Testimony Concerning Initial Public Offerings of Investment Managers of Hedge and Private Equity Funds

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Chairman Kucinich, Ranking Member Issa, and Members of the Subcommittee:

I am pleased to be here today to discuss the Securities and Exchange Commission's perspective with respect to initial public offerings of investment advisory firms that, among other things, manage hedge and private equity funds. As the head of the Commission's Division of Investment Management, I have responsibilities for overseeing and regulating nearly 1,000 investment company complexes with over $11 trillion in assets and more than 10,000 investment advisers that manage more than $37 trillion in assets, as well as administering the federal securities laws applicable to registered investment companies (including mutual funds) and investment advisers.

A number of issues have been raised about the recent IPOs of investment advisory firms that, among other things, manage hedge and private equity funds ("alternative asset managers"), specifically the offerings by Fortress Investment Group LLC ("Fortress") and The Blackstone Group L.P. ("Blackstone"). I am pleased to be able to offer the Committee my knowledge and expertise, especially as it relates to the question of whether alternative asset managers are investment companies and thus subject to the substantive provisions of the Investment Company Act of 1940 (the "Investment Company Act").

Relevant Law for Investment Company Act Status Determinations

Congress enacted the Investment Company Act to provide a separate and different regulatory structure for investment companies, as compared to industrial, or operating, companies. Among the Congress's stated goals was to minimize the risk that an investment company might be managed in the interests of its managers or certain shareholders rather than for the benefit of all shareholders. Unlike operating companies, investment companies are subject to comprehensive substantive requirements in areas such as: limitations on capital structure, *e.g.* borrowing restrictions; limitations on the ability to transact business with affiliates; and limitations on how the investment company must maintain custody of fund assets. Investment companies also are required to maintain specific books and records, which are subject to examination by the

Commission. Section 3 of the Investment Company Act has two main tests for determining whether an issuer is an investment company:

- The first test is whether the issuer is primarily engaged (or holds itself out as being primarily engaged) in the business of investing in securities. (*See* section 3(a)(1)(A) of the Investment Company Act.) This "orthodox investment company" test defines issuers that hold themselves out, or otherwise are clearly recognizable, as investment companies.
- The second test is whether the issuer (a) is engaged in the business of investing, reinvesting, owning, holding, or trading in securities and (b) owns investment securities, the value of which exceeds 40% of its total assets. (*See* section 3(a)(1)(C) of the Investment Company Act.) Companies that fall within this "inadvertent investment company" test are often referred to as inadvertent or prima facie investment companies, presumably because they view themselves as industrial or operating companies rather than investment companies.

The Investment Company Act provides a number of exclusions from these tests for certain companies that appear to meet one or both of the tests but that Congress believed should not be regulated as investment companies. Notably, section 3(b)(1) excludes a company that is engaged primarily in a business other than investing, reinvesting, owning, holding or trading in securities. In addition, section 3(b)(2) excludes an issuer that the Commission declares by order is engaged primarily in a business other than investing, reinvesting, owning, holding or trading in securities, and the Commission has adopted rules under this authority, such as rule 3a-1, which codifies the standards that the Commission has applied over many years in processing individual requests for orders under this section.

SEC Staff Process for Reviewing Investment Company Act Status Issues

Many of the more complex Investment Company Act status determinations arise in the context of companies that view themselves as engaged in an operating business, and not in the investment company business. Consistent with this understanding, these companies file their registration statements and periodic reports with the Commission, and these filings are reviewed initially by the staff of the Commission's Division of Corporation Finance. When an issue arises as to whether a purported operating company should be treated as an investment company, Division of Corporation Finance staff will refer the issue to the Investment Management Division. With regard to the recent IPO registration statements of Fortress and Blackstone, Corporation Finance staff did just that.

The staff reviewed these filings in the normal course and consistent with past review practices. Under the federal securities laws, an issuer of covered securities is strictly liable to investors to assure that a registration statement is in full compliance with the federal securities laws and discloses all material information that a reasonable investor would need to make an investment decision. Consequently, as noted in required legends in all registered public offerings, the Commission does not approve or disapprove of the securities being offered nor does it pass upon the adequacy or accuracy of the disclosure in the prospectus. If the staff is satisfied that the registration statement is in compliance with the federal securities laws, the staff declares the filing effective pursuant to delegated authority by the Commission, which means that the

company is allowed to engage in the transaction it has described in that registration statement. However, the issuer remains liable for the statements contained in that statement.

The staff carefully considers whether a company is an investment company in light of the definitions of investment company under the Investment Company Act and consistent with the Commission's long-standing interpretations of these definitions. The staff considers the status of the relevant entity prior to offering, as well as giving effect to the offering. They also monitor the Investment Company Act status of certain companies on an ongoing basis. In some cases, the staff will determine that the company properly is treated as an operating company. Often, these companies will include risk disclosure in the offering documents about their status under the Investment Company Act, and the consequences to their businesses if they were required to register as investment companies. In other instances, the staff may disagree with a company's investment company status analysis, and request that it either register as an investment company or restructure its business or securities holdings so as to no longer be an investment company. The Commission will bring an enforcement action against the company in appropriate circumstances.

SEC Staff Views on Investment Company Act Status of Fortress and Blackstone

The staff carefully reviewed the registration statements and other information provided by Fortress and Blackstone to determine whether they were investment companies and required to register as such under the Investment Company Act. I am pleased to provide you with the details of our analysis. As described earlier, the Investment Company Act includes two relevant tests for determining Investment Company Act status: one for orthodox investment companies, and one for inadvertent, or prima facie, investment companies.

Orthodox Investment Companies Test

As a general matter, under the orthodox investment company test, the focus is on the investment of the issuer's own assets, not the assets of others (otherwise, all investment advisers might be deemed to be investment companies).

As is described in detail in the registration statements, neither Fortress nor Blackstone is an orthodox investment company. Fortress and Blackstone are engaged primarily (and hold themselves out as being engaged primarily) in the business of providing asset management and financial advisory services to others and not primarily in the business of investing in securities with their own assets. In its registration statement, Fortress described itself as a "global alternative asset manager ... We raise, invest and manage private equity funds, hedge funds and publicly traded alternative investment vehicles." In its registration statement, Blackstone described itself as a "global alternative asset manager and provider of financial advisory services" whose "businesses include the management of corporate private equity funds, real estate opportunity funds, funds of hedge funds, mezzanine funds, senior debt vehicles, proprietary hedge funds and closed-end mutual funds" and whose business also includes the provision of "various financial advisory services, including corporate and mergers and acquisitions advisory, restructuring and reorganization advisory and fund placement services."

The Commission traditionally assesses the "primary engagement" of a company by examining the composition of its assets, sources of its income, the investment activities of its officers and employees, the company's public statements, and its historical development in order to compare the securities and non-securities businesses of the company. Also, the Commission traditionally considers the nature of the assets and income to be the most important factors in this analysis.[1]

Based on the analysis described in the section below (see "Inadvertent Investment Companies Test"), we determined that the assets of Fortress and Blackstone are primarily indicative of an operating, and therefore non-investment company, business.

We believe that the other factors that form the basis for the "primary engagement" test provide further evidence that Blackstone and Fortress are engaged primarily in the business of managing money for others, and are not primarily in the business of investing for themselves. In each case, their income and revenues are primarily derived from their asset management business and not from their own investments; they hold themselves out as money managers and not as investors or investment companies; and they spend most of their time managing others' money, not their own.

As a result, the staff concluded that Fortress and Blackstone appear to be primarily engaged in a non-investment company business.

Inadvertent Investment Companies Test

With respect to determining whether Fortress or Blackstone would constitute an inadvertent investment company, the key test established by Congress in the Investment Company Act is whether more than 40% of a company's assets are investment securities.[2]

Alternative asset managers typically have a variety of assets. In the case of Fortress and Blackstone, as is described in their registration statements, the main assets relevant to the inadvertent investment company test are the general partnership and limited partnership interests in their underlying funds. While limited partnership interests are treated as investment securities, under existing law, general partnership interests are not securities, if the profits relating to those interests generally come from the efforts of the general partners, as opposed to the efforts of others.[3] In the case of Fortress and Blackstone, the issuers maintain control over the day-to-day

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1 *Tonopah Mining Company of Nevada*, 26 SEC 426 (1947).

2 Although the meaning of "securities" under section 3(a)(1)(A) is different than the meaning of "investment securities" under section 3(a)(1)(C), those differences are not relevant to the analysis of Fortress and Blackstone.

3 *See, e.g., Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1980). For example, a general partnership interest can be designated a security if the investor can establish that: (1) an agreement among the parties leaves so little power in the hands of the partner that the arrangement in fact distributes power as would a limited partnership; (2) the partner is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership powers; or (3) the partner is so dependent on some

management of the underlying funds, with senior employees exercising such management through wholly owned subsidiaries. The profits to the general partnership interests result from the efforts of the managers, not others, and the general partnership interests would thus not constitute securities. The fact that the public investors in the securities sold by Fortress and Blackstone have no voting rights with respect to the management of the underlying funds would not change this conclusion. Thus, the general partnership interests would not be securities and therefore not "investment securities" for Investment Company Act purposes.

After determining which assets should be treated as securities and which as non-securities, a value must be assigned to each. The Investment Company Act requires that in making these valuations, an issuer must assign a fair value to general partnership interests like those at issue in the Fortress and Blackstone filings. In order to make such a valuation, an alternative asset manager may consider, among other things, its right to "carried interest" in the underlying funds. This right, which is part of the compensation for managing the underlying funds, entitles the manager to share in the profits of the underlying fund. Typically, an underlying fund must return the capital given to it by limited partners plus any preferential rate of return before the manager can share in the profits of the fund. The manager will then receive a carried interest, which is calculated as a percentage of the profits. Fortress and Blackstone calculate the fair value of their general partnership interests in the underlying funds to include their rights to receive carried interests because such rights are inexorably linked to the general partnership interests.

Applying the principles laid out above, the Division of Investment Management staff concluded that neither Fortress nor Blackstone appears to hold investment securities with a value exceeding 40% of total assets. Put another way, in the context of both Fortress and Blackstone, the value of their "investment securities," (*i.e.*, their limited partnership interests in the funds that they manage and their other securities investments) is less than 40% of total assets. Conversely, the value of the assets that are not "investment securities," (*i.e.*, the general partnership interests, including the right to receive carried interests in the underlying funds) is more than 60% of total assets. This asset composition is indicative of an operating company business, rather than investment company business.

Even if the staff concluded that Fortress or Blackstone held investment securities with a value exceeding 40% of total assets, those entities may have been able to rely on certain exclusions from the definition of investment company under section 3. In particular, section 3(b)(1) of the Investment Company Act excludes a company if it is engaged primarily in a business other than investing in securities. Under section 3(b)(1), the analysis of the entity's primary engagement is similar to that discussed above.[4] In addition, Commission rule 3a-1, which modifies the traditional 40% asset test in certain ways, may also have been available to these entities.[5]

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unique entrepreneurial or managerial ability of the manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership powers. *See id.*

4 *See* Fortress registration statement, at p. 48 (Feb. 9, 2007); (Blackstone registration statement, at p. 60-61 (June 25, 2007).

5 *See* Fortress registration statement, at p. 48 (Feb. 9, 2007).

Two final notes about the analysis performed by the Commission's staff: First, both Blackstone and Fortress included disclosure in the risk factors section of their offering documents regarding potential uncertainty relating to whether they might be deemed to be investment companies under the Investment Company Act, and the impact that registration under the Investment Company Act could have on their businesses. Second, each has an opinion of counsel stating that it is not an investment company.

Finally, it is important to consider that the public investors are buying a share of the entity managing these funds, rather than a share in the underlying funds. Thank you for this opportunity to appear before the Committee. I look forward to working with you to meet the needs of our nation's investors, issuers, and markets, and I would be happy to answer any questions you may have.