WAYNE STATE UNIVERSITY
LAW SCHOOL

October 9, 2007

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1 090
Attention: Nancy M Morris, Secretary

Re: File Number S7-18-07.

Dear Secretary Morris:

I respectfully submit the following comment on proposed Rules 216 and 509 under the Securities Act of 1933, as amended, as set forth in Release No. 33-8766 and in response to the Commission's request for further comments in Release No. 33-8828. I am an assistant professor of law at Wayne State Law School where I teach and write on capital markets issues, including those related to the regulation of hedge funds and private equity.

I draw the Commission's attention to a recently completed draft of my article, *Black Market Capital* (Sept 4, 2007), Wayne State University Law School Research Paper No. #26, which is accessible on the Social Science Research Network at http://ssrn.com/abstract=1012042. Portions of this paper will be presented in January 2008 to the Securities Regulation section of the American Association of Law Schools (AALS) annual meeting, the yearly conference of law professors.

In this Article I examine the unintended effects of current federal securities regulation which prohibits the public offer and purchase in the United States of these hedge fund and private equity investments. I find that public investors, foreclosed from purchasing hedge funds and private equity, instead seek to replicate their benefits. This demand drives public investors to substitute less-suitable, publicly available investments which attempt to mimic the characteristics of hedge funds or private equity. This effect, which I term black market capital, is an economic spur for a number of recent capital markets phenomena, including fund adviser IPOs, special purpose acquisition companies (*SPACS*), business development companies, and specialized exchange traded funds all of which largely attempt to replicate private equity or hedge fund returns and have been marketed to public investors on this basis. Black market capital has not only altered the structure of the U.S. capital market but has shifted capital flows to foreign markets and engendered the creation of U.S. private markets such as Goldman Sachs' GSTrUE.

In my Article I identify and examine the ramifications of black market capital, and conclude that this effect is an irrational and unintended by-product of current hedge fund and private equity regulation. If hedge funds and private equity investments are restricted, the similarity of black market capital investments, such as fund advisers and SPACs to them, should lead to an equivalent regulatory prohibition. Moreover, I also find evidence that black market capital investments are riskier and less-suitable investments than the hedge fund and private equity investments they attempt to mimic.

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The solution, however, is not to similarly ban these black market capital investments. Rather, the SEC should undertake a critical cost/benefits analysis of the individual investor benefits and risks to investing in hedge funds and private equity. This examination should not focus on the systematic risks of these investments as the Commission has traditionally done, but rather their individualized attributes. If the Commission did undertake such an analysis, I believe that they would find that hedge funds and private equity offer unique investing opportunities, including the possibility for diversified and excess returns. This is particularly true of funds of hedge funds and private equity which have shown potential for diversification independent of the U.S. equity and debt markets in recent market turbulence.[1]

I also believe that such an SEC study would find that the individualized risks of these investments are overstated and affected by popular perception. In particular, the oft-cited argument by the Commission and others that these investments are too "risky" often rests on possible system-wide risk created by these investments, particularly hedge funds. This conflates legitimate concerns over the system-wide risk of these investments with their individualized or idiosyncratic risk. The systematic risk of these investments is the potential and actual risk that they inflict on the system itself, the U.S. capital market. Examples of this type of risk include increased market volatility as a consequence of hedge fund market trading, adverse market fluctuations due to hedge fund or private equity over-leverage, and the extreme case of fund collapse with adverse contagion effects on the national or global financial system. Conversely, individualized risk is unique: it is the risk to a particular investor in their investment in hedge funds or private equity funds. There is an important distinction between the regulation of the investing activities of hedge funds and private equity, *i.e.*, regulating systematic risk, and the ability of public investors to access these investments which raises mainly individualized risk issues. As I detail in my Article, the individualized risks related to hedge fund and private equity investment either appear to be overstated by the Commission or are largely similar to those of many permitted equity and debt public investments.

I accordingly believe that any economically-minded analysis premised upon the foregoing distinctions would find significant benefits to amending the Investment Company Act and Investment Advisers Act to permit public, retail offerings of hedge funds and private equity funds. This step would permit public investors to enjoy the same opportunities that private investors now enjoy from investing in these investments. Moreover, such action would reestablish market equilibrium by redirecting capital away from arguably less-suitable black market capital investments directly into hedge funds and private equity. Other benefits of such a regulatory regime are outlined in my Article. Though further study is certainly warranted, the economic benefits of such a regime appear to prospectively outweigh objections previously raised by the Commission and others.

I therefore encourage the Commission to suspend its proposal to adopt Rules 206 and 509 and instead direct the Staff to undertake a thorough cost/benefit regulatory analysis of the benefits and risks of public investment in hedge funds and private equity. This is a task that the Commission has yet to perform though it is an important predicate step to any rule-making in

[1] For example, the Credit/Suisse Tremont Index of Hedge Funds which measures total hedge fund performance is up .78% during the months of June & July compared to a decline of 4.2% for the S&P 500 market index during this same time period.

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this area. I believe that such a study will ultimately find strong reasons for joining the rest of the world's regulators and permitting such public investment. This would be a regulatory step that would likely not only benefit public investors but the United States generally by engendering market equilibrium and increasing the U.S. capital market's competitiveness and efficiency. If I am wrong, the Commission will still have undertaken the hard task of definitively assessing the risks and benefits of hedge fund and private equity public investing and therefore have a stronger basis for promulgating these proposed rules. These thoughts are more fully outlined in my Article.

Very truly yours,

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