INITIAL BRIEF

No. 04-1434

ORAL ARGUMENT NOT YET SCHEDULED

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

PHILLIP GOLDSTEIN, KIMBALL & WINTHROP, INC., and OPPORTUNITY PARTNERS, L.P.,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for Review of an Order of the Securities and Exchange Commission

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

A. PARTIES

All parties, intervenors, and amici appearing before the Commission and this Court are listed in the brief for the petitioners.

B. THE RULING UNDER REVIEW

On December 2, 2004, the Commission adopted the rule and rule amendments that petitioners challenge here, in *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2333 (Dec. 2, 2004), which was published in the Federal Register at 69 Fed. Reg. 72054 (Dec. 10, 2004).

C. RELATED CASES

The case on review has not previously been before this, or any other, Court. Petitioners sued the Commission on December 21, 2004, in the United States District Court for the District of Columbia, seeking to overturn certain provisions of the rule and rule amendments adopted in the Commission's order for which the petitioner seeks this Court's review. The district court action has been stayed pending action by this Court. Counsel is not aware of any other related cases currently pending in this, or any other, Court.

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Adopting Release	*Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2333 (Dec. 2, 2004), 69 Fed. Reg. 72054 (Dec. 10, 2004).
Advisers Act, or Act	Investment Advisers Act of 1940, 15 U.S.C. 80b-1, *et seq*.
Br. __	Petitioners' opening brief at page __.
Investment Company Act	Investment Company Act of 1940, 15 U.S.C. 80a-1, *et seq*.
NSMIA	1996 National Securities Markets Improvement Act, Pub. L. No. 104-290, 110 Stat. 3416 (1996).
Proposing Release	*Registration Under the Advisers Act of Certain Hedge Fund Advisers; Proposed Rule*, Investment Advisers Act Release No. 2266 (July 20, 2004), 69 Fed. Reg. 45172 (July 28, 2004).
Staff Report	*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/spotlight/hedgefunds.htm.

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Respondent.

On Petition for Review of an Order of the
Securities and Exchange Commission

BRIEF OF THE SECURITIES AND EXCHANGE
COMMISSION, RESPONDENT

INTRODUCTION

Investment advisers must register with the Securities and Exchange Commission under the Investment Advisers Act of 1940, 15 U.S.C. 80b-1 *et seq.*, unless they qualify for one of several exemptions. *See* Section 203(a), 15 U.S.C. 80b-3(a). This case involves an exemption that is available to any adviser that has had fewer than fifteen clients during the past twelve months and does not hold

itself out to the public as an investment adviser. *See* Section 203(b)(3), 15 U.S.C. 80b-3(b)(3). The Act does not specify how to count "clients" for purposes of this "private adviser exemption."

The scope of the exemption is ambiguous as applied to advisers to certain pooled investment vehicles, such as private limited partnerships and similar entities known as "hedge funds." Questions have arisen regarding whether an adviser, through the use of such a vehicle, may avoid registration under the Act on the theory that it has a single "client"—even where the adviser is effectively offering its services to fifteen or more persons whose assets are managed through the pooled vehicle. This issue is particularly significant where an adviser both offers interests in such a pooled investment vehicle to investors based on the adviser's skill and experience as an investment manager, and permits investors to withdraw their funds on short notice, as would be true in the case of an individual investment account managed by a registered adviser.

Over a period of many years, the Commission's staff received numerous requests for guidance as to the application of the exemption to pooled investment vehicles. In general, these requests reflected the natural concern that, for purposes of counting clients under the Act, the proper construction of the statute might well require an adviser to count as its clients the investors whose assets were brought

under management through an investment vehicle operated by the adviser, rather than counting only the vehicle itself.

In 1985, the Commission adopted a rule to address the uncertainty regarding this issue. The rule established a safe harbor that allowed advisers to count each pooled investment vehicle as a single client, so long as the investment advice was provided based on the objectives of the vehicle rather than the objectives of its individual investors or owners. *See* Rule 203(b)(3)-1(b)(3), 17 C.F.R. 275.203(b)(3)-1(b)(3). The Commission recognized in proposing the safe harbor that "a different approach could be followed in counting clients." Investment Advisers Act Release No. 956 (Feb. 22, 1985), 50 Fed. Reg. 8740, 8741 (Mar. 5, 1985).

In light of dramatic changes and growth in the hedge fund market since 1985, and particularly in the past five years, the Commission has now determined to take a different approach to counting clients in the case of advisers to certain hedge funds. In the rulemaking on review in this case, commenced after a lengthy staff study, the Commission withdrew the 1985 safe harbor and adopted amendments to rules under the Advisers Act to require advisers to "look through" a pooled investment vehicle and count each investor as a "client" if the vehicle is a "private fund." *See Registration Under the Advisers Act of Certain Hedge Fund*

Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004), 69 Fed. Reg. 72054, 72065 (Dec. 10, 2004) ("Adopting Release"). Private funds, a category of pooled investment vehicles that encompasses most hedge funds, generally include entities that engage in securities transactions privately with each of their investors (because they are excepted from regulation under the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.*, by provisions that preclude the public offering of their securities); that are marketed on the basis of the skill and expertise of the investment adviser; and that offer investors a short-term right to withdraw their assets from management. *Id.* at 72068-69.

The prior safe harbor, as the Commission stated, had become inconsistent with the apparent purpose of Section 203(b)(3) to exempt a category of advisers whose activities were not sufficiently large or national in scope to justify federal regulation. *Id.* at 72066-67. The Commission's action was in response to (i) a dramatic growth in hedge funds and the impact on markets of trading by hedge fund advisers, (ii) an increase in fraud involving hedge fund advisers, and (iii) the broader exposure of smaller, non-traditional hedge fund investors to the risks of hedge fund investing. *Id.* at 72058-61.

The rule and rule amendments close a "loophole," which has arisen under the Commission's safe harbor, allowing hedge fund advisers to avoid registration

in situations where the assets of hedge fund investors are managed similarly (or in many instances identically) to the manner in which a registered adviser manages the assets of clients who directly open accounts with the adviser. *Id.* at 72068-70. The Commission was concerned that the objectives of the Advisers Act "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." *Id.* at 72068. Not only do the rule and rule amendments close this loophole but they do so, as the Commission emphasized, "without imposing burdens on the legitimate investment activities of hedge funds." *Id.* at 72059. The rule and rule amendments do not regulate the trading or investment strategies of hedge funds themselves; they regulate certain hedge fund advisers. *Id.* at 72060. [1/]

Petitioners' challenges to the rule and rule amendments have no merit. Petitioners' main argument is that Congress expressed an unambiguous intent in Section 203(b)(3) that precludes the Commission from adopting the rule and rule amendments. Petitioners erroneously rely, however, on unwarranted inferences drawn from the exemptive provisions of a different statute, the Investment

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[1/] For this reason, petitioners' pervasive references to the "Hedge Fund Rule" create a misleading impression.

Company Act, and on a Supreme Court case, *Lowe v. SEC*, 472 U.S. 181 (1985), which involved a different provision of the Advisers Act not at issue here. Under well-settled principles of statutory construction and administrative law, the Commission had the authority to interpret an ambiguous statutory provision, Section 203(b)(3), and the Commission's reasonable interpretation of this provision is entitled to deference.

COUNTERSTATEMENT OF THE ISSUES

1. Whether the Commission had the authority to adopt a rule interpreting the private adviser exemption in Section 203(b)(3) of the Advisers Act.

2. Whether the Commission's interpretation of Section 203(b)(3) is reasonable.

3. Whether the Commission acted arbitrarily or capriciously.

STATUTES AND REGULATIONS

The pertinent statutes and regulations are set forth in the Addendum to petitioners' brief.

COUNTERSTATEMENT OF THE CASE

A. The Proposed Rule and Rule Amendments

After a year-long study ordered by the Commission, the Commission's staff published a report in September 2003 recommending the registration of hedge fund advisers. *See 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/spotlight/hedgefunds.htm ("Staff Report"). After considering its staff's recommendation, on July 20, 2004, the Commission proposed regulatory action. *See* Investment Advisers Act Release No. 2266 (July 20, 2004), 69 Fed. Reg. 45172 (July 28, 2004) ("Proposing Release").

Recognizing that "[o]ur current regulatory program for hedge funds and hedge fund advisers is inadequate" because "it relies almost entirely on enforcement actions brought after the fraud has occurred and investor assets are gone," the Commission proposed a rule and rule amendments that would modify and rescind the 1985 safe harbor as it applied to advisers of "private funds" and would require advisers to such funds to "look through" and count the investors in their funds in determining whether they are exempt from registration under the Act. *Id.* at 45177, 45182-87. Proposed Rule 203(b)(3)-2 defined a "private fund" as one (i) excepted from the definition of an investment company under Section

3(c)(1) or Section 3(c)(7) of the Investment Company Act; [2] (ii) that offers redemption rights of less than two years; and (iii) whose interests are offered to investors based on the investment advisory skills, ability or expertise of the fund's investment adviser. *Id.* The Commission stated that, by requiring advisers to private funds to "look through" the funds to count each investor as a client, most hedge fund advisers would be required to register under the Act, thus extending the protections of the Act's registration provisions to these hedge fund investors and the securities markets in general. *Id.* at 45177-82.

In response to the Proposing Release, the Commission received letters from over 160 commenters, including investors, hedge fund and other investment advisers, trade associations and law firms. *See* Adopting Release at 72058.

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[2] Section 3(c)(1) of the Investment Company Act, 15 U.S.C. 80a-3(c)(1), excepts from the definition of an "investment company" issuers with fewer than 100 "beneficial owners" that do not make a public offering of their securities. Section 3(c)(7), 15 U.S.C. 80a-3(c)(7), which was added as part of the 1996 National Securities Markets Improvement Act, Pub. L. No. 104-290, 110 Stat. 3416 (1996) ("NSMIA"), excepts from the definition of an "investment company" issuers that do not make a public offering of their securities and whose "owners" are exclusively "qualified purchasers." "Qualified purchasers" are defined as, *inter alia*, natural persons who own at least $5,000,000 in investments. *See* 15 U.S.C. 80a-2(a)(51)(A).

B. The Final Rule and Rule Amendments

On December 2, 2004, the Commission adopted the rule and rule amendments substantially as proposed. The Adopting Release may be summarized as follows:

1. The Need for Regulatory Action

a. Growth in Hedge Funds and Impact of Hedge Fund Advisers on the Markets

Hedge funds have grown exponentially since 1985. *Id.* at 72055-56. From 1999 to 2004, hedge fund assets grew 260 percent, and, in 2003 alone, hedge fund assets grew over 30 percent. *Id.* Hedge fund assets already equal over one-fifth of the amount of assets of mutual funds that invest in equity securities. *Id.* at 72056. As a result, hedge fund advisers have become significant participants in the national securities markets; their trading represents a reported 10 to 20 percent of the equity trading volume in the United States. *Id.*

b. Increase in Fraud Cases Involving Hedge Fund Advisers

This increased growth and participation of hedge funds in the national securities markets has been accompanied by an increase in Commission enforcement actions involving hedge fund advisers. *Id.* at 72056-57. From 1999 to 2004, the Commission instituted 51 enforcement actions alleging that hedge

fund advisers defrauded either their own investors or other market participants in amounts estimated to exceed $1.1 billion. *Id.* at 72056. Even though most of these actions involved hedge fund advisers defrauding their own investors, the Commission found that hedge fund advisers were "key participants" in the recent scandals regarding "late trading" and "market timing" of mutual fund shares that harmed mutual fund investors. *Id.* [3/] The Commission noted that "the frequency with which hedge funds and their advisers appear in these cases and continue to turn up in the [Commission's] investigations is alarming," and estimated that almost 400 hedge funds and 87 hedge fund advisers were involved in these cases. *Id.* at 72057.

[3/] "Market timing" refers to the practice of "(a) frequent buying and selling of shares of the same mutual fund or (b) buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing," both of which "can dilute the value of the[] shares" of mutual fund shareholders, "disrupt the management of the mutual fund's investment portfolio and cause the targeted mutual fund to incur costs borne by other shareholders to accommodate frequent buying and selling of shares by the market timer." *Banc of Am. Cap. Mgmt., LLC*, Securities Act Release No. 8538, 2005 WL 310495, at *4 (Feb. 9, 2005). "Late trading" refers to the practice of "placing orders to buy or sell mutual fund shares after the time as of which a mutual fund has calculated its [net asset value] (usually as of the close of trading at 4:00 p.m. ET), but receiving the price based on the prior [net asset value] already determined as of 4:00 p.m.," thus allowing "the trader to profit from market events that occur after 4:00 p.m. but that are not reflected in that day's price." *Id.* at *5.

c. Broader Exposure of "Retail" Investors to the Risks of Hedge Fund Investing

The Commission found that, due to three recent developments, "[h]edge fund investors are no longer limited to the very wealthy," as a larger segment of the investing public, including smaller investors, pensioners, and other non-traditional hedge fund investors, has started investing, directly and indirectly, in hedge funds. *Id.* at 72057-58. First, some hedge funds are expanding their marketing activities to attract these non-traditional investors by, for example, decreasing their minimum investment requirements. *Id.* at 72057. Second, "funds of hedge funds," which make hedge funds available to more non-traditional investors, have recently developed. *Id.* Third, a number of public and private pension funds, universities, endowments, foundations, and other charitable organizations have begun to invest in hedge funds or have increased their investments in hedge funds. *Id.* at 72057-58. [4/]

[4/] Reports since the Commission adopted the rule confirm that this "retailization" of the hedge fund industry is, in fact, occurring. *See, e.g.,* Jane J. Kim, *Hedge Funds Target Smaller Investors*, Wall St. J., Apr. 27, 2005, at D1; Jenny Anderson & Riva D. Atlas, *If I Only Had a Hedge Fund: Is This the New Emerald City, or the Road to the Next Crash?*, N.Y. Times, Mar. 27, 2005, at Bus. 1 ("[W]ith the newest funds of funds, investors with as little as $25,000 to spend can gain entree."); Matt Ackermann, *Banks to Boost Alternative Investment Options*, American Banker-Bond Buyer, Feb. 2005, at 8 (quoting one investment adviser as stating that "The 'retailization' of hedge funds is happening now.").

2. Registration of Hedge Fund Advisers Will Address the Need for Regulatory Action.

a. Compiling Census Information About Certain Hedge Fund Advisers

Registration under the Advisers Act will provide the Commission the ability to collect important information that it now lacks. *Id.* at 72061. As the Commission noted,

> 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.

Id.

b. Deterring Fraud by Certain Hedge Fund Advisers Through Commission Examinations

Registration of certain hedge fund advisers will help deter fraud by enabling the Commission to conduct examinations that "permit us to identify compliance problems at an early stage, identify practices that may be harmful to investors, and provide a deterrent to unlawful conduct." *Id.* at 72061. While the Commission acknowledged that registration will not eliminate all fraudulent conduct by hedge fund advisers, it noted that the prospect of Commission examinations "increases the risk of getting caught, and thus will deter wrongdoers." *Id.*

c. Keeping Unfit Persons from Advising Certain Hedge Funds

Registration of certain hedge fund advisers will allow the Commission to screen certain individuals associated with an adviser and thereby to deny registration if they have been convicted of any felony or other crime bearing on their fitness to manage investors' funds or had a disciplinary event subjecting them to disqualification. *Id.* at 72063. The Commission considered this authority to be particularly pertinent to the registration of hedge fund advisers because the fraudulent schemes in several of the Commission's enforcement actions involving hedge fund advisers "appear to have been perpetrated by unscrupulous persons" who "may have been attracted to hedge funds because they could operate without regulatory scrutiny of their past activities." *Id.*

d. Requiring Certain Hedge Fund Advisers To Adopt Compliance Controls

Registration under the Advisers Act also carries the additional benefit of subjecting certain hedge fund advisers to Rule 206(4)-7, 17 C.F.R. 275.206(4)-7, which requires registered advisers to adopt compliance controls and procedures designed to prevent violations of the Act, and to designate a chief compliance officer. Adopting Release at 72063-64. The Commission found that while the "development and maintenance of compliance controls involves costs," these are

costs that all registered advisers must bear, including those that are much smaller and have substantially fewer resources than hedge fund advisers, who commonly receive a two percent management fee and a performance fee of twenty percent or more. *Id.*

e. Limiting "Retailization"

Registration under the Act also 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." *Id.* at 72064. Rule 205-3, 17 C.F.R. 275.205-3, applies to registered advisers and provides that each beneficial owner of a private investment company—one that is excepted from the definition of an "investment company" under Section 3(c)(1) of the Investment Company Act because it has fewer than 100 beneficial owners and does not publicly offer its securities—who pays a performance fee must have a net worth of at least $1.5 million or have at least $750,000 of assets under management with the adviser. Thus, an adviser to a private fund that wishes to charge a performance fee will not be able to market interests in the fund to "retail" investors. [5/]

[5/] This concern is not implicated with respect to advisers to "qualified purchaser" funds, which are exempt from registration under the Investment Company Act pursuant to Section 3(c)(7) of that Act, because each owner is

3. The Commission's Authority To Adopt Rule 203(b)(3)-2

Rule 203(b)(3)-2 and the rule amendments were adopted pursuant to the Commission's broad rulemaking authority under Sections 206(4) and 211(a) of the Act. *See* Adopting Release at 72068. As discussed below (*infra* pp. 18-38), the Commission carefully considered and correctly rejected challenges to its authority. *See* Adopting Release at 72067-70.

STANDARD OF REVIEW

Under Section 706 of the Administrative Procedure Act, 5 U.S.C. 706, this Court considers whether an order of the Commission is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. *See AT&T Corp. v. FCC*, 236 F.3d 729, 734-35 (D.C. Cir. 2001). Under Section 213 of the Advisers Act, 15 U.S.C. 80b-13, the Commission's findings of fact are conclusive if supported by substantial evidence. *Cf. Nat'l Rural Elec. Coop. Ass'n v. SEC*, 276 F.3d 609, 614 (D.C. Cir. 2002). The Commission's conclusions of law with respect to the statutes it administers are "binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the

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generally required to have investments of at least $5,000,000. *See* Sections 2(a)(51) and 3(c)(7) of the Investment Company Act, 15 U.S.C. 80a-2(a)(51) and 80a-3(c)(7). Section 205, 15 U.S.C. 80b-5, allows an adviser to enter into a performance fee arrangement with a fund relying on Section 3(c)(7).

statute." *United States v. Mead Corp.*, 533 U.S. 218, 227 (2001) (citing *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837, 843-44 (1984)). The Commission's reasonable interpretation of a statute it administers is entitled to deference under *Chevron*, 467 U.S. at 842-45. As discussed *infra* p. 39, petitioners are incorrect in arguing (Br. 35 n.10) that the Commission's interpretation of the private adviser exemption in Section 203(b)(3) is not entitled to *Chevron* deference.

SUMMARY OF ARGUMENT

1. The Commission had the authority to adopt a rule interpreting the private adviser exemption in Section 203(b)(3) of the Act. Whether, and in what circumstances, Section 203(b)(3) requires looking through an entity such as a private fund has long been an open question. As enacted in 1940, neither the statute itself nor the legislative history defined the term "client" or otherwise set forth a method for counting "clients" for purposes of applying the exemption. Congressional enactments since 1940, as well as a court of appeals decision and regulatory actions by the Commission and its staff, only confirm this ambiguity.

Petitioners erroneously argue that Section 203(b)(3) precludes a "look through" method of counting clients. Their resort to dictionary definitions of "client," however, ignores the ambiguity inherent in applying Section 203(b)(3) to pooled investment vehicles, and in fact, confirms that Section 203(b)(3) is open to

interpretation. In addition, petitioners incorrectly argue that, because Congress chose to exempt certain privately-offered investment pools from regulation under the Investment Company Act, Congress also intended that advisers to such funds would be exempt from registration under the Advisers Act. Finally, petitioners' arguments as to the scope of Section 203(b)(3) based on Congressional silence lack merit.

Petitioners' extensive reliance on *Lowe v. SEC*, 472 U.S. 181 (1985), to attack the Commission's authority also misses the mark. *Lowe* involved a different issue and different statutory provision. *Lowe*'s discussion of "personalized" versus "impersonal" advice cannot properly be extricated from the Court's consideration of the issue in that case—whether a publisher's newsletter that provides "impersonal" advice can be considered a bona fide publication of general circulation such that the publisher falls within a statutory exclusion to the definition of an investment adviser under the Act. This distinction is irrelevant to advisers to "private funds," which provide advisory services to their investors by directly managing their assets through the fund vehicle.

2. The Commission's interpretation of the private adviser exemption is reasonable. The Commission found that, in light of recent changes relating to hedge funds and hedge fund advisers, the safe harbor created in 1985 had become

inconsistent with the statutory purpose. The rule and rule amendments reasonably close a loophole by which hedge fund advisers that provide the same advisory services to each client could evade registration by simply pooling their investors into a limited partnership or similar fund vehicle.

Petitioners' contention that the Commission's rulemaking creates conflicting fiduciary duties ignores the Commission's express statement that the rule and rule amendments do not create or alter any duties. In addition, petitioners misplace their reliance on a 1999 report of the President's Working Group on Financial Markets, because, as the Commission found, the Working Group was not entrusted with protecting investors or the securities markets, and much has changed in the hedge fund industry and the market impact of hedge fund advisers since 1999. Finally, petitioners' argument that the rulemaking violated Section 210(c) of the Act, 15 U.S.C. 80b-10(c) (prohibiting the disclosure of a client's identity except in certain circumstances), should be rejected as waived, and in any event, lacks merit.

3. Petitioners' various procedural arguments are baseless. For example, the 49-day comment period was not too short; a remark by Chairman Donaldson did not chill opposition where 80 commenters—including petitioners—opposed the rule; and the Commission reasonably estimated the costs of compliance.

ARGUMENT

I. THE COMMISSION HAD THE AUTHORITY TO ADOPT A RULE INTERPRETING THE SCOPE OF THE PRIVATE ADVISER EXEMPTION TO REGISTRATION IN SECTION 203(b)(3) OF THE ADVISERS ACT.

In adopting the rule and rule amendments, the Commission principally relied on its broad rulemaking authority under Sections 211(a) and 206(4) of the Act. *See* Adopting Release at 72068. Section 211(a) of the Advisers Act authorizes the Commission to "make, issue, amend, and rescind such rules * * * as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title," and, in exercising this authority, to "classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters." 15 U.S.C. 80b-11(a). Section 206(4) of the Act authorizes the Commission to adopt rules that are "reasonably designed to prevent" fraudulent, deceptive, or manipulative acts, 15 U.S.C. 80b-6(4).

Petitioners contend that the Commission's action exceeded this authority because the rule and rule amendments contradict what they claim are the "clearly expressed intentions of Congress" (Br. 2) to foreclose looking through an investment entity to count individual investors as the adviser's "clients" for

purposes of determining whether the private adviser exemption is available. This contention regarding the scope of the exemption is without merit.

A. Congress Left Open the Scope of Section 203(b)(3) with Respect to the Method of Counting "Clients."

The language of Section 203(b)(3) does not, as petitioners claim, prohibit the Commission from directing advisers to "look through" fund vehicles and count the individual investors in the funds as clients for purposes of applying the private adviser exemption. Rather, whether (and in what circumstances) Section 203(b)(3) requires looking through an entity has long been an open question.

1. The Advisers Act, as Adopted and Amended, Does Not Preclude "Looking Through" a Fund Vehicle for Purposes of Counting Clients.

Section 203(b)(3), enacted in 1940, provides an exemption from the registration requirements of the Act for any investment adviser "who during the course of the preceding twelve months has had fewer than fifteen clients and who does not hold himself out generally to the public as an investment adviser." Investment Advisers Act, § 203(b)(3), Aug. 22, 1940, ch. 686, Title II, 54 Stat. 847, 850 (1940). The statute does not define "client." Further, the legislative history of the Advisers Act does not define "client" or otherwise set forth a method for counting "clients." Moreover, since hedge funds did not exist until

1949 (*see* Adopting Release at 72069), it is difficult to surmise whether Congress would have viewed a hedge fund rather than the fund's investors as the client for purposes of this exemption. Thus, Section 203(b)(3) is ambiguous as to a method for counting clients.

Congress has never resolved this ambiguity despite subsequently amending the Act generally and this provision specifically. For example, Congress amended Section 203(b)(3) in 1980 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." An Act To Amend the Federal Securities Laws To Provide Incentives for Small Business Investment, and for Other Purposes, Pub. L. No. 96-477, § 202, 94 Stat. 2275, 2290 (1980).[6/] This provision would have been superfluous if, as petitioners claim, Congress intended that a shareholder, partner, or beneficial owner of a legal entity could never be counted to determine whether the exemption applied.

[6/] "'Business development companies' are entities whose principal activities are investing in and providing managerial assistance to small, growing businesses." Reginald L. Thomas & Paul F. Roye, *Regulation of Business Development Companies Under the Investment Company Act*, 55 S. Cal. L. Rev. 895, 895 (1982).

Petitioners criticize (Br. 43-45) the Commission's reliance on this amendment to Section 203(b)(3) as "just wrong," and "disingenuous." To the contrary, the 1980 business development provision is the *only* amendment to the private adviser exemption that deals directly with how to count clients. That Congress felt it necessary to indicate who is an adviser's "client" for counting purposes demonstrates, regardless of the specific entity at issue, the ambiguity inherent in applying the exemption. Petitioners point to legislative history (Br. 45) stating that the amendment should not be construed as suggesting whether advisers to entities other than a business development company "should or should not" be regarded as clients for purposes of the exemption. This legislative history actually supports the Commission's argument. Unlike petitioners, the Commission does not contend that the exemption clearly contemplates only one method of counting clients—nor is the Commission required to make this showing. Rather, to establish its authority to interpret the scope of Section 203(b)(3), the Commission need only demonstrate that Section 203(b)(3) is ambiguous. *See Chevron*, 467 U.S. at 843-45. Both the 1980 amendment itself and the legislative history confirm that it is.

Moreover, the Court of Appeals for the Second Circuit has recognized that the scope of Section 203(b)(3) is open to interpretation. In *Abrahamson v.*

Fleschner, 568 F.2d 862 (2d Cir. 1977), *overruled in part on other grounds by TransAmerica Mortgage Advisors v. Lewis*, 444 U.S. 11 (1979), the court held that general partners of limited partnerships investing in securities were investment advisers under Section 202(a)(11) of the Act, 15 U.S.C. 80b-2(a)(11). 568 F.2d at 870-71. The court originally characterized the individual limited partners as the clients of the general partner, *see* [1976-77] Fed. Sec. L. Rep. (CCH) ¶95,889, at 91,282 n.16, but subsequently withdrew this characterization, 568 F.2d at 872 n.16, leaving open the question of whether the partnership or the individual partners should be counted as clients for purposes of the exemption. [7/]

Finally, in 1960, Congress added Section 208(d) to the Act, which makes it unlawful for any person "indirectly, or 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." An Act To Amend Certain Provisions of the Investment Advisers Act of 1940, as Amended, Pub. L. 86-750, § 11, 74 Stat. 885, 887 (1960). As the Commission recognized, this amendment indicates that "[a]lthough Congress in 1940 may not have anticipated

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[7/] The court's original opinion stated, "the general partners * * * were the investment advisers to the limited partners." The court's amended opinion deleted "to the limited partners." *See* Robert Hacker & Ronald Rotunda, *SEC Registration of Private Investment Partnerships after* Abrahamson v. Fleschner, 78 Colum. L. Rev. 1471, 1484 n.72 (1978).

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." Adopting Release at 72069.

In an attempt to counter this demonstration of the ambiguity in the scope of the private adviser exemption, petitioners argue (Br. 33) that because, as enacted in 1940, the Act originally provided an additional exemption for advisers "whose only clients are investment companies," Congress must not have contemplated counting individual investors as clients. As the Commission pointed out, however, "[t]his language does not * * * undermine the Commission's interpretation of section 203(b)(3) with respect to counting the number of clients in a hedge fund." Adopting Release at 72069 n.171. Although this language may suggest that Congress intended that, with respect to *investment companies*, the legal entity be counted as the client, it does not mean that Congress must have intended that, with respect to *private funds* (which are excepted from the definition of "investment company" under the Investment Company Act), the legal entity be counted as the client. *Id.* Moreover, Congress may have exempted advisers to investment companies from registration for a variety of reasons. For example,

Congress could have determined that regulation of advisers to investment companies under the Advisers Act would not be necessary because investment companies were to be subject to extensive regulation under the Investment Company Act, which Congress enacted together with the Advisers Act. *Id.* That Congress exempted from registration advisers to extensively-regulated and publicly-offered registered *investment companies* does not demonstrate that Congress intended to exempt from registration advisers to private entities that did not even exist at the time, are not otherwise regulated, and offer their securities privately to investors. Further, as noted above, if Congress's intent were clear in 1940, then the 1980 amendments to Section 203(b)(3) would have been superfluous.

For the same reason, petitioners' reliance (Br. 34) on the 1970 amendment to the Act that removed the registration exemption for advisers to investment companies and made the private adviser exemption expressly unavailable to them is misplaced. Petitioners contend that this amendment was necessary *only* if Congress understood that an investment company's investors were not to be counted as "clients" of the adviser under the Advisers Act. That is incorrect. Congress could have passed the amendment precisely because the exemption was ambiguous as to whether a fund's investors should be counted as the adviser's

clients. Rather than amending the exemption to resolve the ambiguity of the proper method of counting clients in all circumstances, Congress only resolved the ambiguity in certain limited situations, leaving the issue open as to the scope of Section 203(b)(3) in other situations—such as its applicability to hedge fund advisers. Indeed, the legislative history of this provision disavows any effect of this amendment on "the existing exemptions from registration for investment advisers * * * other than those advising investment companies who neither hold themselves out generally to the public as such nor have 15 or more clients." H.R. Rep. No. 91-1382, at 39 (1970). *Accord* S. Rep. No. 91-184, at 44-45 (1969).

2. The Commission Has Interpreted the Advisers Act To Allow "Looking Through" in Certain Circumstances.

Prior to 1985, there was widespread uncertainty regarding the application of the private adviser exemption to pooled investment vehicles organized as limited partnerships or limited liability companies—including uncertainty within the investment adviser community, whose members recognized that the exemption might well have required "looking through" in certain circumstances. As noted, the Second Circuit's original opinion in *Abrahamson* characterized the individual limited partners as the clients of the general partner, *see* [1976-77] Fed. Sec. L.

Rep. (CCH) ¶95,889, at 91,282 n.16. [8/] Moreover, the Commission staff received numerous requests for guidance. In response, the staff issued no-action letters which resolved the ambiguity in favor of requiring an investment adviser to look through an entity and count each individual advisee or investor as a separate client for purposes of applying the private adviser exemption. *See* Adopting Release at 72067 n.157 (listing no-action letters).

To resolve this uncertainty, in 1985, the Commission created the safe harbor in Rule 203(b)(3)-1. *See* Rule 203(b)(3)-1(b)(3), 17 C.F.R. 275.203(b)(3)-1(b)(3). The safe harbor allowed advisers to count a legal organization as a single client so long as the investment advice was provided based on the objectives of the organization and not on the objectives of individual investors or partners. *Id.* At that time, the Commission did not consider it inconsistent with the Act to exempt advisers to certain pooled investment vehicles from registration. *See* Investment Advisers Act Release No. 956 (Feb. 25, 1985), 50 Fed. Reg. 8740, 8741 (Mar. 5, 1985); Adopting Release at 72068. Nonetheless, in proposing the safe harbor, the

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[8/] The Commission noted, in an *amicus* brief filed while petitions for rehearing in *Abrahamson* were pending, that the Commission had not yet taken a position with respect to whether a partnership should be counted as a client. Supplemental Brief of the Securities and Exchange Commission *Amicus Curiae* at 20 n.34, *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977) (No. 75-7203) (filed May 1977).

Commission stated that, although it was taking the approach of allowing advisers to count the fund vehicle as their clients, "a different approach could be followed in counting clients." 50 Fed. Reg. at 8741.

Petitioners assert (Br. 24-25) that the Commission's "different approach" is contrary to how it treats clients "for all purposes other than determining whether an adviser to a hedge fund falls within the fewer-than-fifteen-clients exemption * * * ." Petitioners' assertion, however, is incorrect. The Commission has, in fact, required advisers to "look through" a fund vehicle in other circumstances. For example, since 1985, the Commission has directed advisers to "look through" fund vehicles to determine whether each investor meets the qualified client criteria to charge a performance fee. *See* Rule 205-3(b), 17 C.F.R. 275.205-3(b); Investment Advisers Act Release No. 996 (Nov. 14, 1985), 50 Fed. Reg. 48556 (Nov. 26, 1985). In addition, the Commission requires advisers to "look through" a fund to deliver to each limited partner custody account statements for funds and securities of limited partnerships for which the adviser acts as general partner. *See* Rule 206(4)-2(a)(3)(iii), 17 C.F.R. 275.206(4)-2(a)(3)(iii); Investment Advisers Act Release No. 2176 (Sept. 25, 2003), 68 Fed. Reg. 56692 (Oct. 1, 2003). [9/]

[9/] When a term appears in different provisions of an act, it is appropriate for an agency to construe each provision in accordance with its distinct purpose. *See Gen. Dynamics Land Sys., Inc. v. Cline*, 540 U.S. 581, 595-96

B. Petitioners' Reliance on Dictionary Definitions, Provisions of the Investment Company Act, and Congressional Inaction Is Misplaced.

Petitioners advance a number of other erroneous arguments in an unsuccessful attempt to show that Congress expressed a clear intent with respect to Section 203(b)(3).

First, petitioners contend (Br. 27), based on dictionary definitions, that "[t]he term 'client' requires no interpretation." This contention ignores the fact that, as discussed above, there has long been an open question as to whether, and in what circumstances, Section 203(b)(3) requires looking through a pooled investment vehicle. Indeed, as noted above, Congress recognized this ambiguity when it amended Section 203(b)(3) in 1980. Further, dictionary definitions cannot be expected to, and do not, address either how clients should be counted or the definition of client in a situation where, as here, advisory services are provided through an affiliated vehicle.

In any event, as the Commission correctly recognized, resort to dictionary definitions confirms that the exemption is open to interpretation. Adopting

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(2004); *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 213 (2001). This is particularly true in the context of the present rule, which is not premised solely on a construction of the term "client," but is based on a reading of the private adviser exemption in Section 203(b)(3) as a whole.

Release at 72069 n.172. As the Supreme Court has held, "[t]he existence of alternative dictionary definitions * * * each making some sense under the statute, itself indicates that the statute is open to interpretation." *Nat'l R.R. Passenger Corp. v. Boston & Maine Corp.*, 503 U.S. 407, 418 (1992). Here, alternative definitions of the term "client" include "[o]ne who consults a legal advisor in order to obtain his professional advice or assistance, or submits his cause to his management," *Webster's New International Dictionary* 502 (2d ed. 1934), as well as "one who depends on the services of any professional or business man, as a customer." *Funk & Wagnalls New Standard Dictionary* 500 (1937). An investor in a hedge fund "submits his cause"—*i.e.*, his money—to the management of the hedge fund adviser, and, in this manner, also "depends on" the adviser's "services * * * as a customer."

Second, petitioners argue that Congress, in enacting the statutory scheme to regulate investment companies and advisers, chose not to impose registration requirements on hedge fund advisers. *See* Br. 31. *See also* Br. 9-14, 23, 32. The fatal flaw in this argument is the assumption that Congress, in providing an exemption from regulation under a different statute, the Investment Company Act, intended (solely by implication) to provide an exemption from regulation under the Advisers Act. *See, e.g.,* Br. 31-32. Thus, petitioners exhaustively demonstrate

(Br. 9-12, 31-32) that private investment companies with fewer than 100 beneficial owners are exempt from the Investment Company Act. All this proves, however, is that hedge funds themselves, to the extent that they are private investment companies with fewer than 100 beneficial owners, are excluded from regulation as investment companies by virtue of Section 3(c)(1) of that Act. The hedge fund adviser rule does not change this. It does not subject any hedge funds to regulation as investment companies. Indeed, as the Commission emphasized in the Adopting Release, by requiring registration of advisers to private funds, the rule does not "require an adviser to follow or avoid any particular investment strategies," or "require or prohibit specific investments." Adopting Release at 72060. The Section 3(c)(1) exclusion in the Investment Company Act, therefore, does not support petitioners' contention that Congress intended to exempt advisers to hedge funds from regulation under the Advisers Act. For the same reason, petitioners' reliance (Br. 32) on the Investment Company Act exclusion for qualified purchasers in Section 3(c)(7) (*see supra* p. 14 n.5) is misplaced.

Third, petitioners' main contention (Br. 13-14, 23, 32) appears to be that Congress codified the safe harbor contained in former Rule 203(b)(3)-1 through inaction by "not amend[ing] 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" and by adding the Section 3(c)(7) exclusion for qualified purchasers to the Investment Company Act in 1996 in NSMIA. Br. 23 (quoting the dissenting Commissioners at Adopting Release at 72097-98), 32. Specifically, petitioners contend that Congress added Section 3(c)(7) to the Investment Company Act with the knowledge that "many advisers to such pools were not registered under the Advisers Act," and that "allowing them to continue in their unregistered state was entirely consistent with Congress's objective of minimizing regulatory restrictions on such pools of money." Br. 23.

As petitioners' argument concedes, Congress did not amend Section 203(b)(3) to clarify how the private adviser exemption should be applied to advisers to hedge funds (even though, in enacting NSMIA, Congress amended other provisions in the Advisers Act). Even if there were some indication that Congress *had* considered this issue, however, at most Congress can only have acquiesced in the Commission's authority to resolve the ambiguity of applying Section 203(b)(3) in these circumstances—authority that the Commission had, in fact, exercised in a prior rulemaking. The Supreme Court held in a similar situation in *Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983), that "even an unequivocal ratification—short of statutory incorporation—of [an agency's policy choice]

would not connote approval or disapproval of an agency's later decision to rescind the regulation." *Id.* at 45. This is particularly true where, as here, (i) petitioners rely on Congressional amendment of a different statute, and (ii) even when Congress *had* amended Section 203(b)(3), in 1970 and in 1980, the legislative history indicates that these amendments do not suggest how to apply the exemption in other circumstances (*see supra* pp.22, 26). Thus, the Commission was free to resolve the ambiguity in applying Section 203(b)(3) to hedge fund advisers by rescinding the 1985 safe harbor and requiring certain hedge fund advisers to look through.

Further, petitioners' argument is contrary to other Supreme Court precedent. The Supreme Court has held that, because "Congressional inaction cannot amend a duly enacted statute," such Congressional acquiescence arguments "deserve little weight in the interpretive process." *Cent. Bank of Denv., N.A. v. First Interstate Bank of Denv., N.A.*, 511 U.S. 164, 186-87 (1994) (citation omitted). As a result, the Court has accepted such arguments only in very limited circumstances. *See, e.g., Bob Jones Univ. v. United States*, 461 U.S. 574, 599-601 (1983) (holding that Congress ratified an agency's long-standing position when it failed to enact 13 bills introduced to overturn the agency's position and, instead, enacted a provision that adopted this position in a different context); *FDA v. Brown & Williamson*

Tobacco Corp., 529 U.S. 120, 143-44, 156-57 (2000) (holding that Congress's "tobacco-specific legislation has effectively ratified the FDA's previous position that it lacks jurisdiction to regulate tobacco" in part because Congress "considered and rejected bills that would have granted the FDA such jurisdiction"). Here, however, there is no indication that Congress introduced, considered, or rejected bills addressing the application of Section 203(b)(3) to qualified purchaser funds or hedge funds, or even considered the provision's use of the term "client."

C. Petitioners' Invitation To Extend *Lowe v. SEC*, Which Dealt With a Different Statutory Provision, Should Be Rejected.

Petitioners' extensive reliance (Br. 14-16, 28-30, 35-36) on *Lowe v. SEC*, 472 U.S. 181 (1985), is a red herring. As the Commission stated, "*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) [of the Advisers Act] for 'the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation.'" Adopting Release at 72069 n.174 (quoting 15 U.S.C. 80b-2(11)(d)). *Lowe* did not purport to interpret "client," which does not even appear in that section. *Lowe* dealt only with publishers. Hedge fund advisers provide services that are on the opposite end of the spectrum from those of publishers. Publishers give investment advice for a set

subscription fee through the general circulation of publications. Thus, they publish speech that others rely upon to make their own investment decisions. On the other hand, a hedge fund adviser directly manages the assets of the investors in the fund, making all strategic investment and trading decisions, usually for a percentage of the profits that its management generates, without publishing anything. Indeed, hedge fund advisers effectively *cannot* publish their advice and remain unregistered under the Act, because such action could be viewed as "hold[ing] [themselves] out generally to the public as an investment adviser," thus potentially precluding them from claiming exemption from registration under Section 203(b)(3). 15 U.S.C. 80b-3(b)(3). By no means can *Lowe* control the scope of the exemption in Section 203(b)(3).

Lowe held that the publisher of an investment newsletter was excluded from the definition of an "investment adviser" under the Act because the Court viewed the newsletter as a "bona fide newspaper, news magazine or business or financial publication of general and regular circulation." 472 U.S. at 208-09, 211. In so holding, the Court avoided the constitutional question whether "an injunction against the publication and distribution of petitioners' newsletters" (which the petitioners characterized as consisting of "impersonal investment advice and

commentary") "is prohibited by the First Amendment." *Id.* at 188-89. *Lowe* also stated, based on the majority's interpretation of the Act's legislative history, that

> [a]lthough neither the text of the Act nor its legislative history defines the precise scope of this exclusion [for publishers of bona fide publications], two points seem tolerably clear. Congress did not intend to exclude publications that are distributed by investment advisers as a normal part of the business of servicing their clients. The legislative history plainly demonstrates that Congress was primarily interested in regulating the business of rendering personalized investment advice, including publishing activities that are a normal incident thereto. On the other hand, Congress, plainly sensitive to First Amendment concerns, wanted to make clear that it did not seek to regulate the press through the licensing of nonpersonalized publishing activities.

Id. at 204. [10/]

This Court should reject petitioners' attempt to extend *Lowe*, which does not discuss or offer any definition of the term "client," to limit the Commission's rulemaking authority to interpret the Act's use of the term "client" in a separate and unrelated provision. According to petitioners (Br. 30), the Commission is prohibited from applying a "look through" method of counting clients because

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[10/] In criticizing the majority's use of legislative history, the concurrence in *Lowe* noted that the Senate Report "make[s] clear that a personal relationship between adviser and client is not a *sine qua non* of an investment adviser under the statute: the Report states that the Act 'recognizes that with respect to *a certain class of* investment advisers, a type of personalized relationship *may* exist with their clients.'" *Lowe*, 472 U.S. at 221 (White, J. concurring) (quoting S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940)) (emphasis in original).

“client” is limited to the recipient of personalized advice, and it is the hedge fund itself—not the individual investors in the fund—that petitioners claim receives personalized advice. *Lowe*’s discussion of “personalized” versus “impersonal” advice, however, is solely for the purpose of determining which type of *publishers* fall within the definition of an investment adviser. *See* Section 202(a)(11) (defining an “investment adviser” as one who “engages in the business of advising others, either directly *or* through publications or writings”) (emphasis added); *Lowe*, 472 U.S. at 188-89 (stating the issue before the Court as whether an “investment adviser” may “be so broadly defined as to encompass the distribution of impersonal investment advice and commentary in a public market”). It has nothing to do with an adviser, such as a hedge fund adviser, which clearly falls within the statutory definition of an investment adviser because it directly manages a pool of securities. *See id.* at 191-92 n.31 (one of the functions of investment advisers is to exercise “‘control over the client’s funds, with the power to make the ultimate determination with respect to the sale and purchase of securities for the client’s portfolio’”) (quoting H.R. Doc. No. 477, 76th Cong., 2d Sess. 13 (1939)); *id.* at 210 n.57 (noting that it was “significant” to the Court’s holding, *inter alia*, that “the Commission has not established that petitioners have had authority over the funds of subscribers,” or “that petitioners have been

delegated decisionmaking authority to handle subscribers' portfolios or accounts"). *See also Abrahamson*, 568 F.2d at 870-71 (the definition of an investment adviser includes persons who "advise" customers by exercising control over purchases and sales made with their money); *United States v. Elliott*, 62 F.3d 1304, 1309-11 (11th Cir. 1996) (relying on *Abrahamson* in holding that the *Elliott* defendants "clearly * * * provided investment advice to their customers, both by advising them in their choice among * * * investment vehicles and *by controlling the investments underlying those investment vehicles*") (emphasis added).

Once it is established that an adviser—such as petitioner Kimball & Winthrop here—directly manages a number of investors' assets sufficient to render it an "investment adviser" under the Act, *Lowe* does not direct how to determine who is the adviser's "client" for any purpose. Such direct management of investors' assets is by no means "impersonal" advice. *Lowe* does not dictate that the adviser's "clients" are only those who have a person-to-person relationship with the adviser. It is therefore entirely consistent with *Lowe* to conclude that, with respect to "private funds" (*see infra* pp. 42-43), each investor (often a limited partner in a fund organized as a limited partnership), who is receiving the same asset management services from the adviser, can be considered

the adviser's "client" for purposes of the Section 203(b)(3) private adviser exemption.

II. THE COMMISSION'S INTERPRETATION OF THE PRIVATE ADVISER EXEMPTION IN SECTION 203(b)(3) IS REASONABLE AND THEREFORE IS ENTITLED TO *CHEVRON* DEFERENCE.

Petitioners claim (Br. 35 n.10) that because the Commission's authority is at issue in this case, the Commission's interpretation of the ambiguous Section 203(b)(3) is not entitled to *Chevron* deference. The Supreme Court has held, however, that *Chevron* deference applies to agencies' interpretations of the statutes they administer, including those that implicate the agencies' jurisdiction or authority. *See CFTC v. Schor*, 478 U.S. 833, 844-45 (1986); *NLRB v. City Disposal Sys. Inc.*, 465 U.S. 822, 829-30 & n.7 (1984). *See also Miss. Power & Light Co. v. Miss. ex rel. Moore*, 487 U.S. 354, 381 (1988) (Scalia, J. concurring) ("[I]t is settled law that the rule of deference applies even to an agency's interpretation of its own statutory authority or jurisdiction."). And this Court has so held as well. *See, e.g., Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 694 (D.C. Cir. 2000) ("the deferential standard of *Chevron* * * * applies to an agency's interpretation of its own statutory jurisdiction").

A. The Commission's Interpretation Is Reasonable.

The Commission reasonably concluded that, to be consistent with the objectives of the Act, it needed to close a loophole that had arisen due to changed circumstances since the safe harbor was adopted in 1985. *See Motor Vehicle Mfrs.*, 463 U.S. at 42 (recognizing that an agency has the authority to change a prior policy). In adopting the Act in 1940, Congress noted the "national concern" regarding the impact that investment advisers have on the national securities exchanges, markets, banking system, and economy. *See* Section 201, 15 U.S.C. 80b-1. Consistent with this concern, Congress, in Section 203(b)(3), exempted from registration a category of advisers whose activities were not sufficiently large or national in scope to justify federal regulation. *See* Adopting Release at 72066-67.

It was reasonable for the Commission to conclude that it would be inconsistent with the statute to allow advisers to funds that had numerous investors and whose trading activities were national in scope to escape regulation. *See id.* at 72056 (finding that hedge fund advisers are significant participants in the securities markets as managers of assets and traders of securities, with some reports estimating that hedge funds represent 10 to 20 percent of the equity trading volume in the U.S.). As the Commission further noted, under the safe harbor, an

adviser with fifteen clients and $100 million in assets under management could move those client assets into a hedge fund it advises and, because the adviser would now have one client, withdraw its Advisers Act registration. *Id.* at 72069. If those clients' assets had been managed similarly or identically before and after they were moved into the hedge fund, the only thing to have changed in this scenario is the registration status of the adviser, thus undermining the purpose of the exemption. *Id.* Indeed, as the Commission pointed out, under the current safe harbor, an adviser could advise hundreds of investors with hundreds of millions of dollars in assets under management and still claim exemption from registration. *Id.* at 72065 & n.134. As the Commission noted, such use of a legal artifice to avoid registering under the Act could be viewed as violating Section 208(d) of the Act, which makes it unlawful for a person "to indirectly * * * do any act or thing which it would be unlawful for such person to do directly under the provisions of this [Act] * * * ." *Id.* at 72069. [11/]

[11/] Further demonstrating the reasonableness of the Commission's interpretation, as the Commission pointed out, the current safe harbor is inconsistent with Congress's allocation of regulatory authority between the Commission and state regulators when it adopted NSMIA in 1996. *Id.* at 72066. As the Commission explained, through continued application of the safe harbor, hedge fund advisers are able to manage hundreds of millions of dollars of client assets and yet be registered only with state regulators even though NSMIA allocated oversight responsibility for advisers with more than $25,000,000 of assets under management to the Commission. *Id.* at

There is no merit to petitioners' argument (Br. 38) that the Commission's rulemaking is unreasonable because, according to petitioners, "[t]he Rule itself provides no explanation for the [Commission's] change in position based on a reason involving the adviser-client-security holder relationship itself." To the contrary, the rule is reasonably related to the objectives of the Act and is carefully tailored to require the registration of "those advisers whose activities involving 'private funds' most directly suggest the need for registration." Adopting Release at 72068. As the Commission stated, the definition of a "private fund" is limited to those funds that: (i) by definition, engage in securities transactions privately with each of their investors because they are excepted from the definition of investment company under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act; (ii) offer investors a short-term right of two years or less to withdraw their assets from management in a manner similar to clients that directly open an account with an adviser; and (iii) 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 individual investors. *Id.* at 72068-69. As noted above, the Commission concluded that "[t]he Act's objectives would be substantially undermined if an adviser with more than fifteen clients could evade

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72066 & n.145.

its registration obligation through the simple expedient of having those clients invest in a limited partnership or similar fund vehicle." *Id.* at 72068. The Commission further stated that "[t]his 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." *Id.*

Indeed, the Commission found that a hedge fund adviser "may not treat all of its hedge fund investors the same," and that, as a result, "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)." *Id.* at 72069-70. Specifically, some hedge funds may offer investors different levels of access to risk and portfolio information, different lock-up periods, and different fee amounts. *Id.* at 72069-70 & nn.180-83. The Commission also found evidence of "side pocket" arrangements, in which a particular set of assets is segregated to provide different investors with distinct investment experiences. *Id.* at 72069-70 & n.183. [12/] Petitioners' attempt (Br. 39)

[12/] *The Wall Street Journal* recently reported on the widespread existence of "side letters" in the industry. *See* Carrick Mollencamp & David Reilly, *Tracking the Numbers/Street Sleuth: Some Big Investors Get to Use the*

to minimize these findings is unwarranted. It is sufficient that the Commission, in its expertise, identified the existence of such arrangements and noted their import to its decision to adopt the rule and rule amendments.

Contrary to petitioners' erroneous assertion (Br. 45-46), the Commission did not state that the purpose of the Section 203(b)(3) exemption was to exempt only advisers to "friends and family." Rather, the Commission stated that Congress intended "to create a limited exemption for advisers whose activities were not national in scope and who provided advice to only a small number of clients, many of whom are likely to be friends and family members." Adopting Release at 72066. *See also id.* at 72067 (providing "friends and family" as an example of the type of clients to an adviser "whose activities were not sufficiently large or national in scope * * * to implicate the policy objectives identified in section 201 of the Act"). Nor did the Commission create this purpose out of "whole cloth," as petitioners claim (Br. 46). The Commission relied primarily on Section 201 of the Act, which sets forth Congress's findings establishing the "national concern" to justify federal regulation of advisers, and reasonably concluded that Congress must have intended to exempt from registration those

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Side Door—During Hedge Fund Boom, Not Everyone Is Equal, Wall St. J., Mar. 14, 2005, at C1.

advisers who would not implicate this "national concern." Adopting Release at 72066 n.138.[13/] Petitioners' claim (Br. 46) that advisers to "friends and family" would not be subject to regulation under the Act because their advice would not be given for compensation also is incorrect: there is no reason, in the record or in common experience, to assume that such advisers necessarily would be providing gratuitous advisory services. *See* Philip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 Geo. Wash. L. Rev. 214, 246 n.100 (1959) (stating that Section 203(b) was "presumably intended to exempt a man who advises a few friends and is paid something by them for his trouble").

B. Petitioners' Arguments That the Rule and Rule Amendments Are Not Reasonable Lack Merit.

First, petitioners argue (Br. 37) that the rule unreasonably creates an "intractable ethical box," because it would be impossible for advisers to reconcile conflicts between duties owed to an entity and duties owed to security holders. As petitioners acknowledge (Br. 37), however, the Commission stated that the rule applies only when counting clients for purposes of interpreting the scope of the

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[13/] While not controlling, the legislative history of Section 3(c)(1) of the Investment Company Act, as the Commission noted, indicates that Congress did not consider "privately placed investment companies, owned by a limited number of investors likely to be drawn from persons with personal, familial, or similar ties" to "rise to the level of federal interest." *Id.* at 72066 n.139.

private adviser exemption. The rule does not create any new duties or alter any duties that otherwise exist. Adopting Release at 72070 & n.187.

Moreover, petitioners assert (Br. 37), based on *Lowe*, that "it is plainly unreasonable for the SEC to define as a 'client' * * * a person who does not have a personalized investment relationship with the adviser." As discussed above (*supra* pp. 34-39), petitioners misplace their reliance on *Lowe*. In any event, in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), in which the Supreme Court first recognized the fiduciary duties created by the Advisers Act, the Court held that an adviser, which published a newsletter and traded securities in advance of its published advice, owed a fiduciary duty to subscribers to its newsletter. *Id.* at 181, 191-93. In addition, the Court in *Lowe* conceded that "admittedly" the definition of an investment adviser "is broad enough to encompass publishers," but must be read together with the exclusion for bona fide publications "in order to locate the place where Congress drew the line * * * ." 472 U.S. at 208-09 n.53. The Court indicated that even a publisher of impersonal newsletters would be an investment adviser under the Act if the newsletters "contained any false or misleading information," "were designed to tout any securities in which [the publisher] had an interest," or have "been timed to specific market activity, or to events affecting or having the ability to affect the securities

industry." *Id.* at 209. If subscribers to an impersonal newsletter can be considered "clients" of the adviser (and thereby in a fiduciary relationship with the adviser), it is reasonable to count investors in hedge funds, who have a much more direct relationship with the hedge fund adviser, as "clients" of the adviser.

Second, petitioners argue (Br. 40) that the Commission's interpretation is unreasonable in light of the 1999 report of the President's Working Group on Financial Markets which stated that registration of hedge fund advisers "would not seem to be an appropriate method to monitor hedge fund activity," and a July 2004 statement by Alan Greenspan, the Chairman of the Federal Reserve Board, that nothing has changed since the Working Group's report to warrant a different conclusion. As the Commission noted, the Working Group's principal concerns 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, while the focus of the Advisers Act is on the prevention of fraud against investors. Adopting Release at 72058 n.43. In addition, the Commission is the only member of the Working Group entrusted with the role of protecting investors and overseeing the nation's securities markets. *Id.* Moreover, the Commission found that things *had* changed since the Working Group's report was issued in 1999: "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." *Id.*

Third, petitioners contend (Br. 41, 43) that the rule and rule amendments are unreasonable because, according to petitioners, two amendments violate the prohibition in Section 210(c) of the Act against "requiring routine disclosure by an investment adviser of the identity, investments or affairs of the adviser's clients." Petitioners' argument concerns: (i) an amendment that deems the records of the hedge fund to be records of the adviser; and (ii) an amendment that extends a pre-existing requirement in Form ADV—that advisers list the name of investment-related limited partnerships and limited liability companies to which the adviser serves as a general partner or manager—to include other "private funds."

Petitioners have waived this argument by failing to raise it before the Commission. *See* Advisers Act Section 213(a), 15 U.S.C. 80b-13(a); *KPMG, LLP v. SEC*, 289 F.3d 109, 117 (D.C. Cir. 2002). Here, neither petitioners nor any other of the 160 commenters raised this point before the Commission, and petitioners have provided no explanation for their failure to do so.

Moreover, it is not surprising that none of the commenters raised this point before the Commission, because: (i) a Commission rule allows advisers to maintain their records by code, rather than by name; and (ii) the Commission

amended Form ADV merely to conform with prior practice recognizing that advisers may use fund vehicles as an instrumentality to provide advisory services.

Thus, petitioners' argument regarding the rule amendment that deems the records of a private fund to be records of the adviser is without merit because it ignores Rule 204-2(d), 17 C.F.R. 275.204-2(d), which was adopted to implement Section 210(c) and provides that advisers may maintain records that identify clients by code rather than by name.

Petitioners' complaint regarding the amendment to Form ADV is also baseless. This particular amendment is merely a technical and minor amendment to conform Form ADV with prior practice. An adviser may use a limited partnership or limited liability company as an instrumentality to provide advisory services. Section 7.B. of Form ADV was amended in 2000 to require registered advisers who "are * * * a general partner in an *investment-related* limited partnership or manager of an *investment-related* limited liability company," to, *inter alia*, identify the limited partnership or limited liability company. *See* Investment Advisers Act Release No. 1897 (Sept. 12, 2000), 65 Fed. Reg. 57438, 57467 (Sept. 22, 2000) (emphasis in original). No commenters objected to this change to Form ADV in 2000, and to our knowledge no adviser (other than petitioners) has asserted that this aspect of the Form violates Section 210(c) since

the amendment went into effect. In the amendment at issue here, the Commission amended Section 7.B to include the inquiry "or do you advise any *other* 'private fund,' as defined under SEC rule 203(b)(3)-1," and to require advisers who provide an affirmative response to this question to complete Section 7.B of Schedule D for each "*other* private fund" for which the adviser acts as the general partner. Adopting Release at 72089 (emphasis added). Thus, the rule minimally amends Form ADV consistent with the Commission's recognition of an investment vehicle as the instrumentality of the adviser. *See* Proposing Release at 45186.

Finally, even if these rule amendments were found to violate Section 210(c) of the Act, this would not invalidate the entire rulemaking. The appropriate remedy would be a remand to the Commission limited to addressing the Section 210(c) issue.

III. THE COMMISSION DID NOT ACT ARBITRARILY OR CAPRICIOUSLY IN ADOPTING THE RULE AND RULE AMENDMENTS.

Petitioners' arguments (Br. 46-54) that the Commission's adoption of Rule 203(b)(3)-2 was arbitrary and capricious do not come close to providing a basis for the Court to set aside the rule. Under this standard, an agency is required to examine the relevant data and articulate a "rational connection between the facts

found and the choice made." *Motor Vehicle Mfrs.*, 463 U.S. at 43 (citation omitted). As the Supreme Court has explained, "[t]he scope of review under the 'arbitrary and capricious' standard is narrow and a court is not to substitute its judgment for that of the agency." *Id. See also, e.g., Ctr. for Sci. in the Pub. Interest v. Dep't of the Treasury*, 797 F.2d 995, 1004 (D.C. Cir. 1986).

A. The Commission's Decision To Adopt the Rule and Rule Amendments Was Rational.

In adopting the rule and rule amendments, the Commission examined the relevant facts and articulated a detailed and rational explanation for its action. As discussed *supra* pp. 9-11, the Commission found that a combination of three factual developments supported increased regulation of hedge fund advisers: (i) enormous growth in the hedge fund industry and in the impact of hedge fund advisers on the markets; (ii) an increase in fraud involving hedge fund advisers; and (iii) broader exposure of non-traditional hedge fund investors to the risks associated with hedge funds. Adopting Release at 72055-58. The Commission determined that registration of certain hedge fund advisers will address these concerns by: (i) serving as a census that will fill the current information gap; (ii) deterring fraud by giving the Commission the ability to conduct examinations; (iii) allowing the Commission to screen certain individuals associated with an adviser

and thereby to deny registration where appropriate; (iv) requiring certain hedge fund advisers to adopt compliance controls and procedures, and to designate a chief compliance officer; and (v) making the net worth requirements in Rule 205-3, 17 C.F.R. 275.205-3, applicable to all direct investors in hedge funds that charge a performance fee. Adopting Release at 72061-64.

B. Petitioners's Arguments That the Commission's Decision Was Arbitrary and Capricious Are Baseless.

1. The Commission's Findings Do Not Contradict the Staff Report.

Petitioners argue (Br. 47-48) that the Commission's findings were "essentially contrary to" the findings of the Staff Report. The Commission, of course, is not bound by a report by its staff. In any event, petitioners' assertions lack merit.

Petitioners assert (Br. 47) that the Staff Report indicated that most of the industry growth was occurring among institutional investors and found "no evidence" that "retailization" was, in fact, occurring. Although the Staff Report indicated that institutional investors were responsible for most of the growth in the industry and found no evidence of "significant numbers of retail investors investing *directly* in hedge funds" *id.* at 80 (emphasis added), petitioners ignore the staff's conclusions that, despite these findings, the lowering of minimum

investment requirements, the development of "funds of hedge funds," and the growing number of pension funds, universities, endowments, foundations, and other charitable organizations that invest in hedge funds, could pose some increased, and potentially inappropriate, risk for retail investors. *Id.* at 80-83. The Commission made the same findings in the Adopting Release, in concluding that the broader exposure of non-traditional hedge fund investors raised the possibility of increased, and potentially inappropriate, risk that these investors were ill-suited to bear. Adopting Release at 72057-58. The Commission's conclusion is a policy judgment that the Commission—using its expert knowledge—is uniquely positioned to make. *See FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 29 (1961); *Domestic Sec., Inc. v. SEC*, 333 F.3d 239, 249 (D.C. Cir. 2003).

Petitioners also criticize (Br. 47) the Commission's reliance on an increase in fraud involving hedge funds and hedge fund advisers as contrary to the Staff Report's conclusion that in 2003 there was no evidence that hedge funds or their advisers engaged "disproportionately" in fraudulent activity. The Commission did not contradict the Staff Report's finding. Rather, the Commission noted that the Staff Report predates the discovery that hedge funds and their advisers were involved, with "alarming" frequency, in the late trading and market timing scandals. Adopting Release at 72056-57, 72062. The Commission also criticized

the notion "that the Commission should wait to act until hedge fund frauds do comprise a disproportionate amount of fraudulent activity." *Id.* at 72062.

2. The Commission Did Not Consider Improper Factors in Adopting the Rule and Rule Amendments.

Petitioners argue (Br. 48-49) that it was improper for the Commission to rely upon its concerns regarding growth in the hedge fund industry, an increase in fraud, and "retailization" in adopting the rule and rule amendments. For example, again relying on provisions of the Investment Company Act, petitioners argue that: (i) growth in the hedge fund industry is not a sufficient justification for regulation because Congress provided the impetus for this growth by adopting Section 3(c)(7) in 1996; and (ii) the Commission cannot consider the danger of retailization to justify registration of hedge fund advisers because the marketing of hedge fund interests is not regulated due to the Section 3(c)(1) and Section 3(c)(7) exemptions under the Investment Company Act. These arguments, however, rest on the faulty premise (*see supra* pp. 30-31) that Congress's exemptions from regulation of private investment companies under the Investment Company Act somehow preclude the Commission from requiring certain investment advisers to register under the Advisers Act.

In addition, petitioners claim (Br. 49-50) that the Commission inappropriately relied on the market timing and late trading scandals (*see supra* pp. 9-10 & n.3), and made an "irrational link" between these mutual fund scandals and hedge fund adviser registration. The rule, however, was not based on any particular scandal, but on an increase in fraud involving hedge fund advisers which included, *inter alia*, their participation in these scandals. Moreover, this link was rational, because the Commission found hedge fund advisers to be "key participants" in these scandals, and noted that some "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." Adopting Release at 72056, 72062 n.91. Petitioners' argument also ignores: the deterrent effect that registration and the possibility of a Commission examination may have on advisers' conduct; the Commission's ability to keep unfit persons from using hedge funds to perpetrate frauds; and the requirement that registered advisers adopt compliance policies and procedures, and designate a chief compliance officer. *Id.* at 72061-63. For the same reason, petitioners' related attack (Br. 50) on the Commission's ability to deter and detect fraud, pointing to the Commission's failure to prevent these scandals, is misguided. The Commission rejected this argument as unsupported and "as illogical as an assertion that because

police officers are unable to prevent or detect all crime, they should be removed from their beats." Adopting Release at 72062.

Finally, petitioners make the remarkable argument (Br. 49) that because the Advisers Act's anti-fraud provision applies to all advisers—whether registered or unregistered—"Congress * * * did not give the SEC the authority to impose the statutory requirement of registration as a method for investigating or deterring adviser fraud." Petitioners' argument ignores Section 206(4) of the Act, which grants the Commission the authority to adopt rules that are "reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." 15 U.S.C. 80b-6(4). The purpose of the registration provisions of the Advisers Act clearly includes the deterrence of fraudulent activity by investment advisers. Congress amended the Act in 1960 to strengthen the registration provisions and their ability to deter fraud by requiring registered advisers to maintain certain books and records, and by granting the Commission the power to conduct routine inspections. *See* Pub. L. 86-750, § 6, 74 Stat. 886; S. Rep. No. 1760, at 4 (1960) ("The prospect of an unannounced visit of a Government inspector is an effective stimulus for honesty and bookkeeping veracity.").

3. The Commission Did Not Chill Opposition to the Rule and Rule Amendments.

Petitioners make a number of unfounded attacks on the process by which the Commission adopted Rule 203(b)(3)-2 and the rule amendments. Petitioners first contend (Br. 50-51) that opposition to the rule was chilled because commenters were given insufficient time to comment on the proposed rulemaking. Notice of a proposed rulemaking "is adequate if it provides 'interested persons an opportunity to participate in the rule making through submission of written data, views or arguments.'" *Omnipoint Corp. v. FCC*, 78 F.3d 620, 629 (D.C. Cir. 1996) (quoting 5 U.S.C. 553(c)). The Court has upheld comment periods much shorter than the 49 days commenters had here after publication in the Federal Register to consider and comment on the proposed rulemaking. *See, e.g., Conn. Light & Power Co. v. NRC*, 673 F.2d 525, 534 (D.C. Cir. 1982) (30 days). *See also Phillips Petroleum Co. v. EPA*, 803 F.2d 545, 559 (10th Cir. 1986) ("Courts have uniformly upheld comment periods of 45 days or less."). Moreover, petitioners, who submitted comments, cannot show that they were harmed. *See, e.g., Omnipoint Corp.*, 78 F.3d at 630.

Petitioners also contend (Br. 51) that Chairman Donaldson discouraged the submission of evidence by stating that opponents had something to hide, thus

(according to petitioners) implying that anyone who opposed the rule "would be targets of SEC scrutiny" once the rule was adopted. Petitioners' suggestion that the Chairman would direct the Commission to retaliate against opponents to the rule violates the "well-settled presumption of administrative regularity," pursuant to which "courts assume administrative officials 'to be men [and women] of conscience and intellectual discipline, capable of judging a particular controversy fairly on the basis of its own circumstances.'" *Louisiana Ass'n of Indep. Producers & Royalty Owners v. FERC*, 958 F.2d 1101, 1119 (D.C. Cir. 1992) (quoting *Withrow v. Larkin*, 421 U.S. 35, 55 (1975)) (alteration in original). Further, petitioners' argument is contradicted by the more than 80 commenters—including petitioners—who opposed the rule. *See* Adopting Release at 72059. [14/]

Petitioners also assert (Br. 51) that the Commission's Adopting Release "ominously suggested the same prospect of SEC attention to those who opposed the rule * * * ." It is, however, logically impossible for a statement in the

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[14/] Petitioners' first comment letter mockingly compared the Commission's staff to a nursery-rhyme character. *See* Comment Letter of Phillip Goldstein (Sept. 10, 2004). Petitioners' second comment letter attached the Supreme Court's decision in *Lowe*, "so that the Commission's legal wizards can familiarize themselves with it." Comment Letter of Phillip Goldstein (Sept. 25, 2004).

Commission's release, issued when it *adopted* the rule, to chill opposition to the rule *while it was still under the Commission's consideration*.

4. The Commission's Analysis of the Costs of Compliance with the Rule and Rule Amendments Was Reasonable.

This Court has recognized that a petitioner's "burden to show error is high" when challenging an agency's economic analysis "in the regulation promulgation process * * * ." *Nat'l Wildlife Fed'n v. EPA*, 286 F.3d 554, 563 (D.C. Cir. 2002). The Commission is entitled to "great deference" in determining "highly complex and technical matters" within its area of expertise. *Domestic Sec.*, 333 F.3d at 248. *See also NRDC, Inc. v. SEC*, 606 F.2d 1031, 1058 (D.C. Cir. 1979) (noting the "inherent uncertainties in quantifying the net cost of gathering and disseminating information" even "with respect to the SEC's financial disclosure requirements, which have been in effect for decades").

Petitioners argue (Br. 54) that the Commission "vastly understated the costs of compliance with the registration requirement." Petitioners complain (Br. 52-53) that the Commission improperly accepted estimates that costs would be low and "ignored" estimates of high costs. To the contrary, the Commission properly evaluated conflicting evidence and made findings crediting some and rejecting

others. "[T]he resolution of conflicting evidence is for the Commission, not the court." *Domestic Sec.*, 333 F.3d at 249.

For example, the Commission estimated that the average cost for a hedge fund adviser to establish a compliance infrastructure would be $20,000 in professional fees and $25,000 in internal costs. Adopting Release at 72081. The Commission noted that commenters who challenged these estimates either did not provide any competing estimates or data, or were estimating for the cost of hiring a dedicated chief compliance officer, which, as explained below, the Commission found was not necessary in all circumstances. *Id.* An agency is not required to dispute criticisms of its cost-benefit analysis that were unsupported by competing data or analysis. *See Sierra Club v. EPA*, 353 F.3d 976, 989 (D.C. Cir. 2004).

The Commission recognized that ongoing costs of compliance would vary depending on a number of factors, especially firm size. Adopting Release at 72082. The Commission accepted the comments of small hedge fund advisers who estimated that their annual compliance costs would be approximately $25,000, but could be as high as $50,000. *Id.* Again, however, the Commission noted that "other small firms," which stated that their fees would be higher, "did not provide us with quantified estimates." *Id.* at 72082 n.338. *See Sierra Club*, 353 F.3d at 989. The Commission also rejected some commenters' assertions that

there would be substantial costs associated with hedge fund advisers' responses to a Commission examination, reasonably determining that the claims of advisers that they used 160 hours of internal staff time or spent an estimated $300,000 to $500,000 in out-of-pocket costs in undergoing a Commission examination were not "representative of our registrants' experiences * * * ." Adopting Release at 72082. *See Domestic Sec.*, 333 F.3d at 249.

Petitioners also complain (Br. 54), quoting the dissenting Commissioners, that the Commission "failed to offer any quantitative estimate for the costs associated with the requirement to have a chief compliance officer." The Commission adequately addressed this issue. The Commission explained that the rule does not require a full-time chief compliance officer, and does not require advisers to hire a new employee to fill the role. Adopting Release at 72081. Rather, depending on the size of the firm, the complexity of its compliance environment, and the qualifications of current staff, the role of chief compliance officer could be filled in-house. *Id.* Because firm size is a key factor in this determination, and because there is not a currently-available comprehensive database of hedge fund advisers, the Commission was not able to determine how many advisers would need to hire a new chief compliance officer. *Id.* Likewise, the Commission lacked information regarding the costs of shifting responsibilities

among staff—which was not provided by commenters challenging the cost estimates—that would have enabled it to better estimate the costs to smaller firms of designating a chief compliance officer from existing staff. *Id.* at 72081-82. [15/]

Petitioners also argue (Br. 52) that the Commission should have conducted a study of the *larger* hedge fund advisers which are already registered under the Act. An agency "has wide latitude in determining the extent of data-gathering necessary to solve a problem." *Allied Local & Reg'l Mfrs. Caucus v. EPA*, 215 F.3d 61, 71 (D.C. Cir. 2000). Petitioners do not explain how the lack of such a study casts a shadow on the Commission's cost-benefit analysis regarding the impact of the rule and rule amendments on advisers of all sizes—especially smaller advisers. As the Commission found, the costs of compliance would vary greatly depending on a firm's size and current compliance structure. [16/]

15/ Quoting the dissenting Commissioners, petitioners claim (Br. 53) that in noting that commenters did not provide the Commission with contrary information, the Commission improperly "shift[ed] responsibility for the cost-benefit analysis to commenters." It is not unreasonable, however, for an agency to indicate that it has imperfect information, note that opponents of the rule who presumably would have competing information have not provided any, and make a decision based on the information actually before the agency. *See, e.g., Professional Pilots Fed'n v. FAA*, 118 F.3d 758, 765 (D.C. Cir. 1997) (An agency "simply cannot be faulted for failing to explain away data that are not part of the record.").

16/ Contrary to another of petitioners' arguments (Br. 53 n.16), we are unaware of any precedent that would require the Commission to consider cost

CONCLUSION

For the foregoing reasons, the order of the Commission should be affirmed.

Respectfully submitted,

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estimates submitted in a comment letter regarding a separate rulemaking.

CERTIFICATE OF COMPLIANCE

I certify that this brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because it contains 13,931 words, excluding the parts exempted by Fed. R. App. P. 32(a)(7)(B)(iii) and Circuit Rule 32(a)(2).

I also certify that this brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because it has been prepared in a proportionally spaced typeface using Word Perfect in 14-Point Times New Roman.

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May 18, 2005

CERTIFICATE OF SERVICE

I certify that on this 18th day of May, 2005, I caused to be filed by hand delivery the original and 7 copies of the foregoing [Initial] Brief of the Securities and Exchange Commission, Respondent, with the Clerk of the United States Court of Appeals for the District of Columbia Circuit, and caused to be served by overnight courier two copies of the same on counsel for petitioners at the following addresses:

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