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To: rule-comments@sec.gov

Re: Proposed Definition of Private Fund in Release No. IA-2266 (File No. S7-30-04)

By way of introduction, we are a Registered Investment Adviser specializing in fixed income relative value strategies, with an emphasis on the mortgage-backed securities market. We currently manage hedge funds, collateralized debt obligation trusts, and a private equity fund.

While we can appreciate that the distinction between hedge funds and private equity or venture capital funds may be a useful one for the Commission, two-year redeemability is not the proper criterion to make the distinction. Rather, the proper distinguishing characteristic of hedge funds is in the important role that Net Asset Value[1] plays in: (i) the determination of investment management fees; and (ii) non-pro-rata capital transactions.

In the case of investment management fees, for hedge funds these fees are generally calculated based on Net Asset Value ("fixed fees") and increases in Net Asset Value ("incentive fees"). In the case of capital transactions (i.e., investor purchases and redemptions), Net Asset Value is generally used in the determination of the purchase price (or redemption price) of hedge fund shares[2].

Private equity and venture capital funds, on the other hand, do not generally allow investors to invest and redeem on a non-pro-rata basis, with the following exception: there is often an initial series of closings (usually lasting a year or less) on which investors can buy into the fund. However, even during this initial period, investors do *not* buy in based on Net Asset Value.

As to investment management fees, private equity and venture capital funds only distribute incentive fees to the manager upon certain well-defined "realization events", which might include: (i) the sale of an underlying investment (i.e., its conversion to cash); or (ii) (especially in the case of venture capital funds) the conversion of a non-publicly traded interest into publicly traded securities (such as exchange-traded shares). Furthermore, upon these realization events, the fee earned is directly tied to the amount of cash (or securities, in the case of a share conversion) distributed to investors[3].

Should the Commission continue to desire to exclude private equity and similar funds from the definition of Private Funds, we would argue that a better criterion would be that, in order to be so excluded, a fund: (i) could not use Net Asset Value, nor any other financial measure similarly based on unrealized gains, as a determinant of investment management fees; and (ii) could not use Net Asset Value to compute the purchase price or redemption value of fund interests. Carve-outs would include: (i) pro rata capital activity[4]; (ii) "holdback", "collateralization tests", and similar calculations used to *reduce* a performance fee

[1] Net Asset Value is of course based in large part on fair market valuations of the underlying positions of the fund.
[2] For hedge funds with fund interests represented by limited partnership interests as opposed to fund shares, similar computations apply, also based on Net Asset Value or analogous concepts.
[3] These fees are sometimes reduced to reflect the performance of the remaining (i.e., unrealized) investments in the fund (see below).
[4] If the capital activity is pro-rata across *all* investors in the fund (for example, in the case of a proportional wind-down), the usual capital-transaction-related issues surrounding share pricing (i.e., the unfair treatment of either incoming or outgoing investors) are effectively moot.

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otherwise payable based on realizations[5]; and (iii) customary carve-outs for "extraordinary circumstances".

Clearly, concern over the use and implementation of valuations (especially in the calculation of Net Asset Value) by hedge funds was a motivating factor in the Commission's decision to explore these proposed regulations. However, it seems perverse that a hedge fund that is engaged in the exact types of activities that are at the very core of the motivation of the proposed regulations can dodge these regulations by actually *diminishing* investor rights and instituting a two-year lockup[6]!

As an illustration, imagine an unscrupulous fund manager who has been investing in illiquid securities and, based on fraudulent overvaluations, has marketed overstated performance (not to mention has been paid underserved performance fees). Such a fund manager would probably be *more* able than others to institute a two-year lockup and still maintain its investor base. Furthermore, we would argue that, philosophically, the Commission should in general be *more* concerned for investors who are unable to redeem from a fund for long periods of time: after all, investors with more frequent redemption rights can at least choose to redeem if they begin to have suspicions of malfeasance.

In summary, we believe that by altering its definition of Private Fund to more directly address the issues that have been at the center of recent fraud enforcement actions, the Commission can more effectively, and more fairly, focus its efforts.

[5] Upon a realization of a profitable investment, private equity funds often provide for a possible performance fee reduction based on the estimated impairments, if any, of the values of the remaining investments in the fund. Venture capital funds typically require that the investors "capital" be adequately collateralized by the remaining fund investments in order for a fee to be granted. In either case, however, these valuation-based calculations serve merely to reduce a fee that would otherwise be payable based simply on realization proceeds distributed.

[6] The industry "buzz" is that, in fact, many hedge fund managers wishing to avoid registration will be trying to institute two-year lockups exactly for this purpose. Clearly, the motivations to do this are greatest for managers engaging in questionable activity.