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RE: NASAA Proposed Model Custody Rule – Comment Letter from Fund Associations

Dear Mr. Hojnacki and other members of the Project Group:

We appreciate the opportunity to comment on the North American Securities Administrator's Association's ("NASAA") proposed revision to its model rules on NASAA Custody Requirements for Investment Advisers, as released for public comment on February 17, 2011 (the "proposed rule").

This letter is submitted on behalf of the California Hedge Fund Association and the Florida Alternative Investment Association. I am a member of the Board of Directors of each of these organizations. Each of these regional industry organizations counts among its membership several hundred advisers to private funds, many of which are, or soon will be, subject to registration as an investment adviser at the state level and which would be affected by the proposed rule. We have also been in contact with several of the other regional hedge fund industry groups regarding this matter, however, due to the lack of publicity regarding the proposal, the short notice period that NASAA has provided for the proposed rule, and the logistics of circulating this information to these other constituents, it is not possible for us to express the views of the other regional associations. I suspect that once this proposal becomes more widely understood, those organizations and their members will express views similar to those provided in this letter. The goal of both the California Hedge Fund Association and the Florida Alternative Investment Association is to ensure that appropriate rules are adopted that serve to both protect and advance investor interests

while maintaining the viability of the alternative investment vehicles through which they seek to achieve differentiated returns.

We commend NASAA for its efforts to enhance the investor protections embodied in its proposed rule and to provide greater regulatory uniformity by largely conforming its proposed model custody rule to the SEC's revised custody rule as adopted on December 30, 2009.

However, we believe that one new requirement of the proposed rule -- the requirement to provide detailed quarterly statements of all fund trade activity to all investors in a fund – falls seriously short of both protecting and advancing the interests of investors in pooled funds.

Overview

As proposed, the NASAA proposed model custody rule would require state-registered investment advisers ("advisers") to unregistered pooled investment vehicles ("funds") to provide detailed statements of fund trade activity ("custodial statements") to each limited partner in the fund. As currently written, unlike the SEC's revised custody rule and NASAA's current model custody rule, the proposed rule does not provide an exception to this disclosure requirement for funds for which audited financial statements are distributed annually to its investors (the "exception").

We believe that this exception is critical to the viability of unregistered pooled vehicles invested in marketable equity securities ("hedge funds"). The SEC reviewed and amended its custody rule effective December 30, 2009. In doing so, the Securities and Exchange Commission (the "SEC") sought to strike the proper balance among competing investor interests, with full consideration of appropriate lessons learned from recent spectacular failings concerning adviser reporting to investors.

The lack of this exception in the proposed rule constitutes a material adverse business risk to state-registered fund advisers, ***a serious competitive detriment to our investors***, and sets an unlevel playing field that threatens to limit the development and availability of private, state-registered fund management in states that adopt this rule.

We believe that it is in recognition of these factors, all of which constitute ultimate detriments to fund investors, that neither the revised SEC custody rule, the previous NASAA model custody rule, nor the individual state rules[i] covering what we believe to be over 95% of assets managed by state-registered fund advisers currently require the delivery of detailed custodial statements to the limited partners of hedge funds subject to an annual financial statement audit.

We therefore respectfully request that, with respect to this exception, NASAA conform its custody rule to that contained in subsection (b)(4) of the SEC's revised custody rule 206(4)-2, as adopted on December 30, 2009.

In the alternative, we would support a requirement that all investors in pooled funds receive a quarterly statement of aggregate fund activity showing the total amount of any additions or withdrawals from the fund and the total value of the fund at the end of the quarter based on the custodian's records of activity. This statement would not have to include individual transactions or portfolio holdings.

You will note that this alternative aggregate capital statement is the same as that proposed by NASAA as an acceptable alternative in its August 5, 2009 comment letter to the SEC on its most recent revision of the SEC custody rule.

We feel that such an aggregate capital statement would strike an appropriate balance between, on the one hand, the value to investors of transparency concerning the amounts and timing of capital flows into and out of, and changes in the size of, funds of which they are members while, on the other hand, still protecting the financial interests of those same investors by keeping proprietary fund trade information from being widely disseminated.

I. Typical Hedge Fund Investors

We think it is important to keep in mind that alternative investment vehicles and hedge funds are not intended for typical retail investors. Fund investors typically include institutional investors (e.g., pensions, endowments, foundations, insurance companies) and other hedge funds (hedge fund of funds), as well as relatively sophisticated high-net-worth individuals. Indeed, regulatory requirements restrict the availability of these vehicles to institutional and other "qualified purchasers", "accredited investors", or those with appropriate financial sophistication and/or financial capacity. [ii]

Such investors want to be free to contract with a fund that provides investment strategies that they view as desirable and in their best interest. Almost by definition, in order to be successful these funds must make non-obvious investment decisions based on proprietary investment strategies, investment reviews and valuation discrepancies. ***The privacy of that information is vital to a fund investor's interests, not contrary to it, because the fund's ability to deliver differentiated returns depends on the confidentiality of that information.***

Given the restriction on availability of these funds to only investors with adequate financial sophistication or capacity, and given the other (now enhanced) investor protections included in the proposed rule, such investors should be able to choose for themselves whether or not to invest in vehicles not designed to regularly report underlying trade activity and positions.

We support appropriate investor protections that still allow sophisticated investors to pursue their investment objectives without the imposition of rules that would harm their interests more than help them.

II. Pooled Investment Vehicles are Different from Separately Managed Accounts

The main difference between pooled investment vehicles and separately managed accounts lies in the fractional ownership structure of pooled investment vehicles.

In a separately managed account, the investor maintains 100% ownership of the portfolio, whereby their interests are 100% aligned with the performance of the portfolio. However, in pooled investments, investors maintain only fractional shares of ownership. The investors' monies are comingled with those of other investors. As such, potential conflicts of interest may arise if the confidentiality of portfolio positions are not protected.

An investor in a pooled investment vehicle invested in marketable securities could, through the proposed rule's detailed reporting provision, gain access to proprietary information concerning the investment positions or strategy. This information could then be used, by the investor or by the investor's other advisers, for personal benefit to the detriment of other investors in the source vehicle via front-running trades, competing for stock to be borrowed in the case of shorting securities, trading against these positions, et cetera.

An investor in a separately managed account has less incentive to "steal" the manager's strategies, since the investor realizes all the benefits of those strategies. In contrast, in a pooled investment vehicle, an investor who uses his knowledge of the fund's strategies can damage the returns of the other investors in the pooled investment vehicle.

III. Investor and Industry Risks

Almost all industries have a mechanism for protecting trade secrets and other intellectual property.

Fund advisers turn investment strategies into investment results. A fund adviser's trade secret is how it turns an easily described strategy into competitively differentiated results, and these secrets are expressed in the record of an adviser's actual trade activity and positions over time.

Requiring advisers to report their trades to a diverse group is tantamount to asking them to disclose their trade secrets. This is one reason why hedge funds, like mutual funds and other pooled vehicles, are specifically designed to keep underlying trades confidential. Trades and investment positions are kept confidential even from the ultimate beneficiaries, except as reported in the annual financial statements or otherwise required under federal securities laws.

Hedge fund investors are protected by the use of third-party custodians to hold the securities, surprise examinations, the provision of audited financial statements or use of an independent party to approve all withdrawals, among other protections.

Both hedge fund and mutual fund investors intuitively understand the reason for this confidentiality. Investors in these vehicles freely agree to limits on their access to fund trades in the interest of pursuing differentiated returns. ***They understand that the risks associated with disclosing all trades and positions and the fund's proprietary trading strategies to a diverse population exceeds the benefits to them.***

In addition, it would be extremely difficult for a fund adviser to build a sustainable business if required to make such disclosures. Investors could circumvent the adviser's fees by investing only the minimum amount necessary to gain access to the fund's positions or strategy. Once the strategy or value discrepancies are exposed through transactions, investors could execute the strategy on their own (and to the detriment of those investors in the fund that do not). The risk of disclosing the fund's strategy and losing its confidentiality in turn reduces an adviser's incentive to make private funds available to investors in the first place.

The Dodd-Frank Act defines "**proprietary information**" for private funds (funds that would be investment companies but for the exemptions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940) and their advisers to include:

> *"sensitive, nonpublic information regarding (i) the investment or trading strategies of the investment adviser; (ii) analytical or research*

> *methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property; and (v) any additional information that the [SEC] determines to be proprietary.*" [iii]

This proprietary information is specifically made subject to enhanced confidentiality measures by the Dodd-Frank Act because of its market-competitive nature.

As briefly described above, there are many ways in which disclosure of proprietary information such as detailed fund portfolio trading activity and positions to a diverse group could hinder the fund's investment performance to the detriment of its investors.

A few additional examples of the risks posed by forced trade and position disclosure are:

Quantitative strategies – algorithmic strategies that typically rely heavily on automated orders to exploit temporal or relational market arbitrage opportunities, often involving sizable orders and thin profit margins. Disclosure of all trades during the quarter would make it very easy for a competitor to reverse engineer a wide percentage of such strategies and imitate them. Such small "black box" strategies (that were not solely futures trading) risk being all but completely undermined by total trade disclosure.

Contrarian value strategies – strategies that assert and exploit significant differences between intrinsic value and market price. These value discrepancies often arise as a result of inattention to a security from market participants, which also typically involves lower (current) trading volumes in that security. The success of these strategies therefore often depends on a fund manager's ability to build a substantial position in a security before the market resolves the discrepancy. It can take time to build such positions under limited volume without alerting the market. These strategies risk seeing their rare opportunities on such value discrepancies dissipate quickly once exposed to other investors.

Event arbitrage – research that identifies companies that are at risk of, or could benefit from, certain events is very valuable, and insight into the events that a successful fund anticipates based on such research (e.g., acquisitions, regulatory changes, new product opportunities, new market entries, dividend changes, share repurchases, etc.) can be quite valuable. Disclosure of a fund's trades in companies could signal to investors and market participants the results of the fund's proprietary research and assessments. In addition, since many of these events are market-sensitive (e.g., a buyout acquisition only remains likely if the

target's stock price stays low until announcement), disclosure could lead not just to a reduced position build, but to the evaporation of the entire trade. It is not uncommon for such anticipatory bidding to affect the very viability of corporate acquisitions.

Option strategies – various option trading strategies (naked short calls, strangles, etc.) are subject to risks similar to that of short positions, but on a magnified basis. Due to the nature of the options markets, certain positions can readily reveal a fund manager's sentiment on the trading range of an underlying security, including resistance and support levels based on the strike price selections within a portfolio. The options market is far less liquid than the equities market, allowing a third party to exploit data obtainable on a fund's positions to force a fund to close existing or open additional positions.

Short positions – given the potential for unlimited losses on short positions, the discovery of short positions in less liquid securities can constitute material market knowledge and may be subject to a manufactured "short squeeze" by other market participants with more resources to the detriment of smaller funds with less resources. In addition, short positions require an adviser to i) locate and borrow the security and ii) pay to borrow the security before an investor is able to execute a short trade. The divulgence of the short position may not only prevent the ability to find further borrowed securities given an increased demand, but could also increase the cost of borrow or worse, force the adviser to repurchase the stock at a premium after a squeeze of its short position, all to the detriment of investors.

Strategies involving limited liquidity/supply in general – fund managers typically generate excess returns by exploiting market inefficiencies not yet uncovered by the broader market, of which some of the above are examples. Discovery of price inefficiencies to exploit is proprietary to the manager. These inefficiencies are typically fragile, temporary, and disappear when pursued by large or quick capital flows. Exposure of an adviser's price inefficiency discoveries to a diverse group of limited partners (including individuals and other funds) substantially increases the risk that these privately-discovered niches will disappear.

IV. Pooled Investment Vehicles are More Similar to Registered Investment Companies

Individual separate account clients typically have regular access to their own investment activity, while investors in retail open-end mutual funds and closed-end funds do not. There are important reasons for this.

Pooled investment vehicles invested in marketable securities include hedge funds, mutual funds (registered open-end investment companies), closed-end investment companies and exchange-traded funds, among others. These funds outline strategies they intend to pursue to achieve returns relative to a particular market segment. In both cases, investors see themselves as invested in the pool itself and the adviser's strategy, rather than the individual securities the adviser buys and sells to pursue that strategy.

Investors in pooled funds have no expectation of how long a given underlying security position will benefit them, no control over whether or when a security will be bought or sold, and no authority to obtain their fractional share of it. Investors in pooled funds recognize that they are delegating those decisions to the fund manager. *Given the degree of this separation between investors and control of a fund's underlying securities, investors appropriately see themselves as owning an interest in the fund itself as a principal entity, rather than the underlying securities in which the fund invests.*[iv]

*In fact, ownership in no other investment entity that we know of entitles investors to know transaction-level detail of purchase and sales activities which take place within that vehicle in order to generate profits and/or losse*s.

Of course, each of these vehicles provides periodic reporting of fund financial results and investment positions to help investors assess the performance of the fund as a whole. Registered open-end investment companies (mutual funds) and closed-end investment companies marketed to unsophisticated retail investors of unknown suitability are required to report their financial statements to investors annually and most of their investment positions by security type, industry, and country classifications not more than semi-annually.[v]

If that financial reporting strikes the appropriate balance between transparency and trade confidentiality in the interests of investors in registered retail pooled funds, it would seem odd for private pooled funds, whose securities are exempt from registration and which are sold only to sophisticated investors of known suitability, to be required to report vastly more detailed information concerning their similar pooled trade activity.

V. Significant Competitive Disadvantage to SEC-registered Hedge Fund Advisers

We understand that one goal of the Project Group in drafting the proposed rule was to bring NASAA's model rule concerning state-registered fund advisers into closer harmony with the rule governing SEC-registered advisers.

However, the proposed rule's new provision requiring total disclosure of all fund activity and positions to all fund investors introduces discord between the NASAA and SEC rules where none previously existed.

Further, it does so to the competitive advantage of larger firms with more resources at their disposal, at the expense of smaller developing firms with fewer resources available.

As a result, in this respect we believe the proposed rule would have a regressive rather than progressive effect on broadening competition, expanding grass-roots innovation, and on merit-based success. It would also risk seriously impeding the natural, organic development of smaller fund advisers into larger fund advisers – the more successful a fund is, the more its trades will be raided by others.

This rule risks keeping small funds small and handicapped relative to large funds, and leaves them unconscionably exposed to attack, pre-emption or imitation of their trading and investment strategies.

This element of the proposed rule does not level the competitive playing field for small funds and their investors; rather it unfortunately tilts it in the direction of the large and the powerful.

VI. Summary

As mentioned at the outset, our goal is to ensure that appropriate rules are adopted that serve to both protect and advance investor interests while maintaining the viability of the alternative investment vehicles through which they seek to achieve differentiated returns.

However, the proposed rule's provision requiring that hedge funds disclose detailed trade activity to investors is contrary to how private funds are designed to operate, contrary to the best interests of their investors, contrary to how similar pooled investment funds are treated for SEC-registered advisers or in jurisdictions that follow

the SEC rather than the NASAA rule, and puts both fund investors and their advisers at a competitive disadvantage in the investment marketplace.

Without a change in this rule, we believe that fund advisers will choose not to launch their funds in states that adopt the NASAA model rule – they may launch them in other states or not at all. This will impede the organic development of the fund management industry in these states, which typically involves transitions from direct financial industry involvement, to state-registered fund advisers, then potentially to SEC-covered advisers. This provision will thus impede the middle growth stage in the development of the broader wealth management industry in states that adopt the model rule in the form proposed.

Since state-registered fund advisers often serve primarily the citizens of their own state, this could leave investors in those states at a competitive disadvantage to the citizens of other states with respect to the availability of private fund management in their state, including hedge funds, venture capital funds and private equity funds.

The effect of this restriction will only be magnified by the transition of fund advisers with $25 - $150 million under management to state regulation in the near future. These fund advisers will be surprised to discover this onerous requirement in states that adopt the NASAA model rule, and will likely respond unfavorably if it is not changed – to the detriment of both the investing public and the developing wealth management industry in those states.

For these reasons, we strongly encourage NASAA to level the playing field for investors in state-covered pooled investment funds by revising the proposed custody rule to include an exception analogous to that provided in subsection (b)(4) of the SEC's custody rule 206(4)-2 as revised on December 30, 2009 or, in the alternative, to instead require reporting of the elements of the aggregate capital statement proposed by NASAA as an acceptable alternative on page 3 of its August 5, 2009 comment letter to the SEC on its most recently revised custody rule.

The goal of enlightened public policy in economic affairs, and good regulation promulgated thereunder, is to keep the goose healthy and its eggs safe for the family, not to endanger the goose.

We believe that the unqualified requirement in NASAA's proposed model rule to report detailed trade activity to all hedge fund investors threatens both the former and the latter.

Very truly yours,

Jay B. Gould, on behalf of:

The California Hedge Fund Association **The Florida Alternative Investment Association**

cc: **NASAA Investment Adviser Regulatory Policy and Review Project Group**

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Sincerely yours,

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[i] Including at least NY, CT, IL, CA, TX, FL, AZ, HI, ID, UT, NE, NM, NV & MN.

[ii] Per the U.S. Supreme Court's decision in SEC v. Ralston Purina, 1953.

[iii] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Title IV "*Regulation of Advisers to Hedge Funds and Others*", Section 404 amendment to the Investment Advisers Act of 1940, Section 204, subsection (b) *Records and Reports of Private Funds*, subsection (10)(B) *Proprietary Information.*

[iv] This point is more eloquently put by the U.S. Court of Appeals for the D.C. Circuit in its June 23, 2006 judgment in Goldstein v. SEC:

> *"An investor in a private fund may benefit from the adviser's advice (or he may suffer from it) but he does not receive the advice directly. He invests a portion of his assets in the fund. The fund manager – the adviser – controls the disposition of the pool of capital in the fund. The adviser does not tell the investor how to spend his money; the investor made that decision when he invested in the fund. Having bought into the fund, the investor fades into the background; his role is completely passive. If the person or entity controlling the fund is not an "investment adviser" to each individual investor, then a fortiori each investor cannot be a "client" of that person or entity."*

[v] Generally accepted accounting principles applicable to investment partnerships exempt from registration under the Investment Company Act of 1940 require that financial statements for such entities include all information necessary for an investor to adequately evaluate the investment and operating performance and financial position of the entity taken as a whole. *Audited financial statements prepared on this basis are required to include, in addition to the entity's basic financial statements and related footnote disclosures, a schedule of investment positions similar to that required in the financial statements of registered investment companies which reports each individual security position comprising more than 5% of net assets, as well as position totals by security type, industry, and country classifications.*