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on

"After Blackstone: Should Small Investors

Be Exposed to Risks of Hedge Funds?"

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## Introduction

Chairman Kucinich, Ranking Member Davis, and members of the Subcommittee, I want to thank you for inviting me to testify today. Important issues are under examination, and I am honored to have been asked to participate.

At the outset, I want to focus on what should and should not be the issue before this Committee. The relevant issue is not the initial public offering of The Blackstone Group L.P. ("Blackstone"); that is a fait accompli. For better or worse, it is history. I submit that the issue for the future is whether that Blackstone offering should become the template for a host of other offerings by other private equity firms and/or hedge funds. At the same time, however, I would advise this Committee that it should not define the issue more broadly than necessary by asking whether public investors should be allowed to invest in hedge funds, hedge fund managers or other functional substitutes for hedge funds and private equity funds. That smacks of paternalism. The SEC is well past the day—and properly so—when it could insist that investors had to be protected (against their will) from exposure to risks that were adequately disclosed.

The real problem with the Blackstone offering, particularly as a likely model for future offerings, is not that it allows public investors to acquire arguably indirect interests in hedge funds, but that it allows them to accept high risk with no accountability or transparency. My message to this Committee is simple: Resist the temptation to recommend sweeping and prophylactic rules; do not try and protect investors from all risk; they do not want such protection. But do require accountability and transparency because, without these, the market over the long run simply does not work. In particular, I urge you to prefer the least drastic means by which to achieve your objective. In the

remainder of my remarks, I will compare the policy options and suggest to you that a focus on listing rules and improved governance is the less drastic option and makes more sense than any attempt to broadly extend the coverage of the Investment Company Act of 1940.

A. Identifying the Problem

Let me put my comments in context. At present, it appears that, in the wake of the Blackstone offering, a stampede of similar offerings is now in progress, as Kohlberg Kravis Roberts & Co. (KKR) and Och-Ziff Capital Management Group LLC have announced plans to go public, and persistent rumors suggest that other firms are on the verge of similar announcements (indeed, an affiliate of the Carlyle Group went public last week on the Euronext NV market in Europe). All in all, this appears to be a giddy, golden era for private equity and similar "alternative investment management companies."

Yet, as this Committee well understands, the Blackstone offering had a number of unique and troubling features from a corporate governance perspective. Among these, three stand out:

(1) The investors received no meaningful voting rights. Specifically, they elect neither the CEO of their firm nor the board of directors of the general partner. Even to the limited extent that they are permitted to vote, they will be systematically outvoted by the 76.4% of the voting rights retained by the insider/founders of Blackstone.

(2) The investors will not be protected by an independent board of directors. Blackstone's initial board is composed of a majority of insiders (with three independent directors—Brian Mulroney, William Parrett, and Lord Nathaniel

Rothschild—having been added just prior to the offering). Moreover, Blackstone's founders—Stephen Schwarzman and Peter Peterson—retain the power, acting together, to appoint and remove the directors of the general partner. Although the board of Blackstone's general partner will have a conflicts committee, its mandate is limited to review of "specific matters that our general partner's board of directors believes may involve conflicts of interest,"[1] and the composition of this committee is not stated in the prospectus. In short, the committee will review only what it is asked to review by the insider-dominated board. Thus, the normal NYSE rules requiring independent nominating and compensation committees have been sidestepped.

(3) The investors are not protected by the fiduciary duties that apply to corporate officers or directors (or even to most partnerships). The Blackstone limited partnership agreement "limits the liability of, and reduces or eliminates the duties (including fiduciary duties) owed by our general partner to our common unitholders and restricts the remedies available to common unitholders for actions that might otherwise constitute breaches of our general partner's duties."[2]

All told, the investors are denied the voting rights, independent board, and fiduciary duties that protect investors in virtually all other publicly held entities. In addition, there will be no annual meeting at which investors can voice their opinions and no right to information (such as shareholders normally have pursuant to Section 220 of the Delaware General Corporation Law).

[1] See Form 424 B4, filed June 25, 2007, at p. 197.
[2] Id. at cover page.

Nonetheless, this is the template that others are likely to follow (at least in a euphoric market) in the ongoing rush to quickly take "private equity" firms public before the current market window closes. Worse yet, the very nature of the private equity business involves inherent conflicts of interest, over issues such as executive compensation, that suggest that the need for accountability and independent review is even greater than normal in the case of these entities. Indeed, it is likely that Blackstone will need to increase significantly its current levels of executive compensation to retain key personnel. As a result, Blackstone's management will be able to set their own executive compensation without oversight or input from their investors.

From the standpoint of corporate governance, this is a throwback not simply to the era before Sarbanes-Oxley, but to the era before even the Securities Exchange Act of 1934. Voiceless, voteless and stripped of legal remedies, Blackstone's investors must remain passive and, if dissatisfied, have no option but to sell their units. Moreover, there is no prospect, even in the distant future, of a corporate control contest—whether by takeover or proxy fight—because no shareholder (other than the founders) may vote more than 20% of the shares. This is a more severe limitation than the traditional "shareholder rights plan" (or "poison pill") because under well-established Delaware law a poison pill cannot be used to block a proxy contest; thus, a new board can be elected and then remove the poison pill by redeeming it. In all respects, the current management of Blackstone is insulated and largely exempt from all the usual mechanisms of corporate accountability.

B. The Policy Options

The pathological governance structure at Blackstone can be attributed to one or both of two reasons, each debatable:

(1) Blackstone asserts that it was exempt (and was so deemed to be exempt by the SEC) from the Investment Company Act of 1940; and

(2) Blackstone was not subject to the usual corporate governance standards of the NYSE because it is a limited partnership, not a corporation.

Blackstone's critics have largely focused on the first exemption and have argued that Blackstone should be subject to the Investment Company Act of 1940 ("ICA"). I believe the applicability of the ICA to the Blackstone offering is a debatable question, on which reasonable minds can disagree, but I am not convinced that Blackstone should have been classified as an "investment company"—for two distinct reasons. First, my assessment differs from that of other able witnesses before this Committee because I do not consider Blackstone to qualify under either relevant statutory definition of an "investment company."[3] Nor in this regard do I consider "carried interest" necessarily to be an investment security.[4] The latter issue is an especially technical one, which I do not think

[3] The ICA contains two relevant definitions of a security. ICA Section 3(a)(1)(A) defines an investment company to be an issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." In my judgment, that is not what Blackstone or other private equity firms do. They are not passive investors, but active managers that restructure firms and employ an active, "hands-on" approach. The second relevant definition—Section 3(a)(1)(C)—uses a 40% test and asks whether the issuer "owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of such issuer's total assets (exclusive of Government securities and cash items…." While this second definition also contains additional requirements, the 40% test in the case of Blackstone would depend on the status of its "carried interests"—are they "investment securities?" On this issue, see note 4 infra.

[4] In his testimony, Professor Mercer Bullard argues that "carried interests" are securities. I have high respect for Professor Bullard and I am aware of no case law that disproves his contentions. Nor am I aware of any case law that truly supports them. I do agree that investments in hedge fund managers, who are principally compensated through a share of the profits of the hedge fund, have economic characteristics resembling those of the hedge fund—but not entirely. The investors in the hedge fund manager share the "upside" with the investors in the hedge fund, but not the "downside"; that is, the investors in the hedge fund can lose their capital, but the investors in the hedge fund managers will simply not receive their share of the non-existent profits from that fund (but may still profit from their share in other funds). On this basis, Professor Bullard says that the investors in the hedge fund manager actually hold a "call option." Ingenious

should be the principal focus of this Committee's attention. Second, my dissatisfaction with attempts to characterize Blackstone as an "investment company" stems from the fact that the ICA is today a straitjacket—a cumbersome, antiquated and, in some respects, arbitrary statute whose application to private equity firms would prevent them from going public even if they had model corporate governance provisions. Whatever were the justifications for the ICA's adoption in 1940, the ICA has over time undergone the familiar pattern of statutory obsolescence that affects many statutes. I do not suggest that it be repealed, but it need not be applied to all new investment vehicles that surface from time to time by stretching this statute to the limits of its logic—and beyond.

The basic problem with the ICA (and its corollary the Investment Advisers Act of 1940 (the "IAA")) is that these two statutes broadly discourage investment vehicles subject to them from:

(1) holding a "concentrated" undiversified portfolio;

(2) owning illiquid securities (even if the potential for profit is very high);

(3) engaging in otherwise lawful short sales;

(4) using more than a trivial degree of leverage; or

(5) paying performance fees contingent on the amount of profits (a practice that is universal in the private equity field, with most firms charging a standard fee equal to 20% of profits over a defined hurdle rate).

As a result, mutual funds (regulated by the ICA) differ from hedge funds (not subject to the ICA) in that (a) mutual funds do not typically hold concentrated positions in their

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and clever, this argument proves too much. If it is valid, every parent corporation holds a call option in its subsidiary, and its actively managed subsidiary would thus become an investment security. At this point, the ICA applies to everything. More than an economic resemblance is necessary before compensation for services becomes an investment security.

portfolio companies (limiting themselves to 1% to 2% positions to retain their diversified character), while hedge funds may acquire up to 10% blocks in a limited number of companies; (b) mutual funds generally invest no more than a small portion of their portfolios (roughly 15% as the result of SEC guidance) in illiquid securities, while hedge funds may be heavily invested in such securities, because they do not face daily, or even short-term, redemption calls from their investors; (c) mutual funds use little leverage, while hedge funds can be leveraged up to their eyeballs; (d) hedge funds often sell short, while mutual funds do not; and (e) hedge funds compensate their managers with contingent fees based on their investment performance. In contrast, because mutual funds are subject to the IAA, they can only pay a much more modest "fulcrum fee."[5] In my judgment few, if any, private equity firms would go public if "fulcrum fees" set the ceiling on the maximum fee that a private equity firm could earn. In short, the IAA's ceiling on performance fees would be simply unacceptable to the industry. Thus, to subject the managers of private equity funds (such as Blackstone) to the ICA is ultimately to preclude public offerings by them (and thus restrict their size and growth)—and this may be the ulterior goal motivating at least some of Blackstone's critics.

At this point, the real social costs of an overly restrictive approach to hedge funds and private equity funds comes into full view: such a policy will deter the growth and evolution of a dynamic sector of the American financial services industry. Hedge funds and private equity funds are playing a valuable role, although in so doing they do generate controversy and make enemies. In particular, hedge funds have proven to be a

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[5] Advisory fees are regulated by Section 205 of the Investment Advisers Act of 1940 (the "IAA"). Rules 205-1 and 205-2 (17 C.F.R. § 275.205-1 and 205-2) thereunder permit "fulcrum fees," which involve averaging the investment adviser's fee over a specified period, increasing <u>and</u> decreasing the fee proportionately with the investment performance of the fund in relation to the investment record of an appropriate index of securities prices.

positive force in corporate governance, precisely because they can take large equity stakes, and today they constitute the most activist class of institutional investors. In the field of corporate governance, they are vastly more proactive than mutual funds, which tend to be passive investors. One of the reasons for their greater activism is the high fees that incentivize them.[6]

Similarly, private equity funds often buy out the public's interest (at a premium) in troubled firms and seek to rehabilitate them for an eventual re-introduction into the public markets. Typically, this cycle may take five to seven years, and only a firm with high incentives would accept this long a period of risk and illiquidity. Private equity firms have also become controversial because their typical mode of operation often involves a financial restructuring and likely layoffs and plant closings. Still, controversial as they may be, this does not make fund managers such as Blackstone too "risky" for public investors. Other fund managers (such as T. Rowe Price) have long been public. The difference between T. Rowe Price and Blackstone is simply that the former receives a flat 1 or 2% fee based on assets under management, while the latter receives a contingent fee based on profits (as measured typically against some hurdle rate). Yes, a Blackstone is riskier than a T. Rowe Price, but that is not a reason to put such an investment wholly beyond the reach of public investors—if adequate accountability and transparency were assured.

Although hedge funds have had some spectacular failures (the obvious example being Long Term Capital Management), the dot.com bubble that burst in 2000 caused far greater losses to investors, and the Enron/WorldCom scandals of 2001-2002 certainly

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[6] For such a view, see Marcel Kahan and Edward Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021 (2007).

justified major reforms (most notably, the Sarbanes-Oxley Act), but no one has yet suggested that investments in large corporations be placed off limits for public investors. Still, that would be the practical consequence of stretching the ICA so that it covered the managers of hedge funds and private equity funds: i.e., public investors would not be able to invest in a Blackstone or a KKR & Co.

C. The Preferred Option

If reading the ICA to apply to fund managers seems overly prophylactic and paternalistic, what then is the answer? Here, let's remember the second reason that the Blackstone offering lacked the minimal corporate governance features that normally characterize initial public offerings: the NYSE's corporate governance listing standards only apply to corporations—and not to partnerships. But, while this statement defines the problem, it provides not even a flimsy rationalization for why there should be such a day-versus-night difference in listing standards. In truth, publicly held partnerships are not that common. To the extent that they are listed, they usually hold inactive portfolios of oil and gas, or timber properties, or real estate. Less active management is required. Hedge funds and private equity fund managers are considerably more proactive, hands-on managers and are also subject to far greater conflicts of interest. In short, there is no valid rationale for the current sharp disparity between the extensive, post-Sarbanes-Oxley listing requirements that both the NYSE and Nasdaq have adopted for public corporations and the complete absence of such requirements in the case of publicly held partnerships.

Nor are comparable listing requirements that difficult to draft for publicly listed partnerships. The NYSE and Nasdaq could require that a publicly held partnership have a single corporate general partner with (1) a board of directors that was majority

independent, (2) independent nominating, audit and compensation committees, and (3) minimum defined voting rights. To be sure, the insiders could still retain a majority of the stock (or could use a dual class capitalization to give themselves greater voting power), but that is true in the case of public corporations as well. Moreover, any heavy-handed use of such tactics would likely lower the stock's market price.

Given that there is no serious justification for exempting publicly held partnerships from similar corporate governance requirements to those applicable to corporations, what should the SEC do? Here, the issue becomes more complicated. Under the D.C. Circuit's decision in Business Roundtable v. S.E.C., 905 F.2d 406 (D.C. Cir. 1990), which invalidated an SEC attempt to adopt a mandatory "one-share, one-vote" rule as a listing condition for exchange-listed companies on the grounds that it exceeded the SEC's authority under Section 19(c) of the Securities Exchange Act of 1934, it must be recognized that the SEC cannot simply impose corporate governance listing requirements on the exchanges. Yet, even in the wake of the Business Roundtable decision, then SEC Chairman Arthur Levitt skillfully negotiated an agreement among the three major exchanges (NYSE, Nasdaq and Amex) in order to adopt a uniform, but limited, rule that precluded actions by listed companies that reduced shareholder voting rights.

Similar diplomacy now seems in order. The SEC should request the exchanges to reconsider their listing rules in light of the Blackstone offering. Undoubtedly, there will be some resistance, but Congress could, of course, revise Section 19(c) to give the SEC greater authority. There is no true Constitutional problem with such a legislative change, and its mere threat may produce change. The first step is probably oversight. This

Committee might ask the NYSE (and Nasdaq) why it (they) think publicly held partnerships should be entirely exempt from all corporate governance requirements.

My belief is that this issue has never seriously been considered because it arose so infrequently. But it is about to arise again and again. Yes, the exchanges will resist SEC pressure because they fear that it may drive some fund managers to go offshore. But for major fund managers that wish to make large scale public offerings, that risk is remote. A U.S. IPO will give them a higher price and greater liquidity.

To sum up: I urge you to resist the notion that the Investment Company Act is a panacea, whose extension to hedge funds and private equity funds will solve all problems. In fact, its extension might well drive firms offshore. The better answer is to focus on the narrow abuse—weak to nonexistent corporate governance—and not seek to cripple the evolution of private equity firms.