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July 27, 2011

Preston DuFauchard
California Corporations Commissioner
Department of Corporations
71 Stevenson Street, 2100
San Francisco, CA 94105

RE: PRO 04/11 - Invitation for Comments – Proposed Changes Under Corporate Securities Law of 1968 – Section 260.237 of Title 10, California Code of Regulations

Dear Mr. DuFauchard:

We appreciate the opportunity to provide comments regarding the proposed amendments to Section 260.237, the California custody rule (the "Proposed Rule") that applies to investment advisers that are registered with the Department of Corporations (the "Department").

This letter is submitted on behalf of the California Hedge Fund Association of which I am a member of the Board of Directors, and for which Pillsbury Winthrop Shaw Pittman LLP acts as outside legal counsel. The California Hedge Fund Association is a regional industry organization that counts among its membership at least one hundred advisers to private funds, many of which are, or soon will be, subject to registration as an investment adviser with the Department and which would be affected by the proposed rule.

The goal of the California Hedge Fund Association is to ensure that appropriate rules are adopted that serve to both protect and advance investor interest while maintaining the viability of the alternative investment vehicles through which they seek to achieve differentiated returns. As you are probably aware, Pillsbury has previously submitted two comment letters regarding a version of a custody rule (the "Model Rule") that was formulated and made available for public comment by the North American Securities Administrators Association ("NASAA"). Those previous comment letters were submitted to NASAA on behalf of the California Hedge Fund Association and the Florida Alternative Investment Association.

We commend the Department for incorporating many of the concepts and specific comments that we made in those two previous submissions to NASAA, but would like to focus on two areas of the Proposed Rule that we believe can be improved and streamlined in ways that are consistent with investor protection and will facilitate the dissemination of periodic reports by fund managers.

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Specifically, we believe that reporting positions that represent 5% or more of a fund's portfolio and the elimination of the requirement of identifying specific short positions in quarterly reports to fund investors is consistent with providing valuable periodic information to investors, protecting both investors and fund advisers from predatory practices, while eliminating undue burdens on California registered investment advisers that advise private funds.

I. Overview

In a pooled fund, the collective interest of all investors taken as a whole should take precedence over the individual interest of any one investor. Pooled funds are designed and understood by their investors to operate in this manner, and they function most effectively and efficiently when managed in this way.

Disclosure of information about a pooled fund that could be used to the benefit of one or more investors or other investment professionals, at the expense of the remaining investors in the fund, is not in the collective interest of a fund's investors taken as a whole for the reasons described in our previous letter.

We note that the Department has retained the NASAA model rule approach of requiring total disclosure of every investment position at each quarter-end to a diverse group of investors. We believe that this requirement for detailed total position disclosure is not in the collective best interest of a diverse but co-interested group of investors and may be harmful to fund investors as this information is disseminated through the market.

Accordingly, we respectfully request that the Department consider amending section 260.237 (a)(5)(ii) of the Proposed Rule to instead require quarterly disclosure of a schedule of investments prepared on the same basis as that required to be included in any audited financial statements of a nonregistered investment partnership under U.S. financial reporting standards, with the appropriate exception of disclosure of any short positions.

These standards require reporting of each individual investment position that exceeds 5% of a fund's net assets, as well as position totals by security type, industry and country classifications for all investment positions. Reporting of investment positions on this basis would strike a more appropriate balance between protecting and advancing investor interest.

Investment position reporting on this basis would also provide investors with a clear, consistent and cogent reporting framework that organizes and highlights material information about the composition of the fund's portfolio and about each individually significant investment position in a manner that would be more readily accessible for investor analysis than would a detailed mass of individual position data.

Reporting positions on this basis would also be similar to that required of various investment vehicles with which a private fund may be compared as investment alternatives. These include open-end and closed-end registered investment companies and exchange-traded funds, which are required to report similar schedules of investments prepared under U.S. financial reporting standards to their investors semi-annually.

This reporting framework would therefore set a more level playing field for investor interest in both (a) the balance struck between protecting and advancing investor interest for private funds as compared to that struck in the reporting required of the alternative vehicles also available to an investor, and (b) in the consistency, comparability and cogency of meaningfully organized information provided by investment vehicles across that spectrum to their investors for review, analysis and comparison purposes.

Finally, given the unique risks peculiar to short sale positions that continue throughout their duration, we strongly suggest that the Department exempt short positions from any individual position reporting requirement. The continuing confidentiality of such positions can be vital to protecting the performance and viability of funds that utilize this strategy, given both the potential for unlimited losses with short positions and the significant impact of short-position demand on the cost to sustain such positions and the related investment returns. Additionally, funds that are managed by California registered investment advisers as of March 2012, i.e., those with less than $100 million under management, are particularly susceptible to a short squeeze by other investment professionals that may gain access to this information and that have the resources to influence the price of the securities that the California registered adviser has sold short on behalf of a fund.

We believe that the need to provide investors with appropriate disclosure by which they can assess a private fund's risk and performance and compare it to others and the need to protect an investment fund's proprietary trade secrets and positions in development are not mutually exclusive. If the means by which a fund generates its returns is compromised, investors will fail to achieve the returns they seek. At the same time, without adequate controls and appropriate disclosures to protect investor interests, frauds and scams could undermine the investor confidence necessary for the viability of the private fund industry.

II. Risks of Detailed Reporting of All Investment Positions

We strongly believe that requiring total disclosure of all fund investment positions is not in the best interest of fund investors. Below, we explain on some of the reasons we believe this to be the case.

Tragedy-of-the-commons problem

We believe that the misalignment of incentives and interests posed by such detailed reporting for a pooled fund to a diverse population of members, which typically includes other funds, institutions and sophisticated private investors, presents serious free-rider and tragedy-of-the-commons problems for the fund and therefore for its investors as a group.

An individual investor's use of position data any more specific than information about the fund's material positions and material elements of its portfolio composition (i.e., breakdown by security type, industry and jurisdiction) is more likely to operate as a threat to the interests of other investors in the pooled fund than it is to operate to that investor's appropriate benefit.

Investment opportunities and position construction

Ironically, total position disclosure risks hurting a small private investment fund the most when it helps an individual investor the least (at least when that investor is properly using that information only to assess the fund rather than to replicate its positions); that is, before a meaningful position has been built.

Many small funds (those under $100 million) rely on contrarian value strategies, event-driven strategies or other strategies that exploit price inefficiencies, often involving limited liquidity or supply of a particular security. These positions are best constructed confidentially in order to avoid market discovery of the inefficiency and its evaporation before a meaningful position can be built.

These positions can take two or more quarters to build, and such pricing opportunities can evaporate if a fund must report even its initial seed positions before the manager can achieve their target size, let alone a size that would be meaningful to an investor in assessing the fund as a whole or its ultimate performance concerning that investment. Three quarters or more may seem like a long time. However, in the competition for investment returns, patience is one of the few provinces of the small private investment fund, along with limited size. Larger funds are more likely to face a variety of pressures to focus on short-term performance. This allows advisers to smaller funds to gain a competitive advantage to the extent they can focus their fund, and its investors, on long-term performance. Such a focus, however, can require the ability to slowly build a meaningful position in a given security before the opportunity it represents is disclosed to a diverse group of individuals and other entities.

In addition, an investment strategy may entail buying and selling the same security multiple times over an extended period of time as long as the fundamentals allow for it. A fund could thereby profit from the same investment thesis over several years, if not longer. But that opportunity could evaporate if the securities involved are exposed to other market participants.

Contrasts with other regulatory reporting

We continue to believe it is important to set a level playing field for portfolio disclosures for private investment funds managed by California-registered and SEC-registered investment advisers (i.e., "SEC-covered funds" and "California-covered funds").

Below, we briefly summarize and contrast three streams of portfolio-level reporting required for these two types of funds.

Proposed Form PF:
Developed pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") this new reporting requirement is designed to ensure that central regulators have access to information about market concentrations for potentially systemically important financial institutions. In summary, Form PF will require reporting of detailed portfolio information for advisers to private funds with assets over $1 billion on a quarterly basis and for funds over $500 million on an annual basis. However, disclosure under Form PF will be made available only to the SEC as a central regulator and to other systemic risk regulators, and will not be made available to

fund investors or the general public. Market confidentiality is designed to be preserved for this information in the manner intended for such "proprietary information" as defined and described in the Dodd-Frank Act.

Therefore, the Proposed Rule would require greater disclosure to market participants than would occur for private funds managed by SEC-registered advisers through Form PF reporting.

Annual financial statements:

Private funds managed by both SEC-registered and California-registered advisers are required to report material elements of portfolio composition in their annual financial statements, including disclosure of each individual position constituting more than 5% of net assets, as well as position totals by security type, industry and country classifications for all investment positions.

Accordingly, there is parity in disclosures by funds managed by SEC-registered advisers and those managed by advisers registered with the Department regarding this requirement.

Quarterly schedule of investments:

Except as described in the next section, funds managed by SEC-registered advisers are not currently required to disclose portfolio information to investors on a quarterly basis for, we believe, the various reasons described herein, among others. However, for funds managed by California-registered advisers, our suggested alternative to the Proposed Rule would provide the same level of portfolio reporting currently provided with the audited financial statements of any private investment fund, whether managed by an SEC-registered adviser or a California-registered adviser.

Schedules 13D, 13G, and Form 13F:

Funds of all size, regardless of the regulatory jurisdiction under which they operate, are required to make certain disclosures on Schedules 13D, 13G and Form 13F where applicable:

- Schedule 13D – ownership of more than 5% of any class of an issuer's voting equity securities;
- Schedule 13G – short-form filing for ownership of 5-20% of any class of an issuer's voting equity securities;
- Form 13F – quarterly reporting of ending positions (but not short positions) in equity securities traded on a national exchange or derivatives thereof held by institutional investment managers with more than $100 million under discretionary management.

Schedules 13D and 13G are primarily directed at market disclosure of concentrations of ownership in a given issuer, rather than concentrations in the investor's portfolio, but nevertheless apply equably to both funds managed by SEC- and California-registered advisers.

Form 13F is required to be filed by an institutional money manager that manages in excess of $100 million in "13F securities." This disclosure form, which is similarly intended to provide access to the public regarding the ownership of large, publicly traded companies also applies equally to both SEC- and California-registered advisers, although it is unlikely that an adviser would manage more than $100 million in 13F securities and remain registered with the Department.

Competitive disadvantage to funds managed by SEC-covered advisers and other vehicles

We continue to believe that requiring total position disclosure by private, non-marketed funds limited to sophisticated, non-retail investors is both overreaching and sets an un-level playing field in the competition for investment returns to the disadvantage of investors in such funds.

The interests of sophisticated investors are adequately protected by the use of qualified custodians, independent parties, surprise financial examinations, full scope financial statement audits, and/or internal control audits, supplemented by adviser state registration, disclosure and compliance requirements and state examinations of that compliance and market-wide disclosure requirements under the 1934 Act.

If, within the constraints of those protections, sophisticated investors consider it in their interest to invest in a fund designed for the purpose of pursuing differentiated returns not to regularly report all investment positions, when those investors have a wide variety of investment alternatives to choose from and are under no compulsion to do so, those sophisticated investors should be free to enter such a contract in the competent pursuit of their own interest if they so choose.

If sophisticated investors instead consider it in their interest to require total position reporting of a fund in which they invest, they are free to privately negotiate for such reporting with that fund and its adviser. Given the foregoing protections and the freedom to negotiate where deemed desirable, there is no need to explicitly mandate additional disclosure requirements that could impede the core investment operations of the fund.

We believe that in most cases, the larger investors in private funds managed by a California-registered adviser have more resources at their disposal than do the advisers to such funds. And small funds need their larger investors much more than those investors need them. We also believe this circumstance inheres regardless of size for state-covered funds. The largest investors in a small, one million-dollar fund will typically be more important to that fund than the reverse. The same will typically be true of funds between $25-$100 million in assets.

Investors in small funds therefore have plenty of scope and power to negotiate for total position reporting if they consider it necessary or desirable. The lack of such a negotiated provision or practice for a given fund would seem to indicate either that its investors did not consider it necessary or in their interest for the fund to provide such disclosure, or that the adviser to that fund considered that disclosure such a threat to the fund's returns (and also thereby to his own earnings) that he was unwilling to agree to such disclosure, even at the "expense" of having to turn away capital.

III. Special Risks of Reporting Individual Short Positions

The disclosure of short positions exposes a fund to significant additional risks and costs that jeopardize the return performance of a fund that uses these positions.

Unlike long positions, the risk of loss on a short position is unlimited, while the risk of loss on a long position is limited to the amount originally invested. As such, disclosure of short positions

exposes funds to tremendous risk. Funds with less capital would be at greater risk to manufactured "short-squeezes" by larger funds, or a group of funds, with more resources and capital. This risk is especially high in less liquid securities. Disclosure of short positions to a diverse group of fund investors will inevitably "leak" to other industry participants who will not hesitate to profit at the expense of the fund with the short position.

While the risk of inviting trades against a fund's short positions is significant, so is the risk of seeing a fund's short positions copied. This is because shorting a security entails borrowing the security from a broker at a cost. The relationship between the inventory of shares available to borrow and the borrowing demand determines that cost. These borrowing rates can be as high as 10% or more for stocks with limited shares available to borrow. Therefore, the borrowing rate charged plays a significant role in determining the viability of the short position. An increase in demand for shares to short threatens to both i) increase the cost to borrow current and future shares, and ii) eliminate the inventory of a security available to short such that an investor may not be able to build an adequate position.

For these reasons the viability of short positions can remain highly dependent on their confidentiality throughout their duration. We therefore request that such positions continue to remain exempt from individual quarterly position disclosure requirements.

We further note that this treatment comports with the SEC's treatment of short positions in Form 13F position disclosures, which appropriately excludes the reporting of short positions.

IV. U.S. Financial Reporting Standards – in General

U.S. financial reporting standards applicable to the financial statements of for-profit and not-for-profit enterprises, including both public and private companies and partnerships, mutual funds, closed-end funds, exchange-traded funds, real estate investment trusts, private equity funds and venture capital funds – including the reporting standards developed specifically for private, nonregistered investment partnerships such as hedge funds – are designed to address this conflict and strike the proper balance between protecting and advancing the interests of investors with the ultimate objective of providing "*information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions*"[1] concerning a particular enterprise or interest therein.

The Financial Accounting Standards Board ("FASB") is the private-sector due-process organization that promulgates financial reporting standards for for-profit and not-for-profit enterprises in the United States. FASB's standards constitute U.S. generally accepted accounting principles ("GAAP"), but this term is something of a misnomer.

FASB's standards are designed to address the form and content of financial reporting by which investors and creditors can assess the economic history, financial condition, operating performance, and future prospects of a particular enterprise.

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[1] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 1, "*Objectives of Financial Reporting by Business Enterprises*".

FASB and its private-sector predecessor organizations have been setting financial reporting standards for issuers of U.S. securities for about a century, and its financial reporting standards are used broadly and deeply throughout the United States. For instance, all financial statement filings with the SEC are required to comply with FASB's financial accounting and reporting standards. This includes the quarterly and annual financial statements of all companies whose securities are publicly traded, as well as those of all registered open-end mutual funds, closed-end funds, exchange traded funds, master limited partnerships, and other reporting entities.

In addition, the laws and regulations of each state defer to FASB's standards as the generally accepted standards of accounting and financial reporting for financial statements and other financial reports prepared or audited by any independent public accounting firm. No public accounting firm or CPA involved therewith may express an unqualified opinion on the financial statements of any for-profit or not-for-profit enterprise that do not comply with the FASB's financial reporting standards.

Moreover, FASB's standards are continually being revised and updated to reflect changes in the needs of investors, the tension between materiality and cost-benefit considerations (including risks vs. benefits of certain disclosures), contrasts among the interests of users of reported information, and developments in markets and technology (for instance, developments in the reliability of fair value measures and the consequent establishment of disclosure requirements within a qualitative hierarchy for those measurements commonly known as Levels 1, 2 and 3).

V. U.S. Financial Reporting Standards for Nonregistered Investment Partnerships

FASB's financial reporting standards applicable to nonregistered investment partnerships such as hedge funds specifically address the form and content of an ending schedule of investment positions required to be included in any set of audited financial statements (that is, any financial statements prepared in accordance with GAAP adequate to achieve an unqualified audit opinion).

In summary, FASB disclosure standards applicable to private hedge funds require an ending schedule of investments identifying each individual security position constituting more than 5% of net assets, as well as totals for all positions by security type, industry, and country classifications. Each nonregistered private fund subject to annual audit of its financial statements is already preparing and disclosing this information on a primary schedule included in its annual audited financial statements.

These financial reporting standards are codified in chapter 946-210-50 of the FASB's Accounting Standards Codification. For ease of reference and review, we have appended the relevant sections of that chapter in their entirety in Exhibit A hereto.

VI. Alternative to Quarterly Disclosure of All Investment Positions

FASB's financial reporting and disclosure standards applicable to nonregistered investment partnerships provide an objective framework for reporting each individually material investment position in a fund's portfolio and material classification information about the fund's remaining

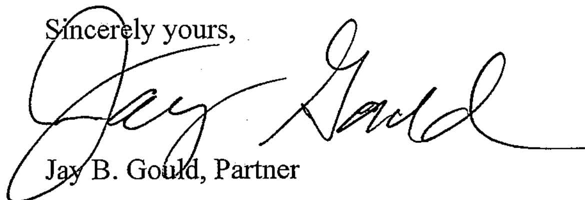
positions. This level of reporting strikes an appropriate balance between providing fund investors with enough information to assess the composition of a fund's portfolio, its concentrations of risk (any position over 5% of net assets), and its adherence to its stated investment strategy, while avoiding many of the detriments of total position disclosure described in our previous letter.

This reporting framework is also consistently applied among the various private funds that a present or potential investor may compare a given fund to, whether its adviser is subject to federal or state oversight. Further, proper and objective application of this position reporting framework is enforced through annual audits of each subject fund's financial statements (including its schedule of investments) by its independent public accounting firm.

In addition, while intra-year quarter-end information reported in this form would not be audited, a schedule prepared and presented on the same framework as the annual audited schedule of investments would make comparisons for consistency, trends and/or anomalies against the audited financials clearer, more accessible and more reliable than trying to compare detailed position lists to detailed position lists, or detailed position lists to the audited schedule of investments presented on the basis described above.

Finally, since each fund subject to annual audit should already have a framework for reporting information in this form, a requirement to report this information on a quarterly basis as well should not impose significant additional burdens on the fund or its adviser. Given the foregoing we suggest, as an alternative to total position disclosure at each quarter-end, that the Proposed Rule instead require quarterly disclosure of a schedule of investments prepared on the same basis as that required for its audited financial statements.

Sincerely yours,



Jay B. Gould, Partner

on behalf of:

The California Hedge Fund Association

Cc: Ivan Griswold
Christopher Ainsworth

Exhibit A

Financial Accounting Standards Board
Accounting Standards Codification:
946 – Financial Services – Investment Companies
210 – Balance Sheet
50 – Disclosure
4 – Investment Companies that are Nonregistered Investment Partnerships

FASB ASC 946-210-50-4 through 6:

Investment Companies that are Nonregistered Investment Partnerships

50-4 Except as noted in the following paragraph, the guidance in paragraph 946-210-50-6 applies to investment partnerships that are exempt from Securities and Exchange Commission (SEC) registration under the Investment Company Act of 1940, which include all of the following:

a. Hedge funds

b. Limited liability companies

c. Limited liability partnerships

d. Limited duration companies

e. Offshore investment companies with similar characteristics

f. Commodity pools subject to regulation under the Commodity Exchange Act of 1974.

50-5 The guidance in the following paragraph does not apply to investment partnerships that are brokers and dealers in securities subject to regulation under the Securities Exchange Act of 1934 (registered broker-dealers) and that manage funds only for those who are officers, directors, or employees of the general partner. For guidance applicable to those entities, see Topic 940.

50-6 The financial statements of an investment partnership meeting the condition in paragraph 946-210-50-4 shall, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule shall do all of the following:

a. Categorize investments by all of the following:

1. Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)

2. Country or geographic region, except for derivative instruments for which the **underlying** is not a security (see (a)(4))

3. Industry, except for derivative instruments for which the underlying is not a security (see (a)(4))

4. For derivative instruments for which the underlying is not a security, by broad category of underlying (for example, grains and feeds, fibers and textiles, foreign currency, or equity indexes) in place of the categories in (a)(2) and (a)(3).

b. Report the percent of net assets that each such category represents and the total value and cost for each category in (a)(1) and (a)(2).

c. Disclose the name, shares or principal amount, value, and type of both of the following:

1. Each investment (including short sales) constituting more than 5 percent of net assets, except for derivative instruments (see (e) and (f)). In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.

2. All investments in any one issuer aggregating more than 5 percent of net assets, except for derivative instruments (see (e) and (f)). In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

d. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments, and categorize them in accordance with the guidance in (a). In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

e. Disclose the number of contracts, range of expiration dates, and cumulative appreciation (depreciation) for open futures contracts of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets. In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

f. Disclose the range of expiration dates and fair value for all other derivative instruments of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds) regardless of counterparty, exchange, or delivery date, if fair value exceeds 5 percent of net assets. In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

g. Provide both of the following additional qualitative descriptions for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets:

1. The investment objective

2. Restrictions on redemption (that is, liquidity provisions).