DISSENT OF COMMISSIONERS CYNTHIA A. GLASSMAN AND PAUL S. ATKINS

TO PROPOSING RELEASE NO. IA-2266

PROPOSED REGISTRATION UNDER THE ADVISERS ACT OF CERTAIN HEDGE FUND ADVISERS

The majority proposes a new rule and rule amendments under the Investment Advisers Act of 1940 that would require advisers to all hedge funds to register with the Commission.[1] We write jointly to dissent from this proposal. Our primary purpose in writing this dissent is to encourage commenters to respond to the issues discussed in the Proposing Release and to address the numerous issues that the release does not raise.

The majority proposes a solution to an ill-defined problem without having given proper consideration to viable alternative solutions in light of the limitations of our own capabilities. We acknowledge that the Commission does not know everything it would like to about hedge funds and hedge fund advisers. Mandatory registration of hedge fund advisers under the Advisers Act would not fill in these information gaps, but would significantly increase industry and Commission burdens. We are confident that there are other ways of obtaining information that would help us with our investor protection mission. However, before attempting a systematic collection of information, we must determine what information we want or need. We hope that commenters can provide us guidance about the types of useful information that would assist the Commission in discovering and deterring hedge fund fraud.

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[1] The term "hedge fund" generally refers to an unregistered pooled investment, privately organized, not advertised, and administered by professional investment managers, whose securities are privately placed with wealthy individual and institutional investors. See generally Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, at 3 (available at http://www.sec.gov/ spotlight/hedgefunds.htm) ("2003 Staff Hedge Fund Report").

Hedge Funds Have Long Been the Subject of SEC Study

As the Proposing Release points out, the Commission has been studying hedge funds since the 1960s.[2] As recently as 1992, in response to a Congressional inquiry, the Commission's staff discussed the "difficulties" that unregulated advisers pose to our enforcement efforts.[3] The report concluded "the Commission has substantial powers to obtain information for enforcement purposes, including the power to compel testimony and document production."[4] Further, the report noted that "the purpose of regulation is to protect investors, not to simplify investigations" and "the potential need to obtain information from hedge funds for enforcement purposes would not seem to be an adequate reason for registration."[5] Seven years later, the President's Working Group on Financial Markets, of which the Commission is a member, issued a report after the near collapse of Long Term Capital Management.[6] This report concluded "requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity."[7]

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[2] See Proposing Release, at n. 24 and accompanying text.

[3] See Letter from Richard C. Breeden, Chairman, SEC, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (June 12, 1992), transmitting Memorandum from William H. Heyman, Director, Division of Market Regulation, and Marianne K. Smythe, Director, Division of Investment Management, to Chairman Breeden, regarding Hedge Funds, at 10 (available at SEC's public reference room under file no. S7-30-04).

[4] Id. at 10.

[5] Id. at 10.

[6] See Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management – Report of the President's Working Group on Financial Markets, by representatives from the Commission, the Treasury Department, the Federal Reserve and the Commodity Futures Trading Commission (Apr. 1999) (available at: http://www.treas.gov/press/releases/reports/hedgfund.pdf) ("PWG LTCM Report").

[7] Id. at B-16.

Last year, however, our staff, after conducting another study of the hedge fund industry, issued a report that recommended, among other things, that the Commission consider requiring hedge fund managers to register as investment advisers under the Advisers Act.[8] This report was the culmination of a study that the Commission authorized the staff to conduct in June 2002 in order to determine the necessity of new rules or legislation for hedge funds.[9] The Commission gave the staff subpoena power to ensure that it could obtain the information that it needed. Of particular concern was whether hedge funds were becoming "retailized" and whether the growth in hedge funds was accompanied by a disproportionate incidence of fraud.

The 2003 Staff Hedge Fund Report found no retailization and no significant increase in fraud. These conclusions were consistent with the views expressed at the Commission's May 2003 roundtable, at which 60 panelists, including representatives of federal, state and foreign government regulators, securities industry professionals, and academics testified. Notwithstanding these findings, the staff recommended registering hedge fund advisers. The Proposing Release fails to make a convincing case that this change from the President's Working Group position, supported by the Commission four years earlier, is warranted. It dismisses the conclusion in the PWG LTCM Report on the basis that the Report and the Proposing Release serve "different purposes."[10] Nonetheless, the Proposing Release cites as a concern underlying

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8 2003 Staff Hedge Fund Report, supra note 1.

9 The objective of the study was to aid the Commission in determining whether regulatory or legislative changes were necessary to respond to the growth in hedge funds. Commission staff reviewed documents and information from 65 hedge fund advisers managing more than 650 different hedge funds, visited hedge fund advisers and prime brokers, and conducted a series of examinations of registered funds of hedge funds. See 2003 Staff Hedge Fund Report, supra note 1, at vii.

10 See Proposing Release at text following n. 32.

the proposed rulemaking the very anomalies and marketplace risks that were a central focus of the PWG LTCM Report.[11]

Registration will not Reduce Enforcement Actions

In support of its proposal, the majority cites Commission enforcement actions. First, it notes that the Commission has brought 46 enforcement actions in the past five years in which hedge fund advisers have defrauded hedge fund investors or used a hedge fund to defraud others. By comparison, the Commission initiated approximately 2,600 enforcement actions during fiscal years 1999 through 2003.[12] As the staff's 2003 Hedge Fund Report states, there is "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."[13]

Even assuming that the number of hedge fund cases is rising disproportionately, the nature of the cases suggests that registration of hedge fund advisers will not stem the increase. The 46 cases suggest that the typical "hedge fund" fraud is perpetrated by an adviser that is too small to be registered with the Commission, was registered already with the Commission, or

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11 See Proposing Release at text accompanying nn. 38 and 39. The majority speaks ominously of the fact that certain hedge fund managers are active traders, but this just indicates their important role in providing liquidity. See Proposing Release at n. 38 and accompanying text (citing Marcia Vickers, The Most Powerful Trader on Wall Street You've Never Heard Of, BUSINESS WEEK, July 21, 2003, at 66 (noting that SAC Capital Advisors "routinely accounts for as much as 3% of the New York Stock Exchange's average daily trading, plus up to 1% of the NASDAQ's")). Federal Reserve Chairman Alan Greenspan explained the important role hedge funds can play. Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing And Urban Affairs Committee (Feb. 12, 2004) ("Greenspan Testimony") ("The value that these institutions have is to create very significant amount of liquidity in our system, and I think that while they have a reputation of being a sort of peculiar type of financial group, I think they've been very helpful to the liquidity and, hence, the international flexibility of our financial system.").

12 See Securities and Exchange Commission, 2002 ANNUAL REPORT at 2, and 2003 ANNUAL REPORT at 17 (reporting number of civil injunctive actions and administrative proceedings initiated during fiscal years 1999 through 2003).

13 See 2003 Staff Hedge Fund Report, supra note 1, at 73.

evaded registration requirements.[14] Mandatory hedge fund adviser registration would not add to the Commission's ability to combat these types of fraud.[15] Importantly, the majority's recitation of these fraud cases illustrates the fact that hedge fund advisers are subject to the antifraud provisions regardless of their registration status.

To substantiate requiring registration, the majority also points to the recent market timing and late trading scandal in the investment company industry in which some hedge funds were implicated. The majority posits that had our examiners been inspecting the hedge funds, they would have found these abuses sooner. But mutual funds and their advisers <u>are</u> registered, and examiners were inspecting the mutual funds involved in the scandals and did not find the abuses. We have been and are continuing to punish fund advisers and their employees for orchestrating these schemes.[16] Although our enforcement actions have been targeted primarily at the regulated

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[14] Specifically, 8 of these 46 cases involve hedge fund advisers who were already registered with the Commission. In 5 of the 46 cases, the fund should have been registered under the Investment Company Act, so their advisers already should have been registered under current rules. In 20 of the 46 cases, the hedge funds were too small to be covered by the proposed rulemaking. In 2 cases, the fraud involved a principal of a registered broker-dealer or investment adviser, over whom we already had full regulatory oversight. Three of the 46 cases were garden-variety fraud designed to swindle investors, regardless of whether the vehicles were called hedge funds, venture capital funds, limited partnerships or prime banks. Registration might have deterred them from using the term "hedge fund," but would not have deterred the fraud itself.

[15] In only 8 of the 46 cases the existence of the rule might have increased in the Commission's oversight. These 8 cases, however, do not justify the proposed rulemaking. Most involve valuation problems, which have been notoriously difficult for us to detect even if the adviser is registered. In addition, only perfectly timed inspections would have improved the Commission's detection of the frauds at issue. With respect to all advisers, registered or unregistered, tips from knowledgeable insiders or third parties are often the key to discovering the fraud. Indeed, tips pointed us to the fraud in 7 of the 8 remaining cases.

[16] <u>See</u>, <u>e.g</u>., In the Matter of Alliance Capital Management, L.P., Investment Advisers Act Release No. 2205 (Dec. 18, 2003); In the Matter of Banc One Investment Advisors Corporation and Mark A. Beeson, Investment Advisers Act Release No. 2254 (June 29, 2004); In the Matter of James Patrick Connelly, Jr., Investment Advisers Act Release No. 2183 (Oct. 16, 2003); In the Matter of Pilgrim Baxter & Associates, Ltd., Investment Advisers Act Release No. 2251 (June 21, 2004); In the Matter of Strong Capital Management, Inc., Investment Advisers Act Release No. 2239 (May 20, 2004); SEC v. Security Trust Co., N.A., Litigation Release No. 18653 (Apr. 1, 2004); In the Matter of Steven B. Markovitz, Release No. 33-8298 (Oct. 2, 2003).

advisers of mutual funds, hedge fund advisers are also answerable – and will be punished – for their violations of the securities laws.[17] In addition to our enforcement actions, we have adopted certain regulatory measures[18] and are considering others to address any underlying, widespread problems.[19] We should revisit our oversight methods rather than looking for more entities to inspect. For example, had we reviewed mutual funds' flow data and understood how to extract the relevant information, we might have discerned these abusive practices.

Form ADV Does Not Meet the Information "Needs" Articulated by the Majority

The majority believes that the information that hedge fund advisers will provide on Form ADV could otherwise only be obtained through "substantial forensic efforts on the part of our staff."[20] Without considerable further amendment, information filed on Form ADV will not provide the details about hedge fund advisers that the majority suggests it needs to assist the Commission in addressing the concerns that the majority refers to in the release.[21] Part I of Form ADV yields little more than a census of name, address, and amount of assets under management. Part II of Form ADV, although more substantive, is unlikely to produce information that would

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17 The Proposing Release states that the staff has identified up to 40 hedge funds that have been involved in the Commission's late trading and market timing actions. See Proposing Release at n. 44 and accompanying text. The reliance on this information to substantiate the proposal is unwarranted. The majority never counted the number of hedge fund advisers, the entities it proposes to register. We estimate that the number of advisers involved with these funds would have been approximately half. In addition, it is unclear at this point how many of the advisers to these 40 funds actually violated the securities laws.

18 See, e.g., Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26418 (Apr. 16, 2004) [69 FR 22299 (Apr. 23, 2004)] and Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74713 (Dec. 24, 2003)].

19 See, e.g., Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 11, 2003) [68 FR 70387 (Dec. 17, 2003)].

20 See Proposing Release at text following n. 70.

21 Form ADV and its instructions are available at http://www.sec.gov/about/forms/formadv.pdf.

prove useful to the Commission because hedge fund advisers will feel compelled to draft their disclosure to protect proprietary information. Perhaps it is proponents' realization that the Form ADV may not provide all the information they need that causes them to characterize the proposal to require hedge fund advisers to register as a modest first step. This begs the question of what this is a first step towards.[22]

No Evidence of Significant Retailization

The majority contends that the retailization of hedge funds is a growing problem. They assert that as more investors qualify as accredited investors, unsophisticated investors might be gaining inappropriate access to hedge funds. Adjustments to the eligibility criteria would address concerns about potential retailization more directly than hedge fund adviser registration.[23]

The majority also points to indirect retailization through pension fund investments in hedge funds.[24] The proposing release cites an increase in pension investments and hedge funds

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22 The staff recommended one possible next step. See 2003 Hedge Fund Staff Report, supra note 1, at 97 (recommending that Commission consider requiring advisers to provide a brochure specifically designed for hedge funds).

23 This would directly address the staff's concern that although it "has not uncovered evidence of significant numbers of retail investors investing directly in hedge funds," "[n]evertheless, the increased number of retail investors qualifying as accredited investors raises our concern that hedge funds and broker-dealers might begin to seek out these investors as a new source of capital for hedge funds." See 2003 Staff Hedge Fund Report, supra note 1, at 80-81. If, as the majority suggests, there are an excess of investor dollars waiting to flow into hedge funds, then it is unclear why hedge funds would need to look to retail investors. See From Alpha to Omega; Hedge Funds, ECONOMIST, July 17, 2004 ("[M]any of the oldest and best-known hedge funds will not accept any new money" because "[f]or many trading strategies … there is a limit to the amount of money that can be moved around cheaply and briskly. While punting large amounts on the highly liquid foreign-exchange or government-bond markets is easy, betting on illiquid corporate bonds or shares is far harder. And the larger the amounts, the more expensive the bets are.").

24 The majority also expresses concern about an increase in hedge fund investment by universities, endowments, foundations, and other charitable organizations because "[l]osses resulting from hedge fund investments, as with any other investment loss, may affect the entities' ability to

from $13 billion to $72 billion since 1997.[25] This amount is approximately one percent of the total amount invested in private and public pension plans.[26] Despite the small portion of pension assets invested in hedge funds, the Proposing Release assumes that pension plan participants' financial well-being depends on Commission protection. Pension plan participants rely on professional money managers, who are fiduciaries of the pension plans, to evaluate investment options on behalf of the plan. Further, pension funds fall under either the oversight of either the Department of Labor or, in the case of public funds, state oversight.

Similarly, the majority points to creeping retailization through publicly-offered funds of hedge funds, noting that currently "there are 40 registered funds of hedge funds that offer or plan to offer their shares publicly."[27] However, these publicly-offered funds must be managed by a registered investment adviser and the fund must also comply with the more prescriptive provisions of the Investment Company Act. The Commission is able to examine registered advisers to registered funds of hedge funds as often as it deems appropriate. The Commission may ask for additional information from a registered adviser. It is therefore unclear how mandatory hedge fund adviser registration would be helpful in this context. However, if the Commission can demonstrate that publicly-offered funds of hedge funds pose real undisclosed risks to retail investors, the Commission could consider whether the problem can be addressed

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satisfy their obligations to their beneficiaries or pursue other intended purposes." See Proposing Release at text following n. 57. We applaud the majority's concern for the nation's educational and charitable institutions, but these organizations hire experienced money managers to invest their money in a way that maximizes the ability of those organizations to carry out their objectives.

25 See Proposing Release at text accompanying n. 60.

26 See Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release: Flow of Funds Accounts of the United States (June 10, 2004) (reporting for year 2003, $4.21 trillion in private pension fund reserves and $2.21 trillion in public pension fund reserves).

27 See Proposing Release at text accompanying n. 54.

by reversing past regulatory actions that have permitted these funds of hedge funds to be publicly offered.

Scope of the Proposed Rule

The majority's proposal would reach fund advisers that advise "private funds," which it defines as funds that: (1) would be subject to regulation under the Investment Company Act of 1940 but for the exception provided in either section 3(c)(1) or section 3(c)(7) of the Act; (2) permit investors to redeem their interests in the fund within two years of purchasing them; and (3) interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser. We question whether the two year lock-up will simply cause hedge fund advisers to lengthen their redemption periods, which would not benefit investors. Further, the majority points to valuation as one of the problems that the proposed rulemaking would address.[28] If valuation concerns are motivating the push for hedge fund registration, we should have the same concerns about private equity and venture capital funds.[29]

Costs of Registration

The proposing release seeks to minimize the burden of registration.[30] It downplays the complexities involved in registering as an investment adviser. Although proponents seem to

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[28] The Proposing Release cites a recent study finding valuation problems in hedge funds, and noted that "the authors attribute these failures, in part, to a lack of regulatory oversight." See Proposing Release at n. 83 and accompanying text (citing Christopher Kundro and Stuart Feffer, Valuation Issues and Operational Risk in Hedge Funds, Capco White Paper (Dec. 2003)). The article does not call for enhanced government regulation, but for more rigorous internal valuation procedures with adequate managerial supervision and, when necessary, utilization of third-party pricing services. See id. at 8-9.

[29] Probate and taxation of investors' estates, financing transactions based on balance sheet assets, marketing to investors of follow-on funds, and secondary sales of investment interests all raise potential valuation issues for private equity and venture funds.

[30] The majority estimated filing fees of approximately $1,000 in the first year and approximately $500 subsequently. In addition, the majority estimated average initial compliance costs of $20,000 in professional fees and $25,000 in internal costs including staff time. See Proposing

believe that, even under the current regulatory regime, Advisers Act registration is the only choice for legitimate advisers,[31] there is no indication that advisers undertake the process of registration lightly.[32] While the burden of this first step is likely to exceed the majority's expectations, future, more substantive regulation may bring even higher costs, such as the stifling of hedge funds' ability to carry out their business.[33]

It is far from certain that the oversight afforded through registration under the Advisers Act will reduce hedge fund investor fraud losses. By contrast, it is certain that fund investors will bear the cost of the additional regulations.[34] The information collected on Form ADV will

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Release at Section IV.B. At the same time the majority characterizes the costs associated with hedge fund adviser registration as small, it contends that the proposal will level the playing field among hedge fund advisers. See Proposing Release at IV.A.5.a.. A level playing field already exists; hedge fund advisers can decide to register and, if registration is important to investors, the market will reward registered advisers. Others suggest that hedge funds have an unfair advantage over mutual funds. This is not the only area in which the Commission permits a mix of unregistered and registered products in order to enhance investors' options without compromising investor protection. Rule 144A [17 CFR 230.144A] private offerings, for example, exist alongside public offerings.

31 Indeed, underlying this proposal is an apparent belief that advisers that are willing to register are better than those who do not. See William Donaldson, Chairman, Securities and Exchange Commission, Testimony before the Senate Banking Committee (July 18, 2004) ("I don't get much push back from people who are operating good funds," he said. "I don't get much push back from people who have nothing to hide.").

32 Adviser registration already carries with it certain substantive requirements, including adherence to rule 206(4)-6 [17 CFR 275.206(4)-6], the proxy voting rule, and rule 206(4)-7 [17 CFR 275.206(4)-7], the compliance rule. More generally, as with any disclosure document, Forms ADV can serve as the basis for a litigation against an adviser, so they are prepared with great care and often costly legal advice.

33 Federal Reserve Chairman Alan Greenspan warned of the likelihood of substantive regulation following registration. See Greenspan Testimony, supra note 11. ("I grant you that registering advisers in and of itself is not a problem. The question is: What is the purpose of that unless you're going to go further? And therefore I feel uncomfortable about that issue.").

34 The majority argues that all investors, regardless of their wealth, deserve the protection of the Investment Advisers Act. See Proposing Release at nn. 15-17. Wealthy investors might not want or need the same level of protection. They often employ well-trained professionals to select investments appropriate for them. If they desire the comfort afforded by a more rigorous regulatory regime, they may select mutual funds or other investments managed by advisers

not be a sufficient basis for hedge fund advisers' investment decisions; hedge fund investors will continue to do their own research to supplement this information.

Even apart from the Form ADV discussion, the majority discounts the fact that registration implies inspection. Effective inspection of all hedge fund advisers will require the Commission to invest substantial resources and expertise that it does not yet have. Targeted exams will not necessarily be less burdensome than routine exams either for the Commission or for those advisers inspected. If we fail to devote adequate resources and develop the necessary expertise to carry out effective risk-based examinations, we are providing a false sense of security by suggesting to the marketplace that, through registration, we have bathed hedge funds in "sunlight."

The majority ignores the opportunity costs of its proposal. The Commission does not have unlimited resources. Resources we devote to regulating hedge fund advisers are resources that we could be devoting to other, perhaps higher, priorities. It is abundantly clear from recent events that we have more work to do in other, more traditional, areas under our jurisdiction.[35]

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registered with the Commission or rely on a registered investment adviser to invest their money for them. Thus, the majority should view the benefit of enhanced protection for wealthy investors against the costs, including limitations on their investment options and potentially higher fees. See , Erik J. Greupner, Comment, Hedge Funds Are Headed Down-market: A Call for Increased Regulation?, 40 SAN DIEGO L. REV. 1555, 1578 (2003) ("[R]egulatory action aimed at eliminating every vestige of fraud in a given market would place such a heavy and costly burden of compliance upon issuers that investors would be safe but unable to achieve any meaningful return on their investments. The regulatory agency would also incur a high cost of enforcement. Carried to its logical end, investor protection as a sole reason for regulation, without also granting markets the freedom to reward those who take risk, ironically keeps investors safe and yet fails to fully protect the investors' sole interest in investing in the first instance: to achieve the highest return commensurate with their individual tolerance for risk.").

35 The majority contends that hedge fund advisers fall within our traditional jurisdiction, but for the safe harbor provision in rule 203(b)(3)-1 [17 CFR 275.203(b)(3)-1 ("A limited partnership is a client of any general partner or other person acting as investment adviser to the partnership")]. See Proposing Release at text accompanying n. 119. We disagree with the majority's suggestion that rule 203(b)(3)-1 conflicts with the spirit of section 208(d) of the Act, which prohibits a person from doing indirectly or through another person something that would be unlawful for the

Would investors be better served if we devoted our additional resources to more effective regulation of mutual funds, the investment of choice for over ninety million Americans, as opposed to hedge funds, whose direct investors are limited to institutions and an estimated 200,000 sophisticated high net worth investors? The Commission is moving away from routine inspections and towards a risk-based inspections system. The majority views hedge fund advisers as ideal candidates for the risk-based approach.[36] As the Commission determines what it is looking for, hedge fund advisers may face repeated, ad-hoc requests for paper and electronic documents. Such an approach cannot be deemed to be "modest."

The Commission Should Explore Alternative Approaches

Before making this proposal, the Commission should have undertaken a study that complements the descriptive overview of hedge funds provided by the 2003 Staff Hedge Fund Report and focuses on identifying the qualitative and quantitative information that would raise red flags and provide systematic data on hedge fund trends and practices. Although speed of implementation seems to be of great concern to the majority, the Commission can defer consideration of adoption of the proposal pending the completion of such an analysis.

This study would include a survey of hedge funds, hedge fund investors, prime brokers, bank lenders and auditors and other relevant sources. The Commission should also review the

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person to do directly. See Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. 956 (Feb 22, 1985) (when the Commission proposed rule 203(b)(3)-1, it explained that the rule's availability is limited "to situations where the general partner advises the partnership based on the investment objectives of the limited partners as a group" to "prevent a general partner, in contravention of section 208(d) of the Advisers Act, from using the partnership to do what it could not do directly itself, namely, provide individualized investment advice to 15 or more clients without registering as an investment adviser"). Hedge fund advisers provide advice to hedge fund investors as a group, not individually, and, therefore, they should not be deemed to be managing the assets of more than 14 persons in contravention of the Act.

[36] Absent clearly identified red flags, we are concerned that high performance will likely invite extra Commission scrutiny.

vast array of data that the Commission and other government agencies already receive.[37] The Commission can glean additional information from investor complaints, examinations of prime brokers and registered hedge fund advisers, and in hedge fund enforcement cases. Another source of information may be hedge funds' filings under the USA Patriot Act.[38] After completing such a study, we could consider whether to require hedge fund advisers to file periodically certain information, which we could then monitor for red flags and trends.[39]

If the data point us to specific problems with hedge funds, we may be able to work with prime brokers, which are already registered with the Commission, to develop solutions. The Proposing Release does not even ask any questions about the role that prime brokers can play, even though prime brokers have already helped us to identify some fraudulent activity at hedge funds.

Request for Comment

We urge commenters to address the following questions and any other issues raised here and in the Proposing Release.

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37 Systemic risk issues are properly addressed jointly with the Treasury and the Federal Reserve. As Federal Reserve Chairman Alan Greenspan has stated, hedge funds have "been very helpful to the liquidity and hence the international flexibility of our financial system." Greenspan testimony, supra note 11. If well-meaning, but ineffective regulation inhibits hedge funds from performing their important function of lubricating our financial system, it could have a negative effect on our economy. The Chairman of the CFTC has expressed a desire for cooperation across agencies. See CFTC Chairman James Newsome, Financial Times, 5 April 2004 ("But my concern is that before any regulatory agency drives specific rules, you have to remember that hedge funds run across multiple jurisdictions. So I would suggest that the [President's] working group is the appropriate mechanism because that group takes the broader context.").

38 See Anti-Money Laundering Programs for Unregistered Investment Companies, 67 FR 60617 (Sept. 26, 2002) (proposing to require, among other things, that unregistered investment companies file a notice containing certain basic information with the Department of Treasury's Financial Crimes Enforcement Network).

39 Proponents tend to paint the proposed approach as little more than a notice filing approach. We suspect that many advisers already regulated under the Advisers Act would not share that view.

- What are the concerns with respect to hedge funds that we should be addressing through rulemaking?
- Would approaches other than hedge fund registration be effective in addressing the concerns raised by the majority? Should we, for example, adjust the eligibility criteria for hedge fund investors? If so, what should the revised criteria be? For example, should we devise another definition of "accredited investor" that differs from that we employ for Regulation D purposes? Would a notice filing and reporting regime be a better alternative to Advisers Act registration? Are there more effective ways of addressing valuation? What measures could we take to enlist prime brokers in identifying valuation problems, fraud, and other red flags at hedge funds?
- What effect will universal registration have on investor demand for hedge fund investment opportunities? Would the registration of all hedge fund advisers expand the universe of eligible hedge funds and encourage even more pension fund investment in hedge funds? Would universal registration lead to calls for a reduction in eligibility criteria for investors because of a belief that registration enhances safety?[40]
- Is there a justifiable basis for distinguishing between the advisers covered by the proposed rulemaking and advisers to venture capital and private equity funds?[41] Are there risks that are peculiar to hedge fund advisers?

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40 As the Proposing Release points out, in some other countries, there is pressure to open up hedge funds, subject to certain regulations, to a wider range of investors. See Proposing Release at n. 52.

41 The majority distinguishes them by noting that, despite similarities, "we have not encountered significant enforcement problems with advisers with respect to their management of these types of funds." See Proposing Release at text accompanying notes 142 through 144. The majority links the higher incidence of abuses to the relative ease with which hedge fund investments can be redeemed. See id. at text accompanying n. 145.

- If the Commission adopts the proposal, should it include an exemption for advisers that are registered with another government agency, e.g., the Commodity Futures Trading Commission?
- Would the proposed rulemaking conflict with the securities laws' traditional view that sophisticated investors do not need the full oversight of the Commission?[42]
- Is the information provided on Form ADV sufficient to address the majority's concerns about hedge funds? What effect would the availability of information on the Form ADV have on the costs investors incur in researching hedge funds? What effect would registration have on the due diligence performed by hedge fund investors and the professionals they hire?
- Are the majority's estimates of the costs of registration and the costs of maintaining a compliance program under rule 206(4)-2, and the costs of complying with other rules under the Advisers Act, accurate? What are the anticipated effects of this rule proposal on new entrants in the marketplace? Would fears about more substantive regulation of hedge fund activity, business models, and business practices drive hedge fund advisers offshore? What burdens will hedge fund advisers face in responding to targeted, time-sensitive document requests under the Commission's new risk-based approach to oversight of registrants? What costs would investors bear as a result of the proposed rulemaking (including any reduction in the number of hedge fund offerings)?

Although the proposal seems innocuous on its face, it may harm investors without helping us perform our role. We need to know more about hedge funds. Registration of hedge fund

42 See, e.g., section 4(2) of the Securities Act of 1933 [15 U.S.C. 77d(2)], Regulation D [17 CFR 230.501-230.508] and rule 144A [17 CFR 230.144A] promulgated thereunder, and sections 3(c)(1) [15 U.S.C. 80a-3(c)(1)] and 3(c)(7) [15 U.S.C 80a-3(c)(7)] of the Investment Company Act.

advisers is not the best way to learn more, and it is unlikely that the Commission will determine in the next sixty days what it needs to know. While we would not normally oppose issuing a rule proposal to solicit comment, we cannot support a proposing release that papers over the weaknesses of the approach it puts forward, overstates the purported benefits, and ignores the possibility that viable, and indeed preferable, alternative approaches may exist.

For all of the foregoing reasons, we respectfully dissent.

Cynthia A. Glassman, Commissioner
Paul S. Atkins, Commissioner