2003 Sound Practices for Hedge Fund Managers*, which contains recommendations that are intended to promote sound business and compliance practices in the hedge fund industry and, in doing so, enhance investor protection while contributing to market soundness. These include recommendations regarding fulfilling responsibilities to investors and compliance with applicable rules and regulations. To further promote industry sound practices, MFA held a seminar in New York on October 30 for an audience of approximately 200 industry professionals where industry experts discussed in detail the different recommendations contained in the *2003 Sound Practices* and explored how they may be implemented by hedge fund advisers in practice.

**3. *Regulators already have access to important information regarding the hedge fund industry.***

The Staff Report states that the Commission has long been concerned about the lack of information available about hedge funds and their investment advisers. It also argues that mandatory registration of hedge fund advisers would not only permit the Commission to collect basic information about such advisers, but also enable the Commission “to more comprehensively and effectively observe the trading activities of the funds managed by such advisers” and “make it easier to detect improper or illegal trading practices.” As discussed below, MFA believes that the concerns cited are not justified as they fail to account for the extent of information already available to federal and state regulators with respect to the hedge fund industry.

The Staff Report acknowledges that currently “the Commission generally has access to records of trading on behalf of hedge funds through the books and records maintained by the brokers that the hedge fund advisers use and the markets on which they trade.”<sup>6</sup> Furthermore, as discussed above, unregistered

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<sup>5</sup> Staff Report at 102.

<sup>6</sup> Staff Report at 94.

hedge fund advisers are already subject to a wide array of regulations and reporting requirements through which regulators, including the Federal Reserve, the Treasury Department, the CFTC and the Commission, are able to gather a significant amount of information about hedge funds and their trading activities. In fact 63 of the 100 largest hedge funds are CFTC registrants and therefore subject to the CFTC's reporting and recordkeeping requirements. In addition the Treasury Department has already proposed two rules that will require certain hedge funds and hedge fund advisers to file notices containing specified information with the Treasury as part of the anti-money laundering programs that they will be required to establish.<sup>7</sup>

As a result, MFA believes that regulators already have access to important information regarding the trading activities of hedge funds and will soon have an additional source of information when Treasury issues final rules on anti-money laundering programs for hedge funds and their advisers.

**4. *Concerns regarding investor qualification should be addressed directly by raising accredited investor standards, not indirectly through mandatory registration.***

The Staff Report expresses concern that the rise in investor wealth and incomes has caused a large number of investors to meet the "accredited investor" standard which could ultimately result in "retail investors investing directly in hedge funds relying on Section 3(c)(1) of the Investment Company Act". The Staff Report asserts that mandatory registration of hedge fund advisers would address this concern.

Although MFA believes that the staff's concern regarding the increase in the number of persons qualifying as accredited investors is valid, it is not one that is appropriately, or even adequately, remedied by requiring hedge fund advisers to register. Instead, the Commission should address this increase directly by raising the accredited investor standard so that the monetary thresholds reflect the inflation in wealth and incomes since 1982.<sup>8</sup>

***B. The Costs of Mandatory Registration Would Outweigh Any Perceived Benefits***

MFA believes that the Staff Report fails to identify and assess the extent of the costs and burdens associated with mandatory registration of hedge fund advisers, which are described below.

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<sup>7</sup> See *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 60617 (Sept. 26, 2002), at 60622.

<sup>8</sup> See MFA's *White Paper on Increasing Financial Eligibility Standards For Investors In Hedge Funds* submitted to the Commission on July 7, 2003.

1. *Scarce federal resources would be diverted away from protecting the retail investing public and devoted to overseeing investments made by sophisticated institutional investors and wealthy individuals that neither need nor seek investor protection as may be provided by the Commission through investment adviser registration.*

All federal agencies face constrained resources, and the Commission is no exception. MFA believes that the Commission already faces a formidable challenge in fulfilling its oversight responsibilities with respect to entities that are currently registered and protecting retail investors. For example, until earlier this year, the Commission's inspection staff had a total of only 350 examiners and support staff to monitor an industry of 13,000 mutual funds and investment advisers.<sup>9</sup> Furthermore, the bifurcated system of state and federal jurisdiction over investment advisers established as part of National Securities Markets Improvement Act<sup>10</sup> in 1996, resulted, at least in part, from the realization that the Commission did not have the resources to effectively regulate all of the federally registered investment advisers.<sup>11</sup> Expanding the Commission's jurisdiction to oversee investments made exclusively by sophisticated institutional investors and wealthy individuals would not only place additional burdens and responsibilities on resources that are already heavily taxed, but more importantly would divert these limited resources away from the agency's public mandate: protecting retail investors. Such expansion would be inconsistent with long-standing public policy that sophisticated investors do not require the protections provided by the regulations applicable to transactions involving unsophisticated market participants.

2. *Commission oversight of the hedge fund industry could create a "moral hazard" for the Commission by creating an unfounded sense of security among hedge fund investors.*

Mandatory registration of hedge fund advisers could create an expectation among investors and financial market participants that the Commission will be able to detect and protect them from difficulties or improper trading or valuation practices in the operations of hedge funds. In doing so, mandatory registration could harm investors and market counterparties that may rely on adviser registration as evidence of Commission supervision and approval and lead them to be less diligent in analyzing potential hedge fund investments or counterparties and less demanding in negotiating relationship terms.

<sup>9</sup> Stephen Labaton, *S.E.C.'s Oversight of Mutual Funds Is Said to Be Lax*, New York Times (Nov. 16, 2003) (online version).

<sup>10</sup> P. L. No. 104-290, 110 Stat. 3416, 3432-33 (1996).

<sup>11</sup> See S. Rep. No. 104-193, at 3 (1996) (citing testimony by SEC Chairman Arthur Levitt that the SEC inspections had become so infrequent that small advisers were inspected, on average, once every 44 years).

3. *The burdens associated with mandatory registration might lead certain hedge fund advisers to relocate offshore, making existing regulation less effective.*

Some have suggested that mandatory registration of hedge fund advisers could encourage those that wish to retain the flexibility necessary to implement innovative investment strategies to move offshore and outside the Commission's jurisdiction.<sup>12</sup> In considering whether to regulate hedge funds directly, the President's Working Group noted that such direct regulation might drive certain hedge fund advisers offshore, making regulation less effective.<sup>13</sup> As Chairman Greenspan put it:

"[M]ost hedge funds are only a short step from cyberspace. Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction. The best we can do in my judgment is what we do today: regulate them indirectly through the regulation of the source of their funds. We are thus able to monitor far better hedge funds' activity, especially as they influence US financial markets. If the funds move abroad, our oversight will diminish."<sup>14</sup>

MFA shares the view of the President's Working Group and is concerned that mandatory registration of hedge fund advisers could lead to a decrease in the amount of information available to U.S. regulators to the extent that domestic hedge fund advisers are motivated to relocate offshore.

4. *The burdens associated with mandatory registration could stifle innovation and deter certain money managers from entering the industry.*

Many of the people that start second careers as hedge fund advisers do so out of a belief that they can develop more successful businesses outside of the environment of brokerage firms, banks and mutual funds. Requiring registration of these advisers could unduly constrain their entrepreneurial efforts by imposing a one-size-fits-all regulatory structure. The imposition of

<sup>12</sup> See, e.g., *Bank Lending to and Other Transactions with Hedge Funds: Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking & Financial Services*, 106th Cong. (1999) ("March 1999 Hearings") (statement of Laurence H. Meyer, Board of Governors, Federal Reserve System).

<sup>13</sup> President's Working Group Report on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (1999) ("PWG Report"), at 42.

<sup>14</sup> See, e.g., March 1999 Hearings 23 (statement of William J. McDonough, President of the Federal Reserve Bank of New York and Chairman of the Basel Committee on Banking Supervision) ("I do not believe that it would be easy to develop a workable approach to the direct oversight of hedge funds. 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. Direct regulation of hedge funds would require a high level of coordination involving the political, legislative, and judicial bodies of many countries. . . ."); *President's Working Group Over-The-Counter Derivatives and Hedge Funds Study Before the Senate Committee on Agriculture, Nutrition & Forestry*, 105th Cong. -- (1998) (statement of James E. Newsome, Commissioner, CFTC) ("There are many who doubt the utility of traditional, direct regulation of hedge funds. Indeed, as I have stated, I believe that heavy-handed regulation will certainly drive business off the shores of the United States.")

this regulatory scheme on hedge fund advisers could impair their ability to implement the innovative and adaptable investment strategies that have contributed to the success of the hedge fund industry and cause them to manage their businesses to meet Commission staff expectations rather than to develop new investment strategies that contribute to market efficiency.

### ***C. Relevance of President's Working Group***

As noted above, the President's Working Group on Financial Markets, consisting of the Secretary of the Treasury and the Chairpersons of the Commission, the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission, published a detailed report following the near-collapse of LTCM entitled *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (the "PWG Report"). The PWG Report recommended a number of measures, both public and private, designed to address the issues raised by LTCM's failure. In considering whether hedge funds and their advisers should be subject to direct regulation, the PWG Report asserted that "[a]ny resort to government regulation should have a clear purpose and should be carefully evaluated in order to avoid unintended outcomes."<sup>15</sup>

MFA believes that the President's Working Group's prior analysis of the issues presented by the direct regulation of hedge fund advisers and the role of its members in the oversight of the hedge fund industry are particularly relevant to the consideration of the Staff Report's recommendation on mandatory registration of hedge fund advisers. Consequently, MFA believes that the Commission should provide the other members of the President's Working Group the opportunity to carefully consider and consult with each other regarding the potential benefits and costs of mandatory registration of hedge fund advisers prior to proposing any rulemaking with respect to this recommendation.<sup>16</sup>

## ***II. MFA Opposes Requiring Registered Hedge Fund Advisers to Provide a Hedge Fund Brochure***

The Staff Report recommends that the Commission consider requiring registered hedge fund advisers to file with the Commission and deliver to investors a disclosure statement tailored to meet the needs of hedge fund investors. The Staff Report suggests that the Commission could require that this "hedge fund brochure" contain disclosure about risk management measures and valuation procedures used by the adviser as well as disclosure about various conflicts of interest and the lock-up periods that apply to investments in the hedge funds managed by the adviser.

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<sup>15</sup> PWG Report at 35.

<sup>16</sup> The President's Working Group may also wish to consider whether requiring mandatory registration (by redefining "client" as proposed in the Staff Report) would necessitate Congressional action. See Part V of MFA's *White Paper on Registration of Hedge Fund Advisers Under the Investment Advisers Act of 1940* submitted to the Commission on July 7, 2003 for a discussion of this issue.

MFA opposes this recommendation for the following three reasons:

- The sophisticated institutional investors and wealthy individuals that invest in hedge funds have sufficient sophistication and market power to demand and obtain the initial and periodic information that they require in order to make informed investment decisions regarding hedge funds.
- MFA shares the view of the Secretary of the Treasury and the Chairman of the Federal Reserve that “[i]nformation and disclosure requirements should be designed to provide investors with real value rather than merely serve mainly to increase costs and decrease returns.”<sup>17</sup> In this regard MFA submits that the information currently obtained by investors as part of their due diligence procedures and through private placement memoranda and other investor communications is far more valuable than the information that could be provided by a prescriptive, one-size-fits-all document.
- MFA sees no basis for imposing different requirements on investment advisers who advise hedge funds relative to other registered investment advisers, for whom the possible areas of disclosure cited by the Staff Report – risk management, valuation, conflicts of interest – are equally as relevant.

### ***III. MFA Supports Clarifying Parameters Applicable to Permissible Solicitation and Advertising***

The Staff Report asserts that there seems to be little compelling policy justification for prohibiting general solicitation in private placement offerings of interests in funds relying on Section 3(c)(7) of the Investment Company Act. MFA agrees that the policy basis for this prohibition is questionable and would support the issuance of guidance by the Commission that would specify the types of communications in which hedge funds may engage. MFA believes that further Commission guidance in this area would help to eliminate the current confusion regarding what constitutes an advertisement or a general solicitation and promote consistent reasonable practices.<sup>18</sup>

### ***IV. MFA Supports Encouraging the Hedge Fund Industry to Embrace and Develop Sound Practices and Commits to Play an Active Role***

The Staff Report states that the Commission should encourage the hedge fund industry and others involved with the industry to embrace existing sound practices and

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<sup>17</sup> Letter to The Honorable Michael G. Oxley, Chairman, House Committee on Financial Services, and Letter to the Honorable Richard C. Shelby, Chairman, Senate Committee on Banking, Housing and Urban Affairs (Nov. 18, 2003).

<sup>18</sup> Allison Bisbey Colter, *Hedge Funds...Coming Soon To A Billboard Near You*, Dow Jones News Service (Nov. 7, 2003).

expand and develop additional sound practice guidelines in areas that further investor protections and enhance the ability of hedge funds to manage their operations. As discussed with respect to promoting sound compliance practices above, MFA strongly supports this recommendation and will continue to devote its staff and resources to achieving this objective through periodically updating and publicizing its *Sound Practices for Hedge Fund Managers* and providing a forum for the industry to identify and develop practices that will enhance investor protection and business operations more generally while contributing to market soundness.

### Conclusion

MFA looks forward to continuing its dialogue with the Commission and its staff as well as the President's Working Group to address the issues raised by the recommendations made in the Staff Report as well as developments in the hedge fund industry more generally as and when they may arise. If you have any questions regarding these comments or would like to discuss them, please call me at 202.367.1140.

Sincerely,



John G. Gaine  
President

cc: Commissioner Paul Atkins  
Commissioner Roel Campos  
Commissioner Cynthia Glassman  
Commissioner Harvey Goldschmid  
Paul Roye, Director of Division of Investment Management  
Cynthia Fornelli, Deputy Director of Division of Investment Management

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57-30-04

Footnote 128  
(HF Proposing Release)

## SHEARMAN & STERLING LLP

January 2004

### SEC Report: Implications of the Growth of Hedge Funds

At the end of last September, the Staff of the U.S. Securities Exchange Commission (the “SEC”) issued its much-anticipated report concerning the “Implications of the Growth of Hedge Funds” (the “Report”). The Report follows the conclusion of the SEC’s fact-finding mission, which commenced in June 2002 and which included the roundtable discussions on hedge funds held in Washington, D.C. in May of this year. The SEC’s decision to study the hedge fund industry was based, in large part, on the tremendous growth of assets under hedge funds’ management coupled with its lack of information about these investment vehicles and their advisers. Although the Report is not binding, it clearly signals the Staff’s position and is likely to lead to regulatory developments in the very near future. Set forth below is a brief summary of the Staff’s recommendations and their implications.

#### I. SUMMARY OF STAFF RECOMMENDATIONS

##### 1. Registration of Hedge Fund Managers as Investment Advisers.

As anticipated, the most significant recommendation is to require hedge fund advisers to register with the SEC under the Investment Advisers Act of 1940 (the “Advisers Act”). This would be accomplished indirectly as follows.

Currently most hedge fund managers rely on an exemption from registration under the Advisers Act which is available to investment managers with less than 15 clients (in any 12-month period) who do not hold themselves out to the U.S. public as investment managers. U.S. managers must count every client in determining if they qualify for this exemption but are allowed to count each hedge fund as a single “client”. Non-U.S. investment managers are only required to count U.S. “clients”.

The Staff recommends a “look-through” of hedge funds for the purpose of calculating the 14-client limit, with each underlying investor counted as a single “client”. While the rule proposal has not yet been drafted, this likely will result. This will result in any investment manager with 14 or more underlying investors in its hedge funds (or, in the case of a non-U.S. manager, 14 or more U.S. investors) having to register as an investment adviser. Most sizeable hedge fund managers are expected to have to register with the SEC on this basis.

It should be noted that the Staff does not recommend regulating hedge funds themselves, restricting their investment practices or requiring disclosure of their portfolio holdings or underlying client identities to the SEC.

**2. Increase in Minimum Investment Requirement for Certain Hedge Funds**

One result of the registration requirement would be that certain hedge fund managers would have to either impose minimum investment requirements of \$750,000 on each hedge fund investor or require that each investor has a net worth of at least \$1.5 million if the managers charge a performance fee for their services (a non-U.S. investment manager would have to impose these requirements on any U.S. investors).

These requirements would effect managers previously relying on the exemptions from registration of their hedge funds and hedge fund shares under the U.S. Securities Act of 1933 (the "1933 Act") and the U.S. Investment Company Act of 1940 (the "1940 Act") available to hedge funds invested in by 100 or less "accredited investors" (commonly known as "Section 3(c)(1)" funds), which otherwise require that hedge fund investors (or, in the case of a non-U.S. fund, U.S. hedge fund investors) have a minimum net worth of \$1 million or an annual income of \$200,000 (or \$300,000 with spouse).

**3. Special Disclosures to the SEC and Hedge Fund Investors.**

The Staff has recommended that registered investment managers of hedge funds be required to file with the SEC and deliver to investors a disclosure document specifically designed for hedge fund investors which would include, among other things, information relating to conflicts of interest, risk management measures and valuation procedures of the investment manager.

**4. Mutual Fund Adoption of Fair Valuation, Suitability and Fee Disclosure Policies Regarding Hedge Fund Investments.**

The Staff has recommended that the boards of U.S. mutual funds (including registered funds of hedge funds) adopt policies and procedures to ensure that any hedge fund investments are valued in accordance with the requirements of the 1940 Act.

The Staff also recommends that these funds disclose to investors estimates of the fees and expenses of any underlying hedge funds and that the Staffs of the SEC and U.S. National Association of Securities Dealers (the "NASD") continue to police violations of broker-dealer suitability obligations relating to the sale of shares of U.S. registered funds of hedge funds.

**5. Elimination of the General Solicitation Ban for Section 3(c)(7) Offerings.**

The Staff has recommended that the general solicitation prohibition for "Section 3(c)(7)" hedge funds (broadly, hedge funds limiting their offerings to individuals owning at least \$5 million of investments and certain institutions owning or managing \$25 million of assets and/or, in the case of non-U.S. hedge funds, non-U.S. persons, in order to avoid the registration requirements of the 1940 Act and the 1933 Act) should be eliminated.

**6. Close Monitoring of Prime Broker Capital Introduction Services**

The Staff recommends that the SEC and the NASD closely monitor capital introduction services typically provided by prime brokers to hedge fund managers for conflict of interest and other issues and consider the impact on broker-dealers' suitability and other regulatory obligations in the context of selling hedge fund shares.

**7. Development of Best Practice Standards.**

The Staff recommends that the hedge fund industry should embrace existing "best practice" standards and supplement current conflict management practices.

**8. Continuation of Efforts to Educate Investors**

The Staff recommends that SEC should continue its efforts to educate investors on hedge funds, their investments strategies, operations and risks.

**9. Mutual Fund Access to Hedge Fund Techniques.**

Finally, the Staff has recommended that the SEC should consider issuing a concept release exploring the adoption by U.S. mutual funds of absolute return strategies (with related performance fees) and techniques such as short-selling typically used by hedge funds.

**II. IMPLICATIONS OF REPORT RECOMMENDATIONS FOR HEDGE FUND ADVISERS**

Hedge Fund advisers, whether registered under the Advisers Act or not, are already subject to the application of the general anti-fraud provisions of that Act. The Staff routinely relies on these provisions to scrutinize transactions between unregistered advisers and clients as well as unregistered advisers' trading practices, management of general conflicts of interest.

Registration, however, would subject hedge fund managers to additional compliance obligations, including (a) maintenance of a prescribed set of books and records, (b) disclosure of their business practices and their disciplinary history, and (c) periodic compliance examinations by the SEC.

Additionally, upon registration, hedge fund advisers would have to disclose the number of hedge funds they manage (and the amount of assets under management with those funds) and comply with client asset custody requirements and the Adviser Act referral rules. These rules require certain written disclosures to be made to a client of a regulated investment adviser when a fee has been paid to a third party for introducing the client. The Staff has in the past taken the position that where a fee is paid by an investment manager of a hedge fund for bringing in investors into the fund, each of these investors is the "client" for the purposes of applying the

referral rules and accordingly, the written disclosures and acknowledgements must be made to, and obtained from, the underlying investors.

It appears likely that the requirement for most hedge fund managers operating in or into the U.S. to register as investment advisers with the SEC is a question of “when” rather than “if”. It also appears likely that the answer to “when?” will be “sooner” rather than “later”. The requirement will have a significant impact in terms of time and cost for smaller sized U.S. investment managers with little compliance culture or infrastructure. It is likely that more substantial managers will already have the infrastructure in place to minimize this impact.

For unregistered non-U.S. investment managers, it is likely that the impact will be less significant because in most jurisdictions where hedge fund managers are concentrated, including, for example, London, Paris and Frankfurt and other European Union jurisdictions, management of third party assets is generally an activity which requires registration with local regulators and ongoing compliance with minimum operational standards, regardless of the number of “clients” for whom these services are provided. It is likely therefore that most major non-U.S. hedge fund managers that will be effected by the SEC’s recommendations will already be complying in their home jurisdictions with broadly similar requirements to those the Staff now seeks to impose.

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