April 12, 2011

VIA E-MAIL (rule-comments@sec.gov) AND U.S. MAIL

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090
Attn: File Number S7-05-11

Re: Proposed Rule on Reporting by Investment Advisers to Private Funds on Form PF (RIN 3235-AK92)

Ladies and Gentlemen:

On behalf of Lone Star U.S. Acquisitions, the adviser to the Lone Star Funds ("Lone Star"), we appreciate the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") and Securities and Exchange Commission's ("SEC") Proposed Rule regarding Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF (the "Proposed Rule"). We encourage the SEC to share this comment letter with representatives of the CFTC and the Financial Stability Oversight Council ("FSOC"), to the extent it would be helpful in the agencies' deliberations about the Proposed Rule.

Lone Star is a global private equity firm that focuses on investment in distressed assets. Lone Star's origins trace back to the U.S. savings & loan crisis in the late 1980s to early 1990s, when key figures of Lone Star's senior management were instrumental in the design and implementation of a highly successful public-private partnership with the FDIC and Resolution Trust Corporation. From this working relationship with the U.S. banking regulators, Lone Star developed its investment methodologies, operations, and policies based on deep analytics and prudent underwriting principles.

Since then, Lone Star has purchased more than $60 billion of investment assets around the world. Given this experience, we hope to offer a broad-based perspective that will be useful in the deliberations of the SEC, CFTC and FSOC regarding the information necessary to ensure proper oversight of the systemic risks posed by private funds.

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General Comments

Lone Star welcomes and supports the SEC's initiative to increase transparency regarding systemic risks posed by private funds. But Lone Star has serious concerns that the Proposed Rule, if finalized as is, would have the unintentional consequence of mis-categorizing certain private equity funds as hedge funds, which is inconsistent with the stated intent of the Proposed Rule. This mis-categorization would require private equity funds to report detailed metrics that do not generally apply to private equity funds. Lone Star has additional comments on the relevance to private equity firms of one of the general questions in the Form PF, as well as the Proposed Rule's question regarding which entities are exempt from filing, and the proposed filing timelines.

Specific Comments

Topic 1: Definitions of Hedge Funds and Private Equity Funds

The preamble to the Proposed Rule clearly differentiates between hedge funds and private equity funds, stating that the latter do not pose as much potential systemic risk. Specifically, the preamble to the Proposed Rule states, "As discussed in more detail below, Form PF would require more detailed information from advisers managing a large amount of hedge fund or liquidity fund assets. Less information would be required regarding advisers managing a large amount of private equity fund assets because, after a review of available literature and consultation with staff representing FSOC's members, it appears that private equity funds may present less potential risk to U.S. financial stability."[1]

The Proposed Rule goes on to define a "hedge fund" as "any private fund that has any one of three common characteristics of a hedge fund: a performance fee using market value (instead of only realized gains), high leverage or short selling."[2]

To begin with, we believe that the intent of the Proposed Rule is correct in differentiating between the reporting requirements for hedge funds and private equity funds for the following reasons:

1. <u>Private Equity Firms Invest for the Long-Term</u>

   Private equity firms generally employ long-only investment strategies (i.e. they do not utilize short selling), which seek capital gains from operational improvements, organic growth, and/or workouts of distressed situations, among other sources of long-term value. Private equity investments are typically held for a period of years. Furthermore, these investment strategies do not typically involve the type of frequent trading employed by many hedge funds, which can exacerbate market volatility and potentially create systemic risk.

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[1] 76 Fed. Reg. 8068, 8072 (2011).
[2] 76 Fed. Reg. 8068, 8075 (2011).

2. Private Equity Fund Managers' Performance Fees are Based on Realized Profit

Consistent with investment in individual, longer-term investments, rather than trading programs, private equity fund managers generally do not receive any performance fees until the investments have been realized; they are not paid on the basis of interim market values.

3. Private Equity Fund Capital Structurally Matches the Tenor of the Underlying Investments

Investors' capital in private equity funds is locked-up for the funds' investment periods, and investors have extremely limited rights to withdraw their capital or cancel their undrawn capital commitments from the funds (i.e. limited redemption rights). This protects against forced liquidation of assets at inopportune times, which can be of critical importance in times of crisis. By contrast, significant investor redemptions can force a hedge fund to liquidate underlying assets, and a large number of hedge funds facing redemptions (such as during a severe market disruption) can exacerbate downturns, thus presenting systemic pressures and imbalances. These scenarios are typically avoided in a private equity fund context. Thus the limited redemption rights of investors in private equity funds is a critical factor that guards against private equity funds contributing to liquidity runs in the broader marketplace that could lead to or intensify systemic risk.

4. Very Limited Use of Derivatives

Given Lone Star's global operations but fundamental operations as a U.S. dollar-based fund, Lone Star employs hedging strategies to manage currency fluctuations. Similarly, it employs hedging strategies to manage interest rate risk related to borrowings. Like many private equity funds, however, the fund is expressly prohibited from utilizing any derivatives for the purpose of speculation. Because Lone Star's use of derivatives is narrow and targeted, its potential to contribute to systemic risk is limited.

5. Private Equity Funds Primarily Employ Standalone Leverage at the Investment Level

According to the preamble to the Proposed Rule, the principal source of systemic risk posed by private equity funds relates to loans in connection with leveraged buyouts and similar transactions. We note that it is not at all clear that loans of this nature do in fact pose systemic risk concerns. Private equity funds typically utilize separate legal entities for their investments. Any leverage utilized for a given investment is related solely to the specific assets it is used to purchase, and is commonly backed by substantial collateral.

These financings typically are not cross-collateralized (directly or through cross-guarantees, etc.). As a result, the failure of any one investment typically does not trigger broader defaults across other fund investments. In this manner, the risk of the leverage is ring-fenced, thus limiting broader systemic implications.

6. Section 2 of the Proposed Form PF Largely Does Not Apply to Private Equity Funds

Section 2 of the proposed Form PF was clearly written with hedge funds in mind, as many of its specific questions are not relevant to private equity funds (please see Appendix A for an analysis of questions in Section 2 as they might relate to private equity funds). Requiring typical private equity funds to file responses to Section 2 would be burdensome both on the FSOC, which would be required to review a significant additional volume of reporting materials containing responses that offer very limited incremental analytical value in FSOC's assessments of systemic risk, and on private equity funds, which would be required to allocate considerable time and financial resources to answering regulatory questions that are not directly related to their operations.

We believe it is sensible for the Proposed Rule to differentiate between hedge funds and private equity funds. However, in our view the current proposed definition does not properly delineate between hedge funds and private equity funds.

We agree that key distinguishing features of hedge funds include interim valuation-based performance fees and short selling (two of the three features included in the Proposed Rule's definition). However, we have concerns with the approach in the Proposed Rule's definition of leverage as a distinguishing feature.

To start, while we appreciate that some level of leverage limitation could be appropriate, we note that the limitation outlined in the Proposed Rule – "in excess of one-half of its net asset value (including any committed capital)" – seems fairly low, well below a level that would lead a fund to pose systemic risk. In any case, regardless of where the limitation is set, we would propose three important points regarding leverage be clarified in the Final Rule. First, we assume the focus is on fund-level debt, i.e. not on debt at the level of portfolio investments. Second, the limitation should be based on *actual* not *potential* use of leverage. Third, a fund should not be automatically reclassified as a hedge fund if its actual borrowings exceed the threshold for a short period of time. For example, in the early stages of a fund, before it has secured all of its committed capital, the fund may utilize higher operating leverage on a bridge basis for a relatively short period of time.

In addition to these features, we would recommend that the Final Rule also include the concept that hedge funds typically provide investors redemption rights at intervals throughout the life of the fund. Redemption rights are a key feature differentiating most hedge funds from private equity funds; the highly limited redemption rights of investors in private equity funds provides an important protection against contributing to liquidity runs that can exacerbate systemic risk.

Another feature that you may also want to consider is that hedge funds commonly invest in derivatives as a core investment strategy (as opposed to only hedging aspects of the fund's underlying investments). Derivatives tend to be highly leveraged, so significant use of derivatives can reinforce the leverage concern the Proposed Rule highlights elsewhere. Thus use of derivatives as part of a fund's investment strategy, is a notable feature of hedge funds that can, in certain circumstances (similar to the redemption feature discussed above), create volatility that may rise to a level of systemic risk.

Finally, we suggest that you consider defining hedge funds so that meeting any one of the criterion used would not qualify a fund as a hedge fund, but instead a fund would be required to meet a preponderance of the criteria (or at a minimum, multiple criteria) to be classified as a hedge fund.

These changes are vital so that the Proposed Rule avoids unnecessarily casting an overly wide net in a manner that would provide little additional useful data or insights to FSOC in its assessments of systemic risk in the nation's financial system.

Topic 2: Reporting Fund Performance

The Proposed Rule suggests that Section 1b of the proposed Form PF would be completed by all private fund advisers, regardless of whether they are advising a private equity fund, hedge fund, or liquidity fund. Within Section 1b, Item C, question 14 asks for the net asset value change for the reporting fund on a monthly basis. Based on other language in the instructions, it appears this question was written with hedge funds or liquidity funds in mind (e.g., *"Change in net asset value should be determined by including subscriptions and redemptions as of the last day of the relevant period and deducting fees. . . including performance fees. . .").*[3] In the hedge fund context, valuations are easily available on a monthly basis since they are measured frequently, even daily – both because their investments tend to be in marketable securities but also because these valuations drive the hedge fund's performance-based fees.

By contrast for private equity funds, since their investment assets are highly illiquid, valuation is much harder to do. Furthermore, since the investments tend to be held for the long-term and interim valuations do not affect private equity fund fees, private equity fund investment valuations are typically done on a quarterly basis. We recommend the Final Rule reflect this distinction and not require monthly valuations for private equity fund assets.

We further recommend that the Final Rule confirm that private equity funds may use their internal valuation results for purposes of reporting on the Form PF. Finally, we would recommend the Final Rule confirm that private equity funds can report the quarterly net change to partnership equity (a partner's invested capital), which is analogous to net asset value, but is more relevant to the private equity fund context given the nature of private equity fund assets.

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[3] 76 Fed. Reg. 8068, 8107 (2011).

Topic 3: Requiring All Advisers Managing in Excess of $1B to Complete Section 2

For the reasons outlined above, we do not support the Proposed Rule's alternate approach of requiring all advisers managing in excess of $1 billion of private funds to complete Section 2 of form PF.[4] This approach would significantly increase the time and costs of filing Form PF for advisers to all larger private equity funds. More importantly, because much of Section 2 does not generally apply to private equity funds, this approach would primarily serve to add a significant burden of review on FSOC, while providing little incremental value to its assessment of systemic risk.

Topic 4: Exempt Advisers

The Proposed Rule requires that only private fund advisers registered with the SEC under the Investment Advisers Act of 1940 (the "Advisers Act") be required to file Form PF.[5] Specifically, private fund advisers who are "exempt reporting advisers" under the Advisers Act would be exempt from filing Form PF. "Exempt reporting advisers" include advisers to private funds that in the aggregate have less than $150 million in assets under management in the United States. As noted in the Proposed Rule, the SEC has proposed that exempt reporting advisers will still be required to file with the SEC a Form ADV containing specific information. We agree with the Proposed Rule that such exempt reporting advisers should not also be required to file Form PF, because these advisers have minimal operations in the U.S. and limited potential contribution to systemic risk overseen by FSOC .

Topic 5: Frequency of Reporting

The Proposed Rule requires "Large Private Fund Advisers" (as defined in the Proposed Rule) to file Form PF not later than 15 days after the end of each calendar quarter.[6]

Like many other larger private equity funds, Lone Star has global investments and provides support for its global operations from Lone Star's US headquarters. In order to complete the Form PF, Lone Star will need to obtain and process information from each of its global investing regions, after giving the regions the needed time to value their investments after quarter end. As discussed above, private equity funds tend to hold highly illiquid investments and thus do not typically mark-to-market their assets on a daily basis (which is another difference between private equity funds and hedge funds). As a result, private equity funds need more time than hedge funds to compile their asset valuations and other data after the quarter end. Thus, it will be virtually impossible for Lone Star to calculate, gather and process the needed information to file Form PF within 15 days after the end of a calendar quarter.

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[4] 76 Fed. Reg. 8068, 8076 (2011).
[5] 76 Fed. Reg. 8068, 8077 (2011).
[6] 76 Fed. Reg. 8068, 8097-8098 (2011).

Instead we propose the timeline for private equity funds to file Form PF be 60 days after the end of a calendar quarter. As noted above, the CFTC and SEC generally consider private equity funds to have less of a systemic risk impact, which further supports the 60 day timeframe as being sufficiently timely for private equity funds to provide data to FSOC for its assessments of systemic risk.

In conclusion, we appreciate the opportunity to offer the SEC our perspective on this important initiative. We would be pleased to elaborate on any of these comments if you would find that helpful. We believe in the importance of providing FSOC with all of the information it needs to assess potential systemic risk and safeguard the nation's financial system. We further believe a thoughtful approach to implementing the requirements of the Dodd-Frank Act will focus on obtaining relevant information from each type of fund outlined in the Proposed Rule, avoid deluging regulators with extraneous information that is not applicable to the filing entities, focus on those investment advisers who are required to register under the Advisers Act, and provide each set of data in a timely manner commensurate with its potential risk. Doing so would be the most effective way to provide FSOC with the information it needs to pursue its critical mission.

Sincerely,

Michael D. Thomson
General Counsel

Appendix A: Section 2 of Form PF and Its Applicability to Private Equity Funds

The instructions for Section 2 of Form PF explicitly state that it is intended to be filled out by hedge funds. Indeed, a review of Section 2 highlights that it was clearly designed with hedge funds in mind, as many of the questions are not directly applicable to the operations or investments of private equity funds. A private equity fund's response to these questions would provide little incremental useful information to FSOC in assessing potential systemic risk. For example:

1. Section 1c-17 – Investment Strategies: It is unclear how a private equity fund would answer this question since the listed strategies are not those generally used by private equity funds.
2. Section 1c-18 – Computer-Driven Trading Algorithms: This question is not typically relevant for private equity funds. For most private equity funds the response would likely be 0%.
3. Section 1c-19 and 1c-20 – Top Five Trading Counterparties: Most private equity funds, like Lone Star, do not employ trading-focused investing strategies. Lone Star has a small number of counterparties related to its efforts to hedge its currency and interest rate exposure, but in general trading counterparties is another measure that is not typically relevant for private equity funds.
4. Section 1c-21 and 1c-22– Trading and Clearing Mechanisms: Like most private equity funds, Lone Star Funds does not employ trading and clearing mechanisms, so we have no applicable response for this detailed question.
5. Section 2a-23 – Aggregate Hedge Fund Exposure: This question is not applicable for Lone Star Funds, as we do not invest in most of these instruments. Moreover, given that we invest primarily in highly illiquid assets we do not mark Lone Star's holdings at the end of each month. This question is also not generally relevant for private equity funds.
6. Section 2a-24 –Turnover Rate: This question is not applicable for Lone Star Funds, nor is it typically a relevant metric for private equity funds.
7. Section 2b-27 – Reporting Fund Exposures: This question is not applicable for Lone Star Funds, as we do not invest in most of these instruments. Moreover, given that we invest primarily in highly illiquid assets we do not mark Lone Star's holdings at the end of each month. Again, this question is not typically relevant for private equity funds.
8. Section 2b-28 – Liquidity of the Reporting Fund's Portfolio: Lone Star's responses to this question would by necessity be highly subjective, particularly given the highly illiquid nature of Lone Star's assets. It is not typically a relevant metric for private equity funds.
9. Section 2b-30 and 2b-31 – Open Positions and Open Positions Over 5%: This question is not applicable for Lone Star Funds, nor is it typically a relevant metric for private equity funds.
10. Section 2b-32 and 2b-33 – Top Five Trading Counterparties' Collateral: See response to Section 1c-19 and 1c-20 above.
11. Section 2b-34 – CCPs: Like most private equity funds, Lone Star does not typically employ trading strategies that expose it to counterparty credit exposure.

12. Section 2b-35 – VaR Calculations: This question is not applicable for Lone Star Funds, nor is it typically a relevant metric for private equity funds.
13. Section 2b-36 – Market Effects on the Portfolio: This question is not applicable for Lone Star Funds based on Lone Star's assets, which are primarily highly illiquid investments, nor is it typically a relevant metric for private equity funds.
14. Section 2b-40 and 2b-41 – "Side Pockets" and Investor Liquidity: These questions are not applicable for Lone Star Funds not only due to the highly illiquid nature of Lone Star's assets, but also due to the highly limited redemption rights of investors. Similarly, these are not typically relevant questions for private equity funds.