COMMENTS OF SADIS & GOLDBERG LLC

FOR THE

COMMODITY FUTURES TRADING COMMISSION

COMMODITY POOL INDUSTRY ROUNDTABLE

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INTRODUCTION

The assets invested in certain private investment pools ("**hedge funds**") in the U.S. represent a relatively minor percentage of the aggregate assets invested in the U.S. financial markets. For example, assets invested in mutual funds total approximatley $8.1 trillion, while assets invested in hedge funds are believed to total $1 trillion.[1] Nonetheless, due to the growing role hedge funds play in the securities markets and a concern about increased fraud in connection with investments in hedge funds, the U.S. Securities and Exchange Commission (the "**SEC**") issued a final rule and rule amendments (the "**Final Rule**") requiring certain hedge fund managers to register with the SEC as investment advisers under the Investment Advisers Act of 1940 (the "**Advisers Act**") by February 1, 2006.

The staff of the Commodity Futures Trading Commission (the "**CFTC**") recognizing that hedge funds play an extremely important role in the function of the futures markets in both the U.S. and abroad, has assembled the Commodity Pool Industry Roundtable with the intention of focusing on the growth, developments and regulation of the commodity pool industry. As the CFTC strives to work with and better understand this growing industry, it is important to dispel certain misconceptions. These comments are intended to briefly address four primary points: (A) prior to issuance of the Final Rule, many hedge funds were subject to regulation; (B) the growth in hedge funds has not caused a proportionate increase in hedge fund fraud; (C) the registration of hedge fund managers will not have a significant impact on detecting fraud committed within the hedge fund industry; and (D) the Final Rule is already having a negative impact on the hedge fund industry's growth and development.

Given the issuance of the Final Rule, many more hedge fund managers who currently are not subject to any form of regulation will be required to register as investment advisers with the SEC, while certain managers or their affiliates who were already registered with other regulatory bodies will now become subject to additonal regulatory scrutiny through this recent registration requirement. At this time, it is unclear whether the Final Rule will achieve its objectives and the impact of the Final Rule on hedge funds whose managers have not been registered is unknown. We suggest that the CFTC and other interested regulators establish an ongoing dialogue with the SEC over an extended period of time to monitor the effects of the Final Rule on the hedge fund industry rather than imposing any additional regulatory requirements on hedge funds or their managers at this time of uncertainty.

A. MANY HEDGE FUND MANAGERS ARE SUBJECT TO REGULATION

Many hedge fund managers are currently subject to regulatory supervision. For example, to the extent that a hedge fund manager trades futures or options on futures on behalf of a hedge fund, the fund is deemed to be a "commodity pool" and the managers to such funds would be required to register as commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**") with the CFTC, absent an exemption from registration. With certain exceptions, all persons and organizations that intend to do business as futures professionals must register under the Commodity Exchange Act and apply for membership with the National Futures Association. The primary purpose of registration is to screen a member's fitness to engage in business as a futures professional and to identify those persons whose activities are subject to federal regulation.[2] As

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[1] See Will the Next Pop You Hear be a Hedge Fund Bubble Bursting?, by Jenny Anderson and Riva D. Atlas, International Herald Tribune (March 30, 2005).
[2] http://www.nfa.futures.org, "Who has to Register."

of May 2003: (i) 18 of the top 25 hedge funds were operated by CPOs; (ii) 55 of the top 100 hedge funds were operated by CPOs; and (iii) 44 of the top 100 hedge funds were registered with the CFTC as CTAs.[3]

Further, a significant number of hedge fund managers have affiliates or funds that are registered as broker-dealers with and regulated by the National Association of Securities Dealers ("**NASD**") and/or the New York Stock Exchange ("**NYSE**") and are subject to comprehensive compliance requirements and regulatory review. In comments submitted to the SEC in May 2003, Charles J. Gradante of Hennessee Group LLC disclosed that based upon their research of hedge funds: (i) 50% were registered as investment advisers with either the SEC or state regulators; and (ii) 25% were registered in some capacity with the CFTC, NASD or the NYSE.[4] The Chairman of the SEC, William H. Donaldson, has conceded that nearly half of hedge fund managers are already registered with the SEC.[5]

B. HEDGE FUND FRAUD HAS NOT DRAMATICALLY INCREASED

In 2002, the SEC staff examined the activities of hedge funds and their managers, including the number of enforcement cases in which hedge fund managers committed fraud. The staff's examination included information presented by 60 panelists, including representatives of federal, state and foreign regulators, as well as academics and securities industry professionals at a Hedge Fund Roundtable in May 2003 (the "**SEC Roundtable**"). Subsequent to the SEC Roundtable, the SEC staff published a report entitled Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, (available at http://www.sec.gov/spotlight/hedgefunds.htm) (the "**2003 Staff Report**"). The 2003 Staff Report found that there is "no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity."[6] These conclusions were consistent with the views expressed by many of the participants of the SEC Roundtable. William H. Donaldson, the Chairman of the SEC, has also testified that he has "no reason to believe that fraud is more prevalent in hedge funds than it is anywhere else."[7]

In July 2004, the SEC staff issued a proposed rule and rule amendments (the "**Release**") to require registration of certain hedge fund managers under the Advisers Act.[8] In the Release, statistics regarding enforcement actions involving hedge fund managers are cited in support to the adoption of the Final Rule. The Release indicates that over a five year period, the SEC staff had initiated approximately 2,600 enforcement actions, including 46 enforcement actions in which hedge fund managers had defrauded investors or used a hedge fund to defraud others.

From June 1999 through June 2004, both the SEC and the CFTC initiated approximately 3,757 enforcement actions, of which approximately 107 enforcement actions involved hedge funds,

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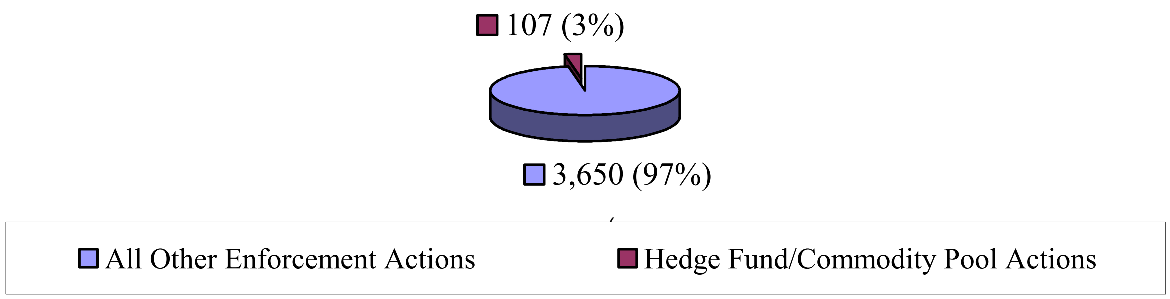
[3] Enforcement/Fraud Concerns, Statements of Patrick J. McCarty, General Counsel, Commodity Futures Trading Commission, SEC Hedge Fund Roundtable, May 14-15, 2003.
[4] Comments of Hennessee Group LLC for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds, Charles J. Gradante, May 14-15, 2003.
[5] SEC Proposes Registering Hedge Fund Advisers, by Richard Sine, (www.issproxy.com/governance/publicatins/2004archived/093.jsp).
[6] 2003 Staff Report at 73.
[7] Testimony of William H. Donaldson, Chairman of the SEC, Recent Developments in Hedge Funds, Hearing Before the Committee of Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (April 10, 2003).
[8] Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. IA-2266, Fed. Reg. 45172 (July 28, 2004).

commodity pools and CPOs. As depicted on the following chart, this represents approximately 3% of all enforcement actions brought during the same time period.[9]

SEC and CFTC Hedge Fund/Commodity Pool Enforcement Actions
Total Combined Enforcement Actions 1999-2004: 3,757



C. Registration will not Materially Increase Detection of Fraud

Certain officials within the federal government believe that registration will not materially increase the SEC staff's ability to detect fraud that may be committed by hedge fund managers. "Frauds almost only can be identified through accidents or informants," Federal Reserve Board Chairman Alan Greenspan said at a Senate Banking Committee hearing on the Federal Reserve's monetary policy report.[10] "The information reported to the SEC by registered investment advisers is very limited…. Nor are examinations of advisers likely to uncover much fraud. Our experience with bank examinations indicates that examiners have a great difficulty uncovering fraud."[11] It has been our experience that enforcement actions resulting from the examination efforts by the SEC involve technical violations of either the Advisers Act or the Investment Company Act of 1940 (the "**Company Act**"), rather than the prosecution of fraud.

In their dissenting opinion to the Release, Cynthia A. Glassman and Paul S. Atkins conducted an analysis of the 46 enforcement actions cited in the Release and stated that "the typical 'hedge fund' fraud is perpetrated by an adviser that is too small to be registered with the [SEC], was registered already with the [SEC], or evaded registration requirements. Specifically, 8 of these 46 cases involve hedge fund advisers who were already registered with the [SEC]. In 5 of the 46 cases, the fund should have been registered under the Company Act, so their advisers already

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[9] The chart has been created based, in part, on information taken from speeches presented by Chairman Donaldson and Commissioner Glassman given on July 14, 2004 and October 26, 2004, respectively. See www.sec.gov/news/speech/spch071404whd.htm and www.sec.gov/news/speech/spch102604cag.htm.

[10] See Greenspan Objects to SEC Hedge Fund Regs, by Ron Orol (July 20, 2004).

[11] Comments of Managed Funds Association to the U.S. Securities & Exchange Commission regarding Registration Under the Advisers Act of Certain Hedge Fund Advisers (September 15, 2004), referencing The Federal Reserve's Second Monetary Policy Report to Congress for 2004, Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 108th Congress (July 20, 2004) (written response of Alan Greenspan, Chairman of the Federal Reserve, to question from Senator Crapo).

should have been registered under current rules. In 20 of the 46 cases, the hedge funds were too small to be covered by the proposed rulemaking. In two cases, the fraud involved a principal of a registered broker-dealer or investment adviser, over whom [the SEC] already had full regulatory oversight. Three of the 46 cases were garden-variety fraud designed to swindle investors, regardless of whether the vehicles were called hedge funds, venture capital funds, limited partnerships or prime banks. Registration might have deterred them from using the term 'hedge fund,' but would not have deterred the fraud itself."[12]

Commissioners Glassman and Atkins concluded that "mandatory hedge fund adviser registration would not add to the [SEC's] ability to combat these types of fraud. In only 8 of the 46 cases the existence of the rule might have increased the [SEC's] oversight. These 8 cases, however, do not justify the [Final Rule]. Most involve valuation problems, which have been notoriously difficult for us to detect even if the adviser is registered. In addition, only perfectly timed inspections would have improved the [SEC's] detections of the frauds at issue. With respect to all advisers, registered or unregistered, tips from knowledgeable insiders or third parties are often the key to discovering the fraud. Indeed, tips pointed us to the fraud in 7 of the 8 remaining cases."[13]

There are several similarities between the enforcement actions brought by the SEC and the CFTC. In May 2003, Patrick J. McCarty, the General Counsel of the CFTC presented an overview of four common variables in connection with 54 enforcement actions brought by the CFTC: (i) the vast majority of the 54 cases (78%) involving commodity pools and CPOs were unregistered commodity pools; (ii) most of those enforcement actions involved the outright misappropriation of investor funds (at times, not involving actual futures trading); (iii) the enforcement actions typically have involved fewer than 50 investors; and (iv) the enforcement actions typically involved assets totaling less than $10 million. Taking into consideration the enforcement actions brought by both the SEC and the CFTC against hedge funds and their managers, registration of hedge fund managers most likely will have little impact on detecting and reducing fraud in the hedge fund industry.

D. IMPENDING REGISTRATION HAS IMPACTED THE HEDGE FUND INDUSTRY

The Final Rule has already had an impact on the hedge fund industry. The burdens associated with registering as an investment adviser and the concern of future regulation is affecting the decisions of existing hedge fund managers and persons contemplating sponsoring a hedge fund. Many managers of hedge funds with assets of less than $30 million are concerned as to their ability to comply with registration requirements and the expenses associated with compliance once they cross the $30 million threshold. The research conducted by Hennessee Group LLC indicates that approximately one-third of the hedge fund industry has less than $10 million in assets under management.[14] Sadis & Goldberg LLC represents several hundred hedge funds and their managers. Our experience with our clientele is consistent with their findings. While working daily with managers with assets approaching $30 million, we are addressing these managers' concerns regarding impending registration and examination by the SEC. Many of these managers believe that registration will reduce their likelihood for success as compared to larger institutions with existing infrastructure and an ability to absorb higher costs. Federal Reserve Board Chairman Alan Greenspan was correct in his concern that the added administrative cost created

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[12] Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to Proposing Release No. IA-2266 Proposed Registration Under the Advisers Act of Certain Hedge Fund Advisers, at 99-100.
[13] Id., at 100.
[14] Comments of Hennessee Group LLC for the U.S. Securities and Exchange Commission Roundtable on Hedge Funds, Charles J. Gradante, May 14-15, 2003.

by registration will raise the barrier to entry in the industry, stifling entrepreneurship.[15] We also believe that the costs associated with advisory registration and routine examination will result in the reduction of the formation of new hedge funds, which in turn will reduce the level of competition in the future.

Rather than implementing any additional regulations on eithe the hedge funds or their managers, we suggest that the CFTC and other interested regulators continue to monitor the industry. We recognize that both the SEC and CFTC are taking steps toward enlightening the public about the risks associated with investing in hedge funds.[16] We believe that educating hedge fund investors will be more effective at combating fraud within the hedge fund industry than further regulation.

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[15] See Votes for Hedge Fund Registration by Kristen French, www.financial-planning.com/pubs/fpi/20041028101.html.

[16] See www.sec.gov/answers/hedge.htm