**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 275 and 279**

**[Release No. IA–2333; File No. S7–30–04]**

**RIN 3235–AJ25**

## Registration Under the Advisers Act of Certain Hedge Fund Advisers

**AGENCY:** Securities and Exchange Commission (the ''Commission'' or ''SEC'').

**ACTION:** Final rule.

**SUMMARY:** The Commission is adopting a new rule and rule amendments under the Investment Advisers Act of 1940. The new rule and amendments require advisers to certain private investment pools (''hedge funds'') to register with the Commission under the Advisers Act. The rule and rule amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets.

**DATES:** *Effective Dates:* February 10, 2005, except for the amendments to § 275.206(4)–2 [rule 206(4)–2] and § 279.1 [Form ADV], which will become effective January 10, 2005.

*Compliance Dates:* Advisers that will be required to register under the new rule and rule amendments must do so by February 1, 2006. Advisers must respond to the amended items of Form ADV in their next ADV filing after March 8, 2005. Section III of this Release contains more information on the effective and compliance dates.

**FOR FURTHER INFORMATION CONTACT:** Vivien Liu, Senior Counsel, Jamey Basham, Branch Chief, or Jennifer L. Sawin, Assistant Director, at 202–942–0719 or *IArules@sec.gov*, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0506.

**SUPPLEMENTARY INFORMATION:** The Commission is adopting new rule 203(b)(3)–2 [17 CFR 275.203(b)(3)–2], amendments to rules 203(b)(3)–1 [17 CFR 275.203(b)(3)–1], 203A–3 [17 CFR 275.203A–3], 204–2 [17 CFR 275.204–2], 205–3 [17 CFR 275.205–3], 206(4)–2 [17 CFR 275.206(4)–2], and 222–2 [17 CFR 275.222–2], and Form ADV [17 CFR 279.1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (the ''Advisers Act'' or ''Act'').

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## I. Background

The Commission regulates investment advisers—persons and firms who advise others about securities—under the Investment Advisers Act of 1940. The Act contains a few basic requirements, such as registration with the Commission, maintenance of certain business records, and delivery to clients of a disclosure statement (''brochure''). Most significant is a provision of the Act that prohibits advisers from defrauding their clients, a provision that the Supreme Court has construed as imposing on advisers a fiduciary obligation to their clients.[1] This fiduciary duty requires advisers to manage their clients' portfolios in the best interest of clients, but not in any prescribed manner. A number of obligations to clients flow from this fiduciary duty, including the duty to fully disclose any material conflicts the adviser has with its clients,[2] to seek best execution for client transactions,[3] and to have a reasonable basis for client recommendations.[4] The Advisers Act does not impose a detailed regulatory regime.

Not all advisers must register with the Commission. The Act exempts an adviser from registration if it (i) has had fewer than fifteen clients during the preceding twelve months, (ii) does not hold itself out generally to the public as an investment adviser, and (iii) is not an adviser to any registered investment company.[5] Advisers taking advantage of this ''private adviser exemption'' must nonetheless comply with the Act's antifraud provisions,[6] but do not file registration forms with us identifying who they are, do not have to maintain business records in accordance with our rules, do not have to adopt or implement compliance programs or codes of ethics, and are not subject to Commission oversight. We lack authority to conduct examinations of advisers exempt from the Act's registration requirements.[7]

The private adviser exemption was not intended to exempt advisers to wealthy or sophisticated clients.[8] It appears to reflect Congress' view that there is no federal interest in regulating advisers that have only a small number of clients and whose activities are unlikely to affect national securities markets.[9] Today, however, a growing number of investment advisers take advantage of the private adviser exemption to operate large investment advisory firms without being registered with the Commission. Instead of managing client money directly, these advisers pool client assets by creating limited partnerships, business trusts or corporations in which clients invest. In 1985, we adopted a rule that permitted advisers to count each partnership, trust

[1] *See SEC* v. *Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180 (1963) (''*Capital Gains*''). *See also Transamerica Mortgage Advisors, Inc., (TAMA)* v. *Lewis*, 444 U.S. 11 (1979); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 471, n. 11 (1977).

[2] *See Capital Gains, supra* note 1, at 191–194.

[3] *See In the Matter of Kidder, Peabody & Co., Incorporated, Edward B. Goodnow*, Investment Advisers Act Release No. 232 (Oct. 16, 1968); *In the Matter of Mark Bailey & Co., and Mark Bailey*, Investment Advisers Act Release No. 1105 (Feb. 24, 1988); *In the Matter of Jamison, Eaton & Wood, Inc.*, Investment Advisers Act Release No. 2129 (May 15, 2003).

[4] *See supra* note 3.

[5] Section 203(b)(3) [15 U.S.C. 80b–3(b)(3)]. The Act also provides several other registration exemptions, which have much more limited application. Registration exemptions are provided to advisers that have only intrastate business and do not give advice on exchange-listed securities (section 203(b)(1) [15 U.S.C. 80b–3(b)(1)]); to advisers whose only clients are insurance companies (section 203(b)(2) [15 U.S.C. 80b–3(b)(2)]); to charitable organizations and their officials (section 203(b)(4) [15 U.S.C. 80b–3(b)(4)]); to church plans (section 203(b)(5) [15 U.S.C. 80b–3(b)(5)]); and to commodity trading advisors registered with the Commodity Futures Trading Commission (''CFTC'') whose business does not consist primarily of acting as investment advisers (section 203(b)(6) [15 U.S.C. 80b–3(b)(6)]).

[6] They are also subject to antifraud provisions of other federal securities laws, including rule 10b–5 under the Securities Exchange Act of 1934 [17 CFR 240.10b–5].

[7] Section 204 of the Advisers Act [15 U.S.C. 80b–4] authorizes the Commission to conduct examinations of all records of investment advisers. Records of advisers exempted from registration pursuant to section 203(b) of the Act [15 U.S.C. 80b–3(b)] are specifically excluded from being subject to these examinations.

[8] *See* discussion, *infra*, in Section II.B.8. of this Release.

[9] *Id.; see also infra* Section II.C of this Release.

or corporation as a single client, which today permits advisers to avoid registration even though they manage large amounts of client assets and, indirectly, have a large number of clients.[10]

One significant group of these advisers provides investment advice through a type of pooled investment vehicle commonly known as a ''hedge fund.'' There is no statutory or regulatory definition of hedge fund, although many have several characteristics in common. Hedge funds are organized by professional investment managers who frequently have a significant stake in the funds they manage and receive a management fee that includes a substantial share of the performance of the fund.[11] Advisers organize and operate hedge funds in a manner that avoids regulation as investment companies under the Investment Company Act of 1940, and hedge funds do not make public offerings of their securities.[12]

Hedge funds were originally designed to invest in equity securities and use leverage and short selling to ''hedge'' the portfolio's exposure to movements of the equity markets.[13] Today, however, advisers to hedge funds utilize a wide variety of investment strategies and techniques designed to maximize the returns for investors in the hedge funds they sponsor.[14] Many are very active traders of securities.[15]

In 2002, we requested that our staff investigate the activities of hedge funds and hedge fund advisers. First, we were aware that the number and size of hedge funds were rapidly growing and that this growth could have broad consequences for the securities markets for which we are responsible. Second, we were bringing a growing number of enforcement cases in which hedge fund advisers defrauded hedge fund investors, who typically were able to recover few of their assets. Third, we were concerned that the activities of hedge funds today might affect a broader group of persons than the relatively few wealthy individuals and families who had historically invested in hedge funds.[16] We directed the staff to develop information for us on a number of related topics, and advise us whether we should exercise greater regulatory authority over the hedge fund industry.

In connection with the staff investigation, we held a Hedge Fund Roundtable on May 14 and 15, 2003, and invited a broad spectrum of hedge fund industry participants to participate. Information developed at the Roundtable, and a large number of additional submissions that we subsequently received from interested persons, contributed greatly to the staff's investigation and our understanding of hedge funds and hedge fund advisers as we developed our proposals.[17]

In September 2003, the staff published a report entitled *Implications of the Growth of Hedge Funds*.[18] The 2003 Staff Hedge Fund Report describes the operation of hedge funds and raises a number of important public policy concerns. The report focused on investor protection concerns raised by the growth of hedge funds. The 2003 Staff Hedge Fund Report confirmed and further developed several of our concerns regarding hedge funds and hedge fund advisers.

### *A. Growth of Hedge Funds*

It is difficult to estimate precisely the size of the hedge fund industry because neither we nor any other governmental agency collects data specifically about hedge funds. It is estimated that there are now approximately $870 billion of assets [19] in approximately 7000 funds.[20] What is remarkable is the growth of the hedge funds. In the last five years alone, hedge fund assets have grown 260 percent, and in the last year, hedge fund assets have grown over 30 percent.[21] Some predict the amount of hedge fund

[10] *See Definition of ''Client'' of an Investment Adviser for Certain Purposes Relating to Limited Partnerships*, Investment Advisers Act Release No. 983 (July 12, 1985) [50 FR 29206 (July 18, 1985)] (''Rule 203(b)(3)–1 Adopting Release''). In 1997, we expanded the rule to cover other types of legal entities that advisers use to pool client assets. *See Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)] (''NSMIA Implementing Release''). Under rule 203(b)(3)–1(a)(2)(i)[17 CFR 275.203(b)(3)–1(a)(2)(i)], an investment adviser may count a legal organization as a single client so long as the investment advice is provided based on the objectives of the legal organization rather than the individual investment objectives of any owner(s) of the legal organization. Rule 203(b)(3)–1(b)(3)[17 CFR 275.203(b)(3)–1(b)(3)] states that ''[a] limited partnership is a client of any general partner or other person acting as investment adviser to the partnership.'' As discussed in more detail below, *infra* note 157, until we adopted this rule there was considerable uncertainty whether advisers to unregistered investment pools were required to look through the pools to count each investor as a client, or could count each pool as a single client.

[11] *See* William Fung and David A. Hsieh, *A Primer on Hedge Funds*, 6 J. of Empirical Fin. 309–31(1999), at 310; David W. Frederick, Institute of Certified Financial Planners, *Hedge Funds: Only the Wealthy Need Apply*, Jan. 30, 1998, at *http://www.yourretirement.com/fidlquest_22.htm* (visited on Oct. 24, 2004); Roy Kouwenberg, Erasmus University Rotterdam & William T. Ziemba, Sauder School of Business, Vancouver and Swiss Banking Institute, University of Zurich, *Incentives and Risk Taking in Hedge Funds*, July 17, 2003, at *http://www.few.eur.nl/few /people/kouwenberg/incentives3.pdf* (visited on Oct. 24, 2004). *See also* Gregory Zuckerman, *Hedge Funds Grab More In Fees As Their Popularity Increases*, Wall St. J., Oct.8, 2004, at A1 (noting that some of the best-performing hedge fund advisers now receive between 30 and 50 percent of their funds' profits). Not all hedge funds, however, are managed by legitimate investment professionals. *See SEC* v. *Ryan J. Fontaine and Simpleton Holdings Corporation a/k/a Signature Investments Hedge Fund*, Litigation Release No. 18254 (July 28, 2003) (22 year-old college student purportedly acted as Signature's portfolio manager and made numerous false claims to investors and prospective investors).

[12] *See* sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 [15 U.S.C. 80a–3(c)(1) and 3(c)(7)].

[13] *See* Carol J. Loomis, *Hard Times Come To The Hedge Funds*, Fortune, Jan. 1970, at 10.

[14] Bernstein Wealth Management Research, *Hedge Fund Myths and Realities* (Oct. 2002) at 3 (''[H]edge funds vary in many ways, including the broad array of strategies they employ, the manager's skill at implementing those strategies and the risks they take * * *''). *See also* Citigroup Asset Management, *Strategic Thinking: What's In A Hedge Fund? Toward A Better Understanding Of Sources Of Returns* (Apr. 2004) (examining 12 hedge fund strategies and challenging the view that hedge funds are all designed to deliver absolute returns).

[15] Ted Caldwell, *Introduction: The Model for Superior Performance*, in Hedge Funds, Investment and Portfolio Strategies for the Institutional Investors, (Jess Lederman & Robert A. Klein eds., 1995); Julie Rohrer, *The Red-Hot World of Julian Robertson*, Institutional Investor, May 1986, at 86.

[16] *See* Douglas W. Hawes, *Hedge Funds—Investment Clubs for the Rich*, 23 Business Lawyer 576 (1968).

[17] Transcripts of the Roundtable participants' presentations (''Roundtable Transcript'') and comments submitted in connection with the Roundtable are available at *http://www.sec.gov/spotlight/hedgefunds.htm*. Staff of the Commodity Futures Trading Commission (''CFTC''), the Commission des Operations de Bourse of France (COB), and the Financial Services Authority of the United Kingdom (FSA), participated in our Roundtable. In addition, Commission staff met with CFTC staff, staff of the Board of Governors of the Federal Reserve, staff of the Department of the Treasury, state securities officials, and staff of the FSA to discuss issues relating to hedge funds, their advisers, and their oversight.

[18] *Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission* (''2003 Staff Hedge Fund Report''), available at *http://www.sec.gov/ spotlight/hedgefunds.htm*.

[19] *See, e.g., Hedge Funds Grab More In Fees As Their Popularity Increases, supra* note 11; Alistair Bair, *Pension Funds Seen Boosting Hedge-Fund Allocations,* CBS MarketWatch, Sept. 13, 2004.

[20] *See* Hennessee Group LLC, *10th Annual Manager Survey (2004).*

[21] *Id.* (Hennessee Group estimates that the 34 percent growth of hedge funds in 2003 was due to both performance (20 percent) and new capital (14 percent)). *See also* Sanford C. Bernstein & Co., *Hedge Fund Industry Update ''One Year Later, The Song Remains The Same,* Bernstein Research Call (July 28, 2004) (hedge fund assets grew globally by approximately 31 percent in calendar year 2003 with aggregate assets reaching $870 billion in March 2004) (''Bernstein 2004 Report''). Hedge fund inflows have also continued to set records. *See* Chris Clair, *Hedge Fund Inflows Set Another Record,* HedgeWorld/Inside Edge, Aug. 16, 2004 (second quarter 2004 inflows of $43.3 billion bested the record set in the first quarter); *Too Much Money Chasing Too Few Real Stars,* Financial Times, July 22, 2004 (first quarter 2004 inflows were $38.2 billion, following record 2003 inflows of $72 billion).

assets will exceed $1 trillion by the end of the year.[22] Hedge fund assets are growing faster than mutual fund assets and already equal just over one fifth of the assets of mutual funds that invest in equity securities.[23]

As a result, hedge fund advisers have become significant participants in the securities markets, both as managers of assets and traders of securities. One report estimates that hedge funds represent approximately ten to twenty percent of equity trading volume in the United States.[24] One article portrayed a single hedge fund adviser as responsible for an average of five percent of the daily trading volume of the New York Stock Exchange.[25] Another reported that hedge funds dominate the market for convertible bonds.[26]

*B. Growth in Hedge Fund Fraud*

The growth in hedge funds has been accompanied by a substantial and troubling growth in the number of our hedge fund fraud enforcement cases.[27] In the last five years, the Commission has brought 51 cases in which we have asserted that hedge fund advisers have defrauded hedge fund investors or used the fund to defraud others in amounts our staff estimates to exceed $1.1 billion.[28]

Although most of our hedge fund fraud cases have involved hedge fund advisers that defrauded their investors, we now too frequently see instances in which hedge funds have been used to defraud other market participants. Most disturbing is that hedge fund advisers have been key participants in the recent scandals involving late trading and inappropriate market timing of mutual fund shares.[29] Many of our enforcement cases involved hedge fund advisers that sought to exploit mutual fund investors for their funds' and their own gain. Some hedge fund advisers entered into arrangements with mutual fund advisers under which the mutual fund advisers

[22] Some estimate that hedge fund assets are already at or near $1 trillion. *See Boom Or Bust? Banks And Hedge Funds,* The Economist (Oct. 9, 2004); Daniel Kadlec, *Will Hedge Funds Take A Dive?,* Time, Oct. 4, 2004; Amey Stone, *Hedge Funds Are Everyone's Problem,* BUSINESSWEEK, Aug. 6, 2004.

[23] As of the end of August 2004, equity mutual funds' assets were $3.8 trillion. At $870 billion, hedge funds' assets were equal to 22.9 percent of this figure. *See* Investment Company Institute, *Trends in Mutual Fund Investing:* August 2004, News Release (available at http://www.ici.org, visited on Oct. 13, 2004).

[24] Sanford C. Bernstein & Co., *The Hedge Fund Industry—Products, Services, or Capabilities,* Bernstein Research Call (May 19, 2003), at 5 (''Bernstein 2003 Report'').

[25] Marcia Vickers, *The Most Powerful Trader on Wall Street You've Never Heard of,* BusinessWeek, July 21, 2003, at 66.

[26] *See* Henny Sender, *Hedge Funds Skid on Convertible Bonds,* Wall St. J., June 30, 2004, at C4 (hedge funds account for about 95% of all trading in convertible bonds).

[27] We are not alone in our concerns regarding hedge fund frauds. In a recent study, over 50 percent of respondents identified hedge funds as ''most likely to be at the centre of an investment controversy'' in the next five years. Bank of New York, RESTORING BROKEN TRUST (July 2004).

[28] This reflects five cases in addition to those we cited in *Registration Under the Advisers Act of Certain Hedge Fund Advisers,* Investment Advisers Act Release No. 2266 (July 20, 2004) [69 FR 45171 (July 28, 2004)] (''Proposing Release''). Some commenters have suggested that the cases we cited in the Proposing Release did not support the need for hedge fund adviser registration because some of the hedge funds had less than $30 million in assets and advisers with less than $30 million in assets under management are not required to register under the Act. First, while staff estimates that approximately half the advisers in these cases managed assets in excess of $30 million or were otherwise subject to registration, it was cases involving these larger advisers that comprise the bulk of the estimated losses, representing more than $1 billion of total $1.1 billion of estimated losses. Second, regardless of whether any particular adviser would be required to register with us, these cases demonstrate the increased prevalence of fraud associated with hedge funds. We note that whether a particular hedge fund adviser will be required to register with us will turn not solely on the amount of assets of a particular hedge fund it advises, but on the total amount of assets the adviser has under management, including those of other clients. See section 203A(a)(1)(A) of the Advisers Act [15 U.S. 80b-3a(a)(1)(A)].

[29] In the past year, we have sanctioned persons charged with late trading of mutual fund shares on behalf of groups of hedge funds, and mutual fund advisers or principals for permitting hedge funds' market timing. *In the Matter of Invesco Funds Group, Inc., AIM Advisors, Inc., and AIM Distributors, Inc.,* Investment Advisers Act Release No. 2311 (Oct. 8, 2004) (Commission found that mutual fund adviser entered into an undisclosed arrangement permitting hedge funds to market time the adviser's mutual funds in a manner inconsistent with the mutual funds' prospectuses); *SEC* v. *PIMCO Advisors Fund Management, LLC,* Investment Advisers Act Release No. 2292 (Sept. 13, 2004) (Commission found that mutual fund adviser entered into a market timing arrangement permitting over 100 mutual fund market timing transactions by hedge funds in exchange for hedge funds' investment in adviser's other investment vehicles; mutual fund adviser also provided hedge funds with material nonpublic portfolio information concerning four of the adviser's mutual funds); *In the Matter of Banc One Investment Advisors Corporation and Mark A. Beeson,* Investment Advisers Act Release No. 2254 (June 29, 2004) (Commission found that investment adviser permitted Canary hedge fund manager Edward Stern to time the adviser's mutual funds, contrary to the funds' prospectuses; helped arrange financing for the timing trades; failed to disclose the timing arrangements; and provided Stern with nonpublic portfolio information); *In the Matter of Pilgrim Baxter & Associates, Ltd.,* Investment Advisers Act Release No. 2251 (June 21, 2004) (Commission found that mutual fund adviser permitted a hedge fund, in which one of its executives had a substantial financial interest, to engage in repeated and prolonged short-term trading of several mutual funds and that one of its executives provided material nonpublic portfolio information to a broker-dealer, which passed it on to its hedge fund customers); *In the Matter of Strong Capital Management, Inc., et al.*, Investment Advisers Act Release No. 2239 (May 20, 2004) (Commission found that investment adviser disclosed material nonpublic information about mutual fund portfolio holdings to Canary hedge funds, and permitted Canary and the adviser's own chairman to engage in undisclosed market timing of mutual funds managed by adviser); *SEC* v. *Security Trust Co., N.A.,* Litigation Release No. 18653 (Apr. 1, 2004) (consent to judgment by trust company charged with facilitating late trades and market timing by affiliated hedge funds over at least a three-year period); *In the Matter of Stephen B. Markovitz,* Administrative Proceedings Release No. 33–8298 (Oct. 2, 2003) (Commission found that Markovitz engaged in late trading on behalf of hedge funds). *See also In the Matter of Alliance Capital Management, L.P.,* Investment Advisers Act Release No. 2205 (Dec. 18, 2003) (Commission found that investment adviser permitted known market timers, including Canary hedge funds, to market time its mutual funds, in exchange for the timers' investments in Alliance's investment vehicles); *In the Matter of James Patrick Connelly, Jr.,* Investment Advisers Act Release No. 2183 (Oct. 16, 2003) (Commission found that vice chairman of mutual fund adviser permitted market timing by known market timer, including at least one hedge fund). We have also sanctioned mutual fund advisers for permitting certain investors to engage in undisclosed market timing of their funds; hedge funds were among the market timers in these cases. *In the Matter of RS Investment Management,* Investment Advisers Act Release No. 2310 (Oct. 6, 2004); *In the Matter of Janus Capital Management, LLC,* Investment Advisers Act Release No. 2277 (Aug. 18, 2004). In addition, we have sanctioned insurance companies for facilitating undisclosed market timing of mutual funds through variable annuity products marketed and sold to market timers including hedge funds. *In the Matter of CIHC, Inc., Conseco Services, LLC, and Conseco Equity Sales, Inc.,* Investment Company Act Release No. 26526 (Aug. 9, 2004) and *In the Matter of Inviva, Inc. and Jefferson National Life Insurance Company,* Investment Company Act Release No. 26527 (Aug. 9, 2004).

We are continuing to pursue several similar cases. To date, we have instituted six enforcement actions (in addition to the 12 settled actions discussed above). See SEC v. Geek Securities, Inc., Litigation Release No. 18738 (June 4, 2004) (alleging that broker-dealer engaged in late trading of mutual funds on behalf of several hedge fund customers, and facilitated hedge funds' market timing transactions in numerous mutual funds by evading the mutual funds' attempts to restrict the transactions); SEC v. Columbia Management Advisors, Inc., Litigation Release No. 18590 (Feb. 24, 2004) (alleging mutual fund wholesaler entered into, and adviser approved, arrangements allowing hedge funds to engage in market timing transactions in nine mutual funds, including one aimed at young investors); SEC v. Mutuals.com, Inc., Litigation Release No. 18489 (Dec. 4, 2003) (alleging that dually registered broker-dealer and investment adviser, three of its executives, and two affiliated broker-dealers assisted hedge fund brokerage customers in carrying out and concealing thousands of market timing trades and illegal late trades in shares of hundreds of mutual funds); SEC v. Druffner, Litigation Release No. 18444 (Nov. 4, 2003) (alleging that five brokers, with the assistance of their branch office manager, evaded attempts to restrict their trading and assisted several hedge funds in conducting thousands of market timing trades in numerous mutual funds); *In the Matter of Theodore Charles Sihpol, III,* Securities Exchange Act Release No. 48493 (Sept. 16, 2003) (charging former broker with playing a key role in enabling Canary hedge fund to engage in late trading in mutual fund shares over a three-year period). *See also In the Matter of Paul A. Flynn,* Securities Exchange Act Release No. 49177 (Feb. 3, 2004) (alleging Flynn assisted numerous hedge funds in obtaining bank financing to fund late trading and deceptive market timing of mutual fund shares).

waived restrictions on market timing in return for receipt of the hedge fund advisers' ''sticky assets,'' *i.e.*, placement of other assets in other funds managed by the mutual fund adviser. Other hedge fund advisers sought ways to avoid detection by mutual fund personnel by conspiring with intermediaries to conceal the identity of their hedge funds. While our investigation is ongoing, the frequency with which hedge funds and their advisers appear in these cases and continue to turn up in the investigations is alarming. Our staff counts almost 400 hedge funds (and at least 87 hedge fund advisers) involved in these cases and others under investigation.[30]

*C. Broader Exposure to Hedge Funds*

The third development of significant concern is the growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds. Hedge fund investors are no longer limited to the very wealthy. We note three developments that we have observed that contribute to this concern.

First, some hedge funds today are expanding their marketing activities to attract investors who may not previously have participated in these types of risky investments.[31] Many hedge funds maintain very high minimum requirements, and many of the hedge fund participants at our Roundtable expressed no interest in attracting ''retail investors.'' Our staff observed, however, that some hedge funds'' minimum investment requirements have decreased over time.[32] In developed markets outside the United States, hedge funds have sought to market themselves to smaller investors, and we can expect similar market pressures to develop in the United States as more hedge funds enter our markets.[33]

Second, the development of ''funds of hedge funds'' has made hedge funds more broadly available to investors.[34] Today there are 52 registered funds of hedge funds that offer or plan to offer their shares publicly.[35] Most funds of hedge funds are today offered only to institutional investors, but there are no statutory limitations on the public offering of these funds. Funds of hedge funds today represent approximately twenty percent of hedge fund capital,[36] and are the fastest growing source of capital for hedge funds today.[37]

Finally, and perhaps most significantly, in the last few years, a growing number of public and private pension funds,[38] as well as universities,

[30] Our Proposing Release reported only 40 hedge funds involved in these cases. Our staff has continued its investigation of late trading and market timing of mutual fund shares and, at our request, conducted a more detailed review. Staff has identified 389 different hedge funds, but in light of the continuing nature of staff's investigations, this number may be incomplete. Advisers registered with the Commission advised some of the 389 hedge funds.

[31] *See* Harriet Johnson Brackey, *New Class of Hedge Funds Reaches Beyond the Wealthy,* San Jose Mercury News, Mar. 23, 2003; Pam Black, *Going Mainstream,* Registered Rep., Mar. 1, 2004; Hanna Shaw Grove and Russ Alan Prince, Let Us In, Registered Rep., Mar. 2004; Jane Bryant Quinn and Temma Ehrenfeld, *The Street's Latest Lure: Some One Is Going to Mint Money With the New Hedge Funds For Smaller Investors,* Newsweek, May 26, 2003. *See also* two recent articles discussing hedge funds in publications for physicians. John J. Grande, *Alternative Investment Strategies Can Offer Significant ROI,* Ophthalmology Times, May 15, 2002; Leslie Kane, *Where to Put Your Money: Four Experts Tell Whether You Should Expect Happy Days for Stocks, and How to Invest Your Money,* Medical Economics, Jan. 9, 2004. *See also* Jenna Gottlieb, *Hedge Fund Deal Raises Product's Bank Profile,* American Banker, Oct. 14, 2004 (one fund of hedge funds adviser stated that hedge funds are becoming mainstream and are marketed to the mass affluent).

[32] *See* 2003 Staff Hedge Fund Report, *supra* note 18, at 81.

[33] Any sales in the United States would, of course, be subject to the registration requirements of the Securities Act, and the hedge fund itself may be subject to the Investment Company Act, unless exemptions were available. See, *e.g.*, Robert Murray, Vega To Target Smaller Investors, Alternative Investment News, Aug 20, 2004 (Spanish hedge fund adviser plans to offer a fund of its hedge funds to U.S. investors). The UK recently introduced a new type of vehicle which will be available only to sophisticated investors, but will still be authorized by the FSA, as a ''half way house'' between retail funds (fully regulated) and wholly unregulated funds. See Financial Services Authority, *The CIS Sourcebook—A New Approach, Feedback on CP185 and Made Text*, Mar. 2004, available at *http://www.fsa.gov.uk/pubs/policy/04_07.pdf* (visited on Oct. 25, 2004). The media recently reported that the FSA was examining whether it should lift the ban on letting ordinary members of the public invest in hedge funds. *See FSA May Lift Ban on Hedge Fund Retail Investors*, Reuters, Sept. 29, 2004, available at *http://www.reuters.co.uk* (visited on Sept. 29, 2004). Starting Jan. 2004, funds of hedge funds may sell their shares to smaller investors in Germany subject to certain regulations and procedures. See Silvia Ascarelli and David Reilly, *Hedge Funds Are Coming to the Masses*, Wall St. J., Apr. 15, 2004; EU Financial Services Group Briefing, Wilmer, Cutler & Pickering, *Hedge Funds in Germany—German Parliament Opens the Market for Alternative Investment Products*, Dec. 5, 2003, available at *http://www.wilmer.com /pubs/results.aspx? iPractice* (visited on Oct. 25, 2004). Since April 2003, funds of hedge funds may sell their shares to smaller investors in France, subject to certain regulations and procedures. *See* Commission des Operations de Bourse (France), Regulating *Alternative Multi-Management Investments*, News Release (Apr. 1, 2003) (available in File No. S7–30–04); Alain Gauvin and Guillaume Eliet, Capital Markets Dept., Coudert Freres, *Regulating Alternative Multi-Management Investments*, 2003, available at *http://www.coudert.com* (visited on Oct. 25, 2004). In Ireland, funds of hedge funds may sell their shares to smaller investors subject to certain regulations and procedures. *See* Matheson Ormsby Prentice, *Establishing a Hedge Fund in Ireland*, 2003, available at http://www.mop.ie/fileupload/publications (visited on Oct. 25, 2004). In Asia, both Hong Kong and Singapore permit authorized hedge funds to sell their shares to investors subject to certain minimum subscription thresholds and regulations. See Donald E. Lacey, Jr., *Democratizing the Hedge Fund: Considering the Advent of Retail Hedge* Funds, Apr. 2003, (International Finance Seminar at Harvard Law School), available at *http://www.law.harvard.edu/programs/pifs/pdfs/donald_lacey.pdf* (visited on Oct. 25, 2004); Mattew Harrison, *Fund Management in Hong Kong and Singapore*, CSU Research and Policy, Jan. 6, 2003. In South Africa, regulators and trade associations recently issued a joint discussion paper to develop an acceptable regulated environment in which existing and new hedge funds can operate (including consideration of whether to permit certain hedge fund products to be marketed to the public). *See* The Financial Services Board, Association of Collective Investments and Alternative Investment Management Association, *The Regulatory Position of Hedge Funds in South Africa—A Joint Discussion Paper* (Mar. 9, 2004). See also Carla Fiford, *South African Hedge Fund Industry Grows by Stealth*, AIMA Journal, Feb. 2004. The media recently reported that in Luxembourg, changes to regulation have allowed offshore hedge funds to list in Luxembourg since September 2004. *See* Phil Davis, *Special Report* Luxembourg: Hedge Fund *Tide May Be About to Turn*, Financial Times, Oct. 18, 2004.

[34] *The Street's Latest Lure: Some One Is Going to Mint Money With the New Hedge Funds For Smaller Investors, supra* note 31; *Going Mainstream, supra note 31; Jessica Toonkel, Firms Take Pause Before Launching Hedge Funds of Funds for Mass Affluent; Hold Your Horses!* Fund Action, Apr. 21, 2003; Michael P. Malloy and Jim Strangroom, *Registered Funds of Hedge Funds,* MFA Reporter (2002); *Fool's Gold,* The Economist, Sept. 1, 2001; Kimberly Hill, *Investors Need Help With Hedge Funds,* Fundfire, May 14, 2004.

[35] An additional 51 funds of hedge funds are registered with the Commission as investment companies but can be sold only through private offerings. The Commission does not have data on the number of additional funds of hedge funds that exist but are not registered with the Commission.

[36] Bernstein 2003 Report, *supra* note 24, at 18.

[37] Hennessee Group LLC, *10th Annual Manager Survey, supra* note 20 (''funds of funds continue to be the fastest growing source of capital for hedge funds, increasing 50 percent since January 1997 (from 16 percent to 24 percent)''). *See also* Pauline Skypala, *Hedge Funds of Funds Booming,* FT.com, Sept. 26, 2004 (Morgan Stanley research estimates that over two-thirds of hedge fund inflows are coming through funds of funds).

[38] According to Greenwich Associates, about 20 percent of corporate and public plans in the United States were investing in hedge funds in 2002, up from 15 percent in 2001. Bernstein Research reports that, among the top 200 U.S. defined benefit plans, at least 15 percent have allocated a portion of their assets to hedge funds. Bernstein 2003 Report, *supra* note 24 at 13. Hennessee Group data indicate that pensions' investments in hedge funds increased from $13 billion in 1997 to $72 billion in 2004. *See* Testimony of Charles J. Gradante, Managing Principal, The Hennessee Group LLC, Before the Senate Committee on Banking, Housing and Urban Affairs, available at *http://banking/senate.gov/_files/gradante.pdf* (visited on Oct. 13, 2004); Hennessee Group LLC, *10th Annual Manager Survey, supra* note 20. *See also Hedge Funds Gaining Acceptance Among Pension Funds,* Morningstar Web Site, June 27, 2003; Chris Clair, *'Unprecedented Pressure': Public Plans Race to Embrace Hedge Funds; This Time They Are Leading, Not Following, Their Corporate Counterparts,* Pensions and Investments, July 8, 2002, at 2; *Alaska Pension Allocates to Hedge Fund,*

Continued

endowments, foundations, and other charitable organizations, have begun to invest in hedge funds or have increased their allocations to hedge funds.[39] More of these institutions have also recently begun to consider these alternative investments.[40] Institutional investments may increase in the next four years to $300 billion.[41] Investors that have not been traditional hedge fund investors, including pension plans that have millions of beneficiaries, are thus today purchasing hedge funds. As a result of the participation by these entities in hedge funds, the assets of these entities are exposed to the risks of hedge fund investing. Losses resulting from hedge fund investing and hedge fund frauds may affect the entities' ability to satisfy their obligations to their beneficiaries or pursue other intended purposes.

In response to these developments, and after extensive consultation with participants in the hedge fund industry in connection with our staff's investigation, we proposed in July of 2004 a new rule that would require hedge fund advisers to count each investor in a hedge fund, rather than only the hedge fund itself, as a client for purposes of the private adviser exemption.[42] As a result, most hedge fund advisers would have to register with the Commission and would be subject to SEC oversight. The rule and rule amendments were designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets.[43]

We received letters from 161 commenters, including investors, hedge fund advisers, other investment advisers, trade associations, and law firms.[44] Forty-two commenters did not express a view on whether we should or should not require hedge fund advisers to register, but asked us to consider particular issues or concerns if we adopted the rule.[45] Thirty-six commenters supported the rule proposal and our efforts to improve our oversight of hedge fund advisers.[46] Several investors and other commenters hailed the proposal as an important step towards protecting investors and the overall securities markets.[47] They pointed out that while registering hedge fund advisers would not eliminate fraud, it would allow the Commission to address potential opportunities for fraud. These commenters also noted that registration may help the hedge fund industry to the extent it discourages persons intent on committing fraud from entering the industry and damaging the reputation of the legitimate managers.[48] They also cautioned that the Commission should

Alternative Investment News, July 1, 2004 (the Alaska State Pension Investment Board has chosen three firms to manage its first $300 million hedge fund allocation).

[39] Median strategic allocation to hedge funds by endowments and foundations was 11 percent in 2001, 10 percent in 2003 and forecast at 12.3 percent in 2005. *See* Goldman Sachs International and Russell Investment Group, *Report on Alternative Investing by Tax-Exempt Organizations 2003,* available at *http://www.russell.com/II/Research_and Resources/Informative_Articles/Goldman_ Russell_ Survey.asp* (visited on Sept. 18, 2004). Others estimate the average allocation to be 12 percent, *see* Bank of New York and Casey, Quirk & Acito, *Institutional Demand for Hedge Funds: New Opportunities and New Standards,* (Sept. 2004) (''BONY Report'') or as high as 17 percent of assets. *See* Hennessee Group, *2004 Hennessee Hedge Fund Survey of Foundations and Endowments* (reporting that an average commitment of 17 percent of assets, and a projected commitment of 19 percent by 2005) (''Hennessee Foundation and Endowment Survey''). *See also* Lewis Knox, *The Hedge Fund: Institutional Money is Swelling the Coffers of the World's Largest Hedge Fund Managers,* 28 Institutional Investor (International Edition) 53 (June 1, 2003); Dan Neel, *Michigan Preps For Hedge, Real Estate,* Investment Management Weekly, Apr. 28, 2003; *Virginia Exposure Soars to 60%,* Financial News (Daily), Apr. 27, 2003 (University of Virginia has invested 50 percent of its portfolio in hedge funds, and plans to increase its exposure to 60 percent of its total portfolio); Chris Clair, *Allocation Goal: 25%—UTIMCO Joins Billion-Dollar Hedge Fund Club,* Pensions and Investments, Apr. 14, 2003, at 3; Chidem Kurdas, *Hedge Funds Continue to Gain in Endowments' Alternative Investments,* HedgeWorld Daily News, Apr. 7, 2003; *Behind the Money Section; University of Wisconsin Searching for Hedge Funds,* 4 Alternative Investment News, Feb. 1, 2003, at 20 ($300 million University of Wisconsin endowment will allocate up to 10 percent, or $25–30 million, to a fund of funds manager); *Baylor University; Inside The Buyside; Increases Hedge Fund Activity by $20–25 Million,* 4 Alternative Investment News, Feb. 1, 2003 at 6; Susan L. Barreto, *Hedge Funds Become Saving Grace for Endowments in Tough Times,* HedgeWorld Daily News, Apr. 4, 2002.

[40] Since we issued our Proposing Release, industry observers have seen smaller foundations expressing growing interest in hedge funds. *Family Foundations Move Towards Hedge Funds,* Fundfire, Oct. 11, 2004 (family foundation consultant notes many family foundations, run by family members with limited investment knowledge, pursuing hedge fund investments). Also, in our Proposing Release, we identified a large number of pension plans that were investing or looking to invest in hedge funds. Since then, a number of additional pension plans have sought, or are seeking, hedge fund investment, according to one trade newsletter. *Cincy Fund Will Weight Alts,* Alternative Investment News, Oct. 8, 2004 (Cincinnati Retirement System will consider alternative investments in 2005); *U.S. Pensions Examine Hedge Funds,* Alternative Investment News, Oct. 8, 2004 (pension plans sponsored by the General Conference of Seventh Day Adventists, Tulare County (CA) Employees' Retirement Association, and City of Laredo (TX) Firefighters Retirement System are considering investment in hedge funds); *Colorado Guns & Hoses Makes Overlay Play,* Alternative Investment News, Oct. 1, 2004 (Colorado fire and police pension fund allocated $75 million to two hedge fund of funds managers); *Service Employees Likely To Seek Hedge Fund of Funds,* Alternative Investment News, Sept. 10, 2004 (Service Employees International Union pension fund may seek to invest up to 5 percent of its $1.5 billion in assets to hedge funds of funds); *New Hampshire Eyes Hedge Funds,* Alternative Investment News, Sept. 10, 2004 (New Hampshire Retirement System is considering allocating up to $100 million to one or more hedge fund of funds managers); *San Bernardino Pension Picks AIG, Benchmark Plus,* Alternative Investment News, Aug. 13, 2004 (San Bernardino County (CA) Employees Retirement Association allocated $100 million to each of two hedge fund of fund managers); *L.A. Water Dept. To Consider Hedge Funds,* Alternative Investment News, July 30, 2004 (defined benefit plan to consider its first allocation to hedge funds early in 2005).

[41] BONY Report, *supra* note 39, at 1. *See also* Lewis Knox, *The Hedge Fund: Institutional Money is Swelling the Coffers of the World's Largest Hedge Fund Managers, supra* note 39.

[42] Proposing Release, *supra* note 28.

[43] In 1999, the President's Working Group on Financial Markets, in the wake of the near-collapse of Long Term Capital Management, Inc., (''LTCM''), published a series of recommendations that did not include registration of hedge fund advisers under the Advisers Act. *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 Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission (Apr. 1999). The principal concerns of the President's Working Group report were the stability of financial markets and the exposure of banks and other financial institutions to the counterparty risks of dealing with highly leveraged entities such as the LTCM hedge fund. The focus of the Advisers Act is different, and includes such concerns as the prevention of frauds on investors. Since the issuance of the President's Working Group report, the size of the hedge fund industry has doubled, the exposure of investors to hedge funds has broadened, and the incidence of fraud we discover involving hedge fund advisers has increased. The Commission is the only member of the President's Working Group with responsibility for the protection of investors and the oversight of our nation's securities markets.

[44] These letters are available on the Internet at *http://www.sec.gov/rules/proposed/s73004.shtml.*

[45] *See, e.g.*, Comment Letter of Van Hedge Fund Advisors (Sept. 15, 2004) (''Van Hedge Letter'').

[46] Hennessee Group also submitted the results of a survey of foundations and endowments, Hennessee Foundation and Endowment Survey, *supra* note 39. Nearly twice as many respondents to the Hennessee Foundation and Endowment Survey favored the proposal (59 percent) as opposed it (30 percent).

[47] *See, e.g.*, Comment Letter of Ohio Public Employees Retirement System, (Aug. 6, 2004) (''Ohio PERS Letter''); Comment Letter of New Jersey State Investment Council (Sept. 17, 2004) (''New Jersey State Investment Council Letter''); Comment Letter of Pennsylvania Securities Commission (July 26, 2004) (''Pennsylvania Securities Commission Letter''); Comment Letter of CFA Institute (Sept. 30, 2004) (''CFA Institute Letter''); Comment Letter of Investment Counsel Association of America (Sept. 14, 2004) (''ICAA Letter''); Comment Letter of Alternative Investment Group Services, LP (Aug. 20, 2004) (''Alternative Investment Group Letter''); Comment Letter of Lyn Batty (July 14, 2004) (''Lyn Batty Letter'').

[48] *See, e.g.*, Comment Letter of Investment Company Institute (Sept. 15, 2004) (''ICI Letter''); Ohio PERS Letter, *supra* note 47; Comment Letter of Investment Management Consultants Association (Sept. 14, 2004) (''IMCA Letter''); Alternative Investment Group Letter, *supra* note 47; Comment Letter of David Patch (July 24, 2004) (''Patch Letter A'').

not wait until the next crisis before taking measures of protection against potential fraud.[49] Some hedge fund advisers and other advisers already registered with the SEC also welcomed the proposal. They used their own experiences to illustrate that registration would not overburden a firm's operation, and that benefits of being a registered adviser more than compensated for the costs.[50]

Eighty-three commenters, including many unregistered hedge fund advisers, their attorneys, and trade associations, however, argued strongly against the proposal. They expressed concerns about the costs of compliance under the new rule,[51] and raised questions about our effectiveness in preventing hedge fund fraud,[52] and the potential intrusiveness of our oversight of hedge fund managers.[53] Some hedge fund investors were concerned that their advisers might pass the costs of registration to them and increase management fees.[54]

[49] *See, e.g.*, Comment Letter of B. H. Bigg (July 23, 2004) (''Bigg Letter''); Comment Letter of Ralph S. Saul (Aug. 18, 2004) (''Saul Letter'').

[50] *See, e.g.*, Comment Letter of Vantis Capital Management LLC (Aug. 6, 2004) (''Vantis August Letter''); Alternative Investment Group Letter, *supra* note 47.

[51] *See, e.g.*, Comment Letter of Managed Funds Association (Sept. 15, 2004) (''MFA Letter''); Comment Letter of Madison Capital Management, LLC (Sept. 15, 2004)(''Madison Capital Letter''); Comment Letter of Proskauer Rose LLP (Aug. 31, 2004) (''Proskauer Letter''); Comment Letter of Schulte Roth & Zabel LLP (Sept. 15, 2004) (''Schulte Roth Letter''); Comment Letter of Keith Black (July 30, 2004) (''Black Letter''); Comment Letter of Guy Lander (Sept. 15, 2004) (''Lander Letter''); Comment Letter of Sidley Austin Brown & Wood, LLP (Sept. 14, 2004) (''Sidley Austin Letter''); Comment Letter of Joseph LaRocco (Aug. 26, 2004) (''LaRocco Letter); Comment Letter of Superior Capital Management LLC (Sept. 8, 2004) (''Superior Capital Letter'').

[52] *See, e.g.*, MFA Letter, *supra* note 51; Comment Letter of Chamber of Commerce of the United States of America (Sept. 15, 2004) (''Chamber of Commerce Letter''); Comment Letter of International Swaps and Derivatives Association (Sept. 15, 2004) (''ISDA Letter''); Comment Letter of David Patch (Sept. 10, 2004) (''Patch Letter B''); Comment Letter of Rodney Pitts (Sept. 15, 2004) (''Rodney Pitts Letter''); Comment Letter of Blanco Partners LP (Sept. 13, 2004) (''Blanco Partners Letter''); Comment Letter of Mark Acquino (Aug. 8, 2004)(''Acquino Letter'').

[53] *See, e.g.*, MFA Letter, *supra* note 51; Chamber of Commerce Letter, *supra* note 52; ISDA Letter, *supra* note 52; Comment Letter of Financial Services Roundtable (Sept. 9, 2004) (''Financial Services Roundtable Letter''); Black Letter, *supra* note 51; Comment Letter of Tudor Investment Corporation (Sept. 15, 2004) (''Tudor Letter''); Comment Letter of David Thayer (Sept. 15, 2004) (''David Thayer Letter''); Lander Letter, *supra* note 51.

[54] *See, e.g.*, Comment Letter of John Waller (July 31, 2004) (''John Waller Letter''); Acquino Letter, *supra* note 52; Comment Letter of Melissa Kadiri (Sept. 15, 2004) (''Melissa Kadiri Letter'').

## II. Discussion

We have carefully considered all of the comments we received.[55] For the reasons discussed below and in the Proposing Release, we are adopting rule 203(b)(3)–2 and related amendments to rule 203(b)(3)–1 and Form ADV, which would require most hedge fund advisers to register with us under the Act.[56]

### *A. Need for Commission Action*

The Commission is the federal agency with principal responsibility for the enforcement and administration of the federal securities laws and the supervision of the securities markets. The federal securities laws seek to protect investors by providing for the transparency of markets, by prohibiting fraud, and by imposing fiduciary obligations.[57] They encourage the formation and efficient allocation of capital and the participation of investors in the capital markets.[58] Our obligations under these laws as well as our commitment to protect investors require us to respond to important market developments, and the authority provided us by those laws permits us to adopt rules and interpret the statutes in order to preserve fair and honest markets.[59]

We believe that, in light of the growth of hedge funds, the broadening exposure of investors to hedge fund risk, and the growing number of instances of malfeasance by hedge fund advisers, our current regulatory program for hedge fund advisers is inadequate. We do not have an effective program that would provide us with the ability to deter or detect fraud by unregistered hedge fund advisers. We currently rely almost entirely on enforcement actions brought after fraud has occurred and investor assets are gone. We lack basic information about hedge fund advisers and the hedge fund industry, and must rely on third-party data that often conflict and may be unreliable.[60]

Requiring hedge fund advisers to register under the Advisers Act will give us the ability to oversee hedge fund advisers without imposing burdens on the legitimate investment activities of hedge funds. We understand the important role that hedge funds play in our financial markets, and we appreciate that the lack of regulatory constraints on hedge funds has been a factor in the growth and success of hedge funds. But commenters have not persuaded us that requiring hedge fund advisers to register under the Act, requiring them to develop a compliance infrastructure, or subjecting them to our examination authority will impose undue burdens on them or interfere significantly with their operations.[61]

[55] During and after the comment period, our staff has continued to have discussions in the President's Working Group with other regulators relating to hedge fund adviser regulation. *See* Letter from Congressman Richard H. Baker to John W. Snow, Secretary, U.S. Department of the Treasury (Oct. 7, 2004) (available in File S7–30–04).

[56] As discussed below, we are also adopting amendments to rules 203A–3, 204–2, 205–3, 206(4)–2, and 222–2. Unless otherwise noted, when we refer to rules 203(b)(3)–1, 203A–3, 204–2, 205–3, 206(4)–2, 222–2, or any paragraph of the rules, we are referring to 17 CFR 275.203(b)(3)–1, 275.203A–3, 275.204–2, 275.205–3, 275.206(4)–2, and 275.222–2 of the Code of Federal Regulations in which the rules are published.

[57] *See Capital Gains, supra* note 1.

[58] *See, e.g., AUSA Life Insurance Co.* v. *Ernst & Young,* 206 F.3d 202 (2nd Cir. 2000) at 217. ''During the Great Depression, Congress enacted the 1933 and 1934 [Securities] Acts to promote investor confidence in the United States securities markets and thereby to encourage the investment necessary for capital formation, economic growth, and job creation.'' Private Securities Litigation Reform Act of 1995, Pub. L. 104–67, S.Rep. No. 104–98 (June 19, 1995), reprinted in 1995 U.S.C.C.A.N. 679, 683.

[59] *See American Trucking Assns., Inc.* v. *Atchison, Topeka & Santa Fe Ry Co.,* 387 U.S. 397, 415 (1967) (''Regulatory agencies do not establish rules of conduct to last forever; they are supposed, within the limits of the law and of fair and prudent administration, to adapt their rules and practices to the Nation's needs in a volatile, changing economy. They are neither required nor supposed to regulate the present and the future within the inflexible limits of yesterday.'').

[60] William Fung and David Hsieh, *Measuring the Market Impact of Hedge Funds,* 7 J. of Empirical Fin. 1 (2000) (''There are varying estimates of the size of the hedge fund industry.''); *Hedg-matics: How Many Funds Exist?* Wall St. J., May 22, 2003, at C5 (''Just how big is the hedge-fund industry? This simple question has been debated because the data on hedge funds are spotty.''); *Letter from Craig S. Tyle, General Counsel of the Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission,* July 2, 2003, available at *http://www.ici.org* (visited on Oct. 10, 2004) (''There is currently no universal database that contains records of all hedge funds, both those currently operating and those that have ceased operating.''); Gaurav S. Amin and Harry M. Kat, *Hedge Fund Performance 1990–2000: Do the ''Money Machines'' Really Add Value?,* 38 Journal of Financial and Quantitative Analysis 2 (2003) (''Due to its private nature, it is difficult to estimate the current size of the hedge fund industry.''). *See also* Bing Liang, *Hedge Funds: The Living and the Dead,* 35 Journal of Financial and Quantitative Analysis 309–326 (2000) (study of statistical inconsistencies in two major hedge fund databases, noting hedge funds ''are basically not regulated. They report their fund information only on a voluntary basis. Therefore, the reliability of hedge fund data is an open question and is critical for hedge fund research and the investment community.''); Harry M. Kat, *10 Things That Investors Should Know About Hedge Funds,* Institutional Investor (Spring 2003) (noting that hedge fund databases are of low quality, that each database covers only a subset of the hedge fund universe, that all present survivorship bias, and that researchers attempting to analyze the hedge fund industry or fund performance may perceive matters very differently depending on the database or index they use).

[61] CFA Institute agreed that the fact that many registered advisers are small firms ''argues strongly that such registration is not overly burdensome.'' CFA Institute Letter, *supra* note 47.

Indeed, the large number of hedge fund advisers currently registered under the Act—many of whom voluntarily register—provides a powerful refutation of the assertions made by commenters who opposed the rule on these grounds.[62] We presume these hedge fund advisers would take steps to avoid registration under the Act if the consequences of registration were as dire as some commenters have asserted.[63] Comments we received from hedge fund advisers that are registered under the Act provide persuasive testimonials that confirm our conclusion.[64]

The Act does not require an adviser to follow or avoid any particular investment strategies, nor does it require or prohibit specific investments. Its most significant provision, which requires full disclosure of conflicts of interest and prohibits fraud against clients, applies regardless of whether the adviser is registered under the Act, and will be furthered by the registration requirement.[65] No commenter identified any provision of the Act that would provide an impediment to an adviser's successful operation of a hedge fund.[66] Arguments by some that registration would somehow inhibit hedge fund advisers' willingness to engage in complex or innovative strategies because they would be second-guessed by our examination staff are baseless. They are refuted by the experience of registered hedge fund advisers.[67] One commenter familiar with the obligations of registered advisers noted that registration would not require hedge fund advisers to reveal their trading strategies or disclose their portfolio holdings, and would not interfere with their ability to leverage their portfolios, and that our proposal would not restrict the ability of hedge funds to provide liquidity to the markets.[68]

We are not aware of any evidence that suggests that registration under the Advisers Act has impeded investment advisers' performance, and commenters did not suggest that registration would have such an effect. Moreover, a recent study, while not conclusive, found that there were no significant differences between performance of hedge funds managed by registered advisers and those managed by unregistered advisers.[69] Five of the ten largest (and presumably most successful) hedge fund advisers are today registered with us under the Advisers Act.[70]

The bare assertions of adverse consequences of registration under the Advisers Act offered by many commenters opposed to our proposed rule, and the anecdotal evidence offered by others, simply do not stand up to scrutiny. There has been no suggestion that hedge funds managed by registered advisers play a diminished role in the financial markets compared to hedge funds managed by unregistered advisers. The empirical evidence we have seen, and the information collected informally by our staff,[71] suggests that registration under the Advisers Act has no adverse effect on the legitimate market activities of hedge funds.

More than 8,500 advisory firms that collectively manage over $23 trillion dollars of assets are today registered under the Advisers Act. We have seen no credible evidence that the Act has in any way impeded their ability to employ successful investment strategies, or to effectively compete with other financial institutions that manage securities portfolios here or abroad.

Some commenters also expressed concerns about what the Commission *might* in the future do that could adversely affect the operation of hedge funds.[72] Such inchoate fears, however, do not provide reason for our not going forward with this important rulemaking. Our record of 64 years of administering the Advisers Act provides no basis for such fears.[73] Our regulatory efforts to

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[62] We estimated, in the Proposing Release, that 40–50 percent of hedge fund advisers are registered under the Act. *See* Section V. of the Proposing Release. *See also* Hennessee Group LLC, *10th Annual Manager Survey, supra* note 20 (39 percent of hedge fund managers surveyed were registered under the Advisers Act).

[63] Moreover, many hedge fund advisers that are not registered with us have indicated that they conform their operations to those of registered advisers. *See* 2003 Staff Hedge Fund Report, supra note 18, at 314.

[64] *See* Vantis August Letter, *supra* note 50 (''While there are incremental costs associated with registration [under the Advisers Act], the burdens are not excessive for any serious investment firm, which is committed to timely and accurate reporting.'') and Alternative Investment Group Letter, *supra* note 47 (''We believe that the compliance costs will be minimal to the well-managed advisor.'').

[65] The antifraud prohibitions of section 206 [15 U.S.C. 80b–6], including provisions restricting an adviser's ability to engage in principal trades and agency cross-transactions with clients, apply to any investment adviser that makes use of the mails or any means of interstate commerce. In contrast, section 204 [15 U.S.C. 80b–4] (authorizing the Commission to require advisers to issue reports and maintain books and records) applies to all advisers other than those specifically exempted from registration by section 203(b) of the Act. Thus, although unregistered advisers are subject to the antifraud provisions of the Act, our ability to enforce those provisions is hampered because in the absence of a registration requirement we cannot identify and examine these advisers.

[66] In the past, hedge fund industry participants cited the restrictions on registered advisers charging performance-based compensation in section 205(a)(1) of the Act [15 U.S.C. 80b–5(a)(1)] as being incompatible with the operation of hedge funds. *See Hard Times Come to the Hedge Funds, supra* note 13; Lawrence J. Berkowitz, *Regulation of Hedge Funds,* 2 Rev. of Securities Reg. (1969). In 1998, however, the Commission eliminated this concern by adopting amendments to rule 205–3. *Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account,* Investment Advisers Act Release No. 1731 (July 15, 1998) [63 FR 39022 (July 21, 1998)]. Further, we proposed to grandfather hedge fund advisers' existing investors that would otherwise not qualify to pay performance fees. *See* Section II.G. of the Proposing Release. No hedge fund industry participant with whom our staff spoke during their year-long investigation indicated that section 205 or the qualified client criteria in rule 205–3 would present any concerns to hedge funds.

[67] *See, e.g.*, ICI Letter, *supra* note 48 (''Many of our investment adviser members—all of whom are registered with the Commission—currently operate hedge funds and have found that registration is not overly burdensome and does not interfere with their investment activities.'').

[68] *Id.* Nor does the Act restrict the ability of advisers to engage in short-selling. Moreover, nothing in the Act or our rules requires any investment adviser to disclose its securities positions. Indeed, we recently declined requests to require advisers to publicly disclose how they voted client proxies out of a concern that they would thereby divulge client securities positions. *Proxy Voting by Investment Advisers,* Investment Advisers Act Release No. 2106 (Jan. 31, 2003) [68 FR 6585 (Feb. 7, 2003)]. The Advisers Act requires us to maintain as confidential information obtained by our examiners in the course of an examination. *See* sections 210(b) and 210A of the Act [15 U.S.C. 80b–10(b) and 10a].

[69] *Bids and Offers,* Wall St. J., July 23, 2004 at C4. In the study, Hedge Fund Research, Inc., an alternative investments research and consulting firm, examined the performance of approximately 2,200 single-strategy hedge funds. *Id.* However, the extent of cross-sectional variability in hedge fund returns makes it difficult to ascertain differences in performance statistically.

[70] *See The Hedge Fund 100,* Institutional Investor, May 2004.

[71] In its investigation of hedge funds, *see supra* Section I of this Release, our staff conducted reviews of registered and unregistered hedge fund advisers, had on-site discussions with them, and met or spoke with a variety of experts to get their perspectives on the hedge fund industry. 2003 Staff Hedge Fund Report, *supra* note 18, at 2.

[72] *See, e.g.*, Chamber of Commerce Letter, *supra* note 52.

[73] Many of the fears concerning Commission oversight expressed by hedge fund advisers today are very similar to those expressed in 1940 by opponents to enactment of the Advisers Act. *See, e.g., Investment Trusts and Investment Companies: Hearings on S.3580 Before the Senate Comm. on Banking and Currency,* 76th Cong., 3d. Sess. (Apr. 22–23, 1940) (''1940 Senate Hearings'') (testimony of James N. White, Scudder, Stevens & Clark, (''We just feel that registration leads to investigation, and that investigation leads to regulation; and it is possible for a good deal of controversial theory on economics to creep into regulation.'')), (testimony of Dwight C. Rose, President, Investment Counsel Association of America, (''* * * all activities and recommendations of a cautious investment counselor would first have to be subjected to the question of whether or not at some time such activities or recommendations might involve difficulties for him in connection with the statute as enacted or with such future rulings as the Commission might take.'')), (testimony of Charles M. O'Hearn, Clarke, Sinsabaugh & Co., (''In addition, we should like to reaffirm our belief that

date that relate specifically to hedge fund advisers have been to modify our rules to accommodate these advisers.[74] Indeed, our proposals, and the rules we are adopting today, include additional regulatory relief to accommodate the needs of funds of hedge funds.[75]

*B. Matters Considered by the Commission*

In the Proposing Release, we identified a series of considerations that led us to propose rule 203(b)(3)–2. These considerations have now led us to adopt the rule. These considerations explain what we intended to achieve by the proposed rule, why we believed some alternative approaches would not be effective, and why we believed our proposed rule reflected the proper administration of the Advisers Act. Many of the commenters discussed these considerations extensively. Those supporting the proposal tended to agree with the considerations we set out; those opposing the proposal challenged them. Below, we discuss each of the considerations set out in the Proposing Release, as well as others raised by commenters. For each, we address our considerations, the principal arguments commenters made against our adoption of the rule, and why we found those arguments to be unpersuasive.[76]

1. Census Information

Registration under the Advisers Act provides the Commission with the ability to collect important information that we now lack about this growing segment of the U.S. financial system.[77] Registered advisers must file Form ADV with us, the data from which will provide us with information we need to better understand the operation of hedge fund advisers, to plan examinations, to better develop regulatory policy, and to provide data and information to members of Congress and other government agencies. This includes information about the number of hedge funds managed by advisers, the amount of assets in hedge funds, the number of employees and types of other clients these advisers have, other business activities they conduct, and the identity of persons that control or are affiliated with the firm.[78]

Currently, neither we nor any other government agency has any reliable data on even the number of hedge funds or the amount of their assets. We must rely on third-party surveys and reports, which often conflict and may be unreliable.[79] Many commenters acknowledged this as a concern, and several agreed that the Commission needs reliable, current and in-depth information about hedge fund advisers.[80] Some commenters, however, urged that, instead of registering advisers and obtaining information on Form ADV, we rely on a coordinated collection of filings and transaction reports currently made by hedge funds, their advisers, or broker-dealers with various government agencies or self-regulatory organizations.[81] We have considered this alternative, but believe that it would lead our staff to engage in a time-consuming forensic exercise to extract a composite of largely transactional information that would ultimately result in an incomplete picture of each hedge fund adviser and an incomplete picture of the hedge fund industry.[82] We still would not know, for example, how many hedge funds, or hedge fund advisers, operate in the United States or their aggregate assets. As we explained in the Proposing Release, we need information that is reliable, current, and complete, and we need it in a format reasonably susceptible of analysis by our staff.

2. Deterrence of Fraud

Registration under the Advisers Act enables us to conduct examinations of the hedge fund adviser.[83] Our examinations permit us to identify compliance problems at an early stage,[84] identify practices that may be harmful to investors, and provide a deterrent to unlawful conduct.[85] They are a key part of our investor protection program, and a key reason we are adopting rule 203(b)(3)–2.[86]

We are not suggesting that registration under the Advisers Act will result in our eliminating, or even identifying, every fraud. The prospect of a Commission examination, however, increases the risk of getting caught, and thus will deter wrongdoers.[87] This risk

we should be forced to take this position [against adviser registration] in the interests of our profession, even if we believed some Federal regulation was desirable, because of the broad and unqualified discretion given to the Securities and Exchange Commission to determine conditions which are vital not only to the convenience but to the very existence of our operations.'')). Registration, however, clearly has not impeded the growth of the investment advisory industry—in 1940, investment advisers managed only $4 billion (approximately $50 billion in today's dollars), but assets managed by advisers subject to registration under the Advisers Act have grown to over $23 trillion today.

[74] *See* Sections II.F. through II.H. of the Proposing Release.

[75] *See* Section II.I. of this Release.

[76] One of these considerations—imposition of minimal burdens—is discussed above.

[77] Collecting information about the nation's investment advisers has been one aim of the Advisers Act since it was enacted in 1940. Although the primary objective of the Advisers Act is the protection of advisory clients, the Act also serves as ''a continuing census of the Nation's investment advisers.'' H.R. Rep. No. 1760, at 2 (1960). Just as data on all advisers was lacking before 1940, there has been no comprehensive data on hedge fund advisers available. *See supra* note 60.

[78] Much of this information is currently collected from hedge fund advisers that are registered with the Commission. A registered adviser that is the general partner of a hedge fund must report that it advises a ''pooled vehicle'' in response to Item 5.D (6) of Part 1A of Form ADV, list each pooled vehicle on Schedule D (Section 7.B.) and disclose the amount of assets in the pooled vehicle and the minimum amount of capital investment per investor.

[79] *See* Bernstein 2004 Report, *supra* note 21, at 2 (''In general, there are very wide discrepancies in market size and performance estimates from different sources. As an example, we found that among three leading hedge fund data providers only approximately 15 percent of funds were included in all three databases.''); *see also supra* note 60.

[80] Even commenters that disagreed with our proposal to register hedge fund advisers agreed that the Commission needs information about them. *See, e.g.*, Comment Letter of Kynikos Associates LP (Sept. 15, 2004) (''Kynikos Letter'').

[81] *See, e.g.*, Chamber of Commerce Letter, *supra* note 52; MFA Letter, *supra* note 51.

[82] One commenter agreed with our concerns and the inadequacy of alternative approaches to collecting information about hedge fund managers. *See* Comment Letter of Long Trail Capital, LLC (Sept. 14, 2004) (Monitoring prime broker information is no substitute for registration of hedge fund advisers because (1) funds use multiple prime brokers, complicating efforts to monitor a fund; (2) the transactional picture is not complete since funds may hold private equity, real estate, or derivatives not cleared by the prime broker; (3) brokers have an incentive to profit from the client relationship with the fund, and not to expend resources trying to oversee its activities; fund advisers should instead be accountable to an overseer with a primary mission to protect investors.)

[83] *See supra* note 7.

[84] One registered hedge fund adviser commented that it benefits from our examination process. *See* Vantis August Letter, *supra* note 50 (''[T]he examiner provides an extra set of critical eyes to review our systems and identify any deficiencies. If we were to have deficiencies, we would want to promptly correct them.'')

[85] During an examination, our staff may review the advisory firm's internal controls and procedures; they may examine the adequacy of procedures for valuing client assets, for placing and allocating trades, and for arranging for custody of client funds and securities. Examination staff also may review the adviser's performance claims and delivery of its client disclosure brochure. Each of these operational areas presents a greater opportunity for misconduct if it is not open to examination.

[86] Other protections of the Advisers Act would also act as deterrents to unlawful conduct by serving as a check on the advisers' control of assets in funds they advise and contribute to the protection of investors in those funds. Our custody rule, for example, requires the adviser to maintain fund assets with a qualified custodian. *See* rule 206(4)–2 under the Advisers Act.

[87] The facts of the action against Stevin R. Hoover and Hoover Capital Management, Inc. are instructive on this question. *See SEC* v. *Hoover and Hoover Capital Management, Inc., (Second Amended Complaint of the SEC)*, (available at *http://www.sec.gov/litigation/complaints/complr17487.htm*). Hoover was involved in a scheme to defraud clients of his advisory firm by, among other things, misappropriating assets and

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should alter hedge fund advisers' behavior by forcing them to account for the consequences of a compliance examination that, like a tax audit, may not occur with great frequency.[88] Hedge fund advisers each day make decisions based on risk analysis of alternative investments, and should be particularly sensitive to the consequences of getting caught if their conduct is unlawful. The consequences may involve paying fines, disgorgement and other penalties, including industry suspensions or bars, as well as loss of reputation. This sensitivity, which may be reflected in the strength of the opposition among some hedge fund advisers to this rulemaking, suggests that the benefits of our oversight may be substantial.

Economic theories of monitoring and deterrence based on principal-agent models have been used to examine regulatory issues related to tax fraud. *See* Jennifer F. Reinganum and Louis L. Wilde, *Income Tax Compliance in a Principal-Agent Framework*, 26 J. Pub. Econ. 1 (Feb. 1985); Jennifer F. Reinganum and Louis L. Wilde, *A Note On Enforcement Uncertainty and Taxpayer Compliance*, 103(4) Quarterly J. Econ. 793 (Nov. 1988). These papers suggest that randomized monitoring is sufficient to generate a deterrent effect. If the magnitude of deterrence is sufficient, randomized monitoring could create a net economic benefit.

Commenters opposing the rule challenged our concerns regarding fraud on two grounds. Some asserted that there was an inadequate record of fraud by hedge fund advisers to support requiring hedge fund advisers to register. They asserted that the 46 cases we cited in the Proposing Release represented only two percent of our enforcement cases over the applicable five-year period.[89] We note, however, that these cases, which have now grown to 51, represented over ten percent of our cases against investment advisers during the same period.

Some commenters cited to us a sentence from the 2003 Staff Hedge Fund Report that indicated that there was no evidence that hedge fund advisers engaged *disproportionately* in fraudulent activity.[90] The 2003 Staff Hedge Fund Report was issued before the discoveries of hedge fund involvement in late trading and inappropriate market timing of mutual fund shares.[91] In addition, implicit in these commenters' arguments is that the Commission should wait to act until hedge fund frauds do comprise a disproportionate amount of fraudulent activity. We reject such arguments. In the face of trends that we now observe, including the potential impact of hedge fund fraud on a growing and broadening number of direct and indirect investors in hedge funds, we believe that waiting would be irresponsible.

Second, some commenters asserted that the Commission would be unsuccessful at detecting fraud by hedge fund advisers, pointing to frauds that have occurred involving mutual funds.[92] Such an assertion amounts to a generalized attack on the Commission's ability to deter and detect fraud in general, and on the premise of statutes that provide us with authority to examine investment advisers.[93] This assertion is unsupported by any empirical data, and is as illogical as an assertion that because police officers are unable to prevent or detect all crime, they should be removed from their beats. Our examination staff uncovered, during routine or sweep exams, five of the eight cases we brought against registered hedge fund advisers,[94] and two of the cases involving unregistered advisers originated out of examinations of related persons that were registered with us.[95]

Finally, some commenters suggested that hedge fund advisers are different from other advisers and that our examiners would be unable to fully understand their trading strategies and investments.[96] This argument does not acknowledge that we are today responsible for the oversight of significant number of registered hedge fund advisers (not all of which are engaged in complex trading strategies), as well as many other advisers (some of which are engaged in complex trading strategies). In our experience, there is nothing unique about hedge fund advisers or the types of frauds they have committed that suggests that our examination program would not or could not play the same effective role. The fraud actions we have brought against unregistered hedge fund advisers have been similar to the types of fraud actions we have brought against other types of advisers, including misappropriation of assets,[97] portfolio

overbilling expenses. When Hoover became aware that the Commission staff was investigating his firm, he established a separate, unregistered advisory firm and perpetuated his fraud through use of a hedge fund he created and controlled.

[88] Several studies examine the impact of deterrence on the decision to commit crimes in different contexts. The seminal paper in this area is Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. Political Econ. 169 (1968). Another influential paper is Isaac Ehrlich, *Participation in Illegitimate Activities: A Theoretical and Empirical Investigation*, 81 J. Political Econ. 521 (1973). The deterrence hypothesis is also discussed in Robert Cooter and Thomas Ulen, Law and Economics, ch.11–12 (1988).

[89] *See, e.g.*, MFA Letter, *supra* note 51; ISDA Letter, *supra* note 52; Chamber of Commerce Letter, *supra* note 52; Schulte Roth Letter, *supra* note 51, Black Letter, *supra* note 51, David Thayer Letter, *supra* note 53; Comment Letter of Sheila C. Bair (Sept. 15, 2004) (''Sheila Bair Letter'').

[90] 2003 Staff Hedge Fund Report, *supra* note 18, at 72.

[91] Some of these hedge fund managers may have been part of a scheme to defraud mutual fund investors and aided and abetted others in defrauding them, in violation of federal securities laws.

[92] *See, e.g.*, Comment Letter of Millrace Asset Group (Sept. 15, 2004) (''Millrace Letter'').

[93] *See* S. Rep. No. 1760, at 3 (1960) (recommending amendments to the Advisers Act that gave Commission examination authority, explaining that ''[t]he prospect of an unannounced visit of a Government inspector is an effective stimulus for honesty and bookkeeping veracity.'').

[94] Eight of the 51 cases involved registered hedge fund advisers, and routine or sweep exams were the source of five of those eight cases. *In the Matter of Alliance Capital Management, L.P., supra* note 29 (Commission found that investment adviser to hedge fund and mutual funds permitted market timing of the mutual funds in exchange for the timers' agreements to invest in the hedge fund); *In the Matter of Nevis Capital Management, LLC, David R. Wilmerding, III and Jon C. Baker,* Investment Advisers Act Release No. 2214 (Feb. 9, 2004) (charging hedge fund adviser with misallocating favorable investment opportunities); *In the Matter of Zion Capital Management LLC, and Ricky A. Lang,* Investment Advisers Act Release No. 2200 (Dec. 11, 2003) (charging hedge fund adviser with misallocating investment opportunities to the adviser's personal account); *SEC* v. *Schwendiman Partners, LLC, Gary Schwendiman, and Todd G. Schwendiman,* Investment Advisers Act Release No. 2043 (July 11, 2002) (charging hedge fund adviser with usurping favorable investment opportunities, for the benefit of the adviser); *In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses,* Investment Advisers Act Release No. 2038 (June 20, 2002) (Commission found hedge fund adviser caused its hedge funds to pay nearly $2 million in unnecessary and undisclosed commission costs, above markups already paid, to broker that had no role in executing trades, as reward for referring investors to the hedge funds).

[95] *SEC* v. *KS Advisors, Inc., et al.*, Litigation Release No. 18600 (Feb. 27, 2004) (asserting hedge fund advisers misrepresented performance and net asset value of two hedge funds to conceal massive trading losses); *SEC* v. *James S. Saltzman,* Litigation Release No. 17158 (Sept. 27, 2001) (asserting hedge fund adviser diverted significant amounts of fund assets to personal use).

[96] *See, e.g.*, Schulte Roth Letter, *supra* note 51; Sidley Austin Letter, *supra* note 51.

[97] *SEC* v. *Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee,* Litigation Release No. 18216 (July 7, 2003); *SEC* v. *Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC,* Litigation Release No. 18214 (July 3, 2003); *SEC* v. *David M. Mobley, Sr., et al.*, Litigation Release No. 18150 (May 20, 2003); *SEC* v. *Vestron Financial Corp., et al.*, Litigation Release No. 18065 (Apr. 2, 2003); *SEC* v. *Hoover and Hoover Capital Management, Inc.,* Litigation Release No. 17487 (Apr. 24, 2002); *SEC* v. *Beacon Hill Asset Management LLC, et al.*, Litigation Release No. 18745A (June 16, 2004); *SEC* v. *House Asset Management, L.L.C., House Edge, L.P., Paul J. House, and Brandon R. Moore,* Litigation Release No. 17583 (June 24, 2002); *SEC* v. *Edward Thomas Jung, et al.*, Litigation Release No. 17417 (Mar. 15, 2002); *SEC* v. *Evelyn Litwok & Dalia Eilat,* Litigation Release No. 16843 (Dec. 27, 2000); *SEC* v. *Ashbury Capital Partners, L.P., Ashbury Capital*

pumping,[98] misrepresentation of portfolio performance,[99] falsification of experience, credentials and past returns,[100] misleading disclosure regarding claimed trading strategies [101] and improper valuation of assets.[102]

*Management, L.L.C., and Mark Yagalla,* Litigation Release No. 16770 (Oct. 17, 2000).

[98] *SEC* v. *Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC,* Litigation Release No. 18247 (July 23, 2003); *SEC* v. *Burton G. Friedlander,* Litigation Rel. No. 18426 (Oct. 24, 2003).

[99] *In the Matter of Samer M. El Bizri and Bizri Capital Partners, Inc.,* Admin Proc. File No. 3–11521 (June 16, 2004); *SEC* v. *Millennium Capital Hedge Fund,* Litigation Release No. 18362 (Sept. 25, 2003); *SEC* v. *Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC, supra* note 97; *SEC* v. *David M. Mobley, Sr., et al., supra* note 97; *SEC* v. *Hoover and Hoover Capital Management, Inc., supra* note 97; *SEC* v. *Beacon Hill Asset Management LLC, et al., supra* note 97; *SEC* v. *Edward Thomas Jung, et al., supra* note 97; *SEC* v. *Michael W. Berger, Manhattan Capital Management Inc.,* Litigation Release No. 17230 (Nov. 3, 2001); *In the Matter of Charles K. Seavey and Alexander Lushtak,* Investment Advisers Act Release No. 1968 (Aug. 15, 2001); *In the Matter of Michael T. Higgins,* Investment Advisers Act Release No. 1947 (June 1, 2001); *SEC* v. *Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla, supra* note 97.

[100] *SEC* v. *J. Scott Eskind,* Litigation Release No. 18558 (Jan. 29, 2004); *SEC* v. *Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee, supra* note 97; *SEC* v. *Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC, supra* note 97; *SEC* v. *Vestron Financial Corp., et al., supra* note 97; *SEC* v. *House Asset Management, L.L.C., House Edge, L.P., Paul J. House, and Brandon R. Moore, supra* note 97; *SEC* v. *Evelyn Litwok & Dalia Eilat, supra* note 97; *SEC* v. *Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla, supra* note 97.

[101] *SEC* v. *Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC, supra* note 97; *SEC* v. *David M. Mobley, Sr., et al., supra* note 97; *SEC* v. *Edward Thomas Jung, et al., supra* note 97; *SEC* v. *Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla, supra* note 97.

We have also charged registered hedge fund advisers with other types of fraud, including: misallocating favorable investment opportunities to a hedge fund, to the detriment of the adviser's other clients, *In the Matter of Nevis Capital Management, LLC, David R. Wilmerding, III and Jon C. Baker, supra* note 94; misallocating investment opportunities to the personal account of a hedge fund adviser, to the detriment of the hedge fund, *In the Matter of Zion Capital Management LLC, and Ricky A. Lang, supra* note 94; usurping a profitable, low-risk investment opportunity available to a hedge fund and taking it for the personal benefit of a hedge fund adviser, *SEC* v. *Schwendiman Partners, LLC, Gary Schwendiman, and Todd G. Schwendiman, supra* note 94; and causing hedge funds to pay commissions to a broker that had no role in executing trades, as reward for referring investors to the adviser's hedge funds, *In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses, supra* note 94. We have no reason to believe that unregistered advisers may not be perpetrating the same types of frauds, beyond our detection.

[102] *SEC* v. *Global Money Management, L.P.,* Litigation Release No. 18666 (Apr. 12, 2004); *SEC* v. *Burton G. Friedlander, supra* note 98; *SEC* v. *Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC, supra* note 98; *SEC* v. *David M. Mobley, Sr., et al., supra* note 97; *SEC* v. *Beacon Hill Asset Management LLC, et al., supra* note 97; *SEC* v. *Edward Thomas Jung, et al., supra* note 97; *In the Matter of Charles K. Seavey and Alexander Lushtak, supra* note 99; *In the Matter of Michael T. Higgins, supra* note 99.

### 3. Keeping Unfit Persons From Using Hedge Funds To Perpetrate Frauds

Registration with the Commission permits us to screen individuals associated with the adviser, and to deny registration if they have been convicted of a felony or had a disciplinary record subjecting them to disqualification.[103] We intend to use this authority to help keep fraudsters, scam artists and others out of the hedge fund industry.[104]

Several of the frauds we have seen appear to have been perpetrated by unscrupulous persons using the hedge fund as a vehicle to defraud investors. These persons appear to never have intended to establish a legitimate hedge fund, but used the allure of a hedge fund to attract their ''marks.'' [105] We have been concerned that these individuals may have been attracted to hedge funds because they could operate without regulatory scrutiny of their past activities.[106] Our lack of oversight may have contributed to the belief that their frauds would not be exposed. Our ability to screen individuals and, in some cases, to block their entrance into the advisory profession should serve to discourage unscrupulous persons from using hedge funds as vehicles for fraud.[107]

[103] Section 203(c)(2) of the Advisers Act [15 U.S.C. 80b–3(c)(2)] permits the Commission, after notice and opportunity for a hearing, to deny registration to an adviser that is subject to disqualification under section 203(e) [15 U.S.C. 80b–3(e)]. Item 11 of Part 1 of Form ADV requires applicants for registration as an investment adviser to report felonies and other disciplinary events occurring during the last 10 years. The Commission's screening, however, does not rely exclusively on an applicant's self-reporting of violations; our staff checks applicants against a large database of securities violators to determine whether there are any unreported disciplinary events.

[104] *See, e.g.,* SEC v. J. *Scott Eskind, supra* note (Eskind, already barred by the Commission from association with any investment adviser, raised more than $3 million from investors for a purported hedge fund, and simply misappropriated it); *SEC* v. *Sanjay Saxena,* Litigation Release No. 16206 (July 8, 1999) (Saxena, already barred by the Commission from the securities industry, defrauded hedge fund investors of approximately $700,000).

[105] *SEC* v. *Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee, supra* note (defendants raised nearly half a million dollars, the majority of which were simply *misappropriated by Jean Pierre*); *SEC* v. *Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, LLC, supra* note 97 (Chabot raised over $1.2 million for an alleged hedge fund but did not buy any stocks or other securities with the funds, instead using the money for his personal expenses).

[106] Comment Letter of Vantis Capital Management LLC (July 14, 2004) (''Vantis July Letter'') (registered hedge fund adviser stated that the lack of scrutiny of hedge fund advisers has led to the industry attracting ''unsavory characters'').

### 4. Adoption of Compliance Controls

Registration under the Advisers Act will require hedge fund advisers to adopt policies and procedures designed to prevent violation of the Advisers Act, and to designate a chief compliance officer.[108] Hedge fund advisers that have not already done so must develop and implement a compliance infrastructure. We adopted this requirement last year for all advisers registered with us in recognition that advisers have the primary obligation to ensure compliance with the securities laws, and to foster more effective compliance practices.[109] Our examination staff resources are limited, and we cannot be at the office of every adviser at all times. Compliance officers serve as the front line watch for violations of securities laws, and provide protection against conflicts of interests.

Comment letters opposing registration of hedge fund advisers did not challenge the benefits of compliance programs; rather, they complained of the costs of developing a compliance infrastructure, and of submitting to our compliance examinations.[110] They asserted that these costs would make them less competitive, and would impose barriers to entry preventing new hedge fund advisers from starting their own hedge funds.[111] We acknowledge that development and maintenance of compliance controls involves costs,[112]

[107] We acknowledge that many new sponsors of hedge funds may not have $25 million of assets under management and thus may not be required to register with us. See section 203A(a)(1) of the Act [15 U.S. 80b-3a(a)(1)] (prohibiting certain advisers having less than $25 million from registering with the Commission). It is likely that if we adopt this rule, many prospective investors may insist that newly-formed hedge fund advisers be registered with the Commission. These advisers will apply for registration pursuant to our rule 203A–2(d) [17 CFR 275.203A–2(d)], which permits an adviser with less than $25 million of assets under management to register with us if the adviser has a reasonable expectation that it will be eligible to register within 120 days.

[108] Rule 206(4)–7 [17 CFR 275.206(4)–7].

[109] *See Compliance Programs of Investment Companies and Investment Advisers,* Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)].

[110] *See, e.g.,* MFA Letter, *supra* note 51; Madison Capital Letter, *supra* note 51; Sidley Austin Letter, *supra* note 51.

[111] *See* Comment Letter of Seward & Kissel LLP (Sept. 15, 2004) (''Seward & Kissel Letter''); Comment Letter of Bryan Cave LLP (Aug. 16, 2004) (''Bryan Cave Letter'').

[112] In the Proposing Release, we estimated that the new registrants would need to spend $20,000 in professional fees and $25,000 in internal costs, including staff time, to develop the compliance infrastructure required of a registered investment adviser. These estimates were based on our

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but these are costs that today all advisers registered with us must bear, including advisers that are much smaller and have substantially fewer resources than many hedge fund advisers.[113]

Our 2003 Staff Hedge Fund Report noted that, while many unregistered hedge fund managers had strong compliance controls, others had very informal procedures that appeared to be inadequate for the amount of assets under their management.[114] These lack of controls concern not only us, but also hedge fund investors. A recent survey of institutional investors reported that the adequacy of operational controls at hedge fund advisory firms was one of most frequently mentioned concerns.[115] While these investors can request to see a hedge fund manager's compliance policies and procedures, we are in a position to determine whether the hedge fund adviser's operations seem to be in accordance with those policies and procedures.

Application of our recent rule requiring more formalized compliance policies administered by an employee designated as a chief compliance officer will serve to better protect hedge fund investors.[116] We also believe it will well serve hedge fund advisers that, for business reasons alone, should have a compliance infrastructure commensurate with the nature of their operations and the risks involved.[117] These costs appear small relative to the scale of the industry.[118] The typical hedge fund fee structure, which involves both a management fee of two percent or more and a performance fee of twenty percent or more provides hedge fund advisers with a substantial cash flow.[119] Today there are many investment advisers registered with us that manage a comparable amount of assets, charge substantially lower fees, and bear these same compliance costs. One recent study estimated that ''in 1999, with $450 billion in assets under management, hedge funds'' fee revenues were higher than those of the whole U.S. equity mutual fund industry.'' [120]

There are today ''[e]xtremely low barriers to entry and tremendous monetary and non-monetary incentives for hedge fund [advisers],'' [121] and thus the cost of compliance with these rules should not present significant additional barriers to entry for new hedge fund advisers. Indeed some have suggested that our regulatory initiative may ''play a positive role of increasing confidence in hedge fund use by further demystifying them.'' [122]

5. Limitation on Retailization

Registration under the Advisers Act will have the salutary effect of resulting in all direct investors in most hedge funds meeting minimum standards of rule 205–3 under the Advisers Act, because hedge fund advisers typically charge performance fees.[123] Rule 205–3 requires that each investor, in a private investment company that pays a performance fee, generally have a net worth of at least $1.5 million or have at least $750,000 of assets under management with the adviser.[124] Many hedge fund advisers will rely on rule 205–3 to continue charging a performance fee to the funds they manage.

Most commenters did not address this effect of registration under the Act, except with respect to expressing their support for the transitional rule we also proposed, and which we discuss later in this Release.[125] Some argued that we should, instead, raise the ''accredited investor'' standards applicable to private offerings pursuant to Regulation D, which may have a similar effect on limiting direct investments in hedge funds.[126] Raising the accredited investor standards would not address the broader concerns, discussed above, of the indirect exposure to hedge funds by an increasingly large number of persons who are beneficiaries of pensions plans or invest through other intermediaries that are likely to meet any higher standards.

6. CFTC Regulation

Several commenters suggested that the Commission exempt from registration hedge fund advisers that are registered with the CFTC as commodity pool operators in order to avoid duplicative registration.[127] In 2000 Congress addressed this concern by adding section 203(b)(6) to the Advisers Act, which exempts any CFTC-registered commodity trading advisor from investment adviser registration if its business does not consist primarily

discussions with industry, including attorneys whose practice involved counseling registered and unregistered investment advisers. Commenters argued that their costs would be higher. We discuss the benefits and costs of our rulemaking in Section IV. of this Release.

[113] *See* ICAA Letter, *supra* note 47. As of September 30, 2004, of the 8,535 advisers registered with the Commission, 2,758 reported on their Form ADV that they were managing less than $50 million in client assets.

[114] *See* 2003 Staff Hedge Fund Report, *supra* note 18 at section VII.A.1.b.

[115] BONY Report, *supra* note 39, at 15–16.

[116] Rule 206(4)–7. Hedge fund advisers have substantial conflicts of interest, both with their hedge funds and with their investors. These conflicts arise from management strategies, fee structures, use of fund brokerage and other aspects of hedge fund management.

[117] One hedge fund adviser agreed: ''Benefits [of registration] include * * * the structure it provides for advisers'' policies and procedures, the value of having an additional layer of oversight of advisers' compliance programs.'' Vantis August Letter, *supra* note 50.

[118] In concluding that registration would impose substantial burdens on a hedge fund adviser, several commenters mistakenly assumed that compliance with rule 206(4)–7(c) would require them to hire a new chief compliance officer. The rule requires all registered advisers to ''designate'' an individual as chief compliance officer, which could be an individual currently employed by the adviser who has similar responsibilities.

[119] Some hedge fund advisers charge up to four percent in asset-based fees, and others take between 30 and 50 percent of their funds' profits. *See Hedge Funds Grab More In Fees As Their Popularity Increases, supra* note 11.

[120] *See* Bernstein 2003 Report, *supra* note 24, at 4.

[121] *Id.* at 15. *See also* Vantis July Letter, supra note 106 (''there are presently too few barriers to entry'' in the hedge fund industry).

[122] Bernstein 2003 Report, *supra note* 24, at 14. Regulatory oversight to deter frauds may forestall erosion of investor confidence in this growing industry. *See, e.g.*, Vantis July Letter, supra note 106 (mandatory registration will improve the image of the hedge fund industry); Hennessee Foundation and Endowment Survey, supra note 39 (survey participant remark that registration ''lends creditability to the field''); Comment Letter of North American Securities Administrators Association, Inc. (Oct. 18, 2004) (SEC registration will increase investor confidence, thereby benefiting hedge fund advisers).

[123] *See supra* note 119.

[124] Hedge funds in the United States are generally organized to avoid regulation under the Investment Company Act by qualifying for an exclusion, from the definition of ''investment company,'' under section 3(c)(1) [15 U.S.C. 80a–3(c)(1)] or 3(c)(7) [15 U.S.C. 80a–3(c)(7)] of that Act. There are no performance fee restrictions on 3(c)(7) funds, but each investor in the fund must be a ''qualified purchaser,'' which for natural persons generally means having investments of at least $5 million. See section 2(a)(51) of the Investment Company Act [15 U.S.C. 80a–2(a)(51)]. Rule 205–3 requires advisers to 3(c)(1) funds to consider each investor in the fund as a client for purposes of charging a performance fee.

[125] *See infra* Section II.H of this Release.

[126] Regulation D [17 CFR 230.501 through 508] exempts from registration under the Securities Act of 1933 offerings and sales of securities that satisfy certain conditions, including certain sales to ''accredited investors.'' As noted in the 2003 Staff Hedge Fund Report, *supra* note 18, at 313, our approach of leaving eligibility requirements for accredited investors unchanged also allows small businesses to continue to seek capital from historical sources.

[127] Comment Letter of Denali Asset Management LLLP (Aug. 27, 2004) (''Denali Letter''); Comment Letter of Willkie Farr & Gallagher LLP (Sept. 13, 2004) (''Willkie Farr Letter''); Comment Letter of National Futures Association (Sept. 14, 2004) (''NFA Letter''); ICAA Letter, *supra* note 47; Comment Letter of Katten Muchin Zavis Rosenman (Sept. 14, 2004) (''Katten Muchin Letter''); Tudor Letter, *supra* note 53; Financial Services Roundtable Letter, *supra* note 53; Jeffrey R. Neufeld (Sept. 15, 2004) (''Neufeld Letter''); Kynikos Letter, *supra* note 80; Comment Letter of the Association of the Bar of the City of New York Committee on Futures Regulation (Sept. 15, 2004) (''NYC Bar Futures Committee Letter''); Comment Letter of the U.S. Commodity Futures Trading Commission (Oct. 22, 2004) (''CFTC Letter'').

of acting as an investment adviser.[128] A hedge fund adviser that qualifies for this statutory exemption is not required to register with us.

We disagree that our oversight of hedge fund advisers that are also commodity pool operators would be duplicative. Most hedge fund portfolios consist primarily of securities, and the CFTC's oversight necessarily focuses more on the area of futures trading, which is the activity of most concern to the CFTC.[129] It would be inconsistent with principles of functional regulation and contrary to the design and purpose of the 2000 amendments to the Advisers Act for the Commission not to oversee hedge fund advisers whose primary business is acting as an investment adviser.[130]

7. Moral Hazard Implications

Some commenters urged us not to adopt the rule because Commission oversight of hedge fund advisers might tend to cause hedge fund investors to rely on that oversight instead of performing appropriate due diligence before making an investment in a hedge fund.[131] Such an argument, if accepted, would support withdrawal of the Commission's oversight of all advisers, particularly of those advisers whose clients are less sophisticated and who might be less likely to appreciate the limitations of regulatory oversight.[132] Congress addressed such arguments in 1940 when it passed the Advisers Act by including a provision in the Act that makes it unlawful for any investment adviser to ''represent or imply in any manner whatsoever that [the adviser] has been sponsored, recommended, or approved, or that his abilities or qualifications have in any respect been passed upon by the United States or any agency or officer thereof.'' [133]

8. Proper Administration of the Advisers Act

In adopting rule 203(b)(3)–2, an important consideration for us has been our dissatisfaction with the operation of the existing safe harbor because it permits advisers, without registering under the Act, to manage large amounts of securities indirectly through hedge funds that may have, collectively, hundreds of investors.[134] We believe that the safe harbor has become inconsistent with the underlying purpose of the registration exemption in Section 203(b)(3), which was designed to exempt advisers whose business activities are too limited to warrant federal attention. Commenters have not persuaded us otherwise. Our actions today withdraw that safe harbor and require advisers to ''private funds''—which will include most hedge funds—to ''look through'' the funds to count the number of investors as ''clients'' for purposes of the private adviser exemption.

Many commenters who opposed the rule urged us to maintain the safe harbor because it operated to exempt advisers to hedge funds in which only wealthy and sophisticated investors participated.[135] This argument implicitly concedes that the Commission should look to the investors in the hedge fund (rather than the hedge fund itself) to determine whether the adviser should be required to register, but concludes that we should continue to exempt the adviser from registration because the ultimate advisory clients are wealthy or sophisticated.

Section 203(b)(3) was not intended to exempt advisers to wealthy or sophisticated clients. First, they were the primary clients of many advisers in 1940 when the provision was included in the Act.[136] Second, it would make no sense for Congress to have imposed a limit on the number of wealthy or sophisticated clients an adviser could have before it had to register under the Act. Surely, the fifteenth wealthy or sophisticated client would not trigger the need for registration. Other

[128] 15 U.S.C. 80b–203(b)(6). Congress enacted section 203(b)(6) as part of the Commodity Futures Modernization Act of 2000, Pub. L. 106–554, 114 Stat. 2763 (2000) (codified in scattered sections of the United States Code). A parallel provision was added simultaneously to the Commodity Exchange Act. Section 4m of the Commodity Exchange Act [7 U.S.C. 6m]. The exemption in section 203(b)(6) is not available if the firm acts as an adviser to a registered investment company or to a company that has elected to be a business development company under section 54 of the Investment Company Act [15 U.S.C. 80a–53].

[129] Roundtable Transcript of May 15 at 236–37, *supra* note (statement of Jane Thorpe that ''NFA certainly has the ability to go in and inspect vehicles that may not directly be trading in futures but based on a risk-based approach is going to focus on those areas that obviously it has the most and we have the most interest in'').

[130] We note that the frequency with which hedge fund advisers may also be registered with the CFTC as commodity pool operators (''CPOs'') may diminish substantially in the future. The CFTC recently adopted rules that may permit most hedge fund advisers to now avoid registering as CPOs or commodity trading advisors (''CTAs''). *See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors; Past Performance Issues* (Aug. 1, 2003) [68 FR 47221 (Aug. 8, 2003)] (''CFTC 2003 Exemptive Release'') (adopting new rule 4.13(a)(3), which exempts CPOs from registration if the pool is sold only to accredited investors and engages in limited trading of commodity interests, new rule 4.13(a)(4), which exempts CPOs from registration if the pool is offered only to persons reasonably believed to be ''qualified eligible persons,'' and new rule 4.14(a)(10), which exempts CTAs who during the preceding 12 months provide advice to fewer than 15 legal entities). *See also* Susan Ervin, *Downsizing Commodity Pool Regulation: The CFTC's New Initiative,* Futures Industry, May/June 2003 (The CFTC has embarked upon a fundamental change in its regulatory program, which would free very sizable portions of the industry from CFTC regulation. Many new entrants would not need to register with the CFTC and many currently registered persons may elect to withdraw from registration.). We expect our staff will consult with the staff of the CFTC to discuss a variety of matters regarding examinations of hedge fund advisers, including the extent to which examinations should be coordinated or results shared.

[131] We note, however, that without the new rule requiring registration, a hedge fund adviser can now choose to register under the Advisers Act but then withdraw its registration, for example, at the prospect of an examination. Thus, without the new rule, any moral hazard would already exist, but without necessarily providing hedge fund investors the benefit of our oversight of their advisers.

[132] *See, e.g.*, 1940 Senate Hearings, supra note (testimony of Dwight C. Rose, President, Investment Counsel Association of America, (''Many incompetents would be permitted to register and describe themselves as registered or licensed investment counsel. This badge of registration and apparent approval by the Federal Government might, therefore, in spite of any express provision denying such approval in the act itself, give to the unsophisticated investor a mistaken and completely underserved impression of qualification and standing.'')). Indeed, such an argument could be made against Commission regulation of any broker-dealer, transfer agent, or investment company.

[133] Section 208(a) of the Act [15 U.S.C. 80b–8(a)]. A registered adviser may refer to itself as ''registered'' so long as the effect of registration is not misrepresented. Section 208(b) [15 U.S.C. 80b–8(b)].

[134] Practically speaking, a single hedge fund can have up to 499 investors; beyond this limit, the fund faces potential obligations to register under section 12 of the Exchange Act [15 U.S.C. 78h] and rule 12g–1 [17 CFR 240.12g–1], generally requiring registration of any issue with 500 holders of record of a class of equity securities and assets in excess of $10 million. Since rule 203(b)(3)–1 has generally allowed an adviser to count each hedge fund as one client, a hedge fund adviser could have 14 funds with 499 investors in each, or a total of 6,986 investors.

[135] *See, e.g.*, Chamber of Commerce Letter, *supra* note 52; MFA Letter, *supra* note 51. Opponents of the Advisers Act made this same argument to Congress in 1940 without success. *See, e.g.*, 1940 Senate Hearings, *supra* note (testimony of Charles O'Hearn, Clarke, Sinsabaugh & Co., (''Regulation of this profession by the Securities and Exchange Commission is not necessary for the protection of small, uninformed investors, since they do not use investment counsel service. There is a marked difference between the owners of investment trust securities and our clients. While investment trusts sell securities in amounts sufficiently small so that even the poorest may buy, our services are designed for and limited to a group of persons who are a minority in the community. We do not deal with the general public. Our clients represent substantial amounts of capital and have adequate means to inform themselves about us through their banking and legal affiliations.'')).

[136] The Commission's 1939 Investment Trust Study to Congress, which preceded enactment of the Advisers Act, found that the average size of individual clients' accounts managed by advisers surveyed in 1936 was $281,000, which equals $3.8 million in today's value. Individual clients represented about 83 percent of these advisers' client base. *See* SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76th Cong., 1st Sess., pt. 2 at 8–9 (1940).

provisions in the federal securities laws designed to exempt transactions or relationships with wealthy or sophisticated investors contain no such limitations.[137]

The intent of Congress in enacting section 203(b)(3) appears to have been to create a limited exemption for advisers whose activities were not national in scope [138] and who provided advice to only a small number of clients, many of whom are likely to be friends and family members.[139] These advisers are unlikely to significantly affect investors and the securities markets generally.[140] While provisions of the Securities Act (and its rules) provide exemptions from registration under that Act for securities transactions with persons, including institutions, that have such knowledge and experience that they are considered capable of fending for themselves and thus do not need the protections of the applicable registration provisions,[141] the Advisers Act does not. When a client—even one who is highly sophisticated in financial matters—seeks the services of an investment adviser, he acknowledges he needs the assistance of an expert. The client may be unfamiliar with investing or the type of strategy employed by the adviser, or may simply not have the time to manage his financial affairs. The Advisers Act is intended to protect all types of investors who have entrusted their assets to a professional investment adviser.

Several commenters opposing the rule pointed to legislation enacted in 1996 that created a new exclusion from the definition of ''investment company'' under the Investment Company Act for pools of securities offered exclusively to ''qualified purchasers'' as evidence that Congress intended that hedge fund advisers be left unregulated by the Advisers Act as well as the Investment Company Act.[142] These commenters offered no support for this proposition.

The 1996 National Securities Markets Improvement Act (NSMIA) exempted these qualified purchaser funds from *only* the Investment Company Act.[143] Its legislative history explains only that Congress believed the protections afforded by the Investment Company Act were unnecessary for financially sophisticated investors.[144] Moreover, the current safe harbor, which can result in hedge fund advisers with hundreds of millions of dollars of assets being registered with one or more state regulators, is inconsistent with the policy and purposes of NSMIA, which allocated oversight responsibility for larger advisers to the Commission.[145]

The legislative record of NSMIA, in fact, suggests that Congress may have expected the Commission to regulate the activities of advisers to hedge funds eligible for the new Investment Company Act exclusion. NSMIA amended section 205 of the Advisers Act to exempt qualified purchaser funds from restrictions on performance fees. Section 205 of the Act does not apply to advisers ''exempt from registration pursuant to Section 203(b),'' and thus affects *only* funds advised by investment advisers registered with the Commission. Thus, Congress understood that at least some of these qualified purchaser pools would be advised by registered advisers, and chose to exempt these advisers only from the restrictions on performance fees.

9. Alternatives Submitted

Several commenters submitted alternative approaches for our consideration. These alternatives included provisions aimed at addressing several of the considerations that led us to propose rule 203(b)(3)–2, such as the need for information about hedge fund advisers and the broadening exposure of investors to hedge funds. We have considered these alternatives. However, as discussed below, the alternatives each involve partial responses to our concerns, and all would deny us the ability to examine the activities of hedge fund advisers, and would not, in our judgment, accomplish the goals of this rulemaking.

Some commenters suggested we except hedge fund advisers from the adviser registration requirement if all investors in their hedge funds meet ''qualified purchaser'' standards under section 3(c)(7) of the Investment Company Act.[146] Others suggested that in lieu of requiring hedge fund adviser registration, we should increase the current ''accredited investor'' standards for private securities offerings under Regulation D.[147] These alternatives would address one aspect of our concern about the prospect of direct ownership of hedge funds by investors who may not previously have participated in these types of risky investments, but would not permit us to protect the interests of those whose exposure is through intermediaries such as funds of funds and pension funds.[148] Moreover, as discussed earlier, the Advisers Act does not exempt an adviser from registration merely because its clients may be wealthy or sophisticated.[149]

Other commenters offered alternatives based on amending our Form D to

[137] *See, e.g.*, section 3(c)(7) [15 U.S.C. 80a–3(c)(7)] of the Investment Company Act.

[138] *See* section 201 of the Act [15 U.S. 80b–1] (activities of investment advisers are of national concern because they substantially affect national securities exchanges and the national economy).

[139] The legislative history of section 3(c)(1) of the Investment Company Act of 1940 [15 U.S.C. 80a–3(c)(1)], a parallel section to section 203(b)(3) that was enacted at the same time, reflects Congress' view that privately placed investment companies, owned by a limited number of investors likely to be drawn from persons with personal, familial, or similar ties, do not rise to the level of federal interest. *See* 1940 Senate Hearings, *supra* note 73.

[140] *See* section 201 of the Act.

[141] *See, e.g.*, sections 4(2) and 4(6) of the Securities Act of 1933 [15 U.S.C. 77d(2) and 77d(6)] and Regulation D and rule 144A [17 CFR 230.144A]; *SEC* v. *Ralston Purina Co.*, 346 U.S. 119 (1953).

[142] *See, e.g.*, Comment Letter of Wilmer Cutler Pickering Hale and Dorr LLP (Sept. 8, 2004) (''Wilmer Cutler Letter'').

[143] Pub L. No. 104–290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

[144] S.Rep. No. 104–293, at 10 (1996).

[145] Title III of NSMIA amended the Advisers Act to allocate regulatory responsibility over advisers between the Commission and state securities authorities. It gave the Commission responsibility for advisers with more than $25 million of assets under management, and preempted state registration and other requirements for advisers registered with the Commission. These are firms that Congress concluded were ''[l]arger advisers, with national businesses [that] should be registered with the Commission and be subject to national rules.'' S. Rep. No. 293, 104th Cong., 2d Sess. (1996) at 3–4.

[146] *See, e.g.*, Financial Services Roundtable Letter, *supra* note 53; Tudor Letter, *supra* note 53. Another commenter suggested that the investments of the hedge fund adviser's insiders be excluded in applying the registration requirements. Comment Letter of Alex M. Paul (July 21, 2004). We are adopting a provision that allows an adviser to exclude certain knowledgeable insiders when counting its clients. *See infra* Section II.D.2 of this Release.

[147] *See, e.g.*, Chamber of Commerce Letter, *supra* note 52; Neufeld Letter, *supra* note 127 (increase accreditation standards, with exemptions for family members of advisory firms' employees). *See also* MFA Letter, *supra* note 51 (suggesting creation of investor accreditation standards under the Advisers Act for hedge fund investors).

[148] Other commenters suggested variations with special rules for funds of funds or pension plans. Regardless of the extent to which these alternatives might limit indirect participation in hedge funds advised by unregistered advisers, these alternatives would not permit us to examine unregistered hedge fund advisers. *See, e.g.*, Bryan Cave Letter, *supra* note 111 (apply investor accreditation standards to funds of funds on a look-through basis); Comment Letter of Leon M. Metzger (Sept. 15, 2004) (''Metzger Letter'') (require fund of funds whose investors do not meet accreditation standards to invest only in funds with registered advisers; coordinate with Department of Labor to prohibit pension fund investments in hedge funds with unregistered advisers); Madison Capital Letter, *supra* note 51 (apply the look-through for purposes of counting up to 15 clients, but the only investors that would be counted towards the limit would be (i) investors that did not meet 3(c)(7) ''qualified purchaser'' standards, (ii) pension funds, and (iii) registered investment companies).

[149] *See supra* Section II.B.8 of this Release.

require hedge funds to provide certain information about their advisers.[150] Some suggested that hedge fund advisers whose funds submitted this information be excepted from adviser registration requirements,[151] while others suggested it be an alternative to registration.[152] Some commenters further suggested that these information requirements be combined with limited application of specific rules that apply only to registered advisers, such as the custody rule or the compliance rule.[153]

[150] Form D [17 CFR 239.500] is the form filed with the Commission by issuers (including many hedge funds) that make private securities offerings in reliance on Regulation D. Other commenters suggested informational filing requirements but did not focus on Form D in particular. *See*, *e.g.*, Comment Letter of the American Bar Association Section of Business Law (Sept. 28, 2004) (''ABA Letter''); MFA Letter, *supra* note 51 (informational filing coupled with certification that insiders of the adviser or its funds did not have disciplinary history that would be reportable under Form ADV, and adviser's agreement to provide certain additional information to the Commission on ''special call'' in limited circumstances).

[151] These commenters suggested registration carve-outs apply to hedge fund advisers whose funds submitted the expanded Form D information and accepted investments only from persons meeting ''accredited investor'' or ''qualified client'' criteria. *See*, *e.g.*, Bryan Cave Letter, *supra* note 111; Seward & Kissel Letter, *supra* note 111. Bryan Cave also suggested that hedge funds be covered under revised and expanded Suspicious Activity Reports (''SARs''), and any information reported be shared with the Commission to aid enforcement efforts. The Financial Crimes Enforcement Network requires banks, brokers, and other financial institutions to file SARs if the institution observes suspected or potential financial crimes. We believe this kind of monitoring of hedge funds' financial transactions with third parties would provide us only with partial information about hedge fund advisers' activities.

[152] *See*, *e.g.*, Comment Letter of Coudert Brothers LLP (Sept. 15, 2004) (''Coudert Letter''); Katten Muchin Letter, *supra* note 127.

[153] *See*, *e.g.*, Bryan Cave Letter, *supra* note 111; MFA Letter, *supra* note 51; Kynikos Letter, *supra* note 80. Kynikos suggested that each adviser certify its compliance with the custody, compliance, and code of ethics rules and its adherence to investor qualification standards, as well as provide investors with special disclosures of key valuation and allocation standards, and distribute quarterly unaudited and annual audited financial statements to investors. Other commenters similarly included audit requirements as part of their alternatives. *See, e.g.*, Madison Capital Letter, *supra* note 51 (suggesting annual audit requirement (with results delivered to investors and the Commission) and expanded Form D information reporting); Willkie Farr Letter, *supra* note 127 (suggesting self-executing exemptive application procedure for advisers whose funds distribute audited financials and special valuation disclosures to investors). We have previously requested comment on alternatives that would incorporate private audits into our oversight of investment advisers. *Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2017 (Feb. 5, 2003) [68 FR 7038 (Feb. 11, 2003)]. However, as commenters in that inquiry noted, reliance on auditors can be problematic, since their reviews are not necessarily designed to address all the issues addressed by our oversight program, and audit personnel do not necessarily have an in-depth knowledge of the Advisers Act. *See*, *e.g.*, Comment Letter of the Council of Institutional Investors (April 10, 2003), available at *http://www.sec.gov/rules/proposed/s70303/cii041003.htm.*

None of these alternatives, however, would provide us with examination authority.[154]

Finally, some commenters suggested that, instead of registering hedge fund advisers, we gather information about them from a variety of regulatory filings currently made by hedge funds, their advisers, and broker-dealers.[155] We have considered this alternative, but the reports and information currently available would provide at best a partial, inadequate view of the activities of hedge fund advisers. While some of the reports emphasized by these commenters might provide us with basic identifying information about hedge funds advisers that are registered as broker-dealers or commodity pool operators, many are not registered in either capacity. These commenters also focus on several existing transactional reporting requirements, arguing they contain a wealth of information about hedge funds. However, as discussed above, making use of this information would require substantial effort on the part of our staff to extract a composite of information about any particular hedge fund, yielding limited information about its assets instead of any useful information about whether its adviser is fulfilling its fiduciary duties. As we stated in the Proposing Release, we need information that is reliable, current, and complete, and we need it in a format reasonably susceptible to analysis by our staff.

### *C. Our Legal Authority Under the Advisers Act*

A few commenters challenged our legal authority to adopt rule 203(b)(3)–2, asserting that the approach of the rule, which requires an adviser to ''look through'' a hedge fund to determine whether it is eligible for the private adviser exemption, is contrary to the Act. For the reasons discussed below, we believe we have broad authority to adopt the rule. We start our discussion with the statutory language.

[154] Further, under this alternative, hedge fund advisers could not use Investment Adviser Registration Depository system (''IARD''), the electronic filing system that investment advisers use to make filings with us. Thus, information about investment advisers to hedge funds would not be integrated with information about other investment advisers, it would not be included in the data reports available to our staff, and disciplinary and other important information about hedge fund advisers would not be available to the public through the Investment Adviser Public Disclosure system, which draws data from the IARD.

[155] *See*, *e.g.*, MFA Letter, *supra* note 51; Tudor Letter, *supra* note 53.

Section 203(b)(3) of the Act provides an exemption from registration for certain investment advisers. To qualify for the exemption, Congress provided two specific tests, each of which an adviser must satisfy. First, the adviser must not advise fifteen or more clients and, second, the adviser must not hold itself out to the public as an investment adviser. In enacting this provision, Congress exempted from the registration requirements a category of advisers whose activities were not sufficiently large or national in scope, *e.g.*, advisers to family or friends, to implicate the policy objectives identified in section 201 of the Act.[156]

Congress did not appear to have addressed or considered whether an adviser must count an investor in a pooled investment vehicle as a client for purposes of section 203(b)(3). Nevertheless, it has long been recognized that determining whether the exemption applies could not be limited to a formalistic assessment of whether the adviser provided investment advice to a single legal entity, but instead requires consideration of the surrounding circumstances of the advisory arrangement, which, in appropriate cases, might call for ''looking through'' the advised entity.[157]

For purposes of counting clients, ''looking through'' the advised entity in appropriate circumstances is fully consistent with the broad remedial purposes of the Advisers Act and the exemptive provisions of section

[156] *See also supra* notes 138–140 and accompanying text.

[157] Before the Commission adopted the safe harbor in 1985, the staff issued numerous no-action letters that required an investment adviser to look through an entity and count each individual advisee or member as a separate client. *See Ruth Levine,* SEC Staff No-Action Letter (Dec. 15, 1976); *David Shilling,* SEC Staff No-Action Letter (Apr. 3, 1976); *B.J. Smith,* SEC Staff No-Action Letter (Dec. 25, 1975); *S.S. Program Limited,* SEC Staff No-Action Letter (Oct. 17, 1974); *Wofsey, Rosen, Kweskin & Kuriansky,* SEC Staff No-Action Letter (Apr. 25, 1974); *Hawkeye Bancorporation,* SEC Staff No-Action Letter (June 11, 1971). Ambiguity with respect to this issue was fueled in part by *Abrahamson* v. *Fleschner,* 568 F.2d 862 (2d Cir. 1977), *cert. denied,* 436 U.S. 913 (1978), *overruled on other grounds by TransAmerica Mortgage Advisors, Inc.* v. *Lewis,* 444 U.S. 11 (1979), in which the Second Circuit held that general partners of limited partnerships investing in securities were investment advisers. The Second Circuit originally characterized the individual limited partners as the ''clients'' of the general partner, (1976–77) Fed.Sec.L.Rep. (CCH) ¶ 95,889, at 91,282 n. 16, but later withdrew this characterization, 568 F. 2d at 872 n. 16, leaving unanswered the issue of whether the partnership, or each of the partners, should be ''counted'' as a client. For a discussion, *see* Robert Hacker and Ronald Rotunda, *SEC Registration of Private Investment Partnerships after Abrahamson* v. *Fleschner,* 78 Colum. L. Rev. 1471, 1477 (1978).

203(b)(3).[158] The Act's objectives would be substantially undermined if an adviser with more than fifteen clients could evade its registration obligation through the simple expedient of having those clients invest in a limited partnership or similar fund vehicle—which the adviser would thereafter count as a single client. This concern is amplified where the adviser solicits investments directly in the fund vehicle based on the adviser's investment management skills, and offers investors the ability to redeem their assets on a short-term basis, as they would be permitted to do if they opened an account directly with the adviser.

The legislative and regulatory history of the Advisers Act since its enactment in 1940 is consistent with the understanding that the statute in appropriate cases may require ''looking through'' the entity for purposes of counting clients. Congressional action involving section 203(b)(3), the Commission's rulemaking under the provision, and staff no-action letters [159] evidence the longstanding recognition that the exemption does not require a rigid approach to counting clients without consideration of the surrounding circumstances.

First, the amendment to section 203(b)(3) in 1980 confirmed that the exemption could be read to require an adviser to ''look through'' a legal entity and count its investors. In 1980, Congress amended the section to provide that, in the case of a business development company, ''no shareholder, partner, or beneficial owner * * * shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner or beneficial owner.'' The language of this provision would have been superfluous absent a recognition that, in some cases, a shareholder, partner, or beneficial owner, could be counted for purposes of the exemption. Further, the legislative history indicates that Congress deliberately left open the question of how to count clients for entities other than business development companies.[160]

Second, the Commission's creation of the existing safe harbor in current rule 203(b)(3)–1 would have been entirely unnecessary if there had not been a substantial concern, at that time, that an adviser to a hedge fund might, in some cases, either be required to ''look through'' the fund for counting purposes or to view itself as having violated the ''holding out'' limitation set out in the statutory exemption.

When adopting the safe harbor in 1985, we determined to resolve the uncertainty regarding when advisers to hedge funds must register by expressly exempting them from registration.[161] At that time, when advisers to hedge funds played a far less significant role in the national markets than they do today, we did not consider it inconsistent with the legislative objectives embedded in the statutory exemption to exempt those advisers from registration. However, as we stated when we proposed the safe harbor, ''a different approach could be followed in counting clients.'' [162] In light of the developments regarding hedge funds and their advisers, we are now taking a different approach.

As discussed above, in the intervening two decades and particularly in recent years, much has changed in our capital markets. The growth of hedge funds, their market activity and their trading volume has been dramatic, and as a result they now have a substantial effect on national securities markets and on the national economy. This growth, together with the increase in fraud involving hedge fund advisers, fully justifies a reexamination of whether it is consistent with the Act to continue to provide an across-the-board registration exemption for all advisers to hedge funds. The amendments adopted by the Commission today recognize those changed circumstances and constitute an appropriate use of the Commission's rulemaking authority under the Act.

The Commission has broad rulemaking authority under section 211(a) of the Act, which states that the Commission may adopt rules ''necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title * * *'' and ''may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters.'' [163] Section 206(4) of the Act provides us with authority to adopt rules ''that define, and prescribe means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive or manipulative.'' [164] Once these advisers are registered, the Commission will be able to carry out its regulatory function with respect to them, such as conducting inspections and examinations,[165] and implementing other provisions, discussed elsewhere in this Release, to further investor protection.

The amendments we adopt today implement our rulemaking authority in a manner specifically targeted to those advisers whose activities involving ''private funds'' most directly suggest the need for registration. As discussed in more detail below,[166] first, a private fund will be one that is excepted from the definition of investment company under section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. By definition, these funds engage in significant securities related activities in a context where they deal privately with

[158] In other circumstances, we look through pools to the investors themselves in specifying advisers' obligations under the Advisers Act. *See, e.g.,* rule 205–3(b) (requiring each investor in a private investment company to meet qualified client criteria if the adviser charges the private investment company a performance fee); rule 206(4)–2(a)(3)(iii) (requiring that custody account statements for funds and securities of limited partnerships for which the adviser acts as general partner be delivered to each limited partner). We note, also, that other regulators have required a look-through approach in similar circumstances. Various states look through investment vehicles to count the investors as ''clients'' of the adviser. *See* Comment Letter of North American Securities Administrators Association (Oct. 18, 2004) (''NASAA Letter''). In addition, section 4m(1) of the Commodity Exchange Act [7 U.S.C. 6m(1)] provides an exemption from CTA registration that parallels the exemption in section 203(b)(3) of the Advisers Act, and until recently, the CFTC looked through legal organizations to count owners for purposes of determining whether a person had provided commodity trading advice to more than 15 persons in the preceding 12 months. *See Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors,* (Mar. 10, 2003) [68 FR 12622 (Mar. 17, 2003)] (proposing new rule 4.14(a)(10) to treat legal organizations as single clients).

[159] *See supra* note 157.

[160] *See* H.R. Rep. No. 96–1341, at 62–63 (1980) (''with respect to persons or firms which do not advise business development companies, [this amendment] is not intended to suggest that each shareholder, partner or beneficial owner of a company advised by such a person or firm should or should not be regarded as a client of that person or firm''), and S.Rep. No. 96–958 at 41.

[161] Rule 203(b)(3)–1 Adopting Release, *supra* note 10 (by providing a safe harbor, rule 203(b)(3)–1 will provide greater certainty regarding when advisers can rely on section 203(b)(3)). Commenters did not challenge our authority to withdraw the safe harbor of rule 203(b)(3)–1(a)(2)(i) with respect to private funds.

[162] *Definition of ''Client'' for Purposes Relating to Limited Partnerships,* Investment Advisers Act Release No. 956 (Feb. 25, 1985) [50 FR 8740 (Mar. 5, 1985)] (proposed rule [203(b)(3)–1] is intended to provide investment advisers to limited partnerships with greater certainty in determining the circumstances under which they may rely on section 203(b)(3)).

[163] 15 U.S.C. 80b–11(a). *See also* section 202(a)(17) of the Act [15 U.S.C. 80(b)–2(a)(17)] (''The Commission may by rules and regulations classify, for the purposes of any portion or portions of this title, persons, including employees controlled by an investment adviser.'').

[164] 15 U.S.C. 80b–6(4). The Supreme Court has upheld, in a similar context, our broad authority to prohibit acts not themselves fraudulent in order to prevent fraudulent or manipulative conduct. *See U.S.* v. *O'Hagan,* 521 U.S. 642, 672–73 (1997).

[165] *See* section 204 of the Act [15 U.S.C. 80b–4] (inspection and examination authority).

[166] *See infra* Section II.E of this Release.

each of their investors (since under sections 3(c)(1) and 3(c)(7) they may not engage in a public offering).[167] Second, the term ''private funds'' is limited to investment pools with redemption features that offer investors a short-term right to withdraw their assets from management, based on their individual liquidity needs and other preferences, in a manner similar to clients that directly open an account with an adviser. This condition will ensure that the definition does not inadvertently include private equity funds, venture capital funds, or other funds that require long-term commitment of capital. Third, the term is limited to those funds that are marketed based on the skills, ability, and expertise of the adviser to the fund, thereby confirming the direct link between the adviser's management services and the investors. These investors thus not only expect to receive, but are solicited explicitly on the basis of, the investment management ability of the adviser. Under the definition of private fund, an adviser will only need to look through for purposes of counting clients where some affirmative steps have been taken to make fifteen or more potential clients aware of the ability to obtain the adviser's services through the fund vehicle.[168] Based on this definition of private fund, we believe registration of these advisers will advance the objectives of the Advisers Act.

Some commenters argued that the Commission lacks authority because the new rule and rule amendments contradict the ''unambiguous'' intent of Congress expressed in section 203(b)(3).[169] However, as discussed above, the intent of Congress appears to have been to create a limited exemption for advisers whose activities were not national in scope and who provided advice to family members or friends. Further, since hedge funds did not exist until 1949,[170] it is unclear whether Congress would have viewed a hedge fund or the hedge fund's investors as the client.[171] Moreover, the term ''client'' is not defined in the Act, nor does the word have one clear meaning.[172] To the extent section 203 is unclear, the Commission has authority to interpret an exemption and to adopt a rule that is reasonably related to the statutory purpose.[173] As we have explained above, rule 203(b)(3)–2 is such a rule.[174]

Although Congress in 1940 may not have anticipated the client counting questions that arose from the development of hedge funds and other pooled investment vehicles, by 1960 it clearly anticipated that, in certain cases, enforcement of the Act may require the Commission or courts to ''look through'' legal artifices to address the substance of a transaction or relationship.[175] Section 208(d), added in 1960, made it unlawful for any person ''to indirectly, through or by any other person to do any act or thing which it would be unlawful for such person to do directly under the provisions of this [Act], or any rule or regulation thereunder.'' [176]

Today, an adviser with, for example, 15 clients and $100 million in assets under management can take those client assets, move them into a hedge fund it advises and, because the adviser now has but one client, withdraw its Advisers Act registration.[177] If those clients' assets had been managed similarly or identically (and today in many cases they are),[178] nothing will have changed, except that the clients will have lost the protection of our oversight. Advisers to hedge funds market their services based on the skills, ability and expertise of the persons who will make the fund's investment decisions. Thus, the clients will still rely exclusively on the efforts and skill of the investment adviser, and any new investors will be attracted to the hedge fund as a means to obtain the asset management services of the adviser. The clients will periodically receive reports from the adviser about the hedge fund, and their decisions whether or not to withdraw their assets from the fund will necessarily rely heavily on those reports.[179]

A hedge fund adviser may not treat all of its hedge fund investors the same. Some investors may have greater access to risk and portfolio information,[180]

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[167] *See* sections 3(a) and 3(b) of the Investment Company Act [15 U.S.C. 80a–3(a) and 80a–3(b)].

[168] Although rule 203(b)(3)–1(c) provides that an adviser will not be deemed to be holding itself out generally to the public as an investment adviser solely as a result of participating in a non-public offering of limited partnership interests, there may be circumstances where the marketing activities of a hedge fund adviser go beyond the scope of this safe harbor.

[169] *See, e.g.*, Wilmer Cutler Letter, *supra* note 142. See also Comment Letter of Managed Funds Association (Oct. 12, 2004).

[170] *See Hard Times Come To The Hedge Funds, supra* note 13 at 10.

[171] The original version of section 203(b) in 1940 also exempted from registration any adviser ''whose only clients are investment companies.'' Investment Advisers Act, Section 203(b), Pub. L. No. 76–768, 54 Stat. 847, 850 (1940). This language does not, as some commenters have asserted, undermine the Commission's interpretation of section 203(b)(3) with respect to counting the number of clients in a hedge fund. *See, e.g.*, Wilmer Cutler Letter, *supra* note 142. Even if Congress in 1940 clearly intended, with respect to investment companies, that a legal entity be the client, that does not mean that Congress must have intended the same result with respect to entities—such as hedge funds—that are not investment companies. Moreover, Congress may have included this provision because it believed that, absent an express exemption for investment companies, individual investors might be counted as clients, or may have simply concluded that advisers to entities subject to Title I of the statute they were considering (the Investment Company Act) would not be subject to Title II (the Advisers Act). Title I of the legislation established a new comprehensive scheme for the regulation of investment companies, and Congress may have determined that the investment advisory relationship between an adviser and an investment company would be governed by the new Investment Company Act. *See* 1940 Senate Hearings, *supra* note 73, (statement of Senator Boren (''there is a distinct separation of investment advisers under the two different sections of the bill'')).

[172] Although commenters argue, citing certain dictionaries, that ''client'' has a plain meaning that cannot include passive investors in an entity who are not being advised individually, resort to dictionary definitions is inconclusive. *See* Webster's Unabridged Dictionary (2nd ed. 1934) (''client'' means ''one who consults a legal adviser in order to obtain his professional advice or assistance, *or submits his cause to his management''* (emphasis added.)).

[173] *Chevron U.S.A.* v. *NRDC,* 467 U.S. 837, 843–44 (1984). Because the Commission has the inherent authority to interpret the ambiguous language used in section 203(b)(3), the absence of a specific grant of authority in the Advisers Act to define terms (such as is found in the Investment Company Act and other securities statutes) does not limit the scope of our authority. Nor is our authority undermined by the fact that, as explained in the Proposing Release, we are changing our interpretation of the statutory exemption from registration created by section 203(b)(3), as it applies to hedge funds, in light of changed circumstances resulting from the growth of hedge funds. Courts have recognized that agencies have clear authority to change a prior position in light of changed circumstances. *See, e.g., American Trucking Assns., Inc.* v. *Atchison, Topeka & Santa Fe Ry Co., supra* note 59; *United Video Inc.* v. *FCC,* 890 F.2d 1173, 1181–82 (D.C. Cir. 1989).

[174] Some commenters assert that the method for counting clients of a private fund set forth in rule 203(b)(3)–2 would be inconsistent with the Supreme Court's view of the scope of the Advisers Act expressed in *Lowe* v. *SEC,* 472 U.S. 181 (1985). However, *Lowe* involved a different issue and a different statutory provision—the meaning of the exclusion from the definition of investment adviser in section 202(a)(11)(D) for ''the publisher of any bona fide newspaper, news magazine or business of financial publication of general and regular circulation.'' 15 U.S.C. 80b–2(11)(d).

[175] *See supra* note 158.

[176] 15 U.S.C. 80b–8d. Congress added section 208(d) to the Advisers Act in 1960, Investment Advisers Act of 1940, Amendment, Pub. L. 86–750, 54 Stat. 847 (1960).

[177] *See, e.g., SEC* v. *Gary A Smith,* 1995 Lexis 22352 (S.D. Mich. 1995) (adviser persuaded client to place accounts in trusts to try to avoid Advisers Act regulation).

[178] *See Status of Investment Advisory Programs Under the Investment Company Act of 1940,* Investment Company Act Release No. 22579 (Mar. 24, 1997) [62 FR 15098 (Mar. 31, 1997)] (adopting rule providing safe harbor from investment company registration for similarly managed accounts).

[179] Similar factors led the Second Circuit to conclude that limited partners of an investment partnership were clients of the general partner/investment adviser for purposes of section 206 of the Act. *See Abrahamson* v. *Fleschner, supra* note 157, at 869–70.

[180] *See, e.g.*, Roundtable Transcript of May 14 at 171, *supra* note (statement of Robert Bernard, Chief

Continued

different lock-up periods may be provided,[181] and some investors may be able to negotiate lower fees.[182] ''Side pockets,'' in which assets are segregated, may operate to provide different investors with different investment experiences.[183] Thus, today each account of a hedge fund investor may bear many of the characteristics of separate investment accounts, which, of course, must be counted as separate clients for purposes of section 203(b)(3). Our rule closes this loophole.

*D. Rule 203(b)(3)–2*

Rule 203(b)(3)–2 requires investment advisers to count each owner of a ''private fund'' towards the threshold of 14 clients for purposes of determining the availability of the private adviser exemption of section 203(b)(3) of the Act.[184] As a result, an adviser to a ''private fund,'' which is defined in rule 203(b)(3)–1 and discussed below, can no longer rely on the private adviser exemption if the adviser, during the course of the preceding twelve months, has advised private funds that had more than fourteen investors.[185] Furthermore, an adviser that advises individual clients directly must count those clients together with the investors in any private fund it advises in determining its total number of clients for purposes of section 203(b)(3).[186] If the total number of individual clients and investors in private funds exceeds fourteen, the adviser is not eligible for the private adviser exemption and must register with us, assuming it meets our minimum requirements for assets under management.

The new rule is designed to amend the method of counting that hedge fund advisers use for purposes of applying the private adviser exemption. It is not intended to alter the duties or obligations owed by an investment adviser to its clients.[187]

1. Minimum Assets Under Management

Rule 203(b)(3)–2 does not alter the minimum amount of assets under management that an investment adviser generally must have in order to register with the Commission. A hedge fund adviser whose principal office and place of business is in the United States cannot (subject to certain exceptions) register with the Commission unless it manages at least $25 million.[188] A hedge fund adviser whose principal office and place of business is outside the United States (an ''offshore adviser'') must register with the Commission if it has more than fourteen clients who are resident in the United States regardless of the amount of assets the adviser has under management. We are not applying the $25 million threshold to offshore advisers, as urged by some commenters,[189] because that threshold is premised on regulation of the unregistered adviser by one or more states in which the adviser has its principal office and place of business.[190]

In determining the amount of assets it has under management, a hedge fund adviser whose principal office and place of business is in the United States must include the total value of securities portfolios in its assets under management. That is, it may not reduce the value of those assets by amounts borrowed to acquire them. An adviser may exclude proprietary assets invested in the fund, and need not include the value of assets attributable to non-U.S. investors.[191]

2. Counting ''Owners''

Rule 203(b)(3)–2 requires investment advisers to count each owner of a private fund towards the threshold of fourteen clients, that is, each shareholder, limited partner, member, or beneficiary of the private fund.[192] In response to suggestions by several commenters we have revised the rule. First, we have added a provision clarifying that an adviser does not have to count itself as a client regardless of the form its ownership in the pool takes.[193] Second, we permit a hedge fund adviser to exclude certain knowledgeable advisory personnel who are ''qualified clients'' (*i.e.*, who are ''insiders'') that may be charged a

of Administration and Finance, RiskMetrics Group) (some investors have the market power to receive full portfolio position disclosure); *id.* at 177–78 (statement of Robert Bernard). *See also* Roundtable Transcript of May 15 at 108–09, *supra* note 17, (statement of Patrick McCarty) (an investor with $25 or $30 million in a fund will have more access than someone investing a small amount).

[181] Ron S. Geffner, *Deals on the Side,* HEDGEFUNDMANAGER, (US East Coast 2005).

[182] *See, e.g.*, Roundtable Transcript of May 14 at 167, *supra* note (statement of David Swensen, Chief Investment Officer, Yale University) (Yale sometimes negotiates ''deal structures'' that differ from the terms set forth in the offering documents); *id.* at 211–12 (same).

[183] *See id.* at 68 (statement of Joel Press, Senior Partner, Ernst & Young). *See also id.* at 56 (statement of Joel Press) (hedge funds may establish separate share classes by type of investor in order to track each investor's return separately). We also note that on June 13, 2002, the Commission issued a Formal Order of Private Investigation in the matter of Investor Protection Implications of Private Investment Fund Growth. In the course of their investigation, our staff reviewed materials that appear to indicate that different investors in a hedge fund may have different investment experiences or may receive different disclosure. Under one limited partnership agreement, for example, limited partners can elect not to participate in the fund's purchase of illiquid assets, which are kept apart from the majority of the fund's assets. Under another limited partnership agreement, as much as 20 percent of the fund's yearly profits, including profits from ''hot issue'' accounts, could be reallocated to certain limited partners. Marketing material for a third hedge fund stated that investors investing over a certain amount in the fund are provided with additional information about the fund's portfolio holdings.

[184] For convenience, we will use the terms ''adviser to a private fund'' and ''hedge fund adviser'' interchangeably. As proposed, rule 203(b)(3)–2 was titled ''definition of client for certain private funds.'' The rule is now titled ''methods for counting clients in certain private funds.'' This change does not alter the substance of the rule but is meant to clarify the rule's scope.

[185] As discussed in Section III of this Release, we are implementing a special transition period for the new rule so that advisers to private funds need not look back for the 12-month period when determining their registration obligations as of the compliance date of the new rule.

[186] Commenters asked us to provide further clarification on how hedge fund advisers should count investors when looking through private funds. Comment Letter of Tannenbaum Helpern Syracuse & Hirschtritt LLP (Sept. 14, 2004) (''Tannenbaum Helpern Letter''). If an adviser manages private funds that have, in the aggregate, more than 14 investors, it must register. Thus, an adviser to two private funds, each of which has eight investors, will need to register. Similarly, an adviser must register if it advises a private fund that has 10 investors, and also manages five other portfolios that are not private funds. For counting purposes, an adviser that is required to count the investors in a private fund need not also count the private fund itself.

[187] We remind advisers, however, that, independent of this new rule, the antifraud provisions of the Advisers Act apply to the adviser's relationship with the fund's limited partners. *See Abrahamson* v. *Fleschner, supra* note 157.

[188] *See* section 203A(a)(1)(A) [15 U.S.C. 80b–3a(a)(1)(A)]. The National Securities Markets Improvement Act of 1996 amended the Advisers Act to divide the responsibility for regulating investment advisers between the Commission and the state securities authorities. Section 203A of the Advisers Act [15 U.S.C. 80b–3a] effects this division by generally prohibiting investment advisers from registering with us unless they have at least $25 million of assets under management or advise a registered investment company, and preempting most state regulatory requirements with respect to SEC-registered advisers. *See* Pub. L. 104–290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

[189] *See* Seward & Kissel Letter, *supra* note 111, Comment Letter of the European Commission (Sept. 15, 2004) (''European Commission Letter''); Comment Letter of the Alternative Investment Management Association Limited (Sept. 15, 2004) (''AIMA Letter''); ABA Letter, *supra* note 150. Seward & Kissel suggested we apply a $100 million threshold to offshore advisers.

[190] Any adviser whose principal office and place of business is in a state that has enacted an investment adviser statute is subject to this statutory minimum. Any investment adviser whose principal office and place of business is outside the United States, or in Wyoming (the only U.S. state that does not have an adviser statute), is not subject to this minimum and must register with us regardless of the amount of assets it manages. See NSMIA Implementing Release, *supra* note 10 at Section II.E.

[191] Instruction 5(b) to Part 1 of Form ADV [17 CFR 279.1]

[192] Rule 203(b)(3)–2(a).

[193] *Id.*

performance fee.[194] An adviser to a private fund may also exclude the value of these insiders' interests in the private fund when calculating the firm's assets under management for purposes of the $25 million registration threshold.[195]

3. Funds of Hedge Funds

Under rule 203(b)(3)–2, a hedge fund adviser whose investors include a fund of funds that is itself a ''private fund'' must apply the general provisions of the new rule, which compel looking through that ''top tier'' private fund and counting its investors as clients for purposes of the private adviser exemption.[196] If the fund of funds is a registered investment company, rule 203(b)(3)–2(b) requires the adviser to an underlying private fund to look through the investment company and to count its investors as clients for purposes of the exemption. Without the look-through requirement, an adviser could provide its services through fourteen or fewer top tier funds and continue to indirectly manage the assets of hundreds or, in the case of registered funds of hedge funds, thousands of investors, without registering or being subject to the Commission's oversight.[197]

4. Offshore Advisers

Some commenters suggested that advisers located offshore [198] be exempted from regulation under the Advisers Act if they are subject to regulation in their home jurisdiction.[199] The Commission has not chosen to take such an approach. The Commission's primary concern when developing regulatory policy that has implications for foreign participants in our markets is to ensure that U.S. investors are protected and that there is a level playing field for all market participants. In this regard, a single set of rules provides greater transparency to investors, who can be confident that they will receive the same level of protection with respect to their investments regardless of the country of origin of their investment adviser. Similarly, a single set of rules assures a level playing field for both U.S. and foreign participants in our markets. Our approach to offshore advisers to offshore funds with U.S. investors, discussed below, represents an accommodation and not a fundamental change of policy in this regard.

Acceptance of home jurisdictional regulatory protections or ''mutual recognition'' may be a compelling alternative for participants in a common regulatory and statutory framework, such as the European Union. However, the absence of such a framework would require us to determine regulatory equivalence of hundreds of potential home jurisdictions. Such an effort would tax our resources. Moreover, regulatory systems that may be equivalent today may diverge in a matter of a few years, thus the evaluation would have to occur on an ongoing basis.[200]

a. Counting Clients of Offshore Advisers

The final rules impose the same counting requirements on offshore advisers to hedge funds as offshore advisers providing advice directly to U.S. clients. Thus, for purposes of eligibility for the private adviser exemption, an offshore hedge fund adviser must look through each private fund it advises, whether or not those funds are also located offshore, and count each investor that is a U.S. resident as a client.[201] An offshore adviser to any hedge fund that, in the course of the preceding twelve months, has more than fourteen investors (or other advisory clients) that are U.S.

[194] Rule 203(b)(3)–2(a). Rule 205–3(d)(1)(iii) under the Advisers Act permits certain knowledgeable personnel of an investment adviser to pay a performance or incentive fee to the adviser without meeting the net worth or invested assets requirements that would otherwise apply. Similarly, rule 3c–5 under the Investment Company Act [17 CFR 270.3c–5] provides that ''knowledgeable employees'' of a private investment pool or of its adviser need not be counted in determining the number of beneficial owners of the pool (for 3(c)(1) pools) or in determining whether all investors in the pool are ''qualified purchasers'' (for 3(c)(7) pools). An adviser could not, however, make a private fund investor a partner in the advisory firm to avoid counting the investor for purposes of the private adviser exemption. *See* section 208(d) of the Advisers Act.

[195] An adviser is permitted, but not required, to include the value of its family and proprietary securities portfolios in calculating its assets under management under Instruction 5.b(1)(a) to Part 1A of Form ADV. A hedge fund adviser may construe the investments of these inside personnel and their families as proprietary or family assets for purposes of calculating its assets under management. This does not, however, alter the fiduciary obligations of the adviser with respect to those accounts.

[196] The new rule does not require the adviser to the underlying fund to receive information as to the identities of the top tier investors, and does not specify when or how often the underlying hedge fund adviser must assess whether the number of investors in the top tier funds exceeds 14. The underlying adviser need not necessarily receive information as to the precise number of the top tier investors, so long as the underlying adviser can determine, on a periodic ongoing basis, its own registration obligations. Although some commenters expressed concern that advisers to funds of funds would face uncertainty as to their registration obligations, we believe it would be exceedingly rare for the top tier funds to have 14 or fewer investors. Most advisers to underlying hedge funds will not be eligible to rely on the private adviser exemption, absent facts and circumstances that provide assurances to the underlying adviser that no more than 14 investors, in the aggregate, are being served.

[197] Commenters suggested that the adviser to an underlying hedge fund be required to look through its top tier funds only under limited circumstances, such as when the top tier fund holds more than ten percent of the underlying fund. *See, e.g.*, Comment Letter of Dechert LLP (Sept. 15, 2004) (''Dechert Letter''), Comment Letter of Davis Polk & Wardwell (Sept. 15, 2004) (''Davis Polk Letter''); ABA Letter, *supra* note 150. Such an approach would, however, permit hedge fund managers to avoid registration simply by providing their services to a multitude of investors through, for example, 12 funds of funds, each of which owned eight percent of the underlying fund.

[198] Whether an adviser is ''offshore'' depends on the location of the adviser's principal office and place of business. *See* rule 203(b)(3)–1(b)(5).

[199] *See, e.g.*, Financial Services Roundtable Letter, *supra* note 53; Tannenbaum Helpern Letter, *supra* note 186. Some commenters raised concerns that regulation under the Advisers Act would conflict with regulations in offshore advisers' home jurisdictions. *See* Financial Services Roundtable Letter, *supra* note 53. According to one law firm's analysis, however, registration under the Advisers Act will have little impact on most non-U.S. hedge fund managers: ''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 affected 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.'' *See* Shearman & Sterling, *SEC Report: Implications of the Growth of Hedge Funds,* Jan. 2004, available in File No. S7–30–04.

[200] So that our oversight of offshore advisers can be conducted effectively and efficiently in light of potential overlap with foreign regimes, we have asked our Division of Investment Management, our Office of Compliance Inspections and Examinations, and our Office of International Affairs to explore ways to obtain and share information with foreign authorities with oversight of hedge advisers that may register with the SEC.

[201] As discussed in Section II.F. of this Release, new rule 203(b)(3)–2 and rule 203(b)(3)–1 are designed to work together. Once the offshore adviser looks through the private fund as required under rule 203(b)(3)–2, rule 203(b)(3)–1(b)(5) provides that only U.S. clients must be counted towards the private adviser exemption.

Commenters asked that, because rule 203(b)(3)–1 speaks only to residents, we provide further guidance on when a client, particularly a client that is not a natural person, should be considered a U.S. client. Several commenters suggested that the Advisers Act should look to the definition of ''U.S. person'' in Regulation S under the Securities Act of 1933. *See* 17 CFR 230.902. Regulation S is designed for use in transactions, not ongoing advisory relationships, and its use in this context raises larger issues that we cannot address in this rulemaking. Until the Commission reconsiders this question, however, we would not object if advisers looked (i) in the case of individuals to their residence, (ii) in the case of corporations and other business entities to their principal office and place of business, (iii) in the case of personal trusts and estates to the rules set out in Regulation S, and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser to the location of the person for whose benefit the account is held.

residents generally must register under the Advisers Act.[202]

At the suggestion of commenters, we are adopting a provision that allows an adviser to a private fund to determine whether an investor is a U.S. client or a non-U.S. client at the time of the investment in the private fund.[203] If an investor is a non-U.S. client at the time of that investment, the adviser may continue to count the investor as a non-U.S. client even if the investor subsequently relocates to the United States.

Several commenters suggested that offshore advisers be required to look through their private funds only if more than 25 percent of the fund was held by U.S. investors.[204] We believe that this suggestion would result in most offshore advisers that serve U.S. investors being exempt from registration, and we are not adopting it.[205]

b. Advisers to Offshore Publicly Offered Funds

The final rule includes an exception to the definition of ''private fund'' for a company that has its principal office and place of business outside the United States, makes a public offering of its securities in a country outside the United States, and is regulated as a public investment company under the laws of the country other than the United States.[206] Absent this provision, advisers to offshore publicly offered mutual funds or closed-end funds might be required to register with us simply because more than fourteen of their investors are now residents in the United States.[207] The exception applies to any type of publicly offered fund, whether in corporate, trust, contractual or other form,[208] so long as the fund is authorized for sale in the same jurisdiction in which it is regulated as a public investment company.[209]

c. Advisers to Offshore Privately Offered Funds

Rule 203(b)(3)–2 limits the extraterritorial application of the Advisers Act that would otherwise occur as a result of the new rule, by providing that an offshore adviser to an offshore private fund may treat the fund (and not the investors) as its client for most purposes under the Act.[210] Because we do not apply most of the substantive provisions of the Act to the non-U.S. clients of an offshore adviser,[211] and because the offshore fund would be a non-U.S. client,[212] the substantive provisions of the Act generally would not apply to the offshore adviser's dealings with the offshore fund.[213]

Commenters supported this aspect of the rule, but also requested that we clarify how we would apply the Advisers Act to offshore advisers relying on it.[214] The offshore adviser will be required (unless eligible for an exemption) to register under the Act[215] and to keep certain books and records as required by our rules,[216] and will

[202] The offshore adviser would not have to register, however, if it were eligible for some other exemption from registration.

[203] Rule 203(b)(3)–1(b)(7). If, however, a non-U.S. investor transfers his interest to a U.S. investor, the adviser should count the transferee as a U.S. client.

[204] Comment Letter of International Bar Association (Sept. 14, 2004) (''International Bar Letter''), ABA Letter, *supra* note 150, AIMA Letter, *supra* note 189.

[205] Commenters pointed out that, because of provisions in the U.S. tax laws, U.S. investors in offshore hedge funds are likely to be tax-exempt investors such as pension and benefit plans subject to the Employee Retirement Income Security Act of 1974 (''ERISA'') [29 U.S.C. 1001 *et seq.*]. Many hedge funds permit no more than 25 percent of the fund's assets to be held by pension plans subject to ERISA in order to prevent the assets of the fund from being deemed ''plan assets'' under ERISA. *See* 29 CFR 2510.3–101 (Department of Labor regulation deems participation by plan investors of 25 percent or more in the unregistered securities of an entity to be significant which would then trigger certain ERISA limitations on the hedge fund). Accordingly, it may be unusual for these funds to have more than 25 percent U.S. ownership.

[206] Rule 203(b)(3)–1(d)(3). Commenters supported this exception.

[207] Section 7(d) of the Investment Company Act [15 U.S.C. 80a–7(d)] generally prohibits a foreign investment company from publicly offering its securities in the United States unless registered with us. That provision does not preclude these foreign investment companies from making private offerings in the United States. *Resale of Restricted Securities,* Investment Company Act Release No. 17452 (Apr. 23, 1990) [55 FR 17933 (Apr. 30, 1990)]. *See also Touche Remnant & Co.,* SEC Staff No-Action Letter (Aug. 27, 1984); *Goodwin, Procter & Hoar,* SEC Staff No-Action Letter (Feb. 28, 1997). Our staff has also provided no-action relief to address circumstances where U.S. persons are shareholders of foreign investment companies as a result of, for example, relocating to the United States. *See, e.g., Investment Funds Institute of Canada,* SEC Staff No-Action Letter (Mar. 4, 1996).

[208] This clarification responds to an issue raised by the European Commission. *See* European Commission Letter, *supra* note 189. Some commenters asked whether all funds listed on an offshore securities exchange were offshore public funds. *See* AIMA Letter, *supra* note 189; Coudert Letter, *supra* note 152. We note that listing criteria in some jurisdictions may be distinct from criteria for public offerings, and we cannot provide guidance in this area at this time. The European Commission also pointed out that some offshore public funds may be authorized for public sale in multiple countries pursuant to harmonized regulations, while others may be sold publicly only in individual countries. A fund would qualify for this exception so long as it is regulated as a public investment company in at least one of the jurisdictions in which it may be offered to the public.

[209] We are aware that, in some jurisdictions, hedge funds may be publicly offered. Such funds would not be public investment companies for purposes of this rule. Whether a particular fund is a public investment company will turn on, among other things, how it is known in those other jurisdictions.

[210] Rule 203(b)(3)–2(c). This provision applies in the case of an adviser whose principal office and place of business is outside the United States, if the fund is organized under the laws of a country other than the United States. The proposal looked instead to the principal office and place of business of the fund, but as one commenter noted, a fund as a passive vehicle typically has no offices. ABA Letter, *supra* note 150.

[211] This policy was first set forth in a staff letter from our Division of Investment Management, in which Division staff stated that they would not recommend to the Commission enforcement action against an offshore fund adviser under such circumstances. *See Uniao de Banco de Brasileiros S.A.,* SEC Staff No-Action Letter (July 28, 1992) (''Unibanco letter'').

[212] It has been estimated that 70 percent of hedge funds are organized offshore. *See* Bernstein 2003 Report, *supra* note at 11.

[213] It is not uncommon for U.S. investors to acquire interests in an offshore hedge fund that has few connections to the United States other than the investors (or the securities in which they invest). The laws governing such a fund would likely be those of the country in which it is organized or those of the country in which the adviser has its principal place of business. U.S. investors in such a fund generally would not have reasons to expect the full protection of the U.S. securities laws. *See Offshore Offers and Sales,* Securities Act Release No. 6863 (Apr. 24, 1990) [55 FR 18306 (May 2, 1990)]. Moreover, as a practical matter, U.S. investors may be precluded from an investment opportunity in offshore funds if their participation resulted in the full application of the Advisers Act and our rules.

[214] Dechert Letter, *supra* note 197, Comment Letter of White & Case LLP (Aug. 31, 2004) (''White & Case Letter''); Comment Letter of Jonathan Baird (Aug. 11, 2004) (''Baird Letter''); ICI Letter, *supra* note 48; Tannenbaum Helpern Letter, *supra* note 186, European Commission Letter, *supra* note 189, Davis Polk Letter, *supra* note 197, AIMA Letter, *supra* note 189; Comment Letter of the Association of the Bar of the City of New York Committee on Private Investment Funds (Sept. 15, 2004) (''NYC Bar Private Funds Letter''); ABA Letter, *supra* note 150.

[215] One commenter asked whether we would view it as misleading for an offshore adviser to represent itself as registered with the Commission under the Advisers Act, given that it is not required under the rule to comply with many provisions of the Act with respect to its offshore clients. NYC Bar Private Funds Letter, *supra* note 214. We note that offshore advisers seeking no-action relief from our staff have undertaken not to represent themselves to offshore clients as registered with us. *E.g., Royal Bank of Canada,* SEC Staff No-Action Letter (June 3, 1998). We are not, at this time, prohibiting offshore advisers from representing themselves as SEC-registered advisers, but we remind them that they remain subject to the Act's antifraud provisions and that substantial clarification and disclosure may be necessary to make the representation not misleading.

[216] Our staff has provided guidance, in a series of no-action letters, regarding the recordkeeping obligations of registered advisers that are located offshore. Under that analysis, the registered adviser must, in order to rely on the no-action relief, comply with our recordkeeping rules, other than (1) rules 204–2(a)(3) and (7) with respect to transactions involving offshore clients that do not relate to advisory services performed by the registered adviser on behalf of United States clients or related securities transactions; and (2) rules 204–2(a)(8), (9), (10), (11), (14), (15) and (16) and 204–2(b) with respect to transactions involving, or representations or disclosures made to, offshore clients. *See, e.g., Royal Bank of Canada, supra* note 215. In the context of rule 203(b)(3)–2, an offshore

remain subject to examinations by our staff.[217] Other requirements, including the Act's compliance rule,[218] custody rule,[219] and proxy voting rule,[220] would not apply to the registered offshore adviser, assuming it has no U.S. clients other than for counting purposes under the private adviser exemption.[221] The registered offshore adviser without U.S. clients (other than for counting purposes) will not be required to adopt a code of ethics but must retain its access persons' personal securities reports that would otherwise be required under such a code.[222]

*E. Definition of ''Private Fund''*

Because our concern is focused on hedge fund advisers and their oversight, we did not propose to require advisers to ''look through'' every business or other legal organization they advised for purposes of determining the availability of the ''private adviser'' exemption. Our proposal included a definition of ''private fund'' in order to identify those legal organizations that advisers would be required to look through.[223] We proposed to define a ''private fund'' by reference to three characteristics shared by virtually all hedge funds, and that differentiate hedge funds from other pooled investment vehicles such as private equity funds[224] or venture capital funds.[225] In our amendments to rule 203(b)(3)–1, we are adopting the definition substantially as proposed, and we discuss each of the characteristics of a private fund below.

1. Section 3(c)(1) and 3(c)(7)

First, a fund will not be a ''private fund'' unless it is a company that would be subject to regulation under the Investment Company Act but for the exception, from the definition of ''investment company,'' provided in either section 3(c)(1) (a ''3(c)(1) fund'') or section 3(c)(7) (a ''3(c)(7) fund'') of such Act.[226] Thus, advisers are not required to ''look through'' most clients that are business organizations, including insurance companies, broker-dealers, and banks, but are required to look through many types of pooled investment vehicles investing in securities, including hedge funds.[227]

adviser to an offshore private fund would treat the fund as its offshore client for purposes of its recordkeeping requirements.

[217] During an examination, the registered offshore adviser must provide to our staff any and all records required to be kept under our rules as well as any records the adviser keeps under foreign law. *Id.* Section 204 of the Act [15 U.S.C. 80b–4] authorizes us to examine *all records* of any registered adviser.

[218] 17 CFR 275.206(4)–7.

[219] 17 CFR 275.206(4)–2.

[220] 17 CFR 275.206(4)–6.

[221] In addition, we would not require an offshore adviser to deliver a written disclosure brochure to its offshore clients (or to any investors in an offshore private fund it advises) under rule 204–3 [17 CFR 275.204–3], although the adviser does have a fiduciary duty to provide those clients with full and fair disclosure of conflicts of interest. We would not require an offshore adviser's contracts with its offshore clients, including an offshore private fund, to include certain provisions that would otherwise be required by section 205. Moreover, with respect to an offshore fund, an adviser, whether located within or without the United States, is not subject to the prohibition on performance fees contained in section 205; section 205(b)(5) makes that prohibition inapplicable to an advisory contract with a person that is not a resident of the United States. [15 U.S.C. 80b–5]. Thus, a registered adviser can charge performance fees to an offshore fund regardless of whether the fund has U.S. investors. We would not apply section 206(3)'s restrictions to an offshore adviser's principal transactions with offshore clients. [15 U.S.C. 80b–6(3)]. We would also not subject an offshore adviser to our rules governing adviser advertising [17 CFR 275.206(4)–1], or cash solicitations [17 CFR 275.206(4)–3] with respect to offshore clients.

A registered offshore adviser must, of course, comply with all of the Advisers Act and our rules with respect to any U.S. clients it may have.

[222] 17 CFR 275.204A–1.

[223] Our approach to defining the scope of rule 203(b)(3)–2 is similar to that taken recently by the Department of Treasury in defining the scope of its proposed rule requiring ''private investment companies'' to adopt anti-money laundering programs. *See Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies,* Department of the Treasury Release [67 FR 60617 (Sept. 26, 2002)]. Like the Treasury Department, we have tried to keep the definition simple, and provide a ''bright line'' indicator of when an adviser must look through a client that is a legal organization.

[224] Private equity funds concentrate their investments in unregistered (and typically illiquid) securities. They typically are long-term investments providing for liquidation at the end of a term specified in the fund's governing documents. Private equity investors typically commit to invest a certain amount of money with the fund over the life of the fund, and make their contributions in response to ''capital calls'' from the fund's general partner. Private equity funds offer little, if any, opportunity for investors to redeem their investments.

[225] Venture capital funds are generally organized to invest in the start-up or early stages of a company. Venture capital funds have the same features that distinguish private equity funds generally from hedge funds, such as capital contributions over the life of the fund and the long-term nature of the investment. A venture capital fund typically seeks to liquidate its investment once the value of the company increases above the value of the investment.

A few commenters suggested that the rule distinguish hedge funds from other privately offered investment pools on the basis of their investment strategies or portfolio composition. *See, e.g.*, Madison Capital Letter, *supra* note 51. We have not adopted such an approach because we are concerned that it could serve to chill advisers' use of certain investment strategies solely in order to avoid registration under the Advisers Act, and might possibly negatively affect the markets.

[226] Rule 203(b)(3)–1(d)(1)(i). Section 3(c)(1) excepts from the definition of investment company, an issuer the securities (other than short-term paper) of which are beneficially owned by not more than 100 persons and that is not making or proposing to make a public offering of its securities. An issuer that is organized in a country other than the United States is not subject to the 100-investor limitation of section 3(c)(1) with respect to its beneficial owners who are non-U.S. persons. Section 3(c)(7) excepts from the definition of investment company, an issuer the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers and that is not making or proposing to make a public offering of its securities. An issuer that is organized in a country other than the United States is not subject to the qualified purchaser limitation of section 3(c)(7) with respect to its owners who are non-U.S. persons. Under certain conditions, an issuer organized in a country other than the United States may make a private placement in the U.S. in accordance with Regulation D concurrently with an offering in another country in accordance with Regulation S under the Securities Act of 1933 without integrating the two offerings for purposes of determining whether the issuer complies with section 3(c)(1) or 3(c)(7) or has made a public offering in contravention of section 7(d) of the Investment Company Act (prohibiting investment companies organized outside of the United States from making a public offering). *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore,* Securities Act Release No. 7516 (Mar. 23, 1998); *See also Touche Remnant & Co.,* SEC Staff No-Action Letter (Aug. 27, 1984) and *Goodwin, Proctor & Hoar,* SEC Staff No-Action Letter (Feb. 28, 1997) (addressing public offerings for purposes of section 7(d)). *Cf. Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145,* Securities Act Release No. 33–6862 (Apr. 30, 1990), at Section II.F. Our staff's no-action letter, *The France Growth Fund, Inc.,* SEC Staff No-Action Letter (July 15, 2003), is superseded to the extent that it is inconsistent with this Release.

An offshore hedge fund in which U.S. persons invest will ordinarily be a section 3(c)(1) or 3(c)(7) issuer because it makes a private offering (if any) in the U.S., and has 100 or fewer beneficial owners that are U.S. persons or requires all of its owners who are U.S. persons to be qualified purchasers, respectively.

[227] These companies, as opposed to other entities, by definition, engage in significant securities related activities. *See* sections 3(a) and 3(b) of the Investment Company Act. Moreover, 3(c)(1) and 3(c)(7) funds invest in the context in which they deal privately with investors because both provisions require that the fund not engage in a public offering.

Commenters asked whether the rule would require a U.S. adviser to look through an offshore pooled investment vehicle whose investors are all non-U.S. persons. If interests in the pool are offered only to non-U.S. investors, it is unlikely that the pool would be relying on the exceptions in either section 3(c)(1) or section 3(c)(7). If the pool does not rely on one of those exceptions, the pool is not a private fund under the rule, and thus only the pool itself would count as a single client.

Many offshore hedge funds are organized as master-feeder structures in which an offshore adviser organizes a ''master'' fund interests in which are purchased by multiple ''feeder funds.'' The feeder funds seek to achieve their investment objectives solely by investing in the master fund and thus the feeder is a conduit that provides different investors access to the master fund. One feeder fund may be organized as a corporation and offered solely to non-U.S. investors, while another may be organized as a limited partnership in a foreign jurisdiction offering its shares exclusively to more than 14 U.S. investors. *See* Thomas P. Lemke et al, Hedge Funds and Other Private Funds: Regulation and Compliance (2004–05) at 19. The

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Several commenters suggested that the definition of private fund exclude 3(c)(7) funds because investors in a 3(c)(7) fund must all be qualified purchasers and can be presumed to have a certain level of financial sophistication.[228] We have considered these comments but believe such an exclusion would not be consistent with the purpose and scope of the private adviser exemption. As we discussed above, the Advisers Act does not exempt from registration advisers whose clients are all financially sophisticated, and indeed a client's decision to engage a professional adviser acknowledges that the client needs an expert's assistance.[229]

2. Redemption Within Two Years

Second, a company will be a private fund only if it permits investors to redeem their interests in the fund within two years of purchasing them.[230] The provision applies to each interest purchased or amount of capital contributed to the fund.[231] Hedge funds typically offer their investors liquidity access[232] following an initial ''lock-up'' period, which is typically for less than two years.[233] Thus, this provision will include most hedge fund advisers, but will exclude advisers that manage only private equity funds, venture capital funds, and similar funds that require investors to make long-term commitments of capital.[234] These other funds are similar to hedge funds in some respects, but the Commission has not encountered significant enforcement problems with advisers with respect to their management of private equity or venture capital funds. In contrast, the Commission has developed a substantial record of frauds associated with hedge funds. A key element of hedge fund advisers' fraud in most of our recent enforcement cases has been the advisers' misrepresentation of their funds' performance to current investors,[235] which in some cases was used to induce a false sense of security for investors when they might otherwise have exercised their redemption rights.[236] Because hedge funds are where we have seen a recent growth in fraud enforcement actions, we will focus our examination resources on their advisers, rather than on advisers to private equity or venture capital funds, at this time.[237] Most commenters who spoke to the issue supported drawing this distinction between hedge funds, on the one hand, and private equity and venture capital funds, on the other.[238]

The rule permits a fund to offer redemption rights under extraordinary circumstances without being considered a private fund under the rule.[239] Private equity and venture capital funds may offer redemption rights under extraordinary circumstances, and these extraordinary redemptions do not change the basic character of the investment pool into a hedge fund. We are omitting the proposed requirement that such circumstances be ''unforeseeable.'' Commenters suggested that to the extent an investor negotiated for the right to redeem its interest in extraordinary circumstances, the circumstances could be viewed as ''foreseeable.''[240] The redemption test

feeder fund is a private fund under rule 203(b)(3)–1(d); interests in the feeder are sold directly to U.S. investors, and thus the feeder must rely on either section 3(c)(1) or 3(c)(7) to avoid being subject to the Investment Company Act. The adviser to the master fund must look through the master fund as well as the feeder in order to count U.S. investors as clients, so that it is not violating section 208(d) of the Act by doing indirectly through the master what it could not do if it provided its advice directly to the feeder fund. *See* discussion *supra* note 176.

[228] Comment Letter of David Schroll (July 27, 2004) (''Schroll Letter''); Proskauer Letter, *supra* note 51; Comment Letter of Guy Judkowski (July 27, 2004) (''Judkowski Letter''); Seward & Kissel Letter, *supra* note 111; Madison Capital Letter, *supra* note 51; Tudor Letter, *supra* note 53; Davis Polk Letter, *supra* note 197; Financial Services Roundtable Letter, *supra* note 53; Comment Letter of Kleinberg, Kaplan, Wolff & Cohen, P.C. (Sept. 15, 2004) (''Kleinberg Letter'').

[229] *See supra* Section II.B.8 of this Release. Further, Congress chose to not to exempt 3(c)(7) fund advisers from the Advisers Act. An adviser that manages more than fourteen 3(c)(7) funds is required to register and is subject to all provisions of the Advisers Act, yet the investors in those funds are no less sophisticated than other 3(c)(7) fund investors. Also, Congress excepted 3(c)(7) fund advisers from performance fee restrictions under section 205 of the Act, which applies only to advisers who are *not* otherwise exempt from registration under section 203(b). *See* section 205(b)(4) [15 U.S.C. 80b–5(b)(4)].

[230] Rule 203(b)(3)–1(d)(1)(ii). Two commenters suggested we shorten the period while another suggested it be longer. *See* AIMA Letter, *supra* note 189; Seward & Kissel Letter, *supra* note 111; Comment Letter of UnFarallon Coalition (Sept. 14, 2004) (''UnFarallon Letter''). Research has shown that hedge funds' average lock-up period is 12 months. Bernstein 2003 Report, *supra* note 24, at 5. We believe a two-year period, therefore, would include most hedge funds as private funds, and we are adopting a redemption test of two years as proposed.

[231] Funds could use a ''first in, first out'' for determining the age of purchases and capital contributions.

[232] Private funds operate in this respect similarly to an account an investor maintains with an adviser.

[233] Hedge funds generally offer semi-annual, quarterly, or monthly liquidity terms to their investors. Because liquidity is important to hedge fund investors, some hedge fund advisers offer certain investors ''side letter agreements'' to provide shorter liquidity terms than other investors in the same fund may receive. *See* Alexander M. Ineichen, *Funds of Hedge Funds: Industry Overview,* 4 J. Wealth Mgmt. 47 (Mar. 22, 2002); Ron S. Geffner, *Deals on the Side,* HEDGEFUNDMANAGER, U.S. East Coast 2005, at 22–23. An investment pool cannot use side letters to bypass the two-year redemption test. That is, if the pool uses side letters to provide some, but not all, investors the opportunity to redeem shares within two years, the pool would meet the definition of a private fund.

[234] This provision is also designed to prevent certain structured finance vehicles from being included as ''private funds.'' *See, e.g.*, rule 3a–7(a) under the Investment Company Act [17 CFR 270.3a–7(a)] (exemption from Investment Company Act is not available to structured finance vehicle issuing redeemable securities); *see also* Comment Letter of Chapman and Cutler LLP (Sept. 15, 2004) (expressing concerns that some structured finance vehicles would inappropriately be deemed to be private funds).

[235] *See, e.g., SEC* v. *Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee,* Litigation Release No. 17303 (Jan. 10, 2002) and *supra* note 97; *In the Matter of Michael T. Higgins, supra* note 99; *SEC* v. *David M. Mobley, Sr., et al., supra* note 99; *SEC* v. *Michael W. Berger, Manhattan Capital Management Inc., supra* note 99; *SEC* v. *Todd Hansen and Nicholas Lobue,* Litigation Release No. 17299 (Jan. 9, 2002).

[236] We are currently pursuing actions in which we allege hedge fund advisers lulled investors into keeping their assets in the hedge fund. *See, e.g., SEC* v *Anthony P. Postiglione, Jr., et al.*, Litigation Release No. 18824 (Aug. 9, 2004).

[237] Moreover, periodic redemption rights offered by hedge funds provide the hedge fund investors with a level of liquidity that allows the investor to withdraw a portion of his or her assets, controlled by the adviser, or to terminate the relationship with the hedge fund adviser and choose a new adviser. The ability to terminate the relationship with an adviser and choose a new one, or to withdraw a portion of one's investment after a relatively short time period, is consistent with the notion that hedge fund advisers are effectively providing advisory services to the fund's investors. As a result, the redeemability feature of the definition of private fund will promote the purposes of the Act by applying the rule to those relationships that the Act was designed to address.

[238] *E.g.,* NYC Bar Private Funds Letter, *supra* note 214. Some commenters expressed concern that hedge fund advisers would extend their lock-up periods beyond two years in order to avoid registration. *E.g.,* Comment Letter of the Greenwich Roundtable (Sept. 15, 2004). Others felt that the two-year test drew an appropriate line between hedge funds and private equity or venture capital funds. *See* Comment Letter of National Venture Capital Association (Sept. 15, 2004) (''NVCA Letter'') (''As a practical means of exempting venture capital from the proposed rule's definition of 'private fund,' two years is appropriate.''). We will continue to monitor developments regarding this aspect of the new rule and whether it continues effectively to distinguish hedge funds from private equity and venture capital funds.

[239] Rule 203(b)(3)–1(d)(2)(i).

[240] *See* Davis Polk Letter, *supra* note 214, NYC Bar Private Funds Letter, *supra* note 150, ABA Letter, supra note 150. Many partnership agreements provide the investor the opportunity to redeem part or all of its investment, for example, in the event continuing to hold the investment became impractical or illegal, in the event of an owner's death or total disability, in the event key personnel at the fund adviser die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time, in the event of a merger or reorganization of the fund, or in order to avoid a materially adverse tax or regulatory outcome. Similarly, some investment pools may offer redemption rights that can be exercised only in order to keep the pool's assets from being considered ''plan assets'' under ERISA. Offering redemption rights that apply only in these types of circumstances will not make the fund a ''private fund'' under the new rule.

also does not restrict the general partner or investment adviser from initiating distributions payable to all owners, or a class of owners, in accordance with the fund's governing documents.[241] The rule also provides an exception to the two-year redemption test for interests acquired through reinvestment of distributed capital gains or income.[242]

3. Advisory Skills, Ability, or Expertise

Third, a company will be a private fund only if interests in it are offered based on the investment advisory skills, ability or expertise of the investment adviser.[243] As we discussed in the Proposing Release, a hedge fund adviser's history, experience, past performance, strategies, and disciplinary record are likely important to investors, who rely on the adviser for their investment's success, in deciding whether to invest in a particular hedge fund.[244] Accordingly, hedge fund advisers often emphasize the portfolio manager's record when marketing their fund, and provide prospective investors with information about the adviser and individual manager. This reliance by hedge fund investors implicates the need for the protections that Advisers Act registration offers.[245]

*F. Other Amendments to Rule 203(b)(3)–1*

We are amending rule 203(b)(3)–1 to clarify that investment advisers may not count hedge funds as single clients under that safe harbor.[246] As discussed earlier, many hedge fund advisers have avoided Advisers Act registration in the past by relying on paragraph (a)(2)(i) of this rule, which we adopted in 1985 in order to permit advisers to count a legal organization, rather than its owners, as a single client.[247] Advisers to private funds may, however, continue to rely on the other paragraphs of rule 203(b)(3)–1 when determining the number of their clients for purposes of the private client exemption.[248] We have designed new rule 203(b)(3)–2 to be used in conjunction with rule 203(b)(3)–1.[249] The adviser to a private fund must, under rule 203(b)(3)–2, look through the fund to its investors, but may rely on the safe harbor of rule 203(b)(3)–1 to determine whether each investor must count as a separate client or whether a ''single client'' may include more than one investor.[250]

*G. Amendments to Rule 204–2*

We are adopting two amendments to the adviser recordkeeping rule. The first of these amendments permits hedge fund advisers that are required to register with us under new rule 203(b)(3)–2 to market their performance from periods prior to their registration with us, even if they have not kept documentation that our rules would otherwise require.[251] This exception applies not only to the adviser's private funds (as proposed), but also to other accounts.[252] Hedge fund advisers are required to retain whatever records they do have that support the performance they earned prior to their registration with us, but are excused from our recordkeeping rule to the extent that those records are incomplete or otherwise do not meet the requirements of rule 204–2.[253]

[241] These are distributions, as distinguished from redemptions initiated by the investor. Similarly, an investor's transfer of his interest to, for example, a new limited partner in a secondary market transaction will not be considered a redemption.

[242] Proposed rule 203(b)(3)–1(d)(2)(ii). Though we proposed this exception only for interests acquired with reinvested dividends, commenters noted that venture capital and private equity funds are more likely to distribute capital gains than declare dividends.

[243] If interests in an investment pool are offered based on the investment advisory skills, ability or expertise of the pool's investment adviser, then the pool is a private fund and all advisers to the pool, including subadvisers, must look through it to count owners as clients for purposes of the private adviser exemption. Advisers may not circumvent the rule by delegating the advisory function to subadvisers, including subadvisers that might not be identified in the fund's offering materials, or by establishing a ''manager of managers'' structure.

[244] *See also* Roundtable Transcript of May 14 at 167–68, *supra* note 17 (statement of David Swensen, Chief Investment Officer, Yale University) (investor looks for ''the character, the intelligence, the integrity, the creativity, and market savvy'' of the fund adviser, and the most important criterion when making an investment decision is the character and quality of the investment adviser).

[245] This is particularly true when this attribute is combined with the redeemability feature discussed earlier, such that an investment in a hedge fund more closely resembles an advisory account. It is also worth noting in this regard that section 203(b)(3) of the Advisers Act [15 U.S.C. 80b–3(b)(3)] specifically excludes an adviser from relying on the exemption, even if it has fewer than 15 clients, if it holds itself out generally to the public as an investment adviser.

[246] Rule 203(b)(3)–1(b)(6). We are also adopting, as proposed, non-substantive changes to the wording of several other paragraphs of rule 203(b)(3)–1 to clarify those sections.

[247] Rule 203(b)(3)–1(a)(2)(i).

[248] For example, particularly paragraph (a)(1) of rule 203(b)(3)–1 allows a ''single client'' to encompass (i) a natural person, (ii) his or her minor children, (iii) his or her relatives, spouse, and relatives of spouse who share the same principal residence, as well as (iv) any accounts or trusts of which the only primary beneficiaries are the foregoing persons. In addition, if a given individual invests in two private funds advised by the same adviser, that individual need be counted only once towards the 14-client threshold.

[249] Several commenters suggested that new rule 203(b)(3)–2 contain a special provision for limited partnerships owned or controlled primarily by members of a single family. *See* Comment Letter of Paul, Hastings, Janofsky & Walker LLP (Sept. 10, 2004) (''Paul Hastings Letter''); Comment Letter of Skadden, Arps (Sept. 14, 2004) (''Skadden Letter''), Kynikos Letter, *supra* note 80, ABA Letter, *supra* note 150. Others suggested we adopt a provision declaring that interests in family limited partnerships are not offered based on the expertise of the adviser. *See* Davis Polk Letter, supra note 197, Comment Letter of William S. McGinness, Jr. (July 26, 2004). This latter suggestion may be true in some circumstances, but there may be other cases in which, for example, a family group has engaged an outside adviser and interests in the family vehicle are offered to family members based on the expertise of the adviser. We believe that rule 203(b)(3)–1(a)(1) already affords family office advisers considerable flexibility before they reach fifteen clients. We also note that we have granted exemptive relief, on application, to a number of family office advisers. *E.g.*, *Bear Creek Inc.*, Investment Advisers Act Release No. 1931 (Mar. 9, 2001) [66 FR 15150 (Mar. 15, 2001)] (notice); *Moreland Management Co.*, Investment Advisers Act Release No. 1700 (Feb. 12, 1998) [63 FR 8710 (Feb. 20, 1998)] (notice). A further exception for family limited partnerships is outside the scope of this rulemaking.

[250] An adviser to a hedge fund underlying a fund of funds must, as discussed earlier, apply new rule 203(b)(3)–2 to look through the top tier fund and count that fund's investors as clients for purposes of the private adviser exemption. Once the underlying adviser has looked through the layers of private funds, however, it may then apply the provisions of rule 203(b)(3)–1(a)(1) to those investors for counting purposes.

[251] Under rule 204–2(a)(16), a registered investment adviser that makes claims concerning its performance track record must keep ''[a]ll accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser); *provided, however*, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph.'' The supporting records must be retained for a period of five years after the performance information is last used. Rule 204–2(e)(3). Thus, if a registered adviser promotes its 20-year performance record in 2004, it must continue to keep its supporting records for its 1984 performance through 2009—five years after the last time that 1984 performance is included.

[252] Rule 204–2(e)(3)(ii). Commenters pointed out that hedge fund advisers may manage other clients' assets.

[253] Commenters generally supported this transitional exemption for hedge fund advisers' past performance records, in order to avoid placing these new registrants at a competitive disadvantage in promoting the returns they have earned, in some cases over many years. *See* Comment Letter of Cumberland Associates LLC (Sept. 9, 2004) (''Cumberland Letter''), Comment Letter of James E. Mitchell (Sept. 1, 2004) (''Mitchell Letter''), ICAA Letter, *supra* note 47, Davis Polk Letter, *supra* note 197; ABA Letter, *supra* note 150. Three commenters suggested that we require hedge fund advisers to place a legend on any marketing materials that contained performance claims for which the adviser did not maintain all required records. CFA Institute Letter, *supra* note 47; ICAA Letter, *supra* note 47,

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As proposed, the exemption would have covered only the records supporting the performance of the adviser's private funds. Commenters pointed out that a hedge fund adviser may also manage other pools, such as private equity funds. The amendment as we are adopting it applies to records supporting any accounts managed by the hedge fund adviser.[254]

Our second amendment to the recordkeeping rule clarifies that, for purposes of section 204 of the Advisers Act,[255] the books and records of a registered hedge fund adviser include records of the private funds for which the adviser acts as investment adviser and the adviser or a related person[256] acts as general partner, managing member, or in a similar capacity.[257] Our examiners require access to these records to determine whether a hedge fund adviser is meeting its fiduciary obligations to a private fund under the Advisers Act and rules.[258]

*H. Amendments to Rule 205–3*

We are adding grandfathering provisions to rule 205–3 under the Advisers Act, the performance fee rule, to avoid disrupting existing arrangements between newly-registered hedge fund advisers and their current pool investors or separate account clients.[259] Most hedge fund advisers charge a ''performance fee'' based on their fund's capital gains or appreciation. Our rules, however, permit registered investment advisers to charge performance fees only to ''qualified clients.''[260] Unregistered hedge fund advisers have not necessarily required all of their investors to meet this standard.[261] We proposed (and commenters supported) an amendment to rule 205–3 grandfathering the existing equity accounts of hedge fund investors, and allowing these investors to add to their accounts.[262] Commenters noted, however, that our proposal would disrupt performance fee agreements with other types of investment pools or separate accounts sometimes managed by hedge fund advisers.[263] We have revised the coverage of the amendment to permit existing owners in any 3(c)(1) fund to retain their investment and to add to it,[264] and to permit the newly-registered advisers to continue in effect advisory contracts they may have with other clients that are not 3(c)(1) funds.

*I. Amendments to Rule 206(4)–2*

We are amending rule 206(4)–2, the adviser custody rule, to allow additional time for completion of audit work on behalf of advisers to funds of hedge funds that choose to distribute audited fund financial statements to investors under the custody rule.[265] The amendments extend from 120 to 180 days the time within which an adviser to a fund of funds may distribute the fund's audited financial statements. Some advisers to funds of funds are not able to comply with the current 120-day deadline because they cannot obtain completion of their fund audits prior to completion of the audits for the underlying funds in which they invest. To be eligible for the extended deadline, a fund of funds must invest at least ten percent of it assets in other, unrelated, pooled investment vehicles.[266] Commenters strongly supported the amendment, but persuaded us that our proposal to extend the period for all pooled investment vehicles (instead of just funds of funds) would lead to the underlying funds taking advantage of the extension themselves, leaving funds of funds in no better position to comply than they were previously.[267]

*J. Amendments to Rule 222–2 and Rule 203A–3*

This rulemaking is designed to alter the method of counting clients that hedge fund advisers use for purposes of determining their registration

UnFarallon Letter, *supra* note 230. The final rule does not impose such a requirement, but we caution hedge fund advisers that they remain, as they were prior to their registration, subject to the Advisers Act's antifraud provisions with respect to their marketing materials. One commenter opposed the exemption.

[254] Rule 204–2(e)(3)(ii).

[255] Section 204 of the Act [15 U.S.C. 80b–4] generally subjects records of registered investment advisers to examination by the Commission.

[256] We include private funds for which the adviser's related person (as defined in Form ADV) acts as general partner, managing member, or in a similar capacity, because many hedge fund advisers establish a separate special purpose vehicle to be named as the fund's general partner.

[257] Rule 204–2(l). One commenter described this amendment as a ''necessary requirement.'' CFA Institute Letter, *supra* note 47. The rule does not require that the adviser maintain duplicate books and records for the funds, nor that a registered private fund adviser be the party to keep the books and records of the private funds in question. Because the private funds' records will be deemed to be records of the adviser, however, our examination staff will have access to them when they examine the adviser.

[258] The rule applies to related person general partners only when the adviser has an advisory relationship with the fund in question. It does not, as one commenter was concerned, apply to every related general partnership in a large financial complex.

[259] Rule 205–3 permits registered advisers to charge performance fees that would otherwise be prohibited by section 205(a) [15 U.S.C. 80b–5(a)]. Registered advisers are not prohibited from charging performance fees to 3(c)(7) funds, investors in which must all be ''qualified purchasers.'' Section 205(b)(4) [15 U.S.C. 80b–5(b)(4)].

[260] Rule 205–3(a). The adviser to a 3(c)(1) fund must look through the fund to determine whether all investors are qualified clients. *See* rule 205–3(b). A ''qualified client'' under rule 205–3 is: (i) A natural person who or a company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser; (ii) A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either: (A) Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or (B) Is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 [15 U.S.C. 80a–2(a)(51)(A)] at the time the contract is entered into; or (iii) A natural person who immediately prior to entering into the contract is: (A) An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or (B) An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months. Rule 205–3(d)(1).

[261] In the absence of relief, the newly-registered adviser would have to either force the non-qualified client out of the 3(c)(1) fund or restructure its fee so that the non-qualified client is not paying the performance-based component of the fee.

[262] Proposed rule 205–(3)(c)(2) (grandfathering investors in ''private funds'').

[263] NYC Bar Private Funds Letter, *supra* note 214.

[264] One hedge fund adviser suggested that we also allow grandfathered investors to open new accounts in the hedge fund in which they were invested, and two other commenters suggested we also allow grandfathered investors to invest in new funds advised by the same hedge fund adviser. Davis Polk Letter, *supra* note 197, ABA Letter, *supra* note 150. These suggestions go significantly beyond our oxbjective in proposing the grandfathering provision, which was to avoid disrupting existing business arrangements.

[265] An adviser acting as general partner to a pooled investment vehicle it manages, including a hedge fund, has custody of the pool's assets. Rule 206(4)–2(c)(1)(iii). The adviser may satisfy its obligation to deliver custody account information to investors by distributing the pool's audited financial statements to investors. Rule 206(4)–2(b)(3). The current rule gives advisers 120 days from the pool's fiscal year-end to distribute the financial statements. *Id.*

[266] A ''fund of funds'' under the amended rule is any limited partnership (or limited liability company or other type of pooled investment vehicle) that invests at least 10 percent of its total assets in other pooled investment vehicles that are not related persons of the fund of funds, or related persons of the adviser or general partner of the fund of funds. Rule 206(4)–2(c)(4). Where the underlying funds are related to the fund of funds, the fund of funds should have ample opportunity to coordinate its audit with that of the underlying funds.

[267] Dechert Letter, *supra* note 197; Renaissance, Alternative Investment Group Letter, *supra* note 47; Comment Letter of Stroock/Credit Suisse Union Bancaire (Sept. 2, 2004) (''Stroock Letter''); Katten Muchin Letter, *supra* note 127; Van Hedge Letter, *supra* note 45; Coudert Letter, *supra* note 152; Comment Letter of Price Meadows (Sept. 15, 2004) (''Price Meadows Letter''); Comment Letter of Silver Creek (Sept. 15, 2004) (''Silver Creek Letter'').

obligations with us. It is not our intention to amend advisers' method of counting clients for other purposes. Two commenters raised concerns about whether private fund investors must be counted as clients for purposes of applying the national ''de minimis'' standard for state adviser registration.[268] One commenter also questioned whether advisers' supervised persons must count private fund investors as clients for purposes of the definition of ''investment adviser representative'' in rule 203A–3.[269]

To respond to commenters' concerns, we are amending both rules 222–2 and 203A–3 to clarify that advisers and supervised persons may, for purposes of those rules, count clients as provided in rule 203(b)(3)–1 without giving regard to the look through requirements in rule 203(b)(3)–2.[270]

*K. Amendments to Form ADV*

We proposed to amend Form ADV to require advisers to ''private funds'' as defined in the proposed rule to identify themselves as hedge fund advisers, and we are adopting this provision as proposed. One commenter spoke to these changes to say they were essential.[271]

**III. Effective and Compliance Dates**

The effective date of the amendments to rule 206(4)–2 and Form ADV is January 10, 2005. The effective date of new rule 203(b)(3)–2 and amendments to rules 203(b)(3)–1, 203A–3, 204–2, 205–3, and 222–2 is February 10, 2005. Hedge fund advisers may elect to begin complying with the new rule and the rule amendments as of their effective date, but have until February 1, 2006 to come into compliance with rule 203(b)(3)–2 and the amendments to rules 203(b)(3)–1, 203A–3, 204–2, 205–3, 206(4)–2, and 222–2.[272] We are providing hedge fund advisers with this long transition period so that they have time to work through any technical issues as they prepare for registration. Our staff will be available to work with these new registrants on resolving technical questions.

By the compliance date, February 1, 2006, each adviser required to register under the new rule[273] must have its registration effective, and must have in place all policies and procedures required under our rules.[274] Each adviser must also have designated a chief compliance officer.[275] Also by February 1, 2006, advisers must ensure that they are in compliance with our rule for custody of client funds and securities.[276] We expect that most private funds are already subject to an annual audit and that advisers will elect to have the audit results distributed to investors within the appropriate time period under the custody rule. Some advisers, however, may need to either arrange for their private funds to be audited or for quarterly transaction statements to be distributed to the investors in lieu of audit results.

Once their registrations are effective, the new registrants must, of course, comply with the Advisers Act and all of our rules, including provisions applying to registered advisers such as the limitations on performance fees,[277] our books and records requirements,[278] and our rules governing advertising[279] and cash solicitations.[280]

Several commenters asked whether the two-year redemption test under the definition of private fund would apply to investments made prior to the effectiveness of the new rules. Advisers must apply the two-year redemption test to any investments made on or after February 1, 2006, whether those investments are made by new or existing investors, but need not apply this test to investments made prior to the compliance date.

The IARD filing system will incorporate the amendments made to Form ADV on March 8, 2005. Registered advisers amending their Form ADV after the form has incorporated the amendments must respond to Item 7.B of Part 1A as amended[281] and must in any event amend their Form ADV to respond to the revised item by February 1, 2006. By implementing these changes to the IARD system in March of 2005, we will allow most registered advisers to respond to the revised item in conjunction with their regular annual updating amendment, rather than requiring them to file an additional amendment. Implementing this change to the IARD system promptly will also ensure that our staff, as well as members of the investing public, can begin to

[268] The ABA Letter, *supra* note 150, and NYC Bar Private Funds Letter, *supra* note 214, both raised this specific concern. Section 222(d) of the Advisers Act [15 U.S.C. 80b–18a(d)] provides that a state may not require an adviser to register with its state securities authority unless the adviser has a place of business located within the state or has had, during the preceding 12-month period, at least 6 clients who are residents of that state. Rule 222–2 [17 CFR 275.222–2] provides that an adviser may rely on rule 203(b)(3)–1 when counting clients for purposes of the de minimis standard.

[269] 17 CFR 275.203a–3. *See* NYC Bar Private Funds Letter, *supra* note 214.

[270] The amendment makes new rule 203(b)(3)–1(a)(6) inapplicable in the context of rules 203A–3 and 222–2. Because new rule 203(b)(3)–1(a)(6) does not apply, advisers are free to look to rule 203(b)(3)–1(a)(2)(i) with respect to private funds.

[271] CFA Institute Letter, *supra* note 47. Because advisers' responses to Form ADV are made available to the investing public on the Internet through the Investment Adviser Public Disclosure system, one commenter asked that we confirm that hedge fund advisers would not be disqualified from relying on section 4(2) of the Securities Act of 1933 [15 U.S.C. 77d(2)] or on rule 506 [17 CFR 230.506] thereunder, both of which are unavailable in the event of a public offering, solely as a result of the private fund being identified through the IAPD. *See* ABA letter, *supra* note 150. The mere identification of a private fund through the IAPD does not render section 4(2) or rule 506 unavailable. We note that Form ADV already calls for registered advisers to identify the private investment pools they manage; this information appears on the IAPD for the estimated 40 to 50 percent of hedge fund advisers that are already registered with us.

[272] Commenters expressing a view on the compliance period generally suggested hedge fund advisers would require one year to begin complying as registered advisers under the Advisers Act and its rules. Dechert Letter, *supra* note 197, Seward & Kissel Letter, *supra* note 111, Davis Polk Letter, *supra* note 197, AIMA Letter, *supra* note 189, Coudert Letter, *supra* note 152; NYC Bar Private Funds Letter, *supra* note 214, NYC Bar Futures Committee Letter, *supra* note 127, ABA Letter, *supra* note 150.

[273] The private adviser exemption requires that the adviser count all persons who have been clients at any time during the preceding 12 months. At the suggestion of a commenter, we will apply the new counting rule only prospectively, without regard to this ''look back'' provision for the period leading up to the compliance date. Coudert Letter, *supra* note 152.

[274] Under the Advisers Act and our rules, registered investment advisers must, for example, have policies in place to ensure compliance with the Act and its rules (rule 206(4)–7), including policies to prevent misuse of material nonpublic information (section 204A [15 U.S.C. 80b–4a]) and policies to ensure that (if they vote client securities) client securities are voted in the best interest of the client (rule 206(4)–6). Registered advisers must also have in place a code of ethics applicable to their supervised persons, which code must require access persons to submit reports of personal securities transactions and holdings (rule 204A–1). We understand that, in many advisory firms, access persons use their year-end brokerage statements to compile their securities holding reports; accordingly, we have set the compliance date for the new rules so as to allow sufficient time for hedge fund advisers' access persons to receive their brokerage statements for the period ended December 31, 2005 and to submit their securities holdings reports before the compliance date. For this reason, we are hereby extending the compliance date for rule 204A–1 from January 7, 2005 to February 1, 2005. *See Investment Adviser Codes of Ethics*, Investment Advisers Act Release No. 2256 (July 2, 2004) [69 FR 41695 (July 9, 2004)] at Section III.

[275] Rule 206(4)–7. Several commenters seemed to believe our rule would require them to hire a new executive to serve as chief compliance officer. As we have explained previously, the rule does not require an adviser to hire new staff, only to designate the person within the firm that is primarily responsible for compliance.

[276] Rule 206(4)–2.

[277] Section 205(a)(1) and rule 205–3.

[278] Rule 204–2.

[279] Rule 206(4)–1.

[280] Rule 206(4)–3.

[281] Similarly, advisers applying for registration with the Commission after the form has incorporated the amendments must respond to Item 7.B of Part 1A as amended.

access information about advisers to private funds.

**IV. Cost-Benefit Analysis**

We are sensitive to the costs and benefits that result from our rules. Rule 203(b)(3)–2 requires certain hedge fund advisers to register with us under the Investment Advisers Act of 1940. We are also adopting related rule amendments to facilitate a smooth transition for hedge fund advisers. In the Proposing Release, we identified possible costs and benefits of the rule and rule amendments and requested comment on our analysis. Many commenters supported the new rule,[282] although many commenters, chiefly hedge fund advisers and a trade association, expressed reservations at the potential costs of the new rule.[283]

*A. Benefits*

As discussed above in this Release, we expect that hedge fund investors, advisory clients and advisers will benefit from the rule and rule amendments, although these benefits are difficult to quantify.

1. Benefits to Hedge Fund Investors

(a) *Deter fraud and curtail losses.* Our oversight may prevent or diminish losses that hedge fund investors would otherwise experience as a result of hedge fund advisers' fraud. Registration allows us to conduct examinations of hedge fund advisers, and our examinations provide a strong deterrent to advisers' fraud, identify practices that may harm investors, and lead to earlier discovery of fraud that does occur.[284] Registration also permits us to screen individuals seeking to advise hedge funds, and to deny entry to those with a history of disciplinary problems.[285]

In the last five years, the Commission has brought or authorized 51 enforcement cases in which we assert hedge fund advisers have defrauded hedge fund investors or used the hedge fund to defraud others. While three of these frauds were detected in time to prevent investor losses, this was the exception rather than the rule.[286] In 40 of these cases, our staff estimates potential investor losses aggregate approximately $1.1 billion.[287] Staff cannot at this time estimate the amount of losses in the remaining eight cases.[288] We are concerned that individuals have targeted hedge fund investors and chosen hedge funds as a vehicle for fraud because these individuals could operate their funds without regulatory scrutiny of their activities. Only eight of the 51 cases involve investment advisers registered with the Commission, with over $75.7 million in estimated aggregate investor losses.[289] The remaining 43 cases involve advisers that were not registered with us, with over $1 billion in estimated aggregate investor losses.[290]

While our regulatory oversight cannot guarantee hedge fund investors will never be defrauded, we expect our oversight will reduce investor losses.[291]

[282] *See supra* notes 46–50 and accompanying text.

[283] *See supra* note 51 and accompanying text.

[284] *See* Section II.B.2 of this Release. We received comments specifically focusing on these benefits under the rule. *See, e.g.*, ICAA Letter, *supra* note 47. One commenter asserted it may be impossible for the Commission to identify potentially harmful compliance problems at an early stage absent the ability to examine hedge fund advisers. ICI Letter, *supra* note 48.

[285] *See* Section II.B.3 of this Release. Commenters also viewed this screening function as an important benefit for investors. *See, e.g.*, Vantis July Letter, *supra* note 106 (registered hedge fund adviser stated that lack of scrutiny of hedge fund advisers has led to the industry attracting ''unsavory characters''); Ohio PERS Letter, *supra* note 47; ICI Letter, *supra* note 48; IMCA Letter, *supra* note 48.

[286] *SEC* v. *EPG Global Private Equity Fund*, Litigation Release No. 18577 (Feb. 17, 2004); *SEC* v. *Millennium Capital Hedge Fund, L.P., Millennium Capital Group, LLC, and Andreas F. Zybell, supra* note 99; *In the Matter of John Christopher McCamey and Sierra Equity Partners, LP*, Securities Exchange Act Release No. 48917 (June 18, 2003).

[287] *SEC* v. *Haligiannis, et al*, Litigation Release No. 18853 (Aug. 25, 2004); *SEC* v. *Scott B. Kaye, et al.*, Litigation Release No. 18845 (Aug. 24, 2004); *SEC* v. *Gary M. Kornman*, Litigation Release No. 18836 (Aug. 18, 2004); *SEC* v. *Anthony P. Postiglione, Jr., et al., supra* note 236; *In the Matter of Samer M. El Bizri and Bizri Capital Partners, Inc., supra* note 99, *SEC* v. *Daniel D. Dyer and Oxbow Capital Partners, LLC,* Litigation Release No. 18719 (May 19, 2004); *SEC* v. *J. Robert Dobbins, Dobbins Capital Corp., Dobbins Offshore Capital LLC, Dobbins Partners, L.P., and Dobbins Offshore, Ltd.*, Litigation Release No. 18634 (Mar. 23, 2004); *SEC* v. *Patrollers Capital Fund and Franklin S. Marone*, Litigation Release No. 18601 (Feb. 27, 2004); *SEC* v. *Darren Silverman and Matthew Brenner*, Litigation Release No. 18597 (Feb. 25, 2004); *In the Matter of Nevis Capital Management, LLC, David R. Wilmerding, III and Jon C. Baker, supra* note 94; *In the Matter of Robert T. Littell and Wilfred Meckel*, Investment Advisers Act Release No. 2203 (Dec. 15, 2003); *SEC* v. *Adam G. Kruger and Kruger, Miller, and Tummillo, Inc.*, Litigation Release No. 18473 (Nov. 20, 2003); *SEC* v. *Koji Goto*, Litigation Release No. 18456 (Nov. 14, 2003); *SEC* v. *John F. Turant, Jr., Russ R. Luciano, JTI Group Fund, LP, J.T. Investment Group, Inc., Evergreen Investment Group, LP, and New Resource Investment Group, Inc.*, Litigation Release No. 18351 (Sept. 15, 2003); *SEC* v. *Michael Batterman, Randall B. Batterman III, and Dynasty Fund, Ltd., et al.*, Litigation Release No. 18299 (Aug. 20, 2003); *SEC* v. *Ryan J. Fontaine and Simpleton Holdings Corporation a/k/a Signature Investments Hedge Fund, supra* note 11; *In the Matter of Ascend Capital, LLC, Malcolm P. Fairbairn, and Emily Wang Fairbairn*, Investment Advisers Act Release No. 2150 (July 17, 2003); *SEC* v. *Beacon Hill Asset Management LLC, et al., supra* note 97; *SEC* v. *J. Scott Eskind, Lorus Investments, Inc., and Capital Management Fund, Limited Partnership, supra* note 100; *SEC* v. *Michael L. Smirlock and LASER Advisers, Inc.*, Litigation Release No. 17630 (July 24, 2002); *SEC* v. *Schwendiman Partners, LLC, Gary Schwendiman, and Todd G. Schwendiman, supra* note 94; *SEC* v. *Von Christopher Cummings, Paramount Financial Partners, L.P., Paramount Capital Management, LLC, John A. Ryan, Kevin L. Grandy and James Curtis Conley*, Litigation Release No. 17598 (July 3, 2002); *SEC* v. *House Asset Management, L.L.C., House Edge, L.P., Paul J. House, and Brandon R. Moore, supra* note 97; *In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses, supra* note 94; *SEC* v. *Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee, supra* note 97; *In the Matter of Zion Capital Management LLC, and Ricky A. Lang, supra* note 101; *SEC* v. *Peter W. Chabot, Chabot Investments, Inc., Sirens Synergy and the Synergy Fund, supra* note 97; *SEC* v. *Vestron Financial Corp., et al., supra* note 97; *SEC* v. *Edward Thomas Jung, et al., supra* note 97; *SEC* v. *Burton G. Friedlander, supra* note 98; *SEC* v. *Hoover and Hoover Capital Management, Inc., supra* note 97; *SEC* v. *Evelyn Litwok & Dalia Eilat, supra* note 97; *SEC* v. *Ashbury Capital Partners, L.P., Ashbury Capital Management, L.L.C., and Mark Yagalla, supra* note 97; *SEC* v. *James S. Saltzman, supra* note 95; *In the Matter of Stephen V. Burns*, Investment Advisers Act Release No. 1910 (Nov. 17, 2002); *In the Matter of Michael T. Higgins, supra* note 99; *SEC* v. *David M. Mobley, Sr., et al., supra* note 97; *SEC* v. *Michael W. Berger, Manhattan Capital Management Inc., supra* note 99; *In the Matter of Charles K. Seavey and Alexander Lushtak, supra* note 99; *SEC* v. *Todd Hansen and Nicholas Lobue, supra* note 235.

[288] *SEC* v. *Global Money Management, LP, LF Global Investments, LLC, and Marvin I. Friedman, supra* note 102; *SEC* v. *KS Advisors, Inc. et al., supra* note 95; *In the Matter of Alliance Capital Management, L.P., supra* note 29; *SEC* v. *Edward J. Strafaci*, Litigation Release No. 18432 (Oct. 29, 2003); *In the Matter of Stephen B. Markovitz, supra* note 29; *Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC, supra* note 98; *In the Matter of Martin W. Smith and World Securities, Inc.*, Investment Advisers Act Release No. 2124 (Apr. 18, 2003); *SEC* v. *Platinum Investment Corp. et al.*, Litigation Release No. 17643 (July 31, 2002).

[289] *In the Matter of Alliance Capital Management, L.P., supra* note 29; *SEC* v. *Michael L. Smirlock, supra* note 287; *SEC* v. *Edward J. Strafaci, supra* note 288; *In the Matter of Nevis Capital Management, supra* note 94; *In the Matter of Martin W. Smith and World Securities, Inc., supra* note 288; *SEC* v. *Schwendiman Partners, LLC, Gary Schwendiman, and Todd G. Schwendiman, supra* note 94; *In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses, supra* note 94; *In the Matter of Zion Capital Management LLC, and Ricky A. Lang, supra* note 101. Staff cannot estimate the amount of losses in 3 of these cases at this time.

[290] Staff cannot estimate the amount of losses in 5 of these cases at this time.

[291] As substantial inflows chase absolute returns, there may be pressure for hedge fund advisers to engage in strategies that may not be consistent with the funds' disclosure or may be unlawful. *See* David Reilly, *Hot Hedge Fund Vega Grapples With Growth: Global/Macro Style of Investing May Provide Room to Maneuver, But a Door Is Closed to New Cash*, The Wall St. J., June 4, 2004, at C1 (as hedge funds' assets explode, difficulties in finding winning strategies raises the specter of diminished returns and concentrations of investment risk that are difficult to unwind in a crisis); Mara Der Hovanesian, *Will Hedge Funds Be Overrun By All The Traffic?*, BusinessWeek, Mar. 11, 2002 (some hedge fund strategies are becoming less effective as the capacity of managers to generate high absolute returns diminishes when investment portfolios are too large). *See also* Alexander M. Ineichen, *Absolute Returns* (2003) at 47 (falling barriers to entry for new hedge fund advisers are causing a dilution of the talent pool, making adviser selection more difficult). In the absence of Commission oversight as a deterrent, these incentives may tempt hedge fund advisers to engage in fraud.

Some commenters argued that registration of hedge fund advisers would not address the frauds evidenced by these enforcement cases, arguing the majority of the advisers in these fraud cases were too small to meet the $30 million threshold for registration under the Advisers Act or were registered already.[292] We disagree with these commenters. Half of the advisers in these 51 cases appear to have managed more than $30 million or otherwise been eligible for registration with us, and it was these larger advisers who caused nearly all the investor losses, representing over $1 billion of the estimated total losses of $1.1 billion. This strongly suggests that the Commission's registration requirement will affect an appropriate group of hedge fund advisers and serve as an effective response to combat hedge fund fraud.

In addition, these commenters argued that examination programs are unable to detect fraud, and that regulatory authorities must instead rely on ''tips'' to uncover misconduct. However, in 5 of the 8 cases against registered advisers, it was our examiners who uncovered the fraudulent conduct.[293] These cases show that registered hedge fund advisers contemplating their chances of ''getting away'' with a breach of their fiduciary duty to their clients would be well advised to fear detection. We believe this has a genuine deterrent effect.[294]

(b) *Provide basic information about hedge fund advisers.*

Form ADV information that hedge fund advisers will file in registering will aid hedge fund investors in evaluating potential managers. Filing Form ADV will require hedge fund advisers to disclose information about their business, affiliates and owners, and disciplinary history. As commenters pointed out, many investors currently lack good access to this information about their hedge fund managers.[295] Although the information hedge fund advisers will be required to provide on their Form ADV filings and to comply with our rules cannot substitute for an investor's due diligence, it should aid investors by providing a publicly accessible foundation of basic information.[296]

(c) Improve compliance controls.

Hedge fund investors should benefit from their advisers' improved compliance controls. Several commenters confirmed this assessment in their comment letters.[297] Once registered, hedge fund advisers will be required to have comprehensive compliance procedures and to designate a chief compliance officer.[298] Specific procedures governing proxy voting[299] and a code of ethics including requirements for personal securities reporting will also be required.[300] In addition, the obligation to commit to a program of compliance controls combined with our examinations foster adherence to a culture of compliance by advisers.[301] These compliance measures are the first line of defense in protecting investors against an adviser's misconduct.

2. Benefits to Mutual Fund Investors

Mutual fund investors will benefit from hedge fund adviser registration to the extent that Commission oversight deters hedge funds and their advisers from illegal conduct that exploits mutual funds. Many of the market timers and illegal late traders involved in recent mutual fund scandals have been hedge fund advisers.[302] The 51 enforcement cases discussed earlier do not include 18 other actions we have brought to date against persons charged with late trading of mutual fund shares on behalf of hedge fund groups, and against mutual fund advisers or principals for permitting hedge fund advisers to market time mutual funds contrary to the mutual funds' prospectus disclosure.[303] Hedge fund advisers reaped huge profits for their funds over an extended period while costing our nation's retail mutual fund investors hundreds of millions of dollars.[304]

3. Benefits to Other Investors and Markets

The registration of hedge fund advisers will benefit not only hedge fund investors but also other investors and the securities markets, to the extent that the Commission's oversight eliminates opportunities for hedge fund advisers to engage in other types of unlawful conduct in the securities markets. Commenters also saw this as a benefit to adviser registration.[305] The mutual fund scandals have shown us that hedge fund advisers' improper or illegal activities can cause harm beyond the hedge funds' own investors. There may be other fraudulent activities by hedge fund advisers of which we are unaware because we cannot examine these advisers regularly. Adviser registration, as discussed above, should lead to earlier discovery of fraudulent activities and thus enhance protections to all investors in the securities markets.

4. Benefits to Regulatory Policy

Registration of hedge fund advisers will benefit all investors and market participants by providing us and other policy makers with better data. We have limited information about hedge fund advisers and the hedge fund industry, and much of what we do have is indirect information extrapolated from other data. This hampers our ability to develop regulatory policy for the protection of hedge fund investors and

[292] *See, e.g.*, MFA Letter, *supra* note 51; LaRocco Letter, *supra* note 51; Chamber of Commerce Letter, *supra* note 52; ISDA Letter, *supra* note 52.

[293] In addition, in two of the 43 cases against unregistered advisers, our examiners uncovered the fraud as a result of examining registered advisers who employed the principals of the hedge fund. *See supra* notes 94 and 95.

[294] *Cf.* Alternative Investment Group Letter, *supra* note 47 (hedge fund managers will realize they are more likely to receive SEC scrutiny and will tighten their procedures toward a greater culture of compliance); Vantis August Letter, *supra* note 50 (possibility of SEC exams on short notice creates an extra incentive for firm professionals to remain disciplined and keep files updated on a timely basis). In addition, as discussed above, examination of regulatory issues relating to the deterrent effect of unannounced government inspections, under economic theories of monitoring and deterrence based on principal-agent models, suggest that randomized monitoring is sufficient to generate a deterrent effect. *See supra* note 88.

[295] UnFarallon Letter, *supra* note 230; Comment Letter of Gregg D. Caplitz (Aug. 9, 2004) (''Caplitz Letter''); Comment Letter of Rosalind D. Herman (August 10, 2004) (''Rosalind Herman Letter'').

[296] The difficulty many institutional investors have in obtaining information about hedge fund advisers is reflected in the Hennessee Group's survey clarifying the involvement of foundations and endowments in the hedge fund market. Among foundations and endowments responding to the survey, those supporting hedge fund adviser registration outnumbered its opponents by nearly 2 to 1. *See* Hennessee Foundation and Endowment Survey, *supra* note 39. Participants at our Hedge Fund Roundtable last year similarly spoke of the difficulty and costs that investors face in obtaining information from hedge fund advisers. Roundtable Transcript, May 15 (statement of Sandra Manzke) (''[I]t's very difficult to get answers out of managers, and they hold all the keys right now. If you want to get into a good fund, and you ask some difficult questions, you may not get that answer. Sure, there is a lot of access, to get online and do background checks, and hire firms * * *. But that's expensive. And can the retail investor do it? No. Firms like ours, we spend a lot of money, we have a lot more people working for us now to uncover these types of situations.'').

[297] *See, e.g.*, ICAA Letter, *supra* note 47, Alternative Investment Group Letter, *supra* note 47, Caplitz Letter, *supra* note 295.

[298] Rule 206(4)–7.

[299] Rule 206(4)–6.

[300] Rule 204A–1.

[301] Some registered hedge fund advisers used their own experiences to support this conclusion. *See, e.g.*, Vantis August Letter, *supra* note 50, Alternative Investment Group Letter, *supra* note 47.

[302] *See supra* note 29.

[303] *Id.*

[304] *Id.*

[305] *See, e.g.*, ICAA Letter, *supra* note 47; Rosalind Herman Letter, *supra* note 295; Patch Letter A, *supra* note 48; Comment Letter of Joe Allebaugh (July 14, 2004) (''Allebaugh Letter''); Vantis August Letter, *supra* note 50; Saul Letter, *supra* note 49.

investors in general.[306] Hedge fund adviser registration would provide the Congress, the Commission and other government agencies with important information about this rapidly growing segment of the U.S. financial system. While some commenters agreed with our assessment of this benefit,[307] others suggested that, instead of registering hedge fund advisers, we compile information about them from a variety of scattered regulatory filings currently made by hedge funds, their advisers, and broker-dealers.[308] We have considered this alternative, but the reports and information currently available would provide at best a partial and inadequate view of the activities of hedge fund advisers.[309]

5. Benefits to Hedge Fund Advisers

Mandatory registration will provide a level playing field for hedge fund advisers. Many hedge fund advisers have already registered with us, and have organized their compliance procedures under the Advisers Act. [310] Unregistered hedge fund advisers, however, vary substantially in their compliance practices.[311] While many of them have adopted sound compliance practices, many others, against whom they and the registered advisers compete, have not allocated resources to implement an effective compliance infrastructure. We received comments noting that mandatory registration would ensure that all hedge fund advisers compete on the same basis in this regard.[312]

Registering hedge fund advisers may enhance investor confidence in a growing and maturing industry. As discussed above, the hedge fund industry has been growing at an extraordinary pace in the past decade.[313] Registration under the Advisers Act will bring hedge fund advisers to the same compliance level as other SEC-registered advisers, thus providing hedge fund investors with additional protections with respect to conflicts of interest addressed by the funds' advisers.[314]

Some commenters, however, argued that registration would create a ''moral hazard'' by providing hedge fund investors with a *false* sense of enhanced investor protection that might cause them to be less diligent in their own investigations.[315] We disagree. Such argument could have been used against registration of any kind of investment adviser and against any regulation of the securities industry.[316] In addition, without the new rule requiring registration, a hedge fund adviser can now choose to register under the Advisers Act but then withdraw its registration, for example, at the prospect of an examination. Thus, without a registration requirement, any ''moral hazard'' would already exist, but without necessarily providing hedge fund investors the benefit of our oversight of their advisers.

*B. Costs*

As we discussed in the Proposing Release, registration of hedge fund advisers under the Advisers Act would not impede hedge funds' operations. Comments from registered hedge fund advisers agreed.[317] The Act does not prohibit any particular investment strategies, nor does it require or prohibit specific investments. Instead of imposing specific procedures on registrants, the Advisers Act is principally a disclosure statute that requires registrants to fully inform clients of conflicts so that those clients can determine whether to give their consent. For the same reasons, registering hedge fund advisers should not impair the ability of hedge funds to continue their important roles of providing price information and liquidity to our markets.[318]

Nevertheless, registration imposes certain costs. In the Proposing Release, we analyzed various costs that hedge fund advisers would incur in connection with registration. Commenters representing the views of unregistered hedge fund advisers generally challenged our cost estimates and predicted the costs of compliance would be burdensome.[319] Comments from registered advisers generally characterized the costs as being significant, but reasonable in light of the nature of the advisory business.[320] As we discussed in the Proposing Release, the costs of compliance for a new registrant can vary widely among firms depending on size, activities, and the sophistication of the existing compliance infrastructure. Investment advisers, whether registered with us or not, place the future of their business at peril if they do not establish a sound compliance infrastructure to fulfill their fiduciary duties towards their clients under the Act. Registered hedge fund advisers estimated that advisers with good compliance infrastructures in place would incur much less incremental cost than those that did not have good compliance infrastructures.[321]

1. Registration Costs

In our Proposing Release, we estimated that the costs of preparing adviser registration submissions, including preparation and submission of Part 1A of Form ADV, would not be high. Although one commenter suggested the costs of preparing a Part 1A submission can be quite high, we believe the commenter's example does not reflect the experience of other advisers, none of whom made similar comments.[322] Part 1A requires advisers

[306] *See* Section II.B.1 of this Release.

[307] *See, e.g.*, Ohio PERS Letter, *supra* note 47, ICAA Letter, *supra* note 47, ICI Letter, *supra* note 48, IMCA Letter, *supra* note 48.

[308] *See, e.g.*, MFA Letter, *supra* note 51, Tudor Letter, *supra* note 53.

[309] *See* Section II.B.9 of this Release.

[310] Many advisers to hedge funds are required to register with us because of other advisory business they have. Still others have chosen to register with us because their investor clients require it. Registered hedge fund advisers commented on the benefits of registration. *See* Vantis August Letter, *supra* note 50.

[311] *See* Section VII.A.1.b. of the 2003 Staff Hedge Fund Report, *supra* note 18.

[312] *See, e.g.*, Saul Letter, *supra* note 49, Rosalind Herman Letter, *supra* note 295, Caplitz Letter, *supra* note 295.

[313] *See* Section I.A. of this Release.

[314] *See, e.g.*, Vantis July Letter, *supra* note 106 (mandatory registration will improve the image of the hedge fund industry); Hennessee Foundation and Endowment Survey, *supra* note 39 (survey participant remark that registration ''lends creditability to the field''); Comment Letter of North American Securities Administrators Association, Inc. (Oct. 18, 2004) (SEC registration will increase investor confidence, thereby benefiting hedge fund advisers).

[315] *See, e.g.*, MFA Letter, *supra* note 51, Chamber of Commerce Letter, *supra* note 52, ISDA Letter, *supra* note 52, David Thayer Letter, *supra* note 52.

[316] Furthermore, section 208(a) of the Act [15 U.S.C. 80b–8(a)] expressly forbids registered advisers from implying that their services bear the imprimatur of the government. Section 208(b) of the Act permits a registered adviser to state that it is registered, but only if the effect of registration is not misrepresented.

[317] Vantis August Letter, *supra* note 50, Alternative Investment Group Letter, *supra* note 47.

[318] *See Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management—Report of the President's Working Group on Financial Markets*, *supra* note 43, at 2. The 2003 Staff Hedge Fund Report also noted that hedge funds' trading brings price information to our securities markets, thus improving market efficiency, and hedge funds also provide liquidity to our capital markets. *See* 2003 Staff Hedge Fund Report, *supra* note 18, at 4.

[319] *See, e.g.*, Madison Capital Letter, *supra* note 51; Chamber of Commerce Letter, *supra* note 52; ISDA Letter, *supra* note 52; Blanco Partners, *supra* note 52; Millrace Letter, *supra* note 92.

[320] Vantis August Letter, *supra* note 50, Alternative Investment Group Letter, *supra* note 47, ICI Letter, *supra* note 48, ICAA Letter, *supra* note 47, CFA Institute Letter, *supra* note 47.

[321] *See* Vantis August Letter, *supra* note 50, Alternative Investment Group Letter, *supra* note 47.

[322] The MFA stated that one of its members expended $75,000 of internal staff time in preparing its Form ADV filing. *See* MFA Letter, *supra* note 51. MFA's comments are also not reflective of other feedback we have received on revised Form ADV and the IARD electronic filing system, which were launched in 2001. *See* Letter from Karen Barr, General Counsel, Investment Counsel Association of America, to Paul F. Roye, Director, Division of

to answer basic questions about their business, their affiliates and their owners, and Part 1A can be completed using information readily available to hedge fund advisers. Numerous hedge fund advisers have already registered with the Commission using Part 1A, and none has reported to us that its business model presents any difficulty in using the form.[323] Advisers must also complete Part II of Form ADV and deliver a copy of Part II or a disclosure brochure containing the same information to clients.[324] Part II requires disclosure of certain conflicts of interest, which even unregistered advisers have a fiduciary duty to disclose to their clients. We expect that hedge fund advisers will face relatively small internal costs in preparing a Part II, and will be likely to include their Part II disclosure as part of their private placement memoranda for their hedge funds, reducing their overall costs even further. We received no comments to the contrary.

2. Cost of Establishing a Compliance Infrastructure

New hedge fund adviser registrants will also face costs to bring their operations into conformity with the Advisers Act and the rules under the Act. In the Proposing Release, we estimated the cost of establishing a compliance infrastructure would primarily consist of establishing procedures and systems that address rules under the Advisers Act such as the books and records rule,[325] the custody rule,[326] the proxy voting rule,[327] the compliance rule,[328] and the code of ethics rule.[329] While some commenters also focused on these factors,[330] others identified additional cost considerations, as we discuss below.

Many unregistered hedge fund advisers have already built sound compliance infrastructures because their business compels it. These firms already have procedures designed to keep good records of all transactions, to keep their clients' assets safe, to provide fair and full disclosure of conflicts of interest, and to prevent their supervised persons from breaching fiduciary duties.[331] In the Proposing Release, we estimated these advisory firms should face little cost to modify their current compliance practices to comply with the Advisers Act rules. Comments from registered hedge fund advisers agreed.[332] For other hedge fund advisers that have not yet established sound compliance programs, however, the costs will be higher.

In the Proposing Release, we estimated the cost for hedge fund advisers to establish the required compliance infrastructure will be, on average, $20,000 in professional fees and $25,000 in internal costs including staff time.[333] These estimates were prepared in consultation with private attorneys who, as part of their practice, counsel hedge fund advisers establishing their registrations with the SEC. The estimates are averages, premised on the understanding that the costs will likely be less for new registrants that have already established sound compliance practices and more for new registrants that do not yet have good compliance procedures. Several law firms and attorneys representing hedge fund advisers challenged these estimates as being too low, but these firms did not provide any estimates of their own.[334] The ICAA, based on the experience of its adviser members generally, commented that the costs of a compliance infrastructure are considerable, but that they are justified, especially considering the relative risks of hedge fund activities as compared to many other investment advisory activities.

Several hedge fund advisers estimated the costs to be in the range of $300,000, but most or all of the cost was attributable to compensation costs for hiring a dedicated chief compliance officer (CCO).[335] Our compliance rule does not require firms to hire a new individual to serve as a full-time CCO, and the question of whether an advisory firm can look to existing staff to fulfill the CCO requirement internally is firm-specific. Firms may consider factors such as the size of the firm, the complexity of its compliance environment, and the qualifications of current staff.

While we recognize some hedge fund advisers will need to designate someone to serve as CCO on a full-time basis, we expect these will be larger firms—those with many employees and a sizeable amount of investor assets under management. Because there is no currently-available comprehensive database of hedge fund advisers, we cannot determine the number of these larger hedge fund firms in operation, but our staff estimates it is relatively few. Staff estimates approximately half of these hedge fund advisers are already registered with us, and have already designated a CCO. While the remaining, unregistered, larger hedge fund advisers may not have designated a CCO as such, many of these firms likely already have personnel who perform similar functions to a CCO, in order to address the firm's liability exposure and protect its reputation.

In smaller hedge fund advisers, the designated CCO will likely also fill another function in the firm, and perform additional duties alongside compliance matters. Firms designating a CCO from existing staff may experience costs to the extent the individual is taking on additional compliance responsibilities or giving up other non-compliance responsibilities. These costs may include costs of shifting responsibilities among employees, and might in some cases include additional compensation costs. Some of these firms may need to add compliance capacity to their staffs. Costs will vary from firm to firm, depending on the extent to which firm staff is already performing some or all of the requisite compliance functions, the extent to which the CCO's non-compliance responsibilities need to be lessened to permit allocation of more time to compliance responsibilities, and the value to the firm of the CCO's non-compliance responsibilities. We do not have access to information that would

Investment Management, U.S. Securities and Exchange Commission (May 16, 2001) (noting that ICAA members found the filing system easy to use and found the form instructions and staff responses to frequently-asked questions to provide useful guidance).

[323] In fact, our new rule makes only one small change to Part 1A, to better identify which advisers' pooled investment vehicles are hedge funds. *See* Section II.K. of this Release.

[324] *See* rule 204–3, the brochure delivery rule.

[325] Rule 204–2.

[326] Rule 206(4)–2.

[327] Rule 206(4)–6.

[328] Rule 206(4)–7.

[329] Rule 204A–1.

[330] *See, e.g.*, Schulte Roth Letter, *supra* note 51; ICAA Letter, *supra* note 47.

[331] One private attorney commenting on the rule noted he knows of few hedge fund managers which do not already comply with the substantive provisions of the Advisers Act as a matter of best practice. Sidley Austin Letter, *supra* note 51.

[332] Alternative Investment Group Letter, *supra* note 47; Vantis August Letter, *supra* note 50.

[333] Our staff has estimated that between 690 and 1,260 hedge fund advisers would be new Advisers Act registrants under the new rule and rule amendments. *See infra* Section V of this Release; Section V of the Proposing Release. Aggregate start-up costs to establish required compliance infrastructure for all new registrants are therefore estimated to range from $31 to $57 million.

[334] Schulte Roth Letter, *supra* note 51; Bryan Cave Letter, *supra* note 111; Davis Polk Letter, *supra* note 197.

[335] Lander Letter, *supra* note 51, Madison Capital Letter, *supra* note 51, MFA Letter, *supra* note 51 (recounting the estimates of members, and noting larger firms' cost for a chief compliance officer can approach $500,000). Data from the SIA *Report on Management and Professional Earnings in the Securities Industry 2003,* modified by the SEC staff for an 1800-hour work-year and with a 35 percent markup for overhead, however, suggest that the total cost for hiring a full-time chief compliance officer in New York City would be approximately $234,000.

allow us to determine these costs, and commenters did not provide estimates.

3. Ongoing Costs of Compliance and Examination

Several comments on our Proposing Release identified additional cost considerations related to hedge fund advisers' ongoing, annual costs of compliance and the costs of undergoing examination by the Commission. There may be a number of unregistered hedge fund firms whose operations are already substantially in compliance with the Advisers Act and that would therefore experience only minimal incremental ongoing costs as a result of registration.[336] There are other unregistered hedge fund advisers, however, who will face additional ongoing costs to conduct their operations in compliance with the Advisers Act. These costs may be significant for some hedge fund advisers.

We do not have access to information that would enable us to determine these additional ongoing costs, which are predominantly internal to the firms themselves. Incremental ongoing compliance costs will vary from firm to firm depending on factors such as the complexity of each firm's activities, the business decisions it makes in structuring its response to its compliance obligations, and the extent to which it is already conducting its operations in compliance with the Advisers Act.[337] We received comments from small hedge fund advisers estimating that their annual compliance costs would be approximately $25,000 and could be as high as $50,000.[338] These commenters and other small hedge fund advisers expressed concerns that compliance costs would be prohibitive in comparison to their management fee revenues.[339] Other small hedge fund advisers commented that their existing staff could not accommodate the compliance responsibilities they would face as a result of registration.[340] We also, however, received comments from investment advisory trade associations noting that thousands of small investment advisers currently operate under the same compliance burden.[341] We note that more than 2,500 smaller advisory firms are currently registered with us.[342] These firms have absorbed these compliance costs, notwithstanding the fact that their revenues are likely to be smaller than those of a typical hedge fund adviser.[343]

Some commenters asserted that there would be substantial costs associated with hedge fund advisers' responses to our examinations. One hedge fund adviser reportedly estimated spending 160 hours of internal staff time during an SEC examination.[344] We believe this does not reflect the typical experience of our registrants, with the possible exception of the very largest advisers, and few of the firms affected by the new rule are likely to be of this size.[345] A law firm commented that two registered hedge fund advisers reportedly spent an estimated $300,000 to $500,000 in out-of-pocket costs preparing for and undergoing SEC examinations.[346] We believe this also is not representative of our registrants' experiences, who do not typically find it necessary to involve private counsel in extensive pre-examination review of their activities and records. Also, we note that one registered hedge fund adviser commented that the firm itself derived benefit from the examination process.[347]

## V. Effects on Commission Examination Resources

The new registration requirement will increase the number of investment adviser firms subject to Commission examinations. The examination program is operated by our Office of Compliance Inspections and Examinations (''OCIE''). OCIE's examination program already covers a number of advisers to hedge funds. These advisers have registered with the Commission, either because they advise non-hedge fund clients for whom registration is required, or because they perceive registration with the Commission to be necessary to their business model. Implementation of rule 203(b)(3)–2 will increase the number of SEC-registered advisers by some amount.

Several commenters expressed concerns about this increase.[348] As stated in the Proposing Release, there are various options we could pursue to lessen the effect of this increase. Though OCIE's resources will be spread over an expanded pool of investment adviser registrants, we are developing risk assessment tools to enhance the efficiency of our examination program by allowing our staff to focus examination resources on the areas of greatest risk to investors. In addition, we have recently adopted measures that require advisory personnel to be more accountable for the efficacy of

[336] One law firm commented that it knew of few hedge fund advisers that are not already complying with the substantive provisions of the Advisers Act as a matter of best practices. Sidley Austin Letter, *supra* note 51. *See also* Superior Capital Letter, *supra* note 51 (noting that the Advisers Act compliance regulations would be ''redundant'' for this firm).

[337] These underlying uncertainties surrounding these internal costs would introduce the same level of uncertainty to various alternatives that we might pursue in determining these costs. For example, advisory firms themselves are not likely to be able to provide reliable estimates for several reasons. First, experiences will vary across firms; second, few firms are likely to have allocated the internal resources necessary to assess which costs are a direct result of legal requirements and which arise from other factors; and third, firms' experience with some newer requirements (such as the adviser compliance rule and the adviser code of ethics rule) is still limited. Attempting to estimate the number of staff hours involved (and applying industry standard wage and benefit costs for the corresponding types of personnel) would entail the same uncertainties.

[338] Comment Letter of Joseph L. Vidich (Aug. 7, 2004) (''Vidich Letter'') (currently managing $10 million hedge fund); Comment Letter of Venkat Swarna (Sept. 14, 2004) (''Swarna Letter'') (anticipates managing $2 million hedge fund). Although these commenters would not be covered by our registration requirement, we have taken their cost estimates into consideration, because other small firms that will be covered did not provide us with quantified estimates.

[339] *See* Vidich Letter, *supra* note 338; Superior Capital Letter, *supra* note 51; LaRocco Letter, *supra* note 51; *see also* ISDA Letter, *supra* note 52.

[340] *See, e.g.*, Millrace Letter, *supra* note 92; *see also* Seward & Kissel Letter, *supra* note 111; Blanco Partners Letter, *supra* note 52.

[341] ICAA Letter, *supra* note 47, CFA Institute Letter, *supra* note 47.

[342] Some commenters suggested the threshold for hedge fund adviser registration should be $50 million, to address their concerns that the cost burden of adviser registration might be disproportionate for advisers managing lesser amounts of assets. *See, e.g.*, LaRocco Letter, *supra* note 51. However, many currently-registered firms, which presently comply with these same registration obligations, manage less than $50 million. As of September 30, 2004, 2,758 advisers registered with us reported that they were managing less than $50 million in client assets. These advisers represent 32 percent of our registrant pool. We also note that establishing a higher assets under management registration threshold for advisers to private funds would allow these other advisers to avoid registration merely by pooling some of their clients' assets into a private fund.

[343] In addition to asset-based investment management fees that are comparable to advisory fees charged by non-hedge fund advisory firms, hedge fund advisers also typically earn incentive compensation equaling 20 percent of the fund's net investment income. *See supra* note 11.

[344] MFA Letter, *supra* note 51 (reporting experience of one registered hedge fund adviser).

[345] As we discuss elsewhere, the absence of a comprehensive database of hedge fund advisers makes it difficult to estimate the number or size of hedge fund advisory firms that will be affected by the new rule. However, staff estimates half or more of the larger hedge fund advisers are likely already registered with us. *See also The Hedge Fund 100, supra* note 70 (estimating that even the top 100 hedge fund advisers manage in the range of $2 billion to $11.5 billion).

[346] Sidley Austin Letter, *supra* note 51.

[347] Vantis August Letter, *supra* note 50 (review provides additional assurance that any deficiencies not already identified by internal or external audit are identified; exam staff offers helpful instruction in regulatory issues and assistance in developing policies and procedures).

[348] *See, e.g.*, Schulte Roth Letter, *supra* note 51, Davis Polk Letter, *supra* note 197, Rodney Pitts Letter, *supra* note 52, Sheila Bair Letter, *supra* note 89, Comment Letter of Alex Cook (Aug. 26, 2004) (''Alex Cook Letter''), Tudor Investment Letter, *supra* note 53.

compliance programs. As of October of this year, registered advisers have begun complying with our new compliance rule, which requires them to implement comprehensive policies and procedures for compliance with the Advisers Act, under the administration of a chief compliance officer.[349] As advisers improve their own compliance regimes, we expect this will facilitate our examination of advisory firms. As discussed in the Proposing Release,[350] another option would be to increase the current threshold for SEC registration from $25 million of assets under management to a slightly higher amount, thereby reducing the number of smaller advisers overseen by the Commission (instead of state securities administrators). Or we could seek additional resources from Congress, if necessary. We are continuing to develop techniques to assess risk.

Our ability to estimate the size of the increase in our workload has been hampered by the absence of any reliable and comprehensive database of hedge funds or advisers to hedge funds. In the Proposing Release, we described our staff's tentative estimates that the addition of new hedge fund advisers to our current registrant pool could increase the total size of this pool by 8 to 15 percent.[351] We received no comment on these estimates.

## VI. Paperwork Reduction Act

As we discussed in the Proposing Release, rule 203(b)(3)–2 contains no new ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 to 3520). The rule amendments contain several collections of information requirements, but the amendments do not change the burden per response from that under the current rules. Rule 203(b)(3)–2 will have the effect of requiring most advisers to hedge funds to register with the Commission under the Advisers Act and will therefore increase the number of respondents under several existing collections of information, and, correspondingly, increase the annual aggregate burden under those existing collections of information. The Commission has submitted, to the Office of Management and Budget (''OMB'') in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, the existing collections of information for which the annual aggregate burden will likely increase as a result of rule 203(b)(3)–2. The titles of the affected collections of information are: ''Form ADV,'' ''Form ADV–W and Rule 203–2,'' ''Rule 203–3 and Form ADV–H,'' ''Form ADV–NR,'' ''Rule 204–2,'' ''Rule 204–3,'' ''Rule 204A–1,'' ''Rule 206(4)–2, Custody of Funds or Securities of Clients by Investment Advisers,'' ''Rule 206(4)–3,'' ''Rule 206(4)–4,'' ''Rule 206(4)–6,'' and ''Rule 206(4)–7,'' all under the Advisers Act. The existing rules affected by rule 203(b)(3)–2 contain currently approved collection of information numbers under OMB control numbers 3235–0049, 3235–0313, 3235–0538, 3235–0240, 3235–0278, 3235–0047, 3235–0596, 3235–0241, 3253–0242, 3235–0345, 3235–0571 and 3235–0585, respectively. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. All of these collections of information are mandatory, and respondents in each case are investment advisers registered with us, except that (i) respondents to Form ADV are also investment advisers applying for registration with us; (ii) respondents to Form ADV–NR are non-resident general partners or managing agents of registered advisers; (iii) respondents to Rule 204A–1 include ''access persons'' of an adviser registered with us, who must submit reports of their personal trading to their advisory firms; (iv) respondents to Rule 206(4)–2 are only those SEC-registered advisers that have custody of clients' funds or securities; (v) respondents to Rule 206(4)–3 are advisers who pay cash fees to persons who solicit clients for the adviser; (vi) respondents to Rule 206(4)–4 are advisers with certain disciplinary histories or a financial condition that is reasonably likely to affect contractual commitments; and (vii) respondents to Rule 206(4)–6 are only those SEC-registered advisers that vote their clients' securities. Unless otherwise noted below, responses are not kept confidential.

We cannot estimate with precision the number of hedge fund advisers that will be new registrants with the Commission under the Advisers Act after rule 203(b)(3)–2 is adopted. As discussed earlier, our staff has estimated that between 690 and 1,260 hedge fund advisers will be new Advisers Act registrants under the new rule and rule amendments.[352] For purposes of estimating the increases in respondents to the existing collections of information, we have used the midpoint of this estimated range, or 975 new respondents. We received no comments on these estimates.

### *A. Form ADV*

Form ADV is the investment adviser registration form. The collection of information under Form ADV is necessary to provide advisory clients, prospective clients, and the Commission with information about the adviser, its business, and its conflicts of interest. Rule 203–1 requires every person applying for investment adviser registration with the Commission to file Form ADV. Rule 204–1 requires each registered adviser to file amendments to Form ADV at least annually, and requires advisers to submit electronic filings through the IARD. This collection of information is found at 17 CFR 275.203–1, 275.204–1, and 279.1. The currently approved collection of information in Form ADV is 102,653 hours. We estimate that 975 new respondents will file one complete Form ADV and one amendment annually, and comply with Form ADV requirements relating to delivery of the code of ethics. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under Form ADV by 28,958 hours [353] for a total of 131,611 hours.

### *B. Form ADV–W and Rule 203–2*

Rule 203–2 requires every person withdrawing from investment adviser registration with the Commission to file Form ADV–W. The collection of information is necessary to apprise the Commission of advisers who are no longer operating as registered advisers. This collection of information is found at 17 CFR 275.203–2 and 17 CFR 279.2. The currently approved collection of information in Form ADV–W is 500 hours. We estimate that the 975 hedge fund advisers that will be new registrants will withdraw from SEC registration at a rate of approximately 16 percent per year, the same rate as other registered advisers, and will file for partial and full withdrawals at the same rates as other registered advisers, with approximately half of the filings being full withdrawals and half being partial withdrawals. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden

[349] Rule 206(4)–7. *See Compliance Programs of Investment Companies and Investment Advisers, supra* note 109.

[350] *See* Section V. of the Proposing Release.

[351] Staff estimated that between 690 and 1,260 hedge fund advisers will be new Advisers Act registrants under the new rule and rule amendments. *See* Section V. of the Proposing Release.

[352] *See* Section V. of the Proposing Release.

[353] 975 filings of the complete form at 22.25 hours each, plus 975 amendments at 0.75 hours each, plus 6.7 hours for each of the 975 hedge fund advisers to deliver copies of their codes of ethics to 10 percent of their 670 clients annually who request it, at 0.1 hours per response. $(975 \times 22.25) + (975 \times 0.75) + (975 \times (670 \times 0.1) \times 0.1)$.

under Form ADV–W and rule 203–2 by 78 hours [354] for a total of 578 hours.

*C. Rule 203–3 and Form ADV–H*

Rule 203–3 requires that advisers requesting either a temporary or continuing hardship exemption submit the request on Form ADV–H. An adviser requesting a temporary hardship exemption is required to file Form ADV–H, providing a brief explanation of the nature and extent of the temporary technical difficulties preventing it from submitting a required filing electronically. Form ADV–H requires an adviser requesting a continuing hardship exemption to indicate the reasons the adviser is unable to submit electronic filings without undue burden and expense. Continuing hardship exemptions are available only to advisers that are small entities. The collection of information is necessary to provide the Commission with information about the basis of the adviser's hardship. This collection of information is found at 17 CFR 275.203–3, and 279.3. The currently approved collection of information in Form ADV–H is 10 hours. We estimate that the approximately 975 hedge fund advisers that will be new registrants will file for temporary hardship exemptions at approximately 0.1 percent per year, the same rate as other registered advisers.[355] Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under Form ADV–H and rule 203–3 by 1 hour [356] for a total of 11 hours.

*D. Form ADV–NR*

Non-resident general partners or managing agents of SEC-registered investment advisers must make a one-time filing of Form ADV–NR with the Commission. Form ADV–NR requires these non-resident general partners or managing agents to furnish us with a written irrevocable consent and power of attorney that designates the Commission as an agent for service of process, and that stipulates and agrees that any civil suit or action against such person may be commenced by service of process on the Commission. The collection of information is necessary for us to obtain appropriate consent to permit the Commission and other parties to bring actions against non-resident partners or agents for violations of the federal securities laws. This collection of information is found at 17 CFR 279.4. The currently approved collection of information in Form ADV–NR is 15 hours. We estimate that the approximately 975 hedge fund advisers that will be new registrants will make these filings at the same rate (0.2 percent) as other registered advisers. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under Form ADV–NR by 2 hours [357] for a total of 17 hours.

*E. Rule 204–2*

Rule 204–2 requires SEC-registered investment advisers to maintain copies of certain books and records relating to their advisory business. The collection of information under rule 204–2 is necessary for the Commission staff to use in its examination and oversight program. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.[358] The records that an adviser must keep in accordance with rule 204–2 must generally be retained for not less than five years.[359] This collection of information is found at 17 CFR 275.204–2. The currently approved collection of information for rule 204–2 is 1,537,884 hours, or 191.78 hours per registered adviser. We estimate that all 975 advisers that will be new registrants will maintain copies of records under the requirements of rule 204–2. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under rule 204–2 by 186,985.5 hours [360] for a total of 1,724,869.5 hours.

*F. Rule 204–3*

Rule 204–3, the "brochure rule," requires an investment adviser to deliver or offer to prospective clients a disclosure statement containing specified information as to the business practices and background of the adviser. Rule 204–3 also requires that an investment adviser deliver, or offer, its brochure on an annual basis to existing clients in order to provide them with current information about the adviser. The collection of information is necessary to assist clients in determining whether to retain, or continue employing, the adviser. This collection of information is found at 17 CFR 275.204–3. The currently approved collection of information for rule 204–3 is 5,412,643 hours, or 694 hours per registered adviser, assuming each adviser has on average 670 clients. We estimate that all 975 advisers that will be new registrants will provide brochures as required by rule 204–3. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under rule 204–3 by 676,650 hours [361] for a total of 6,089,293 hours. We note that the average number of clients per adviser reflects a small number of advisers who have thousands of clients, while the typical SEC-registered adviser has approximately 76 clients. We requested, but did not receive, comments on the number of clients of the average hedge fund adviser.

*G. Rule 204A–1*

Rule 204A–1 requires SEC-registered investment advisers to adopt codes of ethics setting forth standards of conduct expected of their advisory personnel and addressing conflicts that arise from personal securities trading by their personnel, and requiring advisers' "access persons" to report their personal securities transactions. The collection of information under rule 204A–1 is necessary to establish standards of business conduct for supervised persons of investment advisers and to facilitate investment advisers' efforts to prevent fraudulent personal trading by their supervised persons. This collection of information is found at 17 CFR 275.204A–1. The currently approved collection of information for rule 204A–1 is 945,841 hours, or 117.95 hours per registered adviser. We estimate that all 975 advisers that will be new registrants will adopt codes of ethics under the requirements of rule 204A–1 and require personal securities transaction reporting by their "access persons." Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under rule 204A–1 by 115,001 hours [362] for a total of 1,060,842 hours.

*H. Rule 206(4)–2*

Rule 206(4)–2 requires advisers with custody of their clients' funds and securities to maintain controls designed to protect those assets from being lost, misused, misappropriated, or subjected to financial reverses of the adviser. The collection of information under rule 206(4)–2 is necessary to ensure that clients' funds and securities in the

[354] 156 filings (975 × 0.16), consisting of 78 full withdrawals at 0.75 hours each and 78 partial withdrawals at 0.25 hours each.

[355] We expect that no hedge fund advisers would be small advisers that would be eligible to file for a continuing hardship exemption.

[356] 1 filing (975 × 0.001) at 1 hour each.

[357] 2 filings (975 × 0.002) at 1 hour each.

[358] *See* section 210(b) of the Advisers Act [15 U.S.C. 80b–10(b)].

[359] *See* rule 204–2(e).

[360] 975 hedge fund advisers x 191.78 hours per adviser = 186,985.5 hours.

[361] 975 hedge fund advisers times 694 hours per adviser.

[362] 975 hedge fund advisers at 117.95 hours per adviser annually.

custody of advisers are safeguarded, and staff of the Commission uses information contained in the collections in its enforcement, regulatory, and examination programs. This collection of information is found at 17 CFR 275.206(4)–2. The currently approved collection of information for rule 206(4)–2 is 72,113 hours. We estimate that all 975 hedge fund advisers that will be new registrants will have custody. Advisers to pooled investment vehicles such as hedge funds may distribute audited financial statements to their investors annually in lieu of quarterly account statements sent by either the adviser or a qualified custodian. We are amending rule 206(4)–2 to make it easier for advisers to funds of hedge funds to use this approach. We estimate that all 975 new respondents will use this approach and will not be required to undergo an annual surprise examination. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under rule 206(4)–2 by 326,625 hours [363] for a total of 398,738 hours.

*I. Rule 206(4)–3*

Rule 206(4)–3 requires advisers who pay cash fees to persons who solicit clients for the adviser to observe certain procedures in connection with solicitation activity. The collection of information under rule 206(4)–3 is necessary to inform advisory clients about the nature of a solicitor's financial interest in the recommendation of an investment adviser, so the client may consider the solicitor's potential bias, and to protect investors against solicitation activities being carried out in a manner inconsistent with the adviser's fiduciary duties. This collection of information is found at 17 CFR 275.206(4)–3. The currently approved collection of information for rule 206(4)–3 is 10,982 hours. We estimate that approximately 20 percent of the 975 hedge fund advisers that will be new registrants will be subject to the cash solicitation rule, the same rate as other registered advisers. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under rule 206(4)–3 by 1,373 hours [364] for a total of 12,355 hours.

*J. Rule 206(4)–4*

Rule 206(4)–4 requires registered investment advisers to disclose to clients and prospective clients certain disciplinary history or a financial condition that is reasonably likely to affect contractual commitments. This collection of information is necessary for clients and prospective clients in choosing an adviser or continuing to employ an adviser. This collection of information is found at 17 CFR 275.206(4)–4. The currently approved collection of information for rule 206(4)–4 is 10,118 hours. We estimate that approximately 17.3 percent of the 975 hedge fund advisers that will be new registrants will be subject to rule 206(4)–4, the same rate as other registered advisers. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under rule 206(4)–4 by 1,265 hours [365] for a total of 11,383 hours.

*K. Rule 206(4)–6*

Rule 206(4)–6 requires an investment adviser that votes client securities to adopt written policies reasonably designed to ensure that the adviser votes in the best interests of clients, and requires the adviser to disclose to clients information about those policies and procedures. This collection of information is necessary to permit advisory clients to assess their adviser's voting policies and procedures and to monitor the adviser's performance of its voting responsibilities. This collection of information is found at 17 CFR 275.206(4)–6. The currently approved collection of information for rule 206(4)–6 is 103,590 hours. We estimate that all 975 hedge fund advisers that will be new registrants will vote their clients' securities. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under rule 206(4)–6 by 16,283 hours [366] for a total of 119,873 hours.

*L. Rule 206(4)–7*

Rule 206(4)–7 requires each registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, review those policies and procedures annually, and designate an individual to serve as chief compliance officer. This collection of information under rule 206(4)–7 is necessary to ensure that investment advisers maintain comprehensive internal programs that promote the advisers' compliance with the Advisers Act. This collection of information is found at 17 CFR 275.206(4)–7. The currently approved collection of information for rule 206(4)–7 is 623,200 hours, or 80 hours annually per registered adviser. We estimate all 975 advisers that will be new registrants will be required to maintain compliance programs under rule 206(4)–7. Accordingly, we estimate the new rule will increase the annual aggregate information collection burden under rule 206(4)–7 by 78,000 hours [367] for a total of 701,200 hours.

## VII. Effects on Competition, Efficiency and Capital Formation

Section 202(c) of the Advisers Act mandates that the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[368]

As discussed above, rule 203(b)(3)–2 will, in effect, require most hedge fund advisers to register with the Commission under the Advisers Act. The new rule is designed to provide the protection afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission's ability to protect our nation's securities markets. We are also adopting rule amendments that will facilitate hedge fund advisers' transition to registration and improve the Commission's ability to identify hedge fund advisers from information filed on their Form ADV. The new rule and rule amendments may indirectly increase efficiency for hedge fund investors. Hedge fund adviser registration will provide hedge fund investors and industry participants with better access to important basic information about hedge fund advisers and the hedge fund industry. This improved access may allow investors to investigate and select their advisers more efficiently.

We do not anticipate that the new rule will introduce any competitive disadvantages. The new rule may provide a level playing field with respect to advisers' compliance infrastructures. Many hedge fund advisers are already registered with us, either because their investors demand it or because they have other advisory business that requires them to register. These registered advisers must adopt compliance procedures under the

[363] 975 hedge fund advisers times 670 clients times 0.5 hours per annual financial statement distribution.

[364] 195 respondents (975 × 0.2) at 7.04 hours annually per respondent.

[365] 169 respondents (975 × 0.173) at 7.5 hours annually per respondent.

[366] We estimate that 975 hedge fund advisers will spend 10 hours each annually documenting their voting policies and procedures, and will provide copies of those policies and procedures to 10 percent of their 670 clients annually at 0.1 hours per response.

[367] 975 hedge fund advisers at 80 hours per adviser annually.

[368] 15 U.S.C. 80b–2(c).

Advisers Act and must provide certain safeguards to their clients, including their hedge fund investors. While some unregistered hedge fund advisers have adopted sound comparable compliance procedures, others have not. Mandatory registration will require that all hedge fund advisers compete with each other and with other investment advisers on the same basis in this regard. The amendment to rule 204–2 is designed to prevent newly-registered hedge fund advisers from being at a competitive disadvantage with respect to the promotion of their previous performance records, and the amendment to rule 206(4)–2 is designed to allow advisers to funds of hedge funds to use the same approach under the adviser custody rule as do advisers to other pooled investment vehicles.

Some hedge fund advisers may elect to limit the number of investors in their funds, or limit their total assets under management in order to avoid registration under the Advisers Act. To the extent that certain hedge fund advisers choose not to expand their business, some investors may not be able to place their assets with particular advisers; on the other hand, a hedge fund adviser's decision not to expand its business may make it easier for other advisers to enter the market.

The new rule is unlikely to have a substantial effect on capital formation. To the extent that registration and the prospect of Commission examinations improves the compliance culture at hedge fund advisory firms, it may bolster investor confidence and investors may be more likely to entrust hedge fund advisers with their assets for investment. However, these assets may be diverted from other investments in the capital markets.

## VIII. Regulatory Flexibility Act

### *A. Certification*

Pursuant to section 605(b) of the Regulatory Flexibility Act,[369] the Commission hereby certifies that rule 203(b)(3)–2 and the amendments to rules 203(b)(3)–1, 203A–3, 204–2, 205–3, 222–2 and Form ADV will not have a significant economic impact on a substantial number of small entities. Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had $5 million or more on the last day of its most recent fiscal year.[370]

Rule 203(b)(3)–2 and the amendment to rule 203(b)(3)–1 will remove a safe harbor and require certain advisers to private funds to register with the Commission under the Advisers Act by requiring them to count investors in the fund as clients for purposes of the Advisers Act ''de minimis'' exemption from registration. Notwithstanding the new rule, investment advisers with assets under management of less than $25 million will remain generally ineligible for registration with the Commission under section 203A of the Advisers Act.[371] The amendments to rule 203A–3 and 222–2 clarify that advisers may continue to rely on rule 203(b)(3)–1's safe harbor when counting clients for purposes of rules that affect state licensing and registration. The amendments to rules 204–2 and 205–3 will allow advisers affected by the new rule to continue certain marketing practices and performance fees they now have in place. The amendment to Form ADV will require advisers to private funds to identify themselves as such. No other entities will incur obligations from the new rule and amendments. Accordingly, the Commission certifies that rule 203(b)(3)–2 and the amendments to rules 203(b)(3)–1, 203A–3, 204–2, 205–3, 222–2, and Form ADV will not have a significant economic impact on a substantial number of small entities.

### *B. Amendment to Rule 206(4)–2*

The Commission has prepared the following Final Regulatory Flexibility Analysis (''FRFA'') regarding the amendment to rule 206(4)–2 in accordance with section 3(a) of the Regulatory Flexibility Act.[372]

#### 1. Reasons for Action

We are amending rule 206(4)–2, the adviser custody rule, to accommodate advisers to private funds of funds, including funds of hedge funds.[373] Under the rule, advisers to pooled investment vehicles may satisfy their obligation to deliver custody account information to investors by distributing the pool's audited financial statements to investors within 120 days of the pool's fiscal year-end.[374] Some advisers to private funds of funds (including funds of hedge funds) have encountered difficulty in obtaining completion of their fund audits prior to completion of the audits for the underlying funds in which they invest, and as a practical matter will be prevented from complying with the 120-day deadline. We amended the rule to extend the period for funds of funds to distribute their audited financial statements to their investors from 120 days to 180 days, so that advisers to funds of hedge funds may comply with the rule.[375]

#### 2. Objectives and Legal Basis

The objective of the amendment to rule 206(4)–2 is to make the rule requirements easier to comply with for advisers to private funds of funds such as funds of hedge funds. Section IX of this Release lists the statutory authority for the amendment.

#### 3. Small Entities Subject to Rule

The Commission estimates that as of June 30, 2004,[376] approximately 490 SEC-registered investment advisers that would be affected by the amendment to the rule were small entities for purposes of the Advisers Act and the Regulatory Flexibility Act.[377]

#### 4. Reporting, Record-keeping, and Other Compliance Requirements

The amendment will impose no new reporting, record-keeping or other compliance requirements. To the contrary, the amendment will provide all advisers, big or small, that advise funds of funds with the opportunity to reduce the burdens they incur complying with the present rule's requirements to send pools' audited financial statements to their investors within 120 days.

[369] 5 U.S.C. 605(b)

[370] Rule 0–7(a) [17 CFR 275.0–7(a)].

[371] 15 U.S.C. 80b–3A.

[372] 5 U.S.C. 603(a).

[373] Rule 206(4)–2.

[374] Rule 206(4)–2(b)(3).

[375] We initially proposed to extend the period for all investment advisers. Commenters pointed out that such extension would leave the advisers to funds of funds in the same situation, *i.e.*, the underlying hedge funds would use the entire 180-day period, and the advisers to the funds of funds would have no time to prepare financial statements for the funds of funds after they receive the financial statements from underlying hedge funds.

[376] This estimate is based on the information provided by SEC-registered advisers in Form ADV, Part 1A.

[377] *See* Section VIII.A. of this Release for the definition of a small entity. Unlike the other rules and amendments the Commission is proposing today, the scope of the amendment to rule 206(4)–2 is not limited to hedge fund advisers that would be subject to registration requirements under rule 203(b)(3)–2.

5. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with the amendment.

6. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that will accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the new rule, the Commission considered the following alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the amendment for such small entities.

The overall impact of the amendment is to decrease regulatory burdens on advisers; small advisers, as well as large ones, will benefit from the new rule. Moreover, the amendment achieves the rule's objectives through alternatives that are already consistent in large part with advisers' current custodial practices. For these reasons, alternatives to the amendment are unlikely to minimize any impact that the new rule may have on small entities. The 180-day rule cannot be further clarified, or improved by the use of a performance standard. Regarding exemption from coverage of the rule amendment, or any part thereof, for small entities, such an exemption will deprive small entities of the burden relief provided by the amendment.

**IX. Statutory Authority**

We are adopting new rule 203(b)(3)–2 and amendments to rule 203(b)(3)–1, rule 203A–3, rule 204–2, rule 205–3, rule 206(4)–2, rule 222–2 and Form ADV pursuant to our authority under section 19(a) of the Securities Act of 1933,[378] sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934,[379] section 319(a) of the Trust Indenture Act of 1939,[380] section 38(a) of the Investment Company Act of 1940,[381] and sections 202(a)(17), 203, 204, 205(e), 206(4), 206A, 208(d) and 211(a) of the Advisers Act.[382] Section 211(a) gives us authority to classify, by rule, persons and matters within our jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of our authority under the Act.[383] Our authority is described in more detail in Section II.C of this Release.

**Text of Rule, Rule Amendments and Form Amendments**

**List of Subjects in 17 CFR Parts 275 and 279**

Investment Advisers, Reporting and recordkeeping requirements, Securities.

■ For reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

## PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

■ 1. The general authority citation for Part 275 continues to read as follows:

**Authority:** 15 U.S.C. 80b–2(a)(11)(F), 80b–2(a)(17), 80b–3, 80b–4, 80b–4a, 80b–6(4), 80b–6a, and 80b–11, unless otherwise noted.

* * * * *

■ 2. Section 275.203(b)(3)–1 is revised to read as follows:

**§ 275.203(b)(3)–1 Definition of "client" of an investment adviser.**

*Preliminary Note to § 275.203(b)(3)–1.* This section is a safe harbor and is not intended to specify the exclusive method for determining who may be deemed a single client for purposes of section 203(b)(3) of the Act. Under paragraph (b)(6) of this section, the safe harbor is not available with respect to private funds.

(a) *General.* You may deem the following to be a single client for purposes of section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)):

(1) A natural person, and:

(i) Any minor child of the natural person;

(ii) Any relative, spouse, or relative of the spouse of the natural person who has the same principal residence;

(iii) All accounts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries; and

(iv) All trusts of which the natural person and/or the persons referred to in this paragraph (a)(1) are the only primary beneficiaries;

(2)(i) A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to in paragraph (a)(1)(iv of this section), or other legal organization (any of which are referred to hereinafter as a "legal organization") to which you provide investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an "owner"); and

(ii) Two or more legal organizations referred to in paragraph (a)(2)(i) of this section that have identical owners.

(b) *Special rules.* For purposes of this section:

(1) You must count an owner as a client if you provide investment advisory services to the owner separate and apart from the investment advisory services you provide to the legal organization, *provided, however,* that the determination that an owner is a client will not affect the applicability of this section with regard to any other owner;

(2) You are not required to count an owner as a client solely because you, on behalf of the legal organization, offer, promote, or sell interests in the legal organization to the owner, or report periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters;

(3) A limited partnership or limited liability company is a client of any general partner, managing member or other person acting as investment adviser to the partnership or limited liability company;

(4) You are not required to count as a client any person for whom you provide investment advisory services without compensation;

(5) If you have your principal office and place of business outside the United States, you are not required to count clients that are not United States residents, but if your principal office and place of business is in the United States, you must count all clients;

(6) You may not rely on paragraph (a)(2)(i) of this section with respect to any private fund as defined in paragraph (d) of this section; and

(7) For purposes of paragraph (b)(5) of this section, a client who is an owner of a private fund is a resident of the place at which the client resides at the time of the client's investment in the fund.

(c) *Holding out.* If you are relying on this section, you shall not be deemed to be holding yourself out generally to the

[378] 15 U.S.C. 77s(a).

[379] 15 U.S.C. 78w(a) and 78bb(e)(2).

[380] 15 U.S.C. 77sss(a).

[381] 15 U.S.C. 80a–37(a).

[382] 15 U.S.C. 80b–2(a)(17), 80b–3, 80b–4, 80b–6(4) and 80b–11(a).

[383] Section 211(a) also provides that "the Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission * * *."

public as an investment adviser, within the meaning of section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)), solely because you participate in a non-public offering of interests in a limited partnership under the Securities Act of 1933.

(d) *Private fund.* (1) A private fund is a company:

(i) That would be an investment company under section 3(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(a)) but for the exception provided from that definition by either section 3(c)(1) or section 3(c)(7) of such Act (15 U.S.C. 80a–3(c)(1) or (7));

(ii) That permits its owners to redeem any portion of their ownership interests within two years of the purchase of such interests; and

(iii) Interests in which are or have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

(2) Notwithstanding paragraph (d)(1) of this section, a company is not a private fund if it permits its owners to redeem their ownership interests within two years of the purchase of such interests only in the case of:

(i) Events you find after reasonable inquiry to be extraordinary; and

(ii) Interests acquired through reinvestment of distributed capital gains or income.

(3) Notwithstanding paragraph (d)(1) of this section, a company is not a private fund if it has its principal office and place of business outside the United States, makes a public offering of its securities in a country other than the United States, and is regulated as a public investment company under the laws of the country other than the United States.

■ 3. Section 275.203(b)(3)–2 is added to read as follows:

**§ 275.203(b)(3)–2 Methods for counting clients in certain private funds.**

(a) For purposes of section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)), you must count as clients the shareholders, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an ''owner'') of a private fund as defined in paragraph (d) of section 275.203(b)(3)–1, unless such owner is your advisory firm or a person described in paragraph (d)(1)(iii) of section 275.205–3.

(b) If you provide investment advisory services to a private fund in which an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 to 80a–64) is, directly or indirectly, an owner, you must count the owners of that investment company as clients for purposes of section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)).

(c) If you have your principal office and place of business outside the United States, you may treat a private fund that is organized or incorporated under the laws of a country other than the United States as your client for all purposes under the Act, other than sections 203, 204, 206(1) and 206(2) (15 U.S.C. 80b–3, 80b–4, 80b–6(1) and (2)).

■ 4. Section 275.203A–3 is amended by revising paragraph (a)(4) to read as follows:

**§ 275.203A–3 Definitions.**

(a) * * *

(4) Supervised persons may rely on the definition of ''client'' in § 275.203(b)(3)–1, without giving regard to paragraph (b)(6) of that section, to identify clients for purposes of paragraph (a)(1) of this section, except that supervised persons need not count clients that are not residents of the United States.

* * * * *

■ 5. Section 275.204–2 is amended by:

■ (a) Redesignating paragraph (e)(3) as (e)(3)(i); and

■ (b) Adding paragraphs (e)(3)(ii) and (l).

The additions read as follows:

**§ 275.204–2 Books and records to be maintained by investment advisers.**

* * * * *

(e) * * *

(3)(i) * * *

(ii) *Transition rule.* If you are an investment adviser to a private fund as that term is defined in § 275.203(b)(3)–1, and you were exempt from registration under section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)) prior to February 10, 2005, paragraph (e)(3)(i) of this section does not require you to maintain or preserve books and records that would otherwise be required to be maintained or preserved under the provisions of paragraph (a)(16) of this section to the extent those books and records pertain to the performance or rate of return of such private fund or other account you advise for any period ended prior to February 10, 2005, provided that you were not registered with the Commission as an investment adviser during such period, and provided further that you continue to preserve any books and records in your possession that pertain to the performance or rate of return of such private fund or other account for such period.

* * * * *

(l) *Records of private funds.* If an investment adviser subject to paragraph (a) of this section advises a private fund (as defined in § 275.203(b)(3)–1), and the adviser or any related person (as defined in Form ADV (17 CFR 279.1)) of the adviser acts as the private fund's general partner, managing member, or in a comparable capacity, the books and records of the private fund are records of the adviser for purposes of section 204 of the Act (15 U.S.C. 80b–4).

6. Section 275.205–3 is amended by redesignating paragraph (c) as (c)(1) and adding paragraph (c)(2) to read as follows:

**§ 275.205–3 Exemption from the compensation prohibition of section 205(a)(1) for investment advisers.**

* * * * *

(c)(1) * * *

(2) *Advisers to private funds with non-qualified investors.* If you are an investment adviser to a private investment company that is a private fund as that term is defined in § 275.203(b)(3)–1, and you were exempt from registration under section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)) prior to February 10, 2005, paragraph (b) of this section will not apply to the existing account of any equity owner of a private investment company who was an equity owner of that company prior to February 10, 2005.

(3) *Advisers to private funds with non-qualified clients.* If you are an investment adviser to a private investment company that is a private fund as that term is defined in § 275.203(b)(3)–1, and you were exempt from registration under section 203(b)(3) of the Act (15 U.S.C. 80b–3(b)(3)) prior to February 10, 2005, section 205(a)(1) of the Act (15 U.S.C. 80b–5(a)(1)) will not apply to any investment advisory contract you entered into prior to February 10, 2005, provided, however, that this paragraph will not apply with respect to any contract to which a private investment company is a party, and provided further that section 205(a)(1) of the Act will apply with respect to any natural person or company who is not a party to the contract prior to and becomes a party to the contract on or after February 10, 2005.

* * * * *

■ 7. Section 275.206(4)–2 is amended by revising paragraph (b)(3) and adding paragraph (c)(4) to read as follows:

**§ 275.206(4)–2 Custody of funds or securities of clients by investment advisers.**

* * * * *

(b) * * *

(3) *Limited partnerships subject to annual audit.* You are not required to comply with paragraph (a)(3) of this section with respect to the account of a

limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit (as defined in section 2(d) of Article 1 of Regulation S–X (17 CFR 210.1–02(d)) at least annually and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year, or in the case of a fund of funds within 180 days of the end of its fiscal year; and

* * * * *

(c) * * *

(4) *Fund of funds* means a limited partnership (or limited liability company, or another type of pooled investment vehicle) that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person (as defined in Form ADV (17 CFR 279.1)), of the limited partnership, its general partner, or its adviser.

■ 8. Section 275.222–2 is revised to read as follows:

**§ 275.222–2 Definition of ''client'' for purposes of the national de minimis standard.**

For purposes of section 222(d)(2) of the Act (15 U.S.C. 80b–18a(d)(2)), an investment adviser may rely upon the definition of ''client'' provided by section 275.203(b)(3)–1 without giving regard to paragraph (b)(6) of that section.

## PART 279—FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

■ 9. The authority citation for Part 279 continues to read as follows:

**Authority:** The Investment Advisers Act of 1940, 15 U.S.C. 80b–1, *et seq.*

■ 10. Form ADV (referenced in § 279.1) is amended by:

■ a. In Part 1A, Item 7, revising Item 7B; and

■ b. In Schedule D, revising Section 7.B.

The revisions read as follows:

**Note:** The text of Form ADV does not and this amendment will not appear in the Code of Federal Regulations.

Form ADV

* * * * *

Part 1A

* * * * *

Item 7 Financial Industry Affiliations

* * * * *

B. Are you or any related person a general partner in an investment-related limited partnership or manager of an investment-related limited liability company, or do you advise any other ''private fund,'' as defined under SEC rule 203(b)(3)–1? ☐ Yes ☐ No

If ''yes,'' for each limited partnership, limited liability company, or (if applicable) private fund, complete Section 7.B. of Schedule D. If, however, you are an SEC-registered adviser *and* you have related persons that are *SEC-registered advisers* who are the general partners of limited partnerships or the managers of limited liability companies, you do not have to complete Section 7.B. of Schedule D with respect to those related advisers' limited partnerships or limited liability companies.

To use this alternative procedure, you must state in the Miscellaneous Section of Schedule D: (1) that you have related SEC-registered investment advisers that manage limited partnerships or limited liability companies that are not listed in Section 7.B. of your Schedule D; (2) that complete and accurate information about those limited partnerships or limited liability companies is available in Section 7.B. of Schedule D of the Form ADVs of your related SEC-registered advisers; and (3) whether your clients are solicited to invest in any of those limited partnerships or limited liability companies.

* * * * *

Schedule D

* * * * *

SECTION 7.B. Limited Partnership or Other Private Fund Participation

You must complete a separate Schedule D Page 4 for each limited partnership in which you or a related person is a general partner, each limited liability company for which you or a related person is a manager, and each other private fund that you advise.

Check only one box:

☐ Add ☐ Delete ☐ Amend

________________________________

Name of Limited Partnership, Limited Liability Company, or other Private Fund:

________________________________

Name of General Partner or Manager:

If you are registered or registering with the SEC, is this a ''private fund'' as defined under SEC rule 203(b)(3)–1?

☐ Yes ☐ No

Are your clients solicited to invest in the limited partnership, limited liability company or other private fund?

☐ Yes ☐ No

Approximately what percentage of your clients have invested in this limited partnership, limited liability company, or other private fund?

______________%

Minimum investment commitment required of a limited partner, member, or other investor:

$____________________

Current value of the total assets of the limited partnership, limited liability company, or other private fund:

$____________________

Dated: December 2, 2004.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

### Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Registration Under the Advisers Act of Certain Hedge Fund Advisers

Four months ago, the majority proposed to regulate hedge fund advisers over our dissent.[1] We were nevertheless hopeful that a careful review of commentary on the proposal would convince the majority, instead of taking further action on this proposal, to consider better alternatives. Our hope was fueled by the fact that many commenters offered excellent insights and recommendations to the Commission. We are disappointed that the majority, unmoved by the chorus of credible concerns from diverse voices,[2] has determined to adopt the hedge fund registration rules largely as proposed.[3] As discussed below, we continue to agree that we need more information on hedge funds, but we disagree with the majority's solution.

Our main concerns with this rulemaking can be broadly divided into the following categories:

• There are many viable alternatives to this rulemaking that should have been considered.

The needed information about hedge funds can be obtained from other sources, including other regulators and market participants, as well as through a notice and filing requirement. The Commission should have collected and analyzed the existing information and determined what new information would be useful *before* imposing mandatory registration. Further, the Commission has failed to demonstrate that this is the least burdensome and most effective way to accomplish its objective.

• The pretext for the rule does not withstand scrutiny.

Just last year, the staff found that fraud was not rampant in the hedge fund industry, and that retailization was not a concern. Nonetheless, the majority repeatedly asserts

[1] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2266 (July 20, 2004) [69 FR 45172 (July 28, 2004)] (''Proposing Release'').

[2] In addition to the many comments the Commission received, the diversity of voices is illustrated by the appearance of editorials opposing the rulemaking in the *New York Times, Wall Street Journal,* and *Washington Post. See Hands off Hedge Funds,* Wash. Post, B6, July 18, 2004; *Reforming Hedge Funds,* N.Y. Times, D12, June 27, 2004; *The SEC's Expanding Empire,* Wall St. J., A14, July 13, 2004.

[3] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) (''Adopting Release'').

that these issues justify imposition of the rulemaking. The fallacy of the majority's approach is apparent when one notes that registration of hedge fund advisers would not have prevented the enforcement cases cited by the majority, and the rulemaking will have the perverse effect of promoting, rather than inhibiting, retailization.

• The Commission's limited resources will be diverted.

At the open meeting, Chairman Donaldson stated that a task force had been constituted to identify hedge fund risks and implied that the task force would develop a targeted examination model. However, the task force should have completed its work prior to the promulgation of this rulemaking, so that it could be specifically tailored to address actual, as opposed to hypothetical, concerns. Under this rulemaking, the Commission will have to allocate its limited resources to inspect more than 1,000 additional advisers. Our concerns about the misuse of resources were validated when, just two days after the open meeting, the staff stated that, if the Commission cannot undertake its new examination responsibilities, it has in its ''back pocket'' the ability to shift resources from oversight of small advisers.[4] This possible shift should have been raised during the open meeting and weighed by the Commission in deciding whether to adopt the rule.

Our concerns are addressed in detail below.

## I. The Information That the Commission Needs can be Obtained From Other Sources

We share the majority's objective of getting better information about hedge funds and would support alternative measures such as pooling of information from Commission registrants and other government agencies and self-regulatory organizations that collect data on hedge funds, enhanced oversight of existing registrants, a census of all hedge funds, and requiring additional periodic and systematic information to be filed with us. Although the majority anticipates without specificity that ''registration would provide the Congress, the Commission and other government agencies with important information,'' Form ADV is unlikely to provide the information that the Commission needs. Before taking an action of the magnitude of this final rule, the Commission should have determined the information that it needs and worked with its fellow regulators and affected parties to obtain this information. Instead, the process by which the rule was proposed and adopted discouraged a true exchange of ideas about the proposed approach and alternatives.[5]

### *A. Coordination With Other Regulators Should Have Been a Prerequisite to Unilateral Commission Action*

Before adopting this rulemaking, the Commission should have coordinated with other government entities to aggregate the information that is available. The majority correctly notes that such information is not gathered in one convenient place, but we could work with other regulators to improve our and other agencies' access to information.[6] The Commission also could explore ways of expanding the form that the Department of Treasury has proposed to require all unregistered advisers to file as part of its anti-money laundering program for investment advisers.[7]

The majority approved the rulemaking three weeks after Congressman Baker, Chairman of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, asked the President's Working Group on Financial Markets (''PWG'')[8] to work out a data sharing agreement before the Commission proceeded with its rule.[9] Because the regulation of hedge funds has broad market implications, any regulatory requirement would be more appropriately addressed as part of a collaborative effort among the members of the PWG, all of whom apparently have concerns with our proposal.[10] In 1999 after the near collapse of Long Term Capital Management, the PWG issued a report that concluded that ''requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity.''[11] We agree with Chairman Greenspan that nothing has changed since then to warrant a different conclusion.[12]

The majority justifies going forward in the face of such opposition by arguing that the

[4] *See* Robert Schmidt, *Hedge Fund Rule May Cause SEC to Drop Smaller Firms, Roye Says,* Bloomberg (Oct. 28, 2004).

[5] Such a major shift in the Commission's regulatory approach warranted a significantly longer comment and comment review period than we afforded it. The proposal appeared in the **Federal Register** on July 28, 2004, and comments were due by September 15, 2004. Concerned about the brevity of the comment period and its inopportune timing during the vacation month of August, ten commenters requested a reasonable extension, but no extension was granted.

Moreover, once the comment period closed, the staff did not prepare a formal summary analyzing the issues raised by the more than 160 comment letters, most of which opposed the rule. Such summaries are standard procedure for rulemakings of this significance, because the summaries help ensure that the comments are considered by the commissioners and staff. The abbreviated discussion of the comment letters in the adopting release is not a sufficient substitute for a comment summary that is prepared before drafting the release to assist the Commission in deciding whether to adopt a proposed rulemaking and, if so, whether to make any changes.

The majority seems to have concluded that it had already heard all perspectives at the Commission's roundtable on hedge funds in May of 2003 and through the subsequent staff study. See Securities and Exchange Commission, Hedge Fund Roundtable (May 14–15, 2003) (transcript and webcast available at: *http://www.sec.gov/spotlight/hedgefunds.htm*) (''Roundtable''); Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (Sept. 2003) (available at: *http://www.sec.gov/news/studies/hedgefunds0903.pdf*) (''2003 Staff Hedge Fund Report''). However, the roundtable and staff study disproved the existence of the problems that some thought might be found in the hedge fund industry. Consequently, the public did not have sufficient notice that a rulemaking would be forthcoming, much less of the specifics of the proposed rulemaking.

[6] The Commodity Futures Trading Commission (''CFTC''), for example, has offered to enter into an information-sharing arrangement with the Commission and other relevant agencies. *See* Comment Letter of the CFTC (Oct. 22, 2004). The National Futures Association, which is a self-regulatory organization for the futures industry, likewise offered to share the information that it collects about hedge funds. *See* Comment Letter of the National Futures Association (Sept. 14, 2004).

[7] Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Investment Advisers, 68 FR 23646 (May 5, 2003). The proposed rule would apply to, among others, any adviser that has at least $30 million in assets under management and is exempt from registration under section 203(b)(3) of the Investment Advisers Act [15 U.S.C. 80b–3(b)(3)], unless it is otherwise required to have an anti-money laundering program and is subject to examination by a federal regulator. *See* section 103.50(a)(2) of the proposed rule. [31 CFR 103.50(a)(2)]. As proposed, the form is intended to identify unregistered advisers, but the Commission could work with the Department of Treasury to tailor the form to elicit the information that the Commission determines that it needs.

[8] The President's Working Group is made up the heads of the Treasury, the Federal Reserve Board, the CFTC, and the SEC.

[9] *See* Letter from Congressman Richard H. Baker to John Snow, Chairman of the President's Working Group on Financial Markets (Oct. 7, 2004). Oddly, the majority cites this letter, the existence of which we learned about the day before the Open Meeting for this rulemaking, in support of the proposition that ''During and after the comment period, our staff has continued to have discussions with other regulators relating to hedge fund adviser regulation.'' Adopting Release at n. 55.

[10] *See*, *e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004) (''My problem with the SEC's current initiative is that the initiative cannot accomplish what it seeks to accomplish. Fraud and market manipulation will be very difficult to detect from the information provided by registration under the 1940 Act.''); Comment Letter of the CFTC (Oct. 22, 2004) (requesting exemption for CFTC-registered advisers that ''would be complemented by a formal information sharing agreement between the CFTC and SEC related to CFTC-registered CPOs and CTAs''); Judith Burns, *Split SEC Set to Vote on Tighter Hedge Fund Oversight*, Dow Jones News Service, Oct. 25, 2004 (''Federal Reserve Chairman Alan Greenspan and Treasury Secretary John Snow worry that more regulation won't prevent fraud and could reduce benefits that hedge funds bring to markets.'').

[11] Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management—Report of the President's Working Group on Financial Markets, at B–16 (Apr. 1999) (available at: *http://www.treas.gov/press/releases/reports/hedgfund.pdf*) (the Council of Economic Advisers, the Federal Deposit Insurance Corporation, the National Economic Council, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision also participated in the study and supported its conclusions and recommendations). The majority contends that the report did not focus on issues relevant to the Commission's administration of the Advisers Act, but rather on ''the stability of financial markets and the exposure of banks and other financial institutions to the counterparty risks of dealing with highly leveraged entities.'' Adopting Release at n. 43. The Commission cannot protect the nation's securities markets without considering the effect of its rules on the stability of the financial markets.

[12] *See* Alan Greenspan, Chairman, Federal Reserve Board, Written Responses to Questions from Chairman Shelby in Connection with Testimony before the Senate Banking, Housing and Urban Affairs Committee, at 3 (July 20, 2004).

Commission alone among the PWG members bears the ''responsibility for the protection of investors and the oversight of our nation's securities markets,'' [13] but other regulators may be better suited to address some of the majority's specific areas of concern.[14] The majority, for example, did not consult the Department of Labor, which has primary jurisdiction over private pension plan advisers, about this rulemaking even though one of its justifications for the rulemaking is pension fund investment in hedge funds. The CFTC, with which many hedge fund advisers or sponsors are already registered, expressed serious concerns about duplicative regulation by the SEC and recommended an exemption for CFTC registrants.[15] Similarly, although the majority addressed a number of concerns raised with respect to offshore funds, they did not adequately address, through discussions with foreign regulators, commenters' concerns about potentially duplicative regulation.[16]

*B. Before Proceeding With Registration, the Commission Should Have Enhanced Its Oversight of Existing Registrants*

Rather than adding to its stable of registrants, the Commission could have obtained useful information by monitoring transactions through its existing registrants. The Commission, for example, could enhance its oversight of prime brokers to detect and deter fraud by their hedge fund clients and obtain more information about hedge fund advisers.[17] More generally, market surveillance is an effective, targeted way of finding fraud, and would allow us to leverage the knowledge and expertise of other self-regulatory organizations.[18]

*C. Commenters Showed a Commendable Willingness To Help the Commission Obtain the Information We Need Through Mining Existing Information Resources or Developing New Ones*

The commenters, the vast majority of which opposed mandatory registration, suggested a number of alternatives for ensuring that the Commission has ample information about hedge funds. Among the suggestions was requiring investment advisers that are exempt under sections (3)(c)(1) or (3)(c)(7) of the Investment Company Act of 1940 [19] or rely on the safe harbor in rule 203(b)(3)–1 under the Advisers Act [20] to file and annually update information statements with the Commission.[21] These information statements could include information such as the names of all unregistered funds advised, the names and qualifications of the key owners and employees of the adviser, assets under management, other types of accounts managed, a list of the prime brokers used by the adviser, and performance data. The majority's footnote addressing this approach dismisses this as a variant of another suggested approach—expanded Form D reporting.[22] The majority refused to consider either approach because both lack an examination component.[23] For the reasons stated below, we do not believe that the examination aspect of hedge fund regulation will deliver the benefits that the majority believes it will and we are concerned with the diversion of resources that examination will entail.

**II. Mandatory Registration Does Not Address the Concerns Underlying the Rulemaking**

The majority cites three main bases for its action: the growth of hedge fund assets, the growth in hedge fund fraud, and the broader exposure to hedge funds. None of these justifies the majority's action.

*A. The Commission Should Not Necessarily Increase Its Regulatory Requirements on an Industry Simply Because It Has Grown*

The majority points to the growth of the hedge fund industry as a concern underlying the action being taken. Given the industry's size,[24] the Commission has a basis for wanting more information about it, but the Commission should not assume that a greater level of regulation is needed in a flourishing industry with a wealthy and sophisticated investor base.

In the Proposing Release, the majority argued that registration would ''legitimiz[e] a growing and maturing industry that is currently perceived as operating in the shadows.''[25] The Adopting Release does not repeat this dramatic language, but the underlying belief that there is something improper about not registering voluntarily is evident.[26] The Commission should not

[13] Adopting Release at n. 43.

[14] As the Commission has explained elsewhere, the Commission's interest in a particular area does not preclude its working with other regulators. *See, e.g.*, SEC, 2002 Annual Report 1 (available at: *http://www.sec.gov/pdf/annrep02/ar02fm.pdf*) (''Though it is the primary overseer and regulator of the U.S. securities markets, the SEC works closely with many other institutions * * *''). The Adopting Release notes that the staff met with staff of various fellow regulators, but because these meetings were not documented in the comment file, it is difficult to discern what occurred at those meetings. *See* Adopting Release at n. 17.

[15] *See* Comment Letter of the CFTC (Oct. 22, 2004) (''in the interest of good government and in order to avoid duplicative regulation, the CFTC respectfully requests that the SEC provide a registration exemption for these CFTC registrants that do not hold themselves out to the general public as investment advisers.''). Many other commenters also recommended an exemption for CFTC-registered entities. The majority dismisses requests to exempt CFTC-registered commodity pool operators by arguing that Congress already addressed this concern by adding section 203(b)(6) to the Advisers Act in 2000 [15 U.S.C. 80b–3(b)(6)], but that section covers only commodity trading advisers, not commodity pool operators. *See* Adopting Release at text accompanying n. 128. We share the majority's hope that the staff will consult with the CFTC staff regarding examinations, but staff discussions at the implementation stage cannot substitute for discussions about the Commission's proposal prior to adoption. See Adopting Release at n. 130.

[16] Many commenters recommended that the Commission should not require the registration of certain advisers that are subject to oversight by foreign authorities. *See, e.g.*, Comment Letter of the European Commission (Sept. 15, 2004); Comment Letter of the Fédération Européenne des Fonds et Sociétés d'Investissement (Sept. 15, 2004); Comment Letter of the Financial Services Roundtable (Sept. 15, 2004); the International Bar Association (Sept. 14, 2004).

[17] *See, e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, Written Responses to Questions from Chairman Shelby in Connection with Testimony before the Senate Banking, Housing and Urban Affairs Committee, (July 20, 2004) (''If there was a public policy reason to monitor hedge fund activity, the best method of doing so without raising liquidity concerns would be indirectly through oversight of those broker-dealers (so-called prime brokers) that clear, settle, and finance trades for hedge funds. Although the use of multiple prime brokers by the largest funds would complicate the monitoring of individual funds by this method, such monitoring could provide much useful information on the hedge funds sector as a whole.'').

[18] *See, e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, Written Responses to Questions from Chairman Shelby in Connection with Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004) (''Concerns about market manipulation, whether by hedge funds or others, can best be addressed by enhanced market surveillance.'').

[19] 15 U.S.C. 80a–3(c)(1) and 15 U.S.C. 80a–3(c)(7).

[20] 17 CFR 275.203(b)(3)–1.

[21] A number of commenters suggested this approach or a similar annual census form for hedge fund advisers. *See, e.g.*, Comment Letter of the American Bar Association, Section of Business Law (Sept. 28, 2004); Comment Letter of Sheila C. Bair, Professor of Financial Regulatory Policy, University of Massachusetts—Amherst (Sept. 15, 2004); Comment Letter of the U.S. Chamber of Commerce (Sept. 15, 2004); Comment Letter of Kynikos Associates (Sept. 15, 2004); Comment Letter of the Managed Funds Association (Sept. 15, 2004); Comment Letter of Seward & Kissell LLP (Sept. 15, 2004); Comment Letter of Schulte Roth & Zabel, LLP (Sept. 15, 2004); Comment Letter of Tudor Investment Corp. (Sept. 15, 2004). Other commenters suggested requiring hedge fund advisers to file audited financial statements. *See, e.g.*, Comment Letter of Madison Capital Management LLC (Sept. 15, 2004); Comment Letter of James E. Mitchell (Sept. 1, 2004); Comment Letter of Joseph L. Vidich (Aug. 7, 2004); Comment Letter of Willkie, Farr & Gallagher (Sept. 13, 2004) (recommending self-executing exemptive application procedure for advisers that provide investors with audited financials and valuation disclosures).

[22] *See* Adopting Release at n. 150.

[23] *See* Adopting Release at text accompanying n. 154. The majority also concluded that it was not worthwhile for the staff to try to make use of the information generated by existing transactional reporting requirements. *See* Adopting Release at text following n. 155. This seems to be a premature conclusion, particularly in light of commenters' suggestion to tailor current forms so that they meet the Commission's information needs. *See, e.g.*, Comment Letter of Bryan Cave LLP (Aug. 16, 2004) (recommending extensive amendments to Regulation D and Form D and Suspicious Activity Reports); Comment Letter of Madison Capital Management LLC (Sept. 15, 2004); Comment Letter of Proskauer Rose LLP (Aug. 31, 2004); Comment Letter of Tudor Investment Corp. (Sept. 15, 2004).

[24] The majority estimates the hedge fund industry to be $870 billion, which is dwarfed by the approximately $23 trillion under management by registered advisers. *See* Adopting Release at text accompanying n. 19 and following n. 71.

[25] Proposing Release, *supra* n. 1, at text following n. 183.

[26] This belief manifests itself in the perfunctory manner in which the majority dismisses legitimate concerns from opposing commenters by challenging the commenters' integrity. *See, e.g.*, Adopting Release at text accompanying n. 87 (noting, that hedge fund advisers ''should be particularly sensitive to the consequences of getting caught if

Continued

encourage an adviser's registration status to be viewed as a proxy for the adviser's honesty. There are many legitimate reasons for a hedge fund adviser not to register.[27]

*B. Registration Would Not Have Prevented the Violations in the Enforcement Cases Cited by the Majority*

While we acknowledge that hedge fund fraud exists and should be taken seriously, it appears, based on our knowledge, that the majority overstates its relative significance. The 2003 Staff Hedge Fund Report did not find disproportionate involvement of hedge funds or their advisers in fraud.[28] We estimate that the cases cited by the majority during the past five years comprise less than two percent of total SEC cases in the same period. The CFTC similarly found that only three percent of all SEC and CFTC enforcement actions were against hedge funds or their advisers.[29]

Citing to forty-six cases in the Proposing Release and five additional cases in the Adopting Release, the majority is requiring advisers to the most sophisticated investors to register based on fraud cases, most of which were directed at the least sophisticated investors. These cases do not provide a justification for mandatory registration because, in most, the hedge fund advisers would have been too small to be registered under the new requirement,[30] were already registered,[31] or should have been registered.[32] Many were garden-variety fraudsters who could as easily have called their schemes something other than ''hedge funds.'' The majority argues that registration with the Commission permits it to screen registrants and deny registration to anyone who has been convicted of a felony or otherwise has a disciplinary history that warrants disqualification. Many of those implicated in our cases would not even have sufficient assets to be eligible for registration.[33] Others, whose sole objective was to defraud investors, likely would not even attempt to register, but would nevertheless perpetrate their frauds.[34]

The majority also points to the involvement of hedge funds in the recent market timing scandals as evidence of a need for registration. The illegal conduct occurred when advisers to mutual funds contravened their fund prospectuses by allowing hedge funds and others to engage in market timing. While the Commission also should pursue any securities law violations by hedge funds (and is doing so), it should not necessarily impugn hedge fund advisers for the *legally permissible* actions they took to enhance the performance of the hedge funds. Finally, to the extent hedge fund advisers committed illegal actions, it is difficult to believe that this rulemaking would have stopped them. Despite the Commission's examination authority over mutual fund advisers, all of whom must be registered under the Advisers Act, routine examinations did not uncover the illegal conduct. In addition, of the approximately 70 hedge fund advisers involved in these cases, at least 20 were registered.

In the hedge fund context, routine examinations will not be an effective tool for the Commission. The Commission already can invoke its subpoena power to investigate potential fraudulent abuses in hedge funds.[35] Certainly a perfectly-timed routine examination could expose fraud, but with so many registrants and so few examiners, it is unrealistic to anticipate that this will happen very often. Moreover, because hedge fund advisers tend to employ more complex investment strategies than the typical registered adviser, the Commission will have to incur substantial training costs in order to understand and oversee the newly registered hedge fund advisers.[36] Chairman Donaldson envisions being able ''to apply our manpower and expertise in an effective, risk-based system designed not only for this responsibility but ultimately as an underpinning for all examinations and

their conduct is unlawful. * * * This sensitivity, which may be reflected in the strength of the opposition among some hedge fund advisers to this rulemaking, suggests that the marginal benefits of our oversight may be substantial.''). *See also* William H. Donaldson, Chairman, SEC, Testimony before the Senate Banking Committee (July 15, 2004) (video testimony available at: *http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=122*) (''I don't get much push back from people that are operating good funds. I don't get much push back from people who have nothing to hide.'').

[27] *See, e.g.*, Comment Letter of Amaranth Advisors LLC (Sept. 15, 2004) (hedge fund adviser explains that it does not operate in the shadows, but under the scrutiny of a number of regulators); Comment Letter of the Greenwich Roundtable (Sept. 15, 2004) (''The hedge fund industry is already a highly legitimate and professional industry. Sophisticated investors in the hedge fund community make significant allocation decisions based in large part on the rigorous due diligence examinations that they personally perform prior to making an investment.''); Comment Letter of the Managed Funds Association (Sept. 15, 2004) (detailing regulatory obligations to which hedge fund advisers are subject). The perception that hedge funds operate in the shadows might be attributable partially to the limitations to which hedge fund advisers are subject. *See, e.g.*, Testimony of Michael Neus, Principal and Chief General Counsel, Andor Capital Management, LLC, at the Hedge Fund Roundtable, *supra* n. 5 (May 14, 2004) (''it's a highly professional, highly organized industry which, because of restrictions on advertising or holding yourself out to the public, we are not capable of sharing with the general public * * *'').

[28] *See* 2003 Staff Hedge Fund Report, *supra* n. 5, at 73. The majority notes that it is ''not alone in [its] concerns regarding hedge fund frauds'' and cites the results of interviews with managers of European financial institutions about the state of the European Financial Market. *See* Adopting Release at n. 27 (citing Bank of New York, Restoring Broken Trust: A Pan European Study of the Causes of Declining Trust in the European Financial Services Industry and Analysis of the Actions Needed to Rebuild Investor Trust (July 2004). While interesting, the opinions expressed by these European managers are largely immaterial in the context of the U.S. industry, and it is not clear how today's rulemaking will address these concerns.

[29] *See* Testimony of Patrick J. McCarty, General Counsel of the CFTC, before the U.S. Senate Committee on Banking, Housing and Urban Affairs 1 (July 15, 2004). *See also* Comment Letter of the National Futures Association (Sept. 14, 2004) (NFA's experience with the hedge funds it oversees is ''consistent with the comparatively small number of CFTC and SEC enforcement actions involving commodity pool and hedge fund activities.'').

[30] Hedge fund advisers, like other advisers, generally will be *required* to register only if they have assets under management of $30 million or more and advisers with between $25 million and $30 million will be *permitted* to register. *See* Investment Advisers Act section 203A(a)(1) [15 U.S. 80b–3a(a)(1)] and rule 203A–1 [17 CFR 275.203A–1] thereunder.

[31] The majority states that ''[o]ur examination staff uncovered, during routine or sweep exams, five of the eight cases we brought against registered hedge fund advisers * * *.'' Adopting Release at n. 94 and accompanying text. One of those cases was uncovered during a sweep examination that was prompted by a civil complaint filed by the New York Attorney General. *See* In the Matter of Alliance Capital Management, L.P., Investment Advisers Act Release No. 2205 (Dec. 18, 2003). In another, the problem was not discovered until seven years after it began. *See* In the Matter of Portfolio Advisory Services, LLC and Cedd L. Moses, Investment Advisers Act Release No. 2038 (June 20, 2002). The Commission cannot rely on registration to unearth violations in a prompt and predictable manner.

[32] In our dissent to the Proposing Release, we discussed these 46 cases in detail. *See* Proposing Release, *supra* n. 1, at 45197–98. The advisers implicated in the five newly-identified cases likely would fall outside the scope of the rulemaking. *See* SEC v. Haligiannis, et al, Litigation Release No. 18853 (Aug. 25, 2004) (having raised $27 million over eight years, the hedge fund's president and general partners likely would not have been required to register); SEC v. Scott B. Kaye, *et al.*, Litigation Release No. 18845 (Aug. 24, 2004) (having raised only $1.9 million, the adviser likely would not have been required to register); SEC v. Gary M. Kornman, Litigation Release No. 18836 (Aug. 18, 2004) (individual that used inside information to make trades on behalf of hedge funds was owner of broker-dealer registered with the Commission); SEC v. Anthony P. Postiglione, Jr., *et al.*, Litigation Release No. 18824 (Aug. 9, 2004) (having raised approximately $5 million, the adviser likely would not have been required to register); SEC v. Adam G. Kruger and Kruger, Miller, and Tummillo, Inc., Investment Advisers Act Release No. 2297 (Sept. 15, 2004) (having raised approximately $1 million, the adviser likely would not have been required to register).

[33] The majority anticipates that hedge fund investors will demand that even new hedge fund advisers register. These advisers will be able to register even before they have $25 million under management if they have a reasonable expectation of meeting the $25 million threshold within 120 days. *See* rule 203A–2(d) [17 CFR 275.203A–2(d)]. It is not realistic to assume that all new advisers would register. Reaching $25 million in assets under management within four months is likely to be an unrealistic goal for many.

[34] *See also SEC* v. *Sanjay Saxena,* Litigation Release No. 16641 (Aug. 2, 2000) (having already been barred by the Commission from acting as an investment adviser, the defendant used his wife as a front for his advisory activity).

[35] The Commission, for example, employed its subpoena power in order to impose a broad document request on unregistered hedge fund advisers to enable the staff to gather information for the 2003 Staff Hedge Fund Report. *See supra* n. 5.

[36] *See, e.g.*, Comment Letter of W. Hardy Callcott, Bingham McCutchen LLP (Sept. 15, 2004) (anticipating that addition of hedge fund advisers to examination pool could disproportionately slow the examination cycle for all advisers because ''it is likely to take a substantial amount of time and effort for [] examiners to understand what they are seeing—hedge fund trading strategies and operations are often far more complex than those at mutual funds and retail-oriented investment advisers'').

inspections conducted by the Commission.''[37] However, the Commission has not yet demonstrated the effectiveness of this new approach.[38] More specifically, the move towards risk-based oversight will not be effective if we have not identified relevant risk factors.[39]

The majority contends that, even if examinations do not routinely *detect* fraud, the threat of an examination will *deter* fraudulent activity by hedge fund advisers.[40] Any deterrent effect, however, is muted by the fact that the Commission lacks the resources necessary to conduct frequent, comprehensive hedge fund adviser examinations, and our lack of resources is a matter of public record.[41] The Chairman has publicly announced that the Commission is rethinking its inspection model, which historically has focused on site visits and information requests.[42] The new approach will not be centered around routine inspections. Heavy sanctions for fraudulent behavior are a more effective and cheaper deterrent than the specter of an examination every several years.[43] In making these observations, we are not questioning the need for a Commission examination program. Rather, we are suggesting that the Commission should not assume a task that is now handled by the market, particularly since it is a task the Commission is not equipped to perform.

*C. Retail Investors' Exposure to Hedge Funds Is Limited and They Can Be Protected Through More Effective Means Than Registration*

The majority speaks ominously of the ''retailization'' of hedge funds, *i.e.*, their increasing accessibility through pension funds and funds of funds to unsophisticated investors of moderate means. The 2003 Staff Hedge Fund Report, however, found no retailization.[44] Moreover, the Report's conclusion is 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.[45] Hedge fund advisers appear willing to take steps to preclude retailization.[46] Raising the accreditation standards for hedge fund investors, for example, would reduce the number of high net worth individual investors, which is estimated already at fewer than 200,000, to an even smaller universe of investors. Alternatively, we could require registration for funds that allow relatively small investments.

Concern about the exposure of retirees through their pension funds, a cornerstone of the majority's retailization argument, is unwarranted. Although pension fund investment in hedge funds has grown in recent years, just one percent of the more than $6.4 trillion invested in U.S. pension funds is currently invested in hedge funds.[47] Pension fund investments are only eight percent of total hedge fund investments.[48] For every pension fund dollar invested in hedge funds, approximately three pension fund dollars are invested in other private investment funds,[49] yet the rulemaking carefully seeks to avoid reaching them. More generally, pension funds, as part of a risk diversification strategy, invest in hedge funds and other investments in which retirees might not be able to invest directly. Some of these investment vehicles, such as off-shore investment vehicles, venture capital funds, and real estate investment trusts, are not advised by advisers registered with the Commission.

Pension funds, along with the universities and charitable organizations that the majority cites as contributors to the trend towards retailization, are managed by fiduciaries, who typically are highly-skilled.[50] These fiduciaries are responsible for determining whether to invest in hedge funds, the types of hedge funds in which to invest, and how to weigh risk and transparency issues in making these determinations.[51] Neither the information available on Form ADV nor the possibility that a particular hedge fund adviser will be subject to an inspection would substantially reduce these fiduciaries' due diligence obligations.

The majority also worries about retail investors' exposure to hedge funds through funds of hedge funds. Advisers so far have set investment minimums between $25,000 and $1 million.[52] There are a number of ways aside from universal registration to address concerns about retail exposure to these funds. The Commission could require the funds of funds that are targeted to retail

[37] Chairman William H. Donaldson, Remarks at Open Meeting: Registration of Hedge Fund Advisers (Oct. 26, 2004).

[38] *See* Comment Letter of W. Hardy Callcott, Bingham McCutchen LLP (Sept. 15, 2004) (''The Commission should not rely on a risk assessment model to replace regular cycle examinations—certainly not until such a model has been rigorously tested and has a track record of effective implementation.'').

[39] As Chairman Greenspan noted: Even should SEC's proposed risk evaluation surveillance of hedge funds detect possible trading irregularities, which I doubt frankly, those irregularities will likely be idiosyncratic and of mainly historic interest, because by the time of detection, hedge funds would have long since moved on to different strategies.

Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004).

[40] *See* Adopting Release at text accompanying nn. 87–88. Because examinations take place so infrequently, the marginal increase in the chance of getting caught will not change the fraudster's calculus significantly. Further, the majority, to be consistent in its deterrence analysis, should take into account the shift of resources away from other types of advisers and hence the resulting decrease in deterrence for those advisers, particularly because they see the Commission's focus on hedge fund advisers as an area of emerging risk.

[41] As Chairman Donaldson noted when testifying before Congress this year, the Commission has only 495 staff conducting examinations of approximately 8,000 mutual funds, managed in over 900 fund complexes, as well as more than 8,000 investment advisers. *See* Testimony of William H. Donaldson, Chairman, Securities and Exchange Commission, before the House Subcommittee on Commerce, Justice, State, and the Judiciary, Committee on Appropriations (Mar. 31, 2004) (''During most of the period from 1998 to early 2003, the SEC's examination program for funds and advisers had approximately 370 members on its staff (including examiners, supervisors, and support staff). Routine examinations were conducted every five years. In the last two years, program staffing was increased by one-third, to approximately 495 employees. With this staffing increase, the SEC has increased the frequency of examinations of funds and advisers posing the greatest compliance risks, and is conducting more examinations targeted to areas of emerging compliance risk.'').

[42] Testimony of William H. Donaldson, Chairman, SEC, before the Senate Committee on Banking, Housing and Urban Affairs (July 15, 2004) (''I have asked the staff to develop an enhanced risk-based approach to oversight and examination of our investment adviser registrants, including hedge fund advisers.'').

[43] Periodic examinations would likely have no deterrent effect on scam artists, who, under the guise of operating a hedge fund set out to steal money from unwitting investors, because these types of individuals will simply not register.

[44] 2003 Staff Hedge Fund Report, *supra* n. 5, at 80 (''To date, however, the staff has not uncovered evidence of significant numbers of retail investors in hedge funds.'').

[45] *See, e.g.*, Testimony of Robert Schulman, Chairman and CEO, Tremont Asset Management, at the Roundtable, *supra* n. 5 (May 14, 2004) (''It is not a massive flow of money from retail or high net worth investors using registered products. That's not what's fueled the growth here to date. It may come to be that, but that's not what it's been today.'').

[46] *See, e.g.*, Comment Letter of the Managed Fund Association (Sept. 15, 2004) (noting the validity of the Commission's concern about the increased number of persons qualifying as individual investors and recommending an adjustment of the accredited investor standard); Comment Letter of Porter, Felleman, Inc. (Aug. 16, 2004); Comment Letter of Tudor Investment Corp. (Sept. 15, 2004). And if, as the majority notes, hedge fund inflows already are so rapid that hedge fund advisers have more to invest than they can handle, then they will not need to look to retail investors. *See* Adopting Release at n. 21 and accompanying text.

[47] *See* Greenwich Associates, Press Release, *Alternative Investments May Disappoint Dabblers* (Jan. 21, 2004) (available at: *http://www.greenwich.com*).

[48] This assumes that $72 billion of pension money is invested in hedge funds, which are estimated to have total assets of $870 billion. *See* Adopting Release at n. 38 and text accompanying n. 19. The majority does not tell us what proportion of pension fund investments are invested in hedge funds without registered advisers.

[49] *See* Hewitt Investment Group, *In Brief: Immunization—Theory and Practice* 5 (July 2004) (available at: *http://www.hewittinvest.com/pdf/InBrief_Immunization.pdf*) (citing *Greenwich Associates Market Characteristics 2003 Report*) (based on asset allocation of private pension funds). *See also* Comment Letter of the National Venture Capital Association (Sept. 15, 2004) (noting that pension funds, foundations and university endowments have long invested in venture capital funds).

[50] The Department of Labor oversees the conduct of private pension plan advisers. In the public pension fund context, state law requires that the pension fund adviser, often an elected official, act for the benefit of the pensioners.

[51] *See, e.g.*, Transcript of Chronicle of Higher Education Colloquy with John S. Griswold of the Commonfund Group, (May 27, 2004) (available at: *http://chronicle.com/colloquylive/2004/05/endowments/*) (noting the role alternative investments, including hedge funds, play in diversifying endowment portfolios, reducing portfolio risk, and boosting returns).

[52] *See* 2003 Hedge Fund Report, *supra* n. 5, at 69.

investors, and all of their component funds, to have registered advisers.[53] Alternatively, the Commission could prohibit these funds from being publicly offered or place heightened restrictions on investors.

**III. The Majority's Approach Will Have Detrimental Effects on Investors, Advisers, and the Markets**

*A. The New Rule Will Necessitate a Dangerous Diversion of Resources*

In order to administer the new requirement, the Commission will have to divert resources from the protection of unsophisticated investors, including more than 90 million mutual fund investors, to an estimated 200,000 individual and institutional hedge fund investors. This seems unwise so soon after we made the case that we did not have enough staff to oversee the existing pool of registered advisers and funds. In fact, just two days after the majority adopted this rulemaking, the Director of the Division of Investment Management reportedly said that an option that the Commission has in its ''back pocket'' is raising the threshold registration level to $40 million.[54] If the majority was seriously contemplating raising the registration threshold in connection with the rulemaking, it should have sought specific comment on the implications of such a change.[55]

The majority argues that all investors, sophisticated and not, are entitled to protection under the Advisers Act. Indeed, all investors do enjoy the protection of the Act's antifraud provisions. But, as Congress recognized in 1996 in connection with the adoption of Investment Company Act section 3(c)(7), ''[financially sophisticated] investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.''[56] In contrast to mutual fund investors, hedge fund investors have not been conditioned to rely on Commission oversight.[57] They can perform due diligence (or hire someone else to do so for them), review audit reports or third-party internal control reports, and enlist help if they suspect fraud or malfeasance.[58] By adopting the registration requirement, the Commission has upset the private-public balance and taken on a task that it might not have adequate resources to perform.[59]

*B. The Commission Has Failed To Demonstrate That This Is the Least Burdensome and Most Effective Way To Accomplish Its Objective*

In addition to being costly to the Commission, the new registration requirement will be costly to affected advisers, and these costs will be passed on to investors. The majority approaches the costs of its action with a remarkable casualness and tries to shift responsibility for the cost-benefit analysis to commenters.[60] The majority accepts anecdotal evidence from those in support of the rulemaking, but rejects as complaints equivalent statements by those opposed.[61] The majority treats cost estimates provided by commenters as overestimates.[62] The majority failed to aggregate the initial costs associated with registration and did not estimate ongoing costs of compliance.[63]

The majority points to the fact that advisers that are already registered, including hedge fund advisers, are able to bear the costs associated with registration.[64] Yet the majority also argues that its action will level the playing field between hedge fund advisers by imposing the costs on currently unregistered advisers that are borne now only by voluntary registrants. Costs of registration vary across firms.[65] Currently, if the benefits of registration, such as wider appeal to pension funds and other investors, do not outweigh the costs, then hedge fund advisers do not register.[66] Costs are likely to be

[53] *See, e.g.*, Comment Letter of Leon M. Metzger (Sept. 15, 2004).

[54] *See supra* n. 1. Another option discussed in the Adopting Release is asking Congress for more funding, a request Congress might be loathe to fulfill absent assurances the new funds would not again be applied to expand our regulatory reach. *See* Adopting Release at Section V.

[55] Although both the Proposing and Adopting Releases mentioned raising the threshold for registration ''to a slightly higher amount'' as a possible way of compensating for the increase in registered advisers resulting from the rulemaking, the Proposing Release did not solicit comment on whether this was an appropriate reallocation of resources. *See* Proposing Release, *supra* n. 1, at section V and Adopting Release at section V.

[56] S.R. 104–293, at 10 (June 26, 1996).

[57] *See, e.g.*, Comment Letter of the Greenwich Roundtable (Sept. 15, 2004) (nonprofit organization made up of private and institutional investors opposed the rulemaking), Comment Letter of Rodney C. Pitts (Sept. 15, 2004) (hedge fund investor suggesting that Commission resources should not be diverted to protect the relatively small number of hedge fund investors), Comment Letter of Myra Tatum, Pointer Management Co. (Aug. 26, 2004) (manager of fund of funds noting that mandatory registration will not benefit investors; fund of funds manager already conducts extensive due diligence and ongoing monitoring of hedge fund managers). The majority cites a survey conducted by the Hennessee Group in support of its rulemaking. *See* Hennessee Group, 2004 Hennessee Hedge Fund Survey of Foundations and Endowments (submitted as a comment letter for this rulemaking). While 59 percent of the 46 respondents supported the rulemaking, foundations and endowments opposing the rulemaking were larger, more heavily invested in hedge funds, and had more years of experience in hedge fund investment than entities that favored the rulemaking. *See id.*

[58] As one commenter pointed out, ''the ''institutionalization'' of the hedge fund market has had many salutary effects on the industry [because] [m]ost such institutions require funds to complete voluminous questionnaires about management, investment procedures, and operational and risk controls.'' Comment Letter of Schulte, Roth & Zabel LLP (Sept. 15, 2004). Moreover, reports by auditors are a commonly-used method of demonstrating the integrity of internal controls. *See, e.g.*, Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 70, *Service Organizations. See also* Comment Letter of Blanco Partners LP (Sept. 13, 2004) (''We feel that having the highest quality attorneys, auditors and prime[] brokers is a selling point for our fund.''). In other contexts, the Commission views favorably the use of outside control reports. *See, e.g.*, Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, Securities Exchange Act Release No. 50699 (Nov. 18, 2004).

[59] *See, e.g.*, Comment Letter of Sheila C. Bair, Dean's Professor of Financial Regulatory Policy, University of Massachusetts-Amherst (Sept. 15, 2004) (''By promising a 'culture of compliance' through registration, the SEC may be encouraging investors to take a 'free ride', reducing the amount of due diligence they would otherwise conduct on their own. The first line of defense for sophisticated investors should be their own due diligence, not SEC compliance measures, which are already seriously strained.''); Comment Letter of W. Hardy Callcott, Bingham McCutchen LLP (Sept. 15, 2004) (''When *not* promised that the SEC will oversee the adviser, hedge fund investors have been able through private ordering to negotiate adequate protections for themselves—protections apparently at least as effective as those provided by SEC registration and oversight.''), Comment Letter of the U.S. Chamber of Commerce (''[C]ounterparty surveillance (*e.g.*, extended pre-investment due diligence by investors and discipline imposed by lenders) is today pervasive among institutions and other sophisticated [private investment fund] investors.''); Comment Letter of Price Meadows Inc. (Sept. 15, 2004) (noting that market pressures are enhancing investor protection as reflected in the increasing percentage of hedge funds that are audited or rely on third-party administration).

[60] *See, e.g.*, Adopting Release at text accompanying n. 61 (''But commenters have not persuaded us that requiring hedge fund advisers to register under the Act, requiring them to develop a compliance infrastructure, or subjecting them to our examination authority will impose undue burdens on them or interfere significantly with their operations.''). The majority bolstered the cost-benefit analysis and the discussion of alternatives in the final release three weeks after the vote to approve the rulemaking. Such issues should have been thoroughly explored prior to the vote.

[61] *Compare* Adopting Release at n. 64 and accompanying text (relying on the ''persuasive testimonials'' of two commenters who did not provide empirical data to conclude that registration is not overly burdensome) *with* Adopting Release at text following n. 70 (''The bare assertions of adverse consequences of registration under the Advisers Act offered by many commenters opposed to our proposed rule, and the anecdotal evidence offered by others, simply do not stand up to scrutiny.'').

[62] *See, e.g.*, Adopting Release at nn. 344–46 and accompanying text.

[63] In fact, the only cost estimates offered by the majority in its cost-benefit analysis are per-firm costs of $20,000 for professional fees and $25,000 for internal costs that firms would incur in establishing the required compliance infrastructure and aggregate costs of $31 to $57 million. *See* Adopting Release at n. 333 and accompanying text.

[64] *See* Adopting Release at text accompanying n. 320.

[65] *See, e.g.*, Comment Letter of Proskauer Rose LLP (Aug. 31, 2004) (''[F]or certain advisers the benefits of registration exceed the costs and for others the reverse is true, and [] the gulf can be substantial.''). If the majority is correct in its cost estimates, it should be satisfied in simply letting the trend of voluntary registration continue.

[66] Mandating across-the-board registration only serves to eliminate any benefit registered advisers enjoyed in being able to distinguish themselves from unregistered advisers.

particularly onerous for small advisers.[67] According to some, registration costs will be even more burdensome for small hedge fund advisers than they are for other small advisers.[68]

The majority's cost-benefit analysis does not provide a realistic assessment of the direct costs associated with registration.[69] Even the Investment Counsel Association of America (''ICAA''), which supports the majority's action, took issue with the majority's minimization of costs.[70] Advisers must file Form ADV, and are likely to seek the assistance of an attorney because it is a public disclosure form.[71] Once registered, advisers face numerous substantive requirements, including recordkeeping, custody, and compliance requirements, all of which impose costs.[72] The majority failed to offer any quantitative estimate for the costs associated with the requirement to have a chief compliance officer.[73] Hosting a Commission examination team can be very costly, particularly in terms of the opportunity cost of those who must comply with increasingly burdensome document requests and stand ready to answer questions.[74]

In addition to the direct costs of complying with Commission rules, there are likely to be indirect costs as hedge funds advisers are dissuaded from employing complex investment strategies that they cannot explain to Commission examiners. Questions about those strategies are likely since the majority believes there to be substantial conflicts related to ''management strategies, fee structures, use of fund brokerage and other aspects of hedge fund management.'' [75] As one commenter explained, ''there is no doubt that hedge fund managers would abandon a lawful strategy that the Commission takes exception with rather than face the controversy and the associated distractions generated by the Commission's position.'' [76] The effects might be felt by the market as a whole.[77] Advisers might even limit their businesses in order to avoid registering.[78]

The majority reasons that the ''costs appear small relative to the scale of the industry.'' [79] Further, the majority argues, hedge fund advisers' fees provide them with ''a

[67] *See, e.g.*, Comment Letters of Blanco Partners LP (Sept. 13, 2004) (small advisers will be disproportionately burdened); Venkat Swarna (Sept. 14, 2004) (''We estimate the annual compliance costs of a state or federal registration to be in the range of 20,000 to 25,000. These compliance costs would be prohibitive to a small advisor like ours, as these costs alone constitute a sizeable percentage of the portfolio of the fund we would be managing in our case more than 1[%]''); Joseph L. Vidich (Aug. 7, 2004) (''In a one or two person firm, with 10 million under management, the annual cost of compliance could easily fall between 25,000 and 50,000, which represents twenty five to fifty percent of the firms asset management fee.''). *See also Hedge Fund Regulation May Force Consolidation,* PipeLine 3 (June 15, 2003) (reporting study findings that registration would impose significant burdens on small hedge funds in the range of $50,000 to $100,000 annually) (citing Sanford C. Bernstein & Co., *The Hedge Fund Industry—Products, Services, or Capabilities?* (May 19, 2003); Arden Dale, *Small Mutual-Fund Firms Cry Uncle—New Rules Protect Investors, but They Can be a Burden; Cost of a Compliance Cop,* Wall St. J., C15, Sept. 13, 2004 (reporting difficulty of mutual fund advisers that have less than a few billion dollars under management to bear the costs of regulatory requirements, including the Commission's compliance requirement).

[68] *See, e.g.*, Comment Letter of Blanco Partners LP (Sept. 13, 2004) (contending that registration will burden small hedge fund advisers more heavily than the average small adviser); Comment Letters of the International Swaps and Derivatives Association (Sept. 15, 2004) and Guy Judkowski, Hedgehog Capital (explaining that, in contrast to many other small advisers, some small hedge fund advisers deliberately remain small in order to effectively pursue a particular strategy).

[69] Even proponents of registration acknowledge that its costs will be significant enough to deter some advisers from entering the business. *See, e.g.*, Ron Orol, *Regulation? Bring it on,* TheDeal.com, Oct. 11, 2004 (interview of Steven Holzman, the managing partner of Vantis Capital Management LLC, who wrote two comment letters cited repeatedly in support of registration) (Mr. Holzman predicted that registration would help his business by raising barriers to entry and anticipated that ''[w]ith registration, we will have half as many new funds starting up next year * * *.'' ). Nonetheless, the majority cites Mr. Holzman for the proposition that barriers to entry are low and concludes that ''thus the cost of compliance with these rules should not present significant additional barriers to entry for new hedge fund advisers.'' Adopting Release at nn. 121–22 and accompanying text.

[70] *See* Comment Letter of the ICAA (Sept. 14, 2004) (''The fact is that investment adviser regulation and compliance have become increasingly complex and costly.''). *See also* Comment Letter of Davis, Polk & Wardwell (Sept. 15, 2004) (noting that the costs of registration and compliance are ''substantial and increasing'' and will be passed on to investors).

[71] *See, e.g.*, Comment Letter of the Managed Funds Association (Sept. 15, 2004) (reporting that one MFA member incurred over $75,000 in staff time in connection with the preparation of Form ADV).

[72] *See, e.g.,* Comment Letter of Guy P. Lander (Sept. 15, 2004) (reporting that client anticipates spending more than $300,000 in the first year to come into compliance with the rulemaking); Comment Letter of the Managed Funds Association (Sept. 15, 2004) (MFA members report incurring more than $300,000 in outside legal and other expenses associated with registration and compliance requirements); Comment Letter of C. Peter Marin, Superior Capital Management LLC (Sept. 8, 2004) (estimating that compliance costs will be 15–20% of revenues of adviser to small hedge fund); Comment Letter of Millrace Asset Group (Sept. 15, 2004) (hedge fund adviser anticipates having to increase staff from four to five to handle compliance under the rulemaking); Comment Letter of Seward & Kissel LLP (Sept. 15, 2004) (''To properly fulfill the breadth of compliance requirements under the Advisers Act, many advisers would be required to hire at least one additional professional at a cost far greater than the estimate provided.''). The majority did not attempt to estimate ongoing compliance and examination costs because of the difficulty of doing so, dismisses the estimates it received as ''not representative,'' and instead offers the observation that ''one registered hedge fund adviser commented that the firm itself derived benefit from the examination process.'' Adopting Release at IV.B.3.

[73] The majority explains this failure and its rejection of commenters' estimates by noting that advisers are not required to hire someone to fill the role and the chief compliance officer can have responsibilities. *See* Adopting Release at text following n. 335. The majority did not attempt to estimate the real, quantifiable cost of the requirement on firms, which must allocate at least a portion of an employee's time to handling the increased compliance functions. *See* Adopting Release at Section IV.B.2.

[74] *See, e.g.*, David R. Sawyer (Sidley, Austin, Brown and Wood) (Sept. 14, 2004) (reporting that two clients, hedge fund advisers, spent between $300,000 and $500,000 preparing for and hosting examiners, without including opportunity costs).

[75] Adopting Release at n. 116. The staff, in its hedge fund report, noted: ''We are concerned about our inability to examine hedge fund advisers and evaluate the effect of the strategies used in managing hedge funds on our financial markets.'' 2003 Staff Hedge Fund Report, *supra* n., at 11. Certainly, then, hedge fund advisers can anticipate that the staff will be looking into, and perhaps regulating, such strategies.

[76] Comment Letter of Guy P. Lander (Sept. 15, 2004). *See also* Comment Letter of the U.S. Chamber of Commerce (Sept. 15, 2004) (advisers might avoid innovative strategies in order to avoid Commission scrutiny).

[77] *See, e.g.*, Alan Greenspan, Chairman, Federal Reserve Board, Testimony before the Senate Banking, Housing and Urban Affairs Committee (July 20, 2004) (''Should the existing proposal fail in achieving its goal, pressure will become irresistible to expand SEC's regulatory reach in an endeavor to accomplish what it set out to do. Hedge fund arbitrageurs are required to move flexibly and expeditiously if they are to succeed. If placed under increasing restrictions, many will leave the industry, to the significant detriment of our economy.''). *See also* Comment Letter of the International Swaps and Derivatives Association (Sept. 15, 2004) (registration will reduce the number of entrants into the hedge fund industry and force others offshore, which will harm the derivatives industry and the market as a whole); Comment Letter of the Financial Services Roundtable (Sept. 15, 2004) (rulemaking might deter ''the types of innovative and active trading that serve the marketplace as a whole''); Comment Letter of the Managed Funds Association (Sept. 15, 2004) (the rulemaking ''has the potential to create inefficiency and instability in our capital markets by stifling the willingness of hedge funds to act as shock absorbers and provide risk capital in times of market instability''); Comment Letter of Seward & Kissel LLP (Sept. 15, 2004) (rulemaking could raise barriers to entry for new advisers); Comment Letter of Tudor Investment Corp. (Sept. 15, 2004). The majority, in faulting commenters opposing the rule for failing to demonstrate ''that hedge funds managed by registered advisers play a diminished role in the financial markets compared to hedge funds managed by unregistered advisers,'' fails to recognize that the effects of registration might be different for different advisers. Adopting Release at text accompanying n. 71.

[78] The majority's attempt to characterize this as a positive potential effect of the rulemaking is not persuasive. *See* Adopting Release at Section VII (acknowledging that investors might not be able to select the adviser of their choice, but noting that ''a hedge fund adviser's decision not to expand its business may make it easier for other advisers to enter the market.'').

[79] Adopting Release at text accompanying n. 118. It is difficult to discern how the majority made such a determination without making an estimate of the costs. The majority also argues that, absent registration, hedge fund advisers might not understand how beneficial a strong compliance program is to their business. *See* Adopting Release at text accompanying n. 117. Our intervention is unnecessary to solve this problem; the market will punish advisers who provide less compliance controls than investors want. *See, e.g.*, Comment Letter of Leon M. Metzger (Sept. 15, 2004) (''the Commission may want to consider whether the growing movement toward voluntary registration will accomplish the goals of mandatory registration.'').

substantial cash flow.'' [80] It is not the Commission's job to make value judgments regarding the propriety of hedge fund advisers' management fees, which investors have agreed to pay and which presumably reflect the risks of establishing a hedge fund and the high costs of attracting talented managers. Resources used to pay for compliance with new regulatory mandates cannot be used for other purposes, such as hiring new employees or purchasing outside research. Thus, unless the Commission determines that the benefits of imposing the requirements justify the costs, the Commission should not impose the costs.

*C. The Rulemaking May Encourage Retailization*

The majority's proposal ironically may stimulate retailization. First, pension funds and other institutional investors, who indirectly invest in hedge funds on behalf of individuals, might invest more money in hedge funds as a result of the rulemaking. Because such investment vehicles tend to limit hedge fund investments to those with registered advisers, the mandatory registration would expand the potential universe and encourage even more investment in hedge funds, which the majority suggests puts retail investors at risk. Second, if all hedge fund advisers are registered, there is likely to be grassroots demand for access to hedge funds by retail investors.[81] Section 208(a) of the Advisers Act prohibits advisers from representing or implying that they are ''sponsored, recommended, or approved, or that their abilities or qualifications have in any respect been passed upon'' by the government.[82] Registered advisers, however, may advertise themselves as SEC-registered (and anecdotal evidence suggests that they do). Those who are not familiar with the Commission's role likely will not understand how little this means, particularly because the majority has argued that registration will ''legitimize'' hedge funds.

**IV. The Majority's Approach Makes Arbitrary Distinctions Between Funds**

*A. The Definition of ''private funds'' Covered by the Rule Is Unsuitable*

''Private funds'' are defined in the new rule on the basis of three characteristics. A ''private fund'' is a company: (1) That would be subject to regulation under the Investment Company Act but for the exception, from the definition of ''investment company'' provided in either section 3(c)(1) or 3(c)(7) of the Investment Company Act; (2) that permits investors to redeem their interests in the fund within two years of purchasing them; and (3) the interests of which are offered based on the investment advisory skills, ability or expertise of the investment adviser.[83] This definition is arbitrary and not reflective of a relevant difference among different types of private investment companies.[84]

The redemption period is the only criterion that would distinguish most hedge funds from most other types of private funds.[85] Even this criterion will pull into the rule other types of private investment funds, which the majority does not deem at this time to be in need of regulation.[86] More generally, at a time when there is already a trend towards longer lock-ups, this criterion will encourage advisers to extend their redemption periods beyond two years in order to avoid registration.[87] Therefore, it will be more difficult for investors, once they have made the decision to invest in a hedge fund, to ''vote'' on the quality and integrity of the hedge fund manager by leaving the fund.[88] A definition that looked, for example, to portfolio content or frequency of trading rather than redemption period would likely be more precise.[89]

*B. If the Majority's Rationale for Regulation of Hedge Fund Advisers Is Sound, Then It Applies Equally to Advisers to Private Equity and Venture Capital Funds*

We asked in our dissent to the proposal whether there was a basis for excluding advisers to venture capital and private equity funds. Valuation issues, for example, arise in the private equity and venture capital funds, just as they do in hedge funds.[90] The National Venture Capital Association (''NVCA'') filed a comment letter that explained that, while there are meaningful bases upon which to distinguish venture capital funds from hedge funds, the grounds on which the majority distinguished them are not meaningful. Fearing that these same justifications could be used in the future to require venture capital advisers to register, the NVCA opposed the proposal.[91] The majority continues to maintain that advisers to venture capital and private equity funds should remain beyond the scope of this rulemaking because they have not been implicated in as many enforcement actions as advisers to hedge funds have been.[92] We share the NVCA's concern that the majority has not meaningfully differentiated between hedge funds and other private investment funds. Just as the majority's justifications do not support the registration of hedge funds, they do not compel registration of any other type of private investment fund.

**V. In Taking This Action, the Majority Has Departed From Regulatory and Statutory Precedent**

In order to carve out hedge fund advisers as a subset of advisers to private investment

[80] Adopting Release at text accompanying n. 119.

[81] *See, e.g.*, Comment Letter of Madison Capital Management LLC (Sept. 15, 2004) (predicting that the rulemaking will have the effect of inducing hedge funds to admit retail investors).

[82] 15 U.S.C. 80b–8(a).

[83] *See* amended rule 203(b)(3)–1(d).

[84] *See, e.g.*, Comment Letter of the CFA Institute Center for Financial Market Integrity (Sept. 30, 2004) (noting that the two year redemption criterion ''would seem to us to be somewhat arbitrary''); Comment Letter of Madison Capital Management LLC (Sept. 15, 2004) (''the majority's 'private fund' centered regulatory scheme creates an arbitrary distinction among funds''); Comment Letter of the North American Securities Administrators Association (''NASAA feels that the definition of 'Private Fund' is ineffective at distinguishing hedge funds from private equity, venture capital and commodity pools.'').

[85] *See, e.g.*, Comment Letter of Gibson, Dunn & Crutcher LLP (Sept. 13, 2004) (''this component is the *only* factor in the Rule itself that can be relied upon to exempt traditional private equity and venture capital funds'').

[86] Comment Letter of the Financial Services Roundtable (Sept. 15, 2004) (rule will reach some private equity and real estate fund advisers); Commenter Letter of Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP. (Sept. 15, 2004) (requesting narrower definition of ''Private fund'' to avoid including other types of investment vehicles).

[87] *See, e.g.*, Comment Letter of Ellington Management Group LLC (Sept. 15, 2004) (''The industry 'buzz'; is that, in fact, many hedge fund managers wishing to avoid registration will be trying to institute two-year lockups exactly for this purpose.''); Comment Letter of the Greenwich Roundtable (Sept. 15, 2004); Comment Letter of Jeffrey R. Neufeld (Sept. 15, 2004).

[88] The majority inappropriately looks to ease of redeemability as evidence that ''hedge fund advisers are effectively providing advisory services to the fund's investors.'' *See* Adopting Release at n. 237.

[89] *See, e.g.*, Comment Letter of the Greenwich Roundtable (Sept. 15, 2004) (''If the intention of the Rule is to specifically exclude venture capital and private equity funds, then those funds can more easily be excluded without harming genuine hedge fund investors. We would suggest instead that the Rule apply a test that focuses on the marketability of a fund's holdings, rather than on an investor's willingness to lock-up an investment.''); Comment Letter of Kynikos Associates (Sept. 15, 2004) (recommending distinguishing funds on the basis of ''investment characteristics''); Comment Letter of the North American Securities Administrators Association (recommending a test based on frequency with which securities in fund are traded). *See also* Comment Letter of Ellington Management Group LLC (Sept. 15, 2004) (recommending distinguishing hedge funds from other types of private investment funds by looking at how the fund employs net asset value in determining management fees and setting purchase price and redemption fees). The majority explains that it rejected this approach in order to prevent advisers from altering their investment strategies to avoid registration. *See* Adopting Release at n. 225. It is much easier for advisers to alter their redemption period in order to avoid registration.

[90] *See, e.g.*, Comment Letter of Kynikos Associates (Sept. 15, 2004) (noting that while venture capital and private equity funds are ''somewhat different'' from hedge funds, the Commission's concerns, including particularly valuation, are nevertheless applicable); Comment Letter of Leon M. Metzger (Sept. 15, 2004) (interim valuations matter for other types of private funds, *e.g.*, for purposes of the valuation of a deceased investor's estate ); Comment Letter of the Committee on Private Investment Funds, The Association of the Bar of The City of New York (Sept. 15, 2004) (although of ''more limited relevance,'' in the venture capital and private equity context, valuation is important for purposes such as investor reporting, and marketing follow-on funds).

[91] Comment Letter of the National Venture Capital Association (Sept. 15, 2004) (''NVCA believes that the [proposing] Release and the proposed rule create a risk of future burdensome regulation on venture capital that outweighs any investor protection benefit that would come from the proposed rule.'').

[92] The majority also argues that the third prong of the definition, which limits ''private funds'' to those that are marketed based on the skills, ability, and expertise of the adviser, ''confirm[] the direct link between the adviser's management services and the investors.'' Adopting Release at text preceding n. 168. If this reasoning is sound with respect to hedge funds, the same link exists between investors in venture capital and private equity funds and the advisers of those funds.

companies for registration, the majority has redefined ''client'' solely for this particular subset of advisers and then only to determine their eligibility to rely on section 203(b)(3). That section exempts from registration any adviser who during the past year has had fewer than fifteen clients and who does not hold himself out to the public as an investment adviser and does not act as an adviser to investment companies or business development companies.[93] Traditionally, for purposes of section 203(b)(3), advisers counted the funds, not the investors in those funds, as clients. The safe harbor in rule 203(b)(3)–1, which deems ''the legal organization * * * that receives investment advice based on its investment objectives rather than the individual investment objectives of its [owners],'' confirms the propriety of this approach.[94] The majority, however, has now (i) amended rule 203(b)(3)–1 to deprive advisers to ''private funds'' of the safe harbor for counting clients afforded by that rule and (ii) added new rule 203(b)(3)–2 to require advisers to count each owner of a ''private fund'' towards the threshold of 14 clients for purposes of determining the availability of the private adviser exemption of section 203(b)(3) of the Act.

The majority's action marks a departure from the Commission's established approach of determining who an adviser's client is, namely by looking at whether or not the adviser is tailoring the advice to the financial situation and objectives of the individual investors or is simply providing advice to an entity in which individuals share the profits.[95] The core of the advisory relationship is the provision of individualized advice tailored to the needs and financial situation of the client. Thus, in 1997, when the Commission created a safe harbor to enable investment advisers to group clients together, it included safeguards to ensure that the adviser continued to treat each investor, not the group, as a client.[96] As the Commission explained:

A client of an investment adviser typically is provided with individualized advice that is based on the client's financial situation and investment objectives. In contrast, the investment adviser of an investment company need not consider the individual needs of the company's shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder.[97]

An adviser to a hedge fund is not expected to tailor its advice to the needs of individual owners of the fund, who do not necessarily have identical financial situations or objectives.[98]

Not only does the majority's action awkwardly depart from the established approach for identifying an adviser's clients, but the majority rejected compelling challenges to the Commission's statutory authority for this action.[99] When Congress first adopted the Investment Advisers Act in 1940, it did not look through investment companies and treat the underlying shareholders as the client. Rather, the Advisers Act treated the company itself as the client.[100] In this vein, section 203(b) of the Act as originally enacted exempted from registration ''any investment adviser whose only clients are investment companies and insurance companies.''[101] In 1970, when Congress, acting on the Commission's recommendation, amended the Act to require advisers to investment companies to register, it determined that ''the shareholders of investment companies should have the same protections now provided for clients of investment advisers who obtain investment advice on an individual basis.''[102] Advisers to *privately placed* investment companies, however, were not affected by the change. These advisers could still rely on the exemption from registration in section 203(b)(3) for advisers who do not hold themselves out generally to the public as advisers and have fewer than 15 clients.

The Commission assumes that removing the exemption would simply effect Congress's unspoken intent that any adviser who manages a significantly large asset pool must register. The majority points for support to the legislative history of Investment Company Act section 3(c)(1), which exempts investment companies with fewer than 100 owners.[103] But the legislative history of that section suggests that Congress understood that there would be asset pools, some of them large, that were not reached by the statute.[104] Congress has *not* amended section 203(b)(3) to require hedge fund advisers to register despite being aware that many hedge fund advisers are advising large pools of money without being registered. In fact, just eight years ago, Congress, recognizing ''the important role that these pools can play in facilitating capital formation for U.S. companies,'' made the formation of large private pools easier.[105] Congress

[93] 15 U.S.C. 80b–3(b)(3). When Congress amended section 203(b)(3) in 1980 to preclude looking through business development companies in counting clients for purposes of that section, Congress did not ''intend to affect adversely the status of investment advisers which are not registered under the Act.'' H.R. Rep. No. 96–1341, at 62 (1980).

[94] The Commission explained that this safe harbor was ''not intended to specify the exclusive method for a limited partnership, rather than each limited partner, to be counted as a 'client' for purposes of section 203(b)(3) of the Act.'' Definition of ''Client'' of an Investment Adviser for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. 983 (July 12, 1985) [50 FR 29206 (July 18, 1985)].

[95] *See, e.g.*, Definition of ''Client'' for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. 956 (Feb. 25, 1985) [50 FR 8740 (Mar. 5, 1985)] (''Where an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of participants as a group, it appears appropriate to view the pool—rather than each participant—as a client of the adviser.'').

[96] *See* Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997) [62 FR 15098 (Mar. 31, 1997)] (adopting rule 3a–4 under the Investment Company Act [17 CFR 270.3a–4(a)] to provide a nonexclusive safe harbor from the definition of investment company for certain programs under which investment advisory services are provided on a discretionary basis to a large number of advisory clients having relatively small amounts to invest). Among the safeguards in the rule is a requirement that the sponsor of the program must obtain sufficient information from each client to be able to provide individualized investment advice to the client and periodically update the information. *See* rule 3a–4(a)(2). The majority, in support of its approach, posits a situation in which a group of individual clients of an adviser is combined into a hedge fund in order to avoid application of the Advisers Act. The majority's hypothetical example does not tell us whether the investors continue to receive personalized advice. *See* Adopting Release at text accompanying nn. 177–78. If they do not, there is nothing inappropriate about the adviser's characterizing the group as an unregistered investment company; they *should* be characterized as such, so long as they meet the applicable criteria to be classified as a private investment company.

[97] Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (Mar. 24, 1997) [62 FR 15098 (Mar. 31, 1997)].

[98] In instances in which an entity is merely a legal artifice, advisers, of course, are prohibited from counting it, rather than its investors, as clients in order to avoid registration. *See* section 208(d) of the Advisers Act [15 U.S.C. 80b–8d] (making it ''unlawful for any person indirectly * * * to do any act or thing which it would be unlawful for such person to do directly.''). This does not describe the hedge funds the advisers of which are the intended targets of the new rulemaking.

[99] *See, e.g.*, Comment Letters of Schulte Roth & Zabel LLP (Sept. 15, 2004); U.S. Chamber of Commerce (Sept. 15, 2004); Willkie, Farr & Gallagher (Sept. 13, 2004), Wilmer Cutler Pickering Hale and Dorr, LLP (Sept. 8, 2004).

[100] The majority speculates that Congress might not have intended for the legal entity to be treated as the client in the hedge fund context as it is in the investment company context. *See* Adopting Release at n. 171. But for their ability to rely on statutory exemptions from the definition of ''investment company'' under the Investment Company Act, hedge funds generally would fit within the definition. The approach of treating the entity, not the investors, as the client is equally appropriate in both cases.

[101] Investment Advisers Act, Section 203(b), Pub. L. 76–768, 54 Stat. 847, 850 (1940).

[102] *See* Investment Company Act Amendments of 1970, H.R. Rep. No. 91–1382, at 39 (1970).

[103] *See* Adopting Release at n. 139.

[104] Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. 179 (1940) (David Schenker, Chief Counsel of the Investment Trust Study, explained: ''The total assets play no part in the determination as to whether a company is a public investment company or a private investment company * * *.'').

[105] S. Rep. 104–293, at 10 (1996).

added section 3(c)(7) to the Investment Company Act to permit the formation of unregistered pools of an unlimited number of highly sophisticated investors.[106] The Committee report faulted ''regulatory restrictions on these private pools'' for driving American investors offshore.[107] The fact that many advisers to such pools were not registered under the Advisers Act was certainly known to Congress and allowing them to continue in their unregistered state was entirely consistent with Congress's objective of minimizing regulatory restrictions on such pools of assets.

**VI. Conclusion**

When we dissented from this rulemaking at the proposal stage, we asked for comment on a wide range of issues. We were interested in exploring different ways of getting more information about hedge funds, including working with other regulators and enhancing Commission oversight of existing registrants. Commenters responded with legitimate concerns about the costs and unintended consequences and offered their cooperation and a number of more feasible alternatives for addressing the Commission's concerns.

As the commenters pointed out, mandatory registration is an inappropriate response to the concerns underlying this rulemaking. The growth of the industry might support our call for more information, but it is not a valid justification for regulation. Registration is not likely to deter or lessen substantially the harm of fraudulent activities of the type cited by the majority. The majority has failed to demonstrate that retailization is a problem, let alone that mandatory, universal registration would be the appropriate solution. Not only is the majority's rulemaking a poor solution for the problems that the majority cites, but it gives rise to unintended consequences. Among these are the imposition of substantial direct and opportunity costs on hedge fund advisers and their investors, and increased retailization. Moreover, implementing the rulemaking diverts Commission resources from the protection of retail investors. The Commission, in carrying out its mission, should apply its limited resources towards their highest and best use.

The majority also has failed to draw legitimate distinctions between hedge funds and other types of private investment pools that would justify different regulatory schemes. Questions about the wisdom of the majority's approach are compounded by questions about the propriety of this approach in light of legislative and regulatory precedent.

We hoped that the Commission would accord serious consideration to objections to their proposal. Today's rulemaking, which is the wrong solution to an undefined problem, disappoints those hopes and leaves better solutions unexplored.

For all of the foregoing reasons, we respectfully dissent.

Dated: December 2, 2004.

**Cynthia A. Glassman,**

*Commissioner.*

**Paul S. Atkins,**

*Commissioner.*

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[106] 15 U.S.C. 80a–3(c)(7).

[107] S. Rep. 104–293, at 10 (1996).