Securities Industry Association
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July 7, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street NW
Washington, D.C. 20549

Re: Securities and Exchange Commission's May 14-15, 2003 Hedge Fund Roundtable (File No. 4-476)

Dear Mr. Katz:

The Ad Hoc Hedge Fund Committee of the Securities Industry Association[1] appreciates the opportunity to comment on the Commission's recent hedge fund roundtable and applauds the Commission's efforts to learn more about hedge funds and their managers. The roundtable's dialogue and the ongoing comment process should provide regulators, market participants, the press and the public with a more complete understanding of the hedge fund industry, and correct many popular misconceptions about these products.

We are submitting this letter in response to Chairman Donaldson's request for comments concerning issues discussed during the roundtable, and to offer some specific suggestions regarding concepts discussed about the offering process for hedge funds. The Committee respectfully suggests that when preparing its report on hedge funds during the coming months, the Commission's staff carefully weigh its laudable goal of protecting hedge fund investors against the possible stifling of the innovation often associated with hedge funds, and the increased costs that inevitably accompany additional regulation. These costs could create a meaningful barrier to entry in an industry that, to a significant extent, is populated by entrepreneurs or small investment management organizations.

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1 The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 700,000 individuals. The U.S. securities industry manages the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2002, the industry generated $214 billion in U.S. revenues and $285 billion in global revenues. More information about SIA is available on its home page: www.sia.com.

I. The Hedge Fund Industry

The picture of the hedge fund industry painted during the roundtable is of a vibrant entrepreneurial business that has provided significant benefits to hedge fund managers, hedge fund investors and the financial markets. It is a business that is generally non-retail in nature.

Participants in the hedge fund roundtable highlighted the opportunities hedge funds provide to investors and the positive effects hedge funds and the strategies they employ can have on the securities markets.[2] During the two days of the roundtable, hedge fund industry experts and other commentators, for example, often noted that hedge funds have outperformed not only the S&P 500 Index, but also traditionally managed long-only vehicles, especially under current economic conditions. Panelists argued that hedge funds provide investors with the ability to diversify their portfolios to increase the potential for positive investment returns, particularly during periods of market weakness. Hedge funds can and frequently do sell stocks short and otherwise engage in a variety of complex trading and hedging strategies and, as a result, they do not necessarily correlate to the equity and bond markets, unlike many traditional long-only portfolios. Others have recognized these and other benefits that hedge funds provide. For example, the President's Working Group on Financial Markets observed in 1999:

> Financial innovation over more than two decades has created a wide range of financial instruments with different types and degrees of risk. These instruments have unbundled the risks involved in financing real economic activity into distinct instruments that better match the preferences of investors. In doing so, they have most likely lowered the financing costs borne by the real sectors of the economy.[3]

The relative success of hedge funds in the current bear market has caused some to believe in an increased demand for these vehicles on the part of non-institutional, or "retail," investors. Roundtable panelists, however, consistently refuted the notion that hedge funds have become widely available to retail investors. Speakers noted that most hedge funds of consequence, at a minimum, restrict investors to those who are "accredited investors" within the meaning of Regulation D under the Securities Act of 1933 (the "1933 Act"), and often impose more stringent requirements and high minimum investment thresholds. They also asserted that institutions, and not retail investors, are driving the significant growth in the hedge fund industry. The statements of the panelists regarding hedge fund retailization had a strong effect on at least

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2 Their remarks echoed those made by the President's Working Group on Financial Markets a few years ago. The Working Group reported that "hedge funds can provide benefits to financial markets by enhancing liquidity and efficiency. Additionally, they can play a role in financial innovation and the reallocation of financial risk." *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Report of the President's Working Group on Financial Markets, at 2 (April 1999).

3 *Id.*, at A-6.

one Commissioner; Commissioner Cynthia Glassman voiced the view at the completion of the roundtable that retailization is "not a problem that we have to fix."[4] Our members' experiences are consistent with the conclusion expressed by Commissioner Glassman.

Some roundtable participants, most notably Commissioner Roel Campos, asked whether retail investors should have access to hedge funds, and other participants suggested that they should obtain that access by investing in registered funds of hedge funds. Funds of hedge funds typically invest in a broad mix of underlying hedge funds managed by third-party investment managers, creating a portfolio that would be difficult for all but the wealthiest of investors to achieve by investing directly in specific hedge funds. Through funds of hedge funds, investors can access hedge fund strategies and investment returns while reducing through diversification the potential risks and volatility that may be associated with investments in individual hedge funds.

Several panelists observed that an effect of the "institutionalization" of the hedge fund industry is increased transparency as institutional investors have the market power and resources to obtain the information that those investors believe is necessary to evaluate hedge fund advisers and the funds they manage. According to a principal of a well-known hedge fund manager, some institutional investors "more than kick the tires" of individual hedge fund managers. At least one recent article reiterated these remarks:

> Efforts toward greater disclosure have already been undertaken by the hedge fund industry. The search for institutional assets has led many hedge fund operators to respond to detailed requests for proposals (RFPs) long familiar to registered money managers. The Internet has also induced many hedge fund managers to provide more frequent reporting to their investors.[5]

Another level of transparency within the hedge fund industry is provided by services, to which some hedge fund managers subscribe, that calculate a fund's risk profile based on the fund's holdings. Investors in these funds may access these risk assessments, without jeopardizing managers' proprietary trading strategies by having access to the funds' underlying positions.

Although some regulators at the roundtable raised concerns regarding how hedge funds are valued, other participants noted that many hedge funds have implemented rigorous pricing and valuation controls and procedures. Other panelists reported that many hedge funds tend to have skilled auditors and are effectively audited. A partner at a Big Four accounting firm

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4 Neal Lipschutz, *Point of View: Risk Info Needed, Not Who-Can-Invest Rules*, Dow Jones News Service (May 16, 2003).

5 Editorial staff, *Rules Likely For Funds of Hedge Funds Programs,* Securities Industry News (May 19, 2003).

explained that hedge fund auditors determine whether hedge funds have appropriate valuation procedures and controls in place.

A notion embedded in many recent press accounts that the industry has been characterized by frequent instances of fraud was convincingly refuted at the roundtable. Commission staff members at the roundtable acknowledged the existence of some 6,000 hedge funds, but cited only 12 enforcement cases over the past year that appear to involve hedge funds. Commodity Futures Trading Commission ("CFTC") General Counsel Patrick McCarty confirmed that the CFTC has found only a handful of instances of fraud involving hedge funds and their advisers. According to Mr. McCarty, only two to three percent of the enforcement cases brought by the CFTC involve hedge funds. Jane Kang Thorpe, Director of the Division of Clearing and Intermediary Oversight at the CFTC, said that, in light of the CFTC's findings that fraud is not a significant hedge fund problem, the CFTC has proposed rules that would allow hedge fund advisers that engage in limited amounts of futures trading or that market themselves exclusively to the wealthy to deregister as commodity trading advisors with the CFTC.

The roundtable also helped dispel the notion that hedge funds are loosely organized businesses. Participants in the roundtable, in fact, described these funds as highly sophisticated, structured organizations that employ, to varying degrees, certain third-party service providers for additional support in managing and administering their funds. Three service providers that are mentioned frequently in connection with hedge funds are prime brokers, administrators and independent accountants. These third-party firms provide various services to many hedge funds, including the clearing and financing of trades, custodial services, technology services, reporting services, the valuation of assets and the calculation of net asset values, the preparation of financial statements and the performance of audits of hedge funds' financial statements.

Of all of the characterizations of the hedge fund business, the one that was perhaps most consistently challenged at the roundtable is that hedge funds are "lightly regulated." Dealing with a host of applicable regulations is an ongoing endeavor for all hedge funds. Hedge funds are structured to meet the conditions of either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act"). In addition, hedge funds and their managers are subject to the offering restrictions under the 1933 Act and the antifraud provisions of both the Investment Advisers Act of 1940 (the "Advisers Act") and the Securities Exchange Act of 1934 (the "1934 Act"), and the trading activities of the funds are subject to the reporting and broker-dealer related regulations under the 1934 Act.[6] Other U.S. regulatory schemes, such as the Commodity Exchange Act, the Employee Retirement Income Security Act of 1974, federal and state tax laws and anti-money laundering regulations, also may have a very real bearing on a hedge fund's structure and operations. Likewise, many hedge funds and their sponsors catering to non-U.S. investors or having non-U.S. operations may be subject to a panoply of foreign regulation.

[6] Some hedge fund managers are registered as broker-dealers under the 1934 Act and are subject to all applicable requirements under that Act.

II. Offering of Interests in Hedge Funds

During at least two of the roundtable panels, a number of speakers proposed changes to the manner in which interests in private hedge funds are offered and sold. Under the proposals discussed, certain restrictions of the 1933 Act, such as the minimum net worth test for investors in private offerings, would no longer be applicable to the issuer with respect to the offering of interests in such hedge funds, but would apply only to persons to whom the interests are ultimately sold.[7] The Committee believes that relaxing restrictions only with respect to offerings would permit more information to flow to potential investors and the press. This information flow would result in an increase in investors' knowledge base regarding hedge funds, and in turn allow them to make better informed investment decisions.

Some panelists suggested that the current accredited investor standard built into Regulation D under the 1933 Act, last amended over 20 years ago, be tightened. The Committee supports these suggestions, but believes that they should be considered as a single proposal (*i.e.*, any increase in the accredited investor standard should be accompanied by the removal of regulations, other than antifraud provisions, surrounding the offer of securities). Although the Committee recognizes that it may be prudent to tighten the accredited investor standard with respect to investors in privately offered funds,[8] the Committee strongly believes that it would be inconsistent with the law and inappropriate to require that investors in publicly offered, registered hedge funds or funds of hedge funds meet either the current or any tightened accredited investor standard.[9]

Currently, general partners, investment advisers and others involved with the offering of non-public hedge fund interests devote substantial resources to ensuring that solicitations are "private" under various interpretations of the offering restrictions contained in Regulation D. Many hours are spent determining whether a hedge fund manager may speak with the press, and whether an inadvertent statement may necessitate a "cooling off" period before an

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7 Most offerings of interests in hedge funds not designed to be available publicly are structured to rely on Regulation D under the 1933 Act.

8 The Committee acknowledges that broadly raising the accredited investor standard may hinder the capital formation process for certain businesses, especially small businesses that may rely on the ability of private venture capital funds to provide early-stage capital financing.

9 Regulation D, under the 1933 Act, by its terms, does not apply to public offerings of registered securities. We understand, however, that the staff of the Division of Investment Management, in reviewing registration statements of publicly offered funds of hedge funds, has commented that those funds should nevertheless limit their investors to those who meet the definition of accredited investor under Regulation D. Although acknowledging that some managers of publicly offered funds of hedge funds may choose in response to staff comments to limit their investors to accredited investors, the Committee believes that the staff's imposition of a private offering limitation on a publicly offered, registered fund is not only inconsistent with the law, but also inappropriate as a matter of policy. We agree with roundtable participants who asserted that publicly offered, registered funds of hedge funds are the appropriate vehicles through which investors who do not meet the accredited investor standard should be permitted to access hedge fund strategies and returns.

offering can resume. Freeing private funds from the manner of offering restrictions would allow legal and compliance resources to be directed to the critical part of the subscription process -- ensuring that only persons meeting a fund's eligibility criteria be permitted to invest in the fund. We also echo the comments made by a representative of the Commission's Division of Investment Management at the roundtable that:

> the current system increases the cost of capital formation. It decreases the amount of information that's out there to investors to make intelligent decisions, and, for that matter, the financial press and the financial advisory press, the more information that they can distill and provide to investors, the better off we all will be. And the current regulations have had the perverse effect of limiting the amount of information available to people.[10]

The Committee believes it unlikely that many hedge fund managers and general partners would engage in broad advertisements of their funds, even if no regulatory restrictions applied to the manner in which offers of hedge fund interests could be made. As a practical matter, hedge funds not registered under the 1940 Act are quite limited in terms of the number of their investors. As many panelists confirmed, these hedge funds must either limit the number of their investors if they rely on Section 3(c)(1) of the 1940 Act,[11] or have very high eligibility criteria if they rely on Section 3(c)(7) of the 1940 Act.[12] Other federal laws may also limit the number of investors in a fund.

The Committee supports coupling the removal of restrictions on the offering of hedge fund interests with tightening the accredited investor standard. Tightening the criteria for the qualification of persons who may purchase interests in hedge funds will ensure that holders of these interests have either the financial sophistication to understand the risks and rewards involved, the ability to retain a financial adviser to review a proposed investment, or, at the very least, the financial means to withstand market shocks, reduced liquidity and potential losses. Enhancing eligibility requirements would be consistent with the federal securities laws' long recognition, reflected in the underpinnings of Sections 3(c)(1) and 3(c)(7) of the 1940 Act, that private transactions between sophisticated parties should not be regulated.

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10 Transcript of the Hedge Fund Roundtable (remarks of Douglas Scheidt, Associate Director and Chief Counsel of the Division of Investment Management).

11 Section 3(c)(1) generally excludes from the definition of investment company any issuer, the outstanding securities of which are beneficially owned by not more than 100 persons, and that is not making and does not presently propose to make a public offering of its securities.

12 Section 3(c)(7) generally excludes from the definition of investment company any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of the securities, are qualified purchasers, and that is not making and does not at that time propose to make a public offering of such securities.

Amending the definition of accredited investor to a higher threshold would appropriately reflect that approximately 20 years have passed since that provision of Regulation D was last amended. We strongly suggest, however, that any proposal to increase the accredited investor standard contain a provision that would "grandfather" clients of hedge funds at the time the increase in the qualification threshold would take place. Requiring existing investors to redeem their interests, solely because of a regulatory change, could harm those investors (*e.g.*, by causing unfavorable tax results, or forcing them to lose exposure to their desired strategy at an inopportune time), and may not be permitted under some funds' governing documents.

The Committee believes that these proposals, pursued jointly, would further ensure that those persons subscribing for hedge fund interests meet the eligibility criteria for those investments by permitting compliance efforts to be focused on the more critical aspect of the subscription process -- to whom interests ultimately are sold. The Committee further believes that permitting more information to flow to potential investors and the press will increase investors' knowledge regarding these products, and allow them to make better informed decisions about their investments.

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Thank you for the opportunity to comment on the issues discussed at the roundtable. If you have any questions regarding this letter, or if we can otherwise be of assistance, please contact SIA Vice President and Associate General Counsel, Michael D. Udoff at (212) 618-0509 or mudoff@sia.com.

Very truly yours,

Mary A. Mullin
Chair
Ad Hoc Hedge Fund Committee

cc: The Honorable Chairman William H. Donaldson
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Paul F. Roye, Director, Division of Investment Management
Alan L. Beller, Director, Division of Corporation Finance
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