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And

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Before the

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Subcommittee on Domestic Policy

"After Blackstone: Should Small Investors be Exposed to Risks of Hedge Funds?"

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

I'm Joe Borg, Director of the Alabama Securities Commission and President of the North American Securities Administrators Association, Inc., better known as NASAA.[1] I appreciate the opportunity to testify today on an issue of importance to retail investors.

Introduction

Let me begin with a brief overview of state securities regulation, which actually predates the creation of the Securities and Exchange Commission (SEC) and the NASD by almost two decades. State securities regulators have protected Main Street investors from fraud for nearly 100 years. The role of state securities regulators has become increasingly important as over 100 million Americans now rely on the securities markets to prepare for their financial futures, such as a secure and dignified retirement or sending their children to college. Securities markets are global but securities are sold locally by professionals who are licensed in states where they conduct business.

In addition to licensing, state securities regulators are responsible for registering some securities offerings, examining broker-dealers and investment advisers, providing investor education, and most importantly, enforcing our states' securities laws.

Similar to the securities administrators in your states, the Alabama Securities Commission prosecutes companies and individuals who commit crimes against investors, and brings civil actions for injunctions, restitution, and penalties against companies and individuals who commit securities fraud. Another of our responsibilities is to order administrative actions to discipline brokers and firms who engage in violations of rules and regulations by selling unsuitable investments, charging excessive fees, and otherwise taking advantage of investors.

State Securities Regulators Have a Unique Understanding of the Challenges and Risks Confronting Investors

State securities regulators have a special appreciation for the plight of everyday investors who are confronted with a bewildering array of new and complex investment products. We are the only securities regulators who interact with, and advocate for, individual investors on a personal basis each and every day. We read their complaint letters, listen to their phone calls, and conduct in-person interviews with them – often in their homes – all to ensure that their individual complaints and questions are addressed. We also hold

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico, and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

interactive “town meetings” and investor education events. While these events allow us to provide your constituents with valuable investor education, they also provide us with the opportunity to listen and gain valuable insight into their thought processes regarding investments and investment decision-making. In short, state securities regulators are uniquely qualified to address the potential impact of making alternative investments such as hedge funds widely available to the average individual investor.

It is our experience that the vast majority of individual investors who would characterize themselves as “actively engaged” in their investments do not buy securities – rather they are sold securities. In other words, most individual investors rely upon the recommendations of salespersons or the media hype surrounding a particular instrument when making investment decisions.

It is now common knowledge that the average retail investor will not read and cannot understand the typical prospectus. Due to the length and complexity of these documents, retail investors have by necessity come to rely upon the representations of salespersons or easily digested media characterizations.

Additionally, there are vast numbers of individuals who are entirely passive in the selection of their investments. Many of our nation’s school teachers, fire fighters, policemen, and other state, county, and municipal employees rely upon professional advisers to manage their pension funds wisely.

My remarks should not suggest to you that I believe the retail investing public is unable to properly evaluate investments. Nor am I suggesting that regulators should, by adopting a paternalistic approach, withhold alternative investments from the average retail investor. What I do suggest to you today is the following: New investments with highly complex structures, opaque investment holdings and strategies, and dubious profitability have arrived on Main Street, and precisely because of this trend, the investor protections afforded by statutes like the Investment Company Act are more important than ever.

Currently, the world’s leading financial experts cannot agree on either the risks or the merits of many of these investments. Due to a lack of transparency, the level of individual and systemic risk attached to these investments remains unknown to the individual investor. Fee structures and lack of full disclosure obscure real returns. The structure of these new instruments places investors in a vulnerable position, subject to the whims of controlling persons, the lure of past performance “promises”, and literally without recourse. Even the very basic threshold questions of what these new instruments are and what federal registration provisions apply to them appears to have confounded those charged with making such decisions. In light of the complexity and uncertainty surrounding these instruments, allowing them to be offered to the public *without* appropriate regulatory protections poses serious risks to investors.

The Investment Company Act Offers Vital Protections Against the Risks Inherent in the Public Offering of Alternative Investments

As a threshold matter, we believe that when private equity firms engage in public offerings they should be subject to the requirements of the Investment Company Act of 1940 ("the ICA"). The ICA is a shield, protecting main street investors against the potential misuse of their invested funds. It also helps to inoculate the market as a whole – and our economy – against the harm that purely speculative financial interests can sometimes have and the loss of investor confidence that often results.

In 1936, Congress recognized that the Securities Act of 1933 and the Securities Exchange Act of 1934 were insufficient to protect investors from the unique risks posed by investment pools. These pooled investment vehicles, or investment companies, posed special problems to the investing public. As unregulated entities, the investing public was required to accept the representations of the managers on blind faith. While the Securities Act of 1933 and the Securities Exchange Act of 1934 protected investors from potential abuse by corporate managers and financial intermediaries, they could not adequately protect investors from abuses by organizers of pooled investment vehicles. After an exhaustive four-year study, Congress enacted the ICA to impose additional layers of protection for investors, including independent Boards, fiduciary duties, shareholders rights, heightened disclosures, restrictions on permissible investments, and even limits on fees and loads. While mutual funds are the classic and best understood type of investment company, companies such as leveraged buyout funds have traditionally been considered investment companies. However, until now, the risks associated with these funds have been limited because they have always functioned as either private investment companies or they have relied solely on investments from qualified purchasers. The public offering of these investments raises new and serious concerns for millions of everyday investors.

The Blackstone IPO, as the most prominent representative of these vehicles, circumvents the governance protections that the ICA mandates, even though it is no longer a private investment company. For example, under the ICA, a fund must have independent directors who represent the interests of public investors. That is not the case with Blackstone. It is critical to understand that in reality, both pre and post IPO, Blackstone functions as an investment company that earns its income through investments. There is no basis for exempting Blackstone from the protections mandated under the ICA.

The SEC Has Taken a Consistently Broad View of What Constitutes an Investment Company

The SEC has viewed this type of structure broadly and flexibly since the enactment of the ICA in 1940. The SEC made the following findings in its Tenth Annual Report issued in June 1944:

The "Investment Company" concept

Although the terms "Investment company" and "Investment trust" have been part of the language of the financial community for some time, a definition precise enough to distinguish them sharply from holding companies on the one hand and operating companies on the other did not exist prior to the enactment of the Investment Company Act of 1940. The distinctive feature of the Act in this connection is its use of a quantitative or statistical definition, expressed in terms of the portion of a company's assets which are investment securities. Thus the statute provides, inter alia, that a company is an "investment company" if it is engaged in the business of investing, reinvesting, owning, holding, or trading in securities, and owns investment securities (defined to exclude securities of majority-owned subsidiaries and of other investment companies) exceeding 40 percent of its total assets (exclusive of Government securities and cash items). However, the Act provides machinery whereby the Commission may declare by order upon application that a company, notwithstanding the quantitative definition, is nevertheless not an investment company. Thus, companies that believe the application of the quantitative test would unreasonably cause them to be classified as investment companies are given the opportunity of obtaining administrative dispensation by showing that they are primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading securities, either directly or through majority-owned subsidiaries or through controlled companies conducting similar types of businesses. Since November 1, 1940 about 50 such applications have been filed. Knotty questions have been raised by these applications, including difficult and complicated problems of valuation especially with respect to the so-called "special situation" companies".

Such an application was filed on behalf of a company, Bankers Securities Corporation, whose portfolio contained securities of companies engaged in a great variety of enterprises, railroads, utilities, banks, newspapers, insurance companies, industrial companies of every kind, hotels, apartment houses, retail establishments, department stores, and many others. Extensive hearings were held before a trial examiner, briefs were filed and oral argument was had before the Commission. The company contended that it was primarily engaged in the real estate and department store business because the bulk of its investments were in those fields. Based upon the history and operations of the company, its investments in special situations, its statements of policy, and other relevant factors, the Commission concluded not only that the record before it fell short of sustaining the claim that the company was primarily engaged in non-investment company business but that the record demonstrated affirmatively that the applicant was organized and always had been operated as an investment enterprise. The applicant appealed from the

> order of the Commission denying the application to the United States Circuit Court of Appeals for the Third Circuit. On November 21, 1944 that Court unanimously affirmed the Commission's order. Bankers Securities Corp. v. SEC, 146 F.2d 88 (3d Cir. I944)

In its administrative opinion in Bankers Securities Corporation, the SEC recognized that even funds engaged to a significant degree in "special situations" – as is Blackstone – qualify as investment companies:

> In the course of its history, applicant has obtained large and controlling interests in various businesses, disposed of some, and retained others. Its officers have actively managed controlled businesses for the purpose of rehabilitating important investments in the portfolio. This is a well-recognized form of investment company business, known as dealing in 'special situations'. . . . Not only does this record fall short of sustaining applicant's claim that it is primarily engaged in non-investment company business, but it demonstrates affirmatively that Bankers Securities Corporation was organized, and has always been operated, as an investment enterprise. Public investment in the company was invited and has been maintained on representations which meant, in essence, that the company was diversifying stockholders' risk by a varied investment program. Stockholders were not asked to rely on the skill of applicant's management in the merchandising, or in any other specific mercantile or commercial business. They were given to understand that the management was alert always to find profitable repositories of invested funds, and the history of the company bears out the understanding, created in stockholders, that the company was not committing itself primarily to any specific business.

In the Matter of Bankers Securities Corp., 15 S.E.C. 695 (April 7, 1944).

For decades, the SEC has been guided by In re Tonopah Mining Co., 26 S.E.C. 426 (1947). Tonopah set forth five factors to determine whether a company was operating as an investment company – the company's history, its public representations, the activities of its officers and directors, the nature of its assets, and the sources of its income – all of which serve as a proxy for what a "reasonable investor" would believe to be an investment company. Tonopah identified the most important factor as whether "the nature of the assets and income of the company … was such as to lead investors to believe that the principal activity of the company was trading and investing in securities." Blackstone unquestionably meets this test. The Blackstone structure is intended to mask "the nature of the assets and income of the company" in order to avoid the strictures of the ICA, and to allow its continued operation as a de facto private company. Neither purpose serves the interests of investors or marketplace.[2]

[2] In a recent interpretation of Tonopah, the Seventh Circuit placed primary emphasis on the perceptions of a reasonable investor: whether the company's assets and income would lead an investor to believe that the

Blackstone Is an Investment Company and Should Be Treated as One for the Benefit of Investors

Blackstone attempts to escape the conclusion that it is and has always been an investment company through a purely structural maneuver: adding a new layer in its corporate form (Blackstone LP) – and then selling units in Blackstone LP to the public. But measured by the true nature of its activities and its investment holdings, Blackstone should be regulated as an investment company. As the prospectus makes abundantly clear, investors are being told they will share in the rewards and bear the risks of Blackstone's investment activities. The point is reinforced through the identification of carried interest as a significant source of potential gain for investors.

Presumably Blackstone would suggest that their offering poses no undue threat to investors because, while it may be risky, those risks are disclosed. The public policy issue, however, is how much risk, even when disclosed, should be transferred to the general public. In a perfect world, a careful financial adviser will say Blackstone is too risky, too opaque, and too conflicted so we won't invest. However, the real world operates much differently. Securities salespersons sell whatever their firms tell them to sell. They are not likely to delve deeply into the "disclosed risks" with the customer sitting across the kitchen table. The IPO disclosures come dangerously close to an affirmative statement by Blackstone that it will conduct its business in whatever way it chooses and that investors agree to waive any rights or remedies for such conduct (see p. 179-181 of the S-1). It is for precisely these reasons that Congress enacted the ICA: Not just to ensure disclosure, but to impose affirmative duties on such companies and to delineate boundaries in the operation of these inherently risky enterprises.

A fundamental principle of U.S. securities law is that of substance over form. This principle is essential to regulators as well as the investing public. This is because it facilitates our ability to stay ahead of the myriad ways that speculators will attempt to separate people from their money. The securities laws, including the ICA, are remedial in nature. Their purpose is to protect investors and to act as a shield between the economy and financial speculators. Congress intended that the SEC not ignore the substance of an investment, and look beyond its form if a fundamental purpose of the law may be imperiled.

In the Blackstone IPO (which apparently will now be followed by offerings by Kohlberg Kravis Roberts & Co. and Och-Ziff Capital Management), a fundamental purpose of the ICA – protection of the investing public from the potential risks of investment pools – is imperiled. When private speculators turn to the public markets for capital, what Justice Brandeis called "other people's money," they cannot continue to operate as if they were still a private concern.

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company was an investment company. Even under this novel and perhaps overly subjective view, Blackstone still falls within the ambit of the ICA. SEC v. Nat'l Presto Indus., 486 F.3d 305 (7th Cir. 2007).

Conclusion

Alternative investments have a legitimate place in our financial markets. Indeed, we do not object to access to these investments by retail investors so long as they are accompanied by all appropriate and necessary investor protections, rights, and remedies. This can only be accomplished by ensuring such investments are offered pursuant the appropriate Act. Your constituents, America's retail investors, are not accustomed to the realities of alternative investments: complex capital structures; portfolios of illiquid and difficult to value securities; the use of substantial leverage; concentration of investments; self-dealing transactions with affiliates; excessive compensation arrangements detrimental to their interests; and disenfranchisement as shareholders. Congress sought to eliminate these elements of alternative investments from the public marketplace. Surely your constituents are still deserving of the protections so wisely provided to them.