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on

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

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EXECUTIVE SUMMARY

When Congress enacted the Investment Company Act of 1940 ("ICA"), it generally divided the market of investment companies between those that could be sold publicly subject to regulation under the Act, and those that only could be sold privately without such regulation. Congress determined that investment companies, unlike other issuers, were particularly susceptible to abuse and that they therefore should be sold to unsophisticated investors only subject to pervasive, substantive regulation. The market has overwhelmingly endorsed this bifurcated regulatory structure, with assets of registered investment companies exceeding $11 trillion, and assets of private investment companies exceeding $1 trillion, at the end of 2006. The public offering of hedge fund managers threatens to derail the regulatory scheme applicable to investment companies.

Hedge fund managers are highly susceptible to precisely the abuses that Congress designed the ICA to address. They employ complex capital structures; invest in illiquid; difficult to value securities; use substantial leverage; concentrate their investments; engage in self-dealing transactions with affiliates; permit excessive compensation arrangements; and disenfranchise their shareholders. The SEC has stated that a major reason that it attempted to regulate hedge fund managers was the prevalence of fraud in the industry. Such concerns militate for caution when considering the sale of interests in hedge fund managers to small investors.

Hedge fund managers are functionally equivalent to the private investment companies they manage. The assets and income of hedge fund managers (as that term is used herein) are primarily attributable to direct holdings of shares in the funds they manage, co-investments in their funds' portfolio companies, and carried interests. Their economic performance is derived directly from the investment performance of the hedge funds they manage, a fact not lost on the markets. The financial press has universally linked their prospects to the future performance of their funds, and their market valuations equal about one-third of their assets under management, compared with one or two per cent for traditional asset managers. The financial press has recommended them to small investors as way to access the exclusive world of hedge funds. That is the appeal

of hedge fund managers because exposure to hedge fund returns is functionally what they offer.

Notwithstanding that hedge fund managers fall squarely within the definition of investment company under the ICA and raise precisely the investor protection concerns that the ICA is intended to address, the SEC has decided to leave their regulation to the "morals of the market place." It will be only a matter of time before a hedge fund manager experiences a dramatic collapse or perpetrates a colossal fraud. What will be different this time is that thousands of unsophisticated investors will incur substantial losses in an investment to which Congress has painstakingly attempted to restrict public access.

Congress should act promptly to ensure that hedge fund managers are not permitted to sell shares to unsophisticated investors without adequate regulation. This does not mean that hedge fund managers should be subject to all of the provisions of the ICA. Indeed, Congress granted the SEC broad exemptive authority to craft targeted exemptions from the ICA for the many issuers that fit the definition of investment company but are not appropriately regulated under the ICA. The SEC has adopted a number of rules and granted hundreds of exemptions pursuant to this authority, yet it has abdicated its responsibility to do the same for hedge fund managers. I strongly urge Congress, if the SEC declines to act promptly to ensure the proper regulation of hedge fund managers, to amend the ICA to expressly include hedge fund managers within its purview.

Chairman Kucinich, Ranking Member Davis, members of the Subcommittee, thank you for the opportunity to appear before you to discuss the public offering of interests in hedge fund managers. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and an Assistant Professor of Law at the University of Mississippi School of Law, where I teach securities regulation, law and economics, corporate finance, corporate law and banking law. I was previously an Assistant Chief Counsel in the SEC's Division of Investment Management and an attorney in the investment management practice of Wilmer, Cutler & Pickering (now WilmerHale). I founded Fund Democracy in January 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments. Fund Democracy has attempted to achieve this objective in a number of ways, including filing petitions for hearings, submitting comment letters on rulemaking proposals, testifying on legislation, publishing articles, lobbying the financial press, and creating and maintaining an informational Internet web site.

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I. INTRODUCTION

If the judgment of free markets were the only measure of regulatory efficacy, then mutual fund regulation would be an unqualified success. Americans have invested over $10 trillion in mutual funds, a testament to free market approval unmatched in the history of collective investment vehicles. The most striking aspect of mutual fund regulation is that it embraces the kind of merit regulation that Congress abjured elsewhere in the federal securities laws. The federal securities laws generally reflect Congress's view that the public offering of securities is best regulated through a system of disclosure that is designed to enable investors to make informed investment decisions. This approach reflects the view that the evaluation of the substantive merits of investments should be left to the markets. In contrast, mutual fund regulation reflects a decidedly merit-based approach to regulation. Mutual funds operate under both the full disclosure principles embodied in the Securities Act of 1933 and the detailed, pervasive operational rules codified in the Investment Company Act of 1940 ("ICA").

On the one hand, Congress adopted this approach to mutual fund regulation because of the heightened threat and complexity of the risks involved in the public offering of a highly liquid pool of securities. During 1920s and 1930s, the fund industry was rife with abuses that were exacerbated by weak corporate governance, complex capital structures, affiliated transactions, and leveraging. The ICA, which is the product of balanced negotiation between regulators and industry, prohibits or severely restricts the practices most prone to abuse.

On the other hand, Congress recognized that merit regulation itself created a kind of regulatory risk – the risk of regulatory obsolescence as market developments produce new financial instruments for which regulation under the ICA was inappropriate. Congress accordingly granted the SEC broad discretion to exempt firms that fell within the definition of investment company under the ICA from some or all of the ICA's provisions. For example, section 6(c) of the ICA of the authorizes the SEC to exempt issuers from the Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the ICA]."[1] Congress also granted the SEC specific authority under section 3(b)(2) to exempt certain issuers that it found were not primarily engaged in the business of investing.[2] The SEC traditionally has exercised this authority to accommodate new financial instruments that trigger regulation under the ICA, but it has abandoned this proven approach to investment company regulation by allowing the public sale of hedge fund managers without appropriate regulatory oversight.

The public offering of hedge fund managers raises precisely the concerns that Congress intended the ICA to address. Hedge funds and hedge fund managers employ complex capital structures; invest in illiquid, difficult to value securities; use substantial leverage; concentrate their investments; engage in self-dealing transactions with affiliates; permit excessive compensation arrangements; and disenfranchise their shareholders. Congress decided that these practices were permissible for hedge funds provided that they were sold only to sophisticated investors. The public sale of hedge fund managers, which are the economic equivalent of hedge funds, directly contradicts Congress's intent and the express requirements of the ICA. Hedge fund managers fall squarely within the definition of the ICA, yet the SEC has decided leave their regulation to the markets instead of exercising its exemptive authority to tailor the provisions of the ICA to their particular needs. Congress should act promptly to ensure that hedge funds are appropriately regulated.

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[1] ICA § 6(c).

[2] *See* ICA § 3(b)(2).

This testimony discusses key aspects of mutual fund and hedge fund regulation in Parts II and III, respectively. Part IV analyzes the status of hedge fund managers under the ICA. This Part explains why hedge fund managers meet the definition of investment company under the ICA, with special attention paid to the general presumption that a general partnership interest is not a security and the nature of carried interests. Part V identifies some of the common practices of hedge fund managers that raise particular concerns under the ICA. Part VI briefly sets forth recommendations as to steps Congress should take to ensure the appropriate regulation of hedge fund managers. Part VII concludes.

II. MUTUAL FUND REGULATION

Mutual fund rules touch upon every aspect of their operations. The ICA effectively requires that funds be operated under the authority of a board of directors of which at least 40 per cent are independent of the fund's manager and its affiliates. The Act also assigns specific responsibilities to fund directors, including approval of the fund's contracts with its manager and principal underwriter. Exemptive rules have expanded the role of the fund board. The SEC has granted numerous exemptions from the Act relating to, among other activities, the pricing of fund shares, creation of multiple classes, charging of 12b-1 fees, and engaging in transactions with affiliates. Although these activities are prohibited by the ICA, the SEC decided that, subject to heightened board oversight and other conditions, exemptions that permit these activities could be granted consistent with the protection of investors. For example, funds that engage in activities in reliance on these rules generally must have a majority of independent directors and submit the nomination of independent directors to the board's independent directors.[3]

[3] As a consequence of the recent mutual fund market timing scandal, the SEC increased the independent majority to 75 per cent and required an independent chairman. *See generally* Mercer Bullard, *Comments on Martin Lybecker's Enhanced Corporate Governance*, 83 Wash. U. L. Q. 1095 (2005); Mercer Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 Houston L. Rev. 1271 ((2006). These requirements were vacated by a U.S. Court of Appeals and currently await re-proposal by the SEC. *See Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. 2006).

Mutual fund rules also grant specific powers to fund shareholders. For example, material changes in a fund's management contract or 12b-1 fees (*e.g.*, fee increases) require shareholder approval, as do changes in a fund's fundamental investment policies. The ICA authorizes private claims by fund shareholders against fund managers for charging excessive fees. The SEC has exempted hundreds of funds from shareholder approval requirements for management contracts when, for example, the fund uses a multimanager structure in which the fund's portfolio is managed by subadvisers.[4]

The ICA prohibits or restricts a wide range of transactions with affiliates. Many mutual fund lawyers consider these rules to comprise the heart of the statute.[5] Funds are generally prohibited from selling or buying securities or other property to or from their affiliates.[6] The ICA also includes a catch-all provision that prohibits "joint transactions" involving a fund and its affiliates except as approved by order of the SEC. The SEC has adopted numerous exemptive rules that permit transactions with affiliates, such as transactions between funds that are affiliated only by reason of their having a common manager. The SEC also has granted hundreds of exemptions from the joint transactions prohibition, including exemptions for business development companies -- which are functionally similar to private equity funds -- that permit co-investments in portfolio companies.

The ICA directly regulates funds' capital structure, investments and fees. For example, the Act severely restricts funds' ability to borrow or otherwise to create leverage, limits investments in financial firms and in other funds, and prohibits one-sided performance fees such as carried interests that do not provide for a reduction in fees in the event of underperformance. Leverage restrictions prevent the problems that caused Long-Term Capital Management's collapse in the late 1990s, which was partly due to its

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[4] *See generally* Exemption from Shareholder Approval for Certain Subadvisory Contracts, Inv. Co. Act Rel. No. 26230 (Oct. 23, 2003) (discussing exemptions).

[5] *See* Remarks by Paul Roye before the Investment Company Institute 1999 General Membership Meeting, Washington, D.C. (May 21, 1999) (then Director, Division of Investment Management, SEC) (The importance of the prohibitions against affiliated transactions to mutual fund investors and to the mutual fund industry cannot be underestimated and the consequence of their demise cannot be overestimated.").

[6] For this purpose, the term "affiliate" is defined broadly to include persons and entities whose affiliation is one step removed from the fund. For example, a business in which a fund held a 10-per-cent interest would be an affiliate, as would an affiliate of that business (known as a "second-tier affiliate").

high debt-to-equity ratio.[7] Mutual funds are prohibited from issuing any senior class of securities, which generally prevents them from favoring some investors over others or otherwise permitting the creation of superior claims to fund assets other than those made by a general creditor.[8] Funds therefore cannot, for example, issue securities representing a severable interest in the performance of part of their portfolios or in the performance of their portfolios above a minimum rate of return. The SEC has granted numerous exemptions and provided extensive no-action guidance that provides conditional relief from restrictions on leverage and senior securities.

Mutual funds are required to effect transactions at their next calculated net asset value ("NAV") and generally must honor redemption requests in cash within seven days of tender. The practical effect of this requirement is that funds must value their portfolios based on current, verifiable market prices in order to ensure their ability to meet all redemption requests at NAV.[9] Toward this end, the SEC informally prohibits stock and bond mutual funds from investing more than 15 per cent of their portfolios in illiquid securities because of the uncertainties attendant upon their valuation. Funds generally are permitted to distribute capital gains only once each year in order to prevent confusion between income distributions and distributions that reflect a return or capital.

In summary, the ICA, in combination with SEC exemptive orders and rules, pervasively regulates fund operations. Without the regulatory flexibility provided by the SEC's exemptive authority, it is unlikely that the industry would have achieved its current level of success. Many of the structures used and features offered by mutual funds exist only because of the SEC's prudent use of its exemptive authority. For example, money market funds would not exist but for an SEC rule that permits the valuation of their shares at par. With over $2.3 trillion under management, money

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[7] *See generally*, President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management at 10 - 22 (1999) ("*President's Working Group*"); Roger Lowenstein, When Genius Failed: The Rise and Fall of Long-Term Capital Management (2000).

[8] *See generally Implications of the Growth of Hedge Funds*, Staff Report of the Securities and Exchange Commission at 38 – 39 (2003).

[9] *See*, *e.g.*, In the Matter of Hammes, Inv. Co. Act Rel. No. 26290 (Dec. 11, 2003) (enforcement action involving mispricing of mutual fund's portfolio securities for which market prices were not readily available).

market funds have become the dominant short-term cash option for Americans.[10] Without SEC exemptive relief, funds would not be able to offer the multiple classes of shares that permit the tailoring of distributions arrangements to investors' particular needs. The use of fund assets for distribution, known as 12b-1 fees, also was prohibited until the SEC adopted rule 12b-1. Although subject to increasing criticism in recent years, rule 12b-1 has accounted for a substantial part of the growth of mutual fund assets. Along with multiclass funds and 12b-1 fees, SEC rules have permitted deferred sales charges, transactions between funds, and participation in affiliated underwritings that would otherwise have been prohibited or severely restricted under the ICA.

Of particular relevance here, the SEC has used its exemptive authority to permit public offerings by entities that trigger mutual fund regulation but for which the full application of the Act is not appropriate. In the fanfare surrounding the rapid growth of exchange-traded funds ("ETFs"), the SEC's central role in the creation of this popular new investment vehicle has been unfairly neglected. An ETF is an investment company that, for the most part, is regulated as a mutual fund. The ICA generally prohibits the offering of ETFs primarily because their shares are not individually redeemable, but the SEC granted exemptive relief from this and other ICA requirements because it recognized that ETFs could be sold without compromising the basic principles underlying the ICA. Exchange-traded funds operating under SEC exemptions held more than $420 billion in assets at the end of 2006.[11]

In other cases, the SEC has recognized that entities that are functionally similar to mutual funds should be granted more expansive relief from the ICA. The SEC has granted dozens of exemptions under section 3(b)2) of the ICA to entities that inadvertently fall within the definition of investment company under the ICA. Rule 3a-7, which is discussed further *supra*, generally excludes structured finance vehicles from the definition of investment company. Thus, the regulation of mutual funds has combined the benefits of a relatively fixed statutory regime and a flexible exemptive program to create the regulatory environment for one of the most successful financial services

[10] *See* ICI Fact Book at 127 (2007).

[11] *See id.* at 31.

products ever sold.[12] The success of mutual funds is a testament to the potential and importance of government action in wealth creation in a capitalist democracy.

III. HEDGE FUND REGULATION

Hedge fund regulation presents a stark contrast to the pervasive disclosure and substantive rules under which mutual funds operate. Hedge funds are not subject to regulation under the ICA, and hedge fund managers generally are not registered as investment advisers under the Investment Advisers Act of 1940 because they have a small number of clients.[13]

Hedge funds fall within the definition of investment company under the ICA, and they therefore are subject to regulation under that Act in the absence of an applicable exemption.[14] Hedge funds typically rely on one on the private offering exemptions under the ICA to avoid registration under the Act. These exemptions generally are available to funds whose outstanding securities are privately offered and: (1) beneficially owned by 100 or fewer investors, or (2) sold exclusively to qualified purchasers. Qualified purchasers include individuals with at least $5 million in assets. Thus, hedge funds are generally unregulated in the sense that they are subject only to antifraud rules under the

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[12] *See* Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, SEC, at n.67 (May 1992) ("[T]he bill does not attempt to set up an ideal form of investment company and then compel all companies to conform to the ideal. Its provisions have been scrupulously adapted to the existing diversities of investment company organizations and functions." (quoting Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 3d Sess. 43 (1940) (statement of Robert E. Healy, Commissioner, SEC))).

[13] *See* Investment Advisers Act § 203(b)(3) (generally exempting investment advisers with fewer than 15 clients from registration). For this purpose, each fund counts as one client. The SEC adopted a rule that effectively required registration of hedge fund managers by defining "client" to include each investor in a fund, *see* Registration Under the Advisers Act for Certain Hedge Fund Advisers, Inv. Advisers Act Rel. No. 2333 (Dec. 2, 2004), but the rule was recently vacated by the U.S. Court of Appeals. *See Goldstein v. SEC*, 451 F.3d 873 (D.C. 2006) (vacating Investment Advisers Act rule 203(b)(3)-2).

[14] Hedge funds traditionally have relied on the private offering exemption to avoid registration under section 4(2) of the Securities Act of 1933 or Regulation D thereunder. A fund can be a registered investment company under the ICA without making a public offering for purposes of the Securities Act, although this is rarely done.

securities laws, securities regulations that apply generally to large institutional traders, and contract, corporate and other legal rules of general commercial applicability.

Like the enormous growth of mutual funds, the recent growth of the hedge fund industry is substantially attributable to the regulatory regime to which they are subject. Hedge funds' general freedom from regulatory investment constraints allows them to take risks and obtain returns that are impermissible and unavailable to mutual funds.[15] Their ability to charge one-sided performance fees provides stronger financial incentives to their managers to pursue superior risk-adjusted returns. Hedge funds are afforded the kind of governance and capital structure flexibility that permit a high level of responsiveness to a wide range of market opportunities. The combination of these factors presents a markedly different value proposition to investors from that which is presented by mutual funds. Although some research suggests that, in fact, hedge funds do not produce risk-adjusted returns superior to market returns,[16] the markets have provided an overwhelming endorsement of hedge funds and, implicitly, the general regulatory scheme under which they are regulated.

The occasional spectacular hedge fund collapse has not dimmed the market's enthusiasm for hedge funds. Limiting hedge fund investing to sophisticated investors presumptively mitigates the effect of hedge fund failures because hedge fund losses are easily absorbed by the diversified portfolios that sophisticated investors would hold. In theory, a properly diversified portfolio would hold enough outperforming investments to achieve superior risk-adjusted returns even after accounting for the occasional hedge fund implosion. Although one can argue that individual investors' eligibility to invest in hedge funds actually depends on their wealth rather than their sophistication, wealth is a useful, if imperfect proxy for sophistication. An individual's wealth also implies a greater capacity to absorb losses, and to the extent that wealthy investors have claims against their advisers for making unsuitable recommendations, they are more likely to bring these claims, and the claims are more likely to be cost-effective. In contrast, ineligible investors generally lack the sophistication to evaluate hedge fund risk, cannot

[15] *See generally Goldstein*, 451 F.3d at 875 - 76.

[16] *See*, *e.g.*, Burton Malkiel & Atuna Saha, *Hedge Funds: Risk and Return*, 61 Fin. Analysts J. 80 (2005).

easily absorb losses attendant upon the realization of such risks, and do not have the wherewithal or cost-effective claims to enforce their legal rights.

Thus, hedge fund regulation entails a kind of regulatory quid pro quo. Hedge fund managers and investors, and indirectly society at large, benefit from the potential for greater returns and more efficient allocation of capital that minimal regulation can facilitate.[17] In return, hedge funds may be sold only to sophisticated investors. This regulatory quid pro quo collapses, however, when retail investors are exposed to hedge fund risks, regardless of whether investors assume those risks by investing in a hedge fund or the hedge fund's manager.[18] When unsophisticated investors are permitted to invest in hedge funds or hedge fund managers, they are subject to precisely the risks that Congress enacted the ICA to address. For some investors, the risks will not be realized, and they may experience superior investment returns. It is inevitable that a publicly sold hedge fund manager will some day experience a sudden, dramatic collapse, however, and retail investors will experience substantial losses.[19] Unless Congress no longer supports basis for investment company regulation embodied by the ICA, it should take steps to ensure that this breach in regulatory scheme for mutual funds and hedge funds is promptly repaired.

IV. HEDGE FUND MANAGERS UNDER THE INVESTMENT COMPANY ACT

This section of this testimony explains why hedge fund managers are investment companies under the ICA, but before conducting that analysis, some preliminary points are necessary to frame the discussion. First, this testimony uses the term "hedge fund manager" to describe a manager the assets and income of which are primarily attributable to investments in securities issued by operating companies and investment companies,

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[17] *See President's Working Group*, *supra* note 7, at 2.

[18] *See Goldstein*, 451 F.3d at 875 ("Investment vehicles that remain private and available only to highly sophisticated investors have historically been understood not to present the same dangers to public markets as more widely available investment companies, like mutual funds.").

[19] *See Hedge Funds: Risk and Return*, *supra* note 16, at 87 ("Investors in hedge funds take on a substantial risk of selecting a dismally performing fund or, worse, a failing one.").

and carried interests. Many hedge fund managers have very different sources of assets and income, but the managers of relevance to this testimony are those that have the characteristics of an investment company, such as the Blackstone Group ("Blackstone"). The term "hedge fund manager" also includes what are often referred to as "private equity managers" or "alternative asset managers." For purposes of investment company regulation, the various categories of managers of unregistered investment companies are not significant to the extent that the manager's assets and income are largely attributable to investments (including carried interests). This testimony uses Blackstone solely for illustrative purposes as a model of a hedge fund manager.

Second, it should be noted the most important policy question facing Congress is not so much the legal status of hedge fund managers, but rather their economic characteristics and the regulatory issues that these characteristics raise. As discussed below, an investment in a hedge fund manager is the functional equivalent of a leveraged investment in the manager's hedge funds. Such an investment therefore raises the same regulatory risks that are presented by hedge funds, and the federal securities laws prescribe that such investments should not be sold directly to retail investors. This does not mean, as often suggested by some commentators, that hedge funds are the exclusive province of the rich. In fact, the largest investors in hedge funds are institutional investors who invest assets that are beneficially owned by small investors. Prohibiting hedge funds and their managers from selling shares directly to small investors therefore does not deny these investors access to such investment opportunities, but merely requires that they make their investments through sophisticated intermediaries.

Third, it is entirely consistent with the definition of investment company and the overall structure of the ICA for a hedge fund manager to fit within that definition, despite the fact that in many respects it does not resemble a conventional investment company. The definition of investment company includes a wide range financial businesses that are different from conventional investment companies, yet they, too, fall squarely within the definition. The definition of investment company is so broad, for example, as to require express exclusions for banks; insurance companies; public utilities; investment banks;

consumer finance companies; common trust funds; certain oil, gas and mineral interests; public charities; and voting trusts.[20]

The definition of investment company even applies to operating companies that are not remotely similar to investment companies from an investment perspective, but that fit within the definition because they temporarily hold a substantial amount of investment securities. Congress accordingly created an exception for such companies to the extent that they are primarily engaged in a non-investment business and granted the SEC specific authority to exempt companies on the same basis.[21] Under this authority, the SEC promulgated rule 3a-1, which sets forth an assets and income test by which an investment company can escape from the statutory definition. The SEC also has routinely granted exemptive orders to such "inadvertent investment companies" provided that their situation is temporary and they hold only safe, liquid investments.[22] In some cases, the SEC may have exercised its exemptive authority too liberally, such as in the exemptions granted at the market's height in the late 1990s to firms such as Enron and Idealab!,[23] but at least the agency required that these firms submit to the process required by the ICA.

Thus, the ICA reflects Congress's adoption of a strategy of cutting a wide swath with the definition of investment company and then excluding entities through a combination of statutory and administrative exemptions. The SEC's decision to ignore the status of hedge fund managers as investment companies flatly contradicts both the express terms of the ICA and the inherent logic of its regulatory scheme. What is unusual about the Blackstone IPO is not the fact that it is an investment company, but rather the SEC's decision to allow Blackstone effectively to bypass this issue altogether. The SEC has a long history of respecting the breadth of the definition of investment company by

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[20] *See* ICA §§ 3(a)(1)(C) & 3(c).

[21] *See* ICA §§ 3(b)(1) & (2).

[22] *See*, *e.g.*, *In the Matter of Applied Materials, Inc.*, Inv. Co. Act Rel. Nos. 27064 (Sep. 13, 2005) (notice) & 27114 (Oct. 12, 2005) (order).

[23] *See In the Matter of Bill Gross' Idealab!*, Inv. Co. Act Rel. Nos. 24469 (Mar. 28, 2000) (notice) & 24567 (July 26, 2000) (order); *In the Matter of Enron Corp.*, Inv. Co. Act Rel. Nos 22515 (Feb. 14, 1997) (notice) & 22560 (Mar. 13, 1997) (order).

conducting a substantive review of all entities that fit its terms. The SEC has variously: (1) forbidden the public offering of such firms without registration and full compliance with the ICA, (2) required registration under the ICA while exempting firms from certain of its provisions, or (3) granted firms a complete conditional or temporary exemption from the ICA. In contrast, the SEC's response to hedge fund managers has been to abdicate its traditional regulatory role to the market. Blackstone's operations as described in its registration statement implicate every one of the major concerns that were the impetus for the enactment of the ICA, and the nature of its assets and income reflect the essential characteristics of an investment company under the Act. The regulatory gauntlet having been thrown, the SEC has declined to meet the challenge that this new financial instrument has presented.

A. Why Hedge Fund Managers are Investment Companies

The ICA sets forth two definitions of investment company that apply to a hedge fund manager.[24] An issuer that satisfies either definition is an investment company, and Blackstone, for example, satisfies both. The first definition applies to 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."[25] Hedge fund managers hold themselves out as asset managers,[26] which leaves the inquiry under this definition as to whether -- notwithstanding how they hold themselves out -- they are primarily engaged in the business of investing in securities. The second definition applies to an issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a

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[24] The third definition applies to an issuer that "is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding." ICA § 3(a)(1)(B).

[25] ICA § 3(a)(1)(A).

[26] *See*, *e.g.*, Blackstone Registration Statement at 60 (June 21, 2007) ("Blackstone Registration Statement") ("We believe that we are engaged primarily in the business of providing asset management and financial advisory services and not in the business of investing, reinvesting or trading in securities. We also believe that the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provision of services.")

value exceeding 40 per cent of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."[27] The second definition differs from the first in that merely holding securities is sufficient provided that the issuer meets the 40-per-cent test. Based on the information provided in its registration statement, Blackstone is primarily engaged in the business of investing and holding securities and more than 40 per cent of its total assets are investment securities.

i. The Primarily Engaged Definition

As illustrated by Blackstone, hedge fund managers fit the first definition of investment company. The nature of Blackstone's assets and income demonstrate that it is primarily engaged in the business of investing. Blackstone's registration statement provides no explanation as to why it does not fit within this definition except to state: "We do not believe the equity interests of The Blackstone Group L.P. in its wholly-owned subsidiaries or the general partner interests of these wholly-owned subsidiaries in the Blackstone Holdings partnerships are investment securities."[28] It appears from this statement that Blackstone relies on the general presumption under the federal securities laws that a general partnership is not a security (the "general partnership presumption") for its determination that it is not an investment company. It is correct that, if Blackstone does not invest in or hold any securities because its general partnership interests are not securities, it would not fall within either the first or second definition of investment company. Based on the information provided in Blackstone's registration statement, however, one could not reasonably conclude that Blackstone's use of a general partnership structure removes Blackstone from the definition of investment company.

[27] ICA § 3(a)(1)(C).

[28] Blackstone Registration Statement at 60.

1. General Partnership Interest

Blackstone carries out its operations through a multi-tiered structure. Blackstone owns a 100 per cent interest in a series of entities that act as general partners to a series of holding companies ("Blackstone Holdings") that directly or indirectly manage a series of hedge funds.[29] Through each of the general partnership interests, Blackstone owns 22 per cent of Blackstone Holdings.[30] The remaining 78 per cent of Blackstone Holdings is owned by Blackstone management. After its IPO, public investors owned 56 per cent of Blackstone, with the remaining 44 per cent owned by an investment company controlled by China ("China").

Although public investors and China own 100 per cent of the economic interests in Blackstone, they have no control over the firm. An entity controlled by Blackstone management acts as the sole general partner of Blackstone. The public investors have no ability to remove the general partner or otherwise exercise any effective control over Blackstone. The public investors' lack of any control over Blackstone means that they also have no control over the Blackstone's actions in its capacity of the general partner of Blackstone Holdings.

Blackstone's structure thereby illustrates one reason that the general partnership presumption does not apply. The presumption that a general partnership interest is not a security is based on the notion that traditional general partners "have the sort of influence which generally provides them with access to important information and protection against a dependence on others."[31] In Blackstone's case, however, the economic reality is that its public investors will have no influence, no access to information, and no protection against dependence on Blackstone management.[32] Although Blackstone itself

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[29] A detailed diagram of Blackstone's structure appears at page 16 of its June 21, 2007 registration statement.

[30] This information is based on Blackstone's June 21, 2007 registration statement and does not reflect the sale of underwriters' overallotment of shares in the IPO. The sale of such shares would not change this analysis.

[31] *Williamson v. Tucker*, 645 F.2d 404, 422 (5th Cir. 1981).

[32] *See Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 241 n.7 (4th Cir. 1988) (ultimate test of general partnership status is "the economic reality of partnership interests.")

effectively is the general partner of and exercises complete control over Blackstone Holdings, and Blackstone therefore has the requisite influence, access and protection of a general partner, those elements do not extend to Blackstone's public investors. The influence, access and protection afforded by the general partnership interest in Blackstone Holdings reside entirely with Blackstone management and do not extend to the public investors in Blackstone because they have no influence, access or protection *vis as vis* Blackstone, much less *vis a vis* Blackstone Holdings.

Blackstone's understanding of the general partnership presumption confuses the meaning of "security" in the context of the ICA with its meaning in other contexts. It is the SEC's longstanding position that a financial instrument that is not a security under other federal securities laws nonetheless may be a security under the ICA.[33] Under other federal securities laws, the term "security" serves the purpose of determining when what is being *sold* should be subject to the federal securities laws. Under the definition of investment company, the meaning of "security" determines whether what is being *held* by a firm should subject it to regulation under the ICA. Under the ICA, the question of what an entity invests in or holds is not asked out of a concern for the entity, but out of concern for the investors in the entity. The ICA is designed to regulate financial instruments the investing and holding of which raise the substantive concerns that the ICA is designed to address, *e.g.*, complex capital structures, leverage, affiliated transactions and excessive fees.

Blackstone's apparent position on the general partnership presumption would, in effect, render meaningless the definition of investment company. If the general partnership presumption applied to hedge fund managers, virtually any mutual fund could evade regulation under the ICA simply by holding interests in the fund through a general partnership interest. To illustrate, consider the Smith Large Cap Fund ("Smith Fund") that is managed by the Smith Management Company ("Smith"). As in a traditional mutual fund structure, public investors own shares of the Smith Fund that represent a *pro rata* interest in the net assets of the Fund. Smith could reorganize the fund as a

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[33] *See generally* Joseph Franco, *The Investment Company Act's Definition of "Security" and the Myth of Equivalence*, 7 Stan. J.L. Bus. & Fin. 1 (2002) (discussing SEC position on nonequivalence of meaning of security in ICA and other federal securities statutes).

partnership, the sole general partner of which would be Smith PTP, a publicly traded partnership. Smith would act as the sole general partner of Smith PTP. In a public offering, Smith PTP could offer 100 per cent of the economic interests in Smith PTP to public investors, with Smith retaining exclusive control over Smith PTP and thereby over the Fund. With the exception that Smith PTP's public investors would have no control over Smith PTP, the resulting structure would be functionally identical to the traditional mutual fund structure, but Smith PTP would not own any securities – assuming the general partnership presumption holds – and therefore would not be an investment company. The general partnership presumption is based on the investors' influence and access, yet the effect of interposing the general partnership interest in this illustration is to eliminate the investors' influence and access as to the fund. It is illogical to apply a general partnership presumption that derives from the nature of the investors' access and authority when the general partnership interest is used to eliminate investors' access and authority.

Congress anticipated the use of structures such as Blackstone's to evade regulation under the ICA. Section 48(a) of the Act prohibits any person from, "directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of [the ICA]." Accepting Blackstone's general partnership presumption would permit it to use an "other person" (the general partnership) to accomplish indirectly what Blackstone would be prohibited from doing directly. Thus, the mere interpositioning of a general partnership interest between a publicly traded partnership and a fund does not resolve the question of whether the publicly traded partnership is an investment company. Courts have consistently held that whether a financial instrument is a security depends on the particularly facts and circumstances. Whether the general partnership presumption holds for an entity such as Blackstone depends on the nature of the general partnership assets and income, in other words, on the application of the definition of investment company at the general partnership level. In the case of Blackstone, it is the assets and income of Blackstone Holdings that answer the question of whether the general partnership presumption holds.

2. Assets and Income

In the context of an entity such as Blackstone, the general partnership presumption is demonstrably rebutted by the nature of its assets and income. As of March 31, 2007, Blackstone held $17.2 billion in assets, of which $5.2 billion are categorized as "Investment, at Fair Value" and $4.1 billion "Other Intangible Assets."[34] The category of Investment, at Fair Value includes investments in Blackstone's funds and co-investments in the funds' portfolio companies.[35] Blackstone "make[s] significant investments in the funds [it] manage[s]"[36] and expects to use some of its IPO proceeds to fund additional investments in its investment funds.[37] These investments and the investments in portfolio companies are clearly securities for purposes of the definition of investment company. The category of Other Intangible Assets substantially comprises carried interests.[38] Assuming that carried interests are also securities, as discussed *supra*, 54 per cent of Blackstone's assets are securities, and it therefore is primarily engaged in the business of investing.

This percentage is based on a generous calculation of the relevant denominator because it includes substantial assets that are not indicative any business activity other than investing. Blackstone's $17.2 billion in assets includes a $1 billion "Deferred Tax Asset," which reflects income tax benefits received by reason of the increase in the tax basis of assets purchased from Blackstone management to form Blackstone and it substantially offset by a $863 million tax liability to Blackstone management.[39] The Deferred Tax Asset therefore does not reflect any business activity apart from the

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[34] Blackstone Registration Statement at 89.

[35] *Id*. at 181.

[36] *Id*. at 108.

[37] *See id*. at 181.

[38] The Other Intangible Assets "relate to the contractual right to future fee income from our management, advisory and incentive fee contracts and the contractual right to earn future carried interest from our corporate private equity, real estate and mezzanine funds." *Id*. at 91.

[39] *Id*. at 89 & 92 – 93 (*see* line item: "Due to Existing Owners"). The remainder of the $1 billion is reflected as $154 million adjustment to Partners' Capital. *Id*.

investing activities that are directly reflected by its $9.3 billion in securities. Blackstone's $3.7 billion in goodwill similarly does not reflect an alternative business activity to Blackstone's investing business. Blackstone calculated goodwill by subtracting the fair value of its tangible and intangible assets from the purchase price (that is, the price Blackstone paid to management to acquire interests in the various pre-IPO entities).[40] Thus, goodwill does not reflect assets that indicate any business other than investing. Blackstone's $1.8 billion in cash similarly indicates no business other than investing (and is expressly excluded from the asset denominator for purposes of the 40-per-cent test in the second definition of investment company). Thus, the 37 per cent of Blackstone's assets that are comprised of tax assets, goodwill and cash provide no evidence that Blackstone is engaged in any business other than investing. Removing these assets from the total assets denominator increases the percentage of its assets represented by investments (including carried interests) from 54 to 87 per cent, which further demonstrates that it is engaged almost exclusively in the business of investing.

Blackstone's income also reflects an enterprise that is primarily engaged in the investing business. In calendar year 2006, Blackstone's total income was $2.7 billion, of which $1.2 billion represented "Performance Fees and Allocations" and $385 million represented "Net Gains from Investment Activities."[41] Blackstone's "Net Gains from Investment Activities reflect the "realized and unrealized gains from underlying investments in corporate private equity, real estate and marketable alternative asset management funds."[42] Blackstone's "ability to generate carried interest is an important element of [its] business and carried interest has historically accounted for a very

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[40] *Id*. at 90 – 91. Blackstone's "allocation [between intangible assets and goodwill] is subject to change as valuation analyses are finalized and remaining information on the fair value of assets and liabilities is received." *Id*. at 91.

[41] *Id*. at 95. In the first quarter of 2007, Blackstone received $1.3 billion in income, of which 68 per cent comprised the combination of $653 million in Performance Fees and Allocations and $228 million in Net Gains from Investment Activities. *Id*. at 96.

[42] *Id*. at 113. Specifically, a large percentage of its $385 million in 2006 Net Gains was "related to gains from [its] investment funds which are deconsolidated for segment purposes. The increase was primarily due to increases in appreciation in [its] real estate opportunity funds' limited service portfolios and recent office portfolio acquisitions." *Id*. at 118; *see also id*. at 95 & 116.

significant portion of [its] income."[43] Thus, 59 per cent -- a comfortable majority -- of Blackstone's income represents investing activities, which further demonstrates that it is primarily engaged in the investment business.

Blackstone's own characterization of its performance metrics reflects the view that it is primarily engaged in the business of investing. Blackstone's segment-by-segment financial information shows that it primarily evaluates its performance based on investment returns, not advisory fees. The financial information in Blackstone's segment-by-segment discussion:

> is reflected in the manner utilized by [its] senior management to make operating decisions, assess performance and allocate resources. Management makes operating decisions and assesses the performance of each of [its] business segments based on financial and operating metrics and data that are presented without the consolidation of any of the investment funds [it] manage[s].[44]

Blackstone's discussion of its corporate private equity segment, for example, shows that its income is primarily attributable to investment gains and carried interests. Of its "Economic Net Income" in calendar years 2004, 2005 and 2006 and the first quarter of 2007, 69, 72, 51 and 65 per cent, respectively, represents investment gains and carried interests.[45] Blackstone's Real Estate segment paints a similar picture, with 70, 69, 63 and 53 per cent of its "Economic Net Income" in calendar years 2004, 2005 and 2006 and the first quarter of 2007, respectively, being attributable to investment gains and carried interest.[46]

Not all of Blackstone's income reflects its investing business. In 2006, Blackstone received $854 million in Fund Management Fees and $257 million in Advisory Fees, which represents 41 per cent of its total income. The fact that Blackstone is also engaged in the asset management business, however, does not change the fact that

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[43] *Id*. at 180.

[44] *Id*. at 120.

[45] *Id*.

[46] *Id*. at 124. The Corporate Equity and Real Estate segments represent the largest segments of Blackstone's business, with 2006 Earned Net Income of $1 billion and $900 million, respectively. The next largest segments – Financial Advisory and Marketable Alternative Asset Management – had 2006 Earned Net Income of $194 million and $192 million, respectively. *Id*. at 128 & 131.

it is "primarily" engaged in the business of investing, as indicated by the predominance of investing reflected by its assets and income. If it charged primarily asset-based fees or reduced the amount of its direct investments in its funds and its funds' portfolio companies, a hedge fund manager such as Blackstone could easily escape the definition of investment company, but it has chosen to engage primarily in the business of investing and therefore falls within the first definition of investment company.

3. Carried Interests are Securities

The foregoing analysis assumes that carried interests qualify as securities and that income from carried interests should be treated as investment income. As discussed below, this assumption is supported by legal and practical considerations. For purposes of this analysis, a carried interest is a contractual right to receive a specified portion of the value of a security or portfolio that represents an annualized investment return in excess of a fixed minimum return, or "hurdle rate," after a specified period. This definition is intended solely for illustrative purposes, as the specific terms of a carried interest for any given fund varies widely, as illustrated by Blackstone's arrangements with the funds that it manages. Blackstone's carried interests generally entitle it to 20 per cent of its funds' net annual appreciation with hurdle rates of up to 10 per cent.[47] For example, a carried interest might entitle its holder to receive 20 per cent of a fund's return in excess of an annualized return of 10 per cent after 10 years ("20/10 carried interest"). If a portfolio was worth $386 million at its inception and had an annualized return of 10 per cent, it would be worth $1 billion at the end of ten years. After 10 years, the holder of a 20/10 carried interest would be entitled to 20 per cent of the value of the fund in excess of $1 billion. If the portfolio grew at an annualized rate of 20 per cent, it would be worth approximately $2.4 billion after ten years, and the carried interest owner would experience a gain of $280 million (20% * $1.4 billion).

A 20/10 carried interest shares the characteristics of a number of financial instruments that are included in the definition of security. For example, a carried interest

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[47] *Id*. at 180.

is an "investment contract" as that term has been interpreted by the courts. A carried interest is an investment contract because its purchase constitutes an investment of money in a common enterprise with the reasonable expectation of profits solely from the efforts of others.[48] Public investors in a hedge fund manager: (1) pay money (2) that is pooled with money invested by others (3) for purpose of receiving a share of the profits of funds and portfolio companies (4) that depend solely on the efforts of Blackstone management and the management of the portfolio companies. As discussed above, the interpositioning of a general partnership interest cannot by itself change the fact that an investment in a hedge fund manager is functionally identical to an investment contract.

A carried interest also is functionally similar to an option, which is included in the definition of security. A carried interest is the functional equivalent of an option to purchase a security or pool of securities ("call option" or "call") at a strike price equal to the fund's value assuming that it performs at its hurdle rate. For example, a 20/10 carried interest would represent the right to receive 20 per cent of the difference between the value of a portfolio as the end of its ten-year life and its value assuming a 10 per cent annualized return. This is functionally identical to a call where the holder owns the right to purchase 20 per cent of a portfolio at a strike price equal to the portfolio's value assuming 10 per cent return ("20/10 call").

To illustrate, consider a fund with $386 million in assets at its inception, which would grow to $1 billion over its ten-year life assuming an annualized return of 10 per cent. If the fund's actual annualized return were 20 per cent, its value would be $2.4 billion after ten years. The holder of a 20/10 carried interest would receive 20 per cent of $1.4 billion at the of the 10-year period (*i.e.*, the difference between its ending balances assuming the 10-per-cent, hurdle-rate return and the actual 20-per-cent return), or $280 million. An investor who purchased an option exercisable after 10 years to buy 20 per cent of the fund for $200 million (the strike price) would experience an identical return as the 20/10 carried interest. At the end of 10 years, the 20/10 call would be exercised at the strike price of $200 million for a gain of $280 million ((20% * $2.4 billion) - $200 million). Thus, the gain on the carried interest and the stock option would be identical.

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[48] *See SEC v. Howey*, 328 U.S. 293 (1946).

A call and a carried interest are equivalent not only at the end of a fund's life, but also during the life of the fund. For example, if a 50 per cent owner of the fund held a 20/10 call, the other owner held a 20/10 carried interest, and each owner transferred all of his rights in the call/carried interest to separate public traded partnerships (PTPs) at the end of the fund's fifth year, the investors in each PTP would be identically situated. The unrealized value of each PTP would equal $68 million at the time the PTP was sold, after which the value of each PTP would fluctuate depending on the subsequent performance of the portfolio.[49] For example, if the fund's return were 10 per cent in each of its remaining five years (rather than the 20 per cent assumed above), its ending value would be $1.5 billion, and the liquidation value of each PTP would equal approximately $100 million (20% * ($1.5 billion – $1 billion)). The equivalence of carried interests and call options are illustrated by the manner that Blackstone has used to price carried interests. In its May 1 registration statement, Blackstone stated that it would "measure the fair value of its [carried interests], and their option-like payoffs, using a valuation model consistent with the Black-Scholes pricing framework . . .."[50] Black-Scholes is a valuation tool used to price options that considers, among other things, the range of likely performance outcomes in measuring the present value of the financial instrument.

Some have argued that carried interests more closely resemble compensation for services, but carried interests bear strongly distinguishing characteristics. The traditional form of compensation paid for asset management services is an asset-based management fee, which differs from a carried interests in at least two significant respects. First, an asset-based fee rises and falls not only with the value of the managed portfolio, but also with assets under management. A 10 per cent decline in the value of a portfolio that is accompanied by a 10 per cent increase in assets under management will leave asset-based fee revenues unchanged. In contrast, a 10 per cent decline in the value of the portfolio will reduce the value of a 20/10 carried interest, while the increase in assets under management will have no effect. The carried interest on the new assets under

[49] For simplicity, this ignores future changes in the fair value of the call/carried interest. For accounting purposes, such changes would be included in calculating the fair value of calls and carried interests.

[50] Blackstone Registration Statement at 84 (May 1, 2007).

management have no value unless and until the portfolio's performance exceeds the hurdle rate.

Second, the 10 per cent decline in the fund's value causes a 10 per cent decline in the asset-based fee, whereas the effect of such a decline on the carried interest can range from zero to many multiples of the 10 per cent decline in the fund's value. It is in this sense that carried interests are leveraged financial instruments. To illustrate, consider a hedge fund with $1 billion in assets at its inception that pays its manager a 1 per cent asset-based fee and 20/10 carried interest.[51] If there were no change in the value of the fund after one year, but the fund received $100 million in new assets on its second day of operations, the manager's asset-based fee for that year would equal $11 million, with $1 million of that fee being attributable to the $100 million in new assets. The carried interest would be worth nothing, and the receipt of $100 million in new assets would have no effect on that value. Assuming that the same fund declines in value in its second year from $1.1 billion to $1 billion, the asset-based fee would decline from $11 million to $10 million, bringing total asset-based fees to $21 million. Again, the decline would have no effect on the still valueless carried interest.

Returning to the fund's first year and assuming no new contributions but a 10 per cent increase in value on the fund's first day to $1.1 billion, the asset-based fee in for the first year also would increase 10 per cent -- to $11 million. In contrast, the carried interest still would be worth nothing because the fund's annualized return would not have exceeded the 10 per cent hurdle rate. If the fund increased in value to $1.2 billion instead of $1.1 billion, the asset-based fee would increase by $1 million to $12 million. In contrast, the value of the carried interest for that year would increase from zero to $20 million (20 per cent of the $100 million increase in value above the hurdle rate value). Subsequent changes in the value of the fund would cause the amount of asset-based fees and the value of the carried interest to continue to diverge. A second-year increase in the fund's value from $1.2 to $1.5 billion would raise the asset-based fees for that year to $15 million, for a total of $27 million in fees over the first two years. The carried interest

[51] For simplicity, these illustrations assume that the carried interest is not valued using a pricing model that takes into account the likelihood that the fund's performance will exceed its hurdle rate. This assumption has no effect on relative leveraged nature of asset-based fees and carried interests. These illustrations also assume the calculation of fees and carried interests only at year-end.

would increase in value from $20 million to $60 million (20% * ($1.5 billion – $1.2 billion hurdle rate value)). While the total asset-based fees approximately double in value, the carried interest triples in value.

These illustrations show how dramatically changes in the value of the portfolio can affect the value of a carried interest compared to their effect on an asset-based fee. In comparison with asset-based fees, which are earned on an ongoing basis and stable relative to the value of the portfolio, carried interests are highly unstable. This key difference between asset-based fees and carried interests – between compensation for services and a leveraged equity investment -- is most starkly illustrated when a portfolio declines precipitously in value. If the fund discussed immediately above declined in value on the first day of its third year from $1.5 billion to $1 billion, the manager would add another $10 million to its asset-based fees while retaining previous fees, thereby bringing total asset-based fees for the three-year period to $37 million. In contrast, the value of the carried interest would decline from $60 million to zero *in one day*. The loss of the entire value of the carried interest illustrates how it is fundamentally different from compensation for services. Unlike carried interests, compensation for services cannot have negative performance.

When public investors purchase units representing carried interests, they are purchasing a leveraged equity financial instrument. At the end of the fund's second year in the foregoing example, the value of the carried interests would equal $60 million plus the expected value of future changes in that amount due to the fund's future performance. A simplified estimate of the value of future increases, assuming that the fund would increase in value during the third year at the same rate as in each of the first two years (22.5 per cent annually), would produce an expected liquidation value of $100 million at the end of the third year.[52] If the investors paid $100 million for the carried interests at the end of the second year, they would incur a $100 million, 100 per cent loss when the fund was liquidated at the end of the third year. In contrast, the purchaser of the right to the manager's asset-based fees for all three years would lose a small fraction of this

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[52] Assuming that the hedge fund had a three-year life and third-year performance would equal to the annualized return of the fund to date, the expected value of the carried interest at the end of the second year would be $100 million. This equals the $60 million value of the carried interest at the end of the second year plus the $40 million increase attributable to the fund's third-year, 22.5 per cent return.

amount.[53] The "clawback" to which carried interests are subject is simply a different name for leveraged investment losses and cannot reasonably be characterized as an aspect of compensation for services.

ii. The 40-Per-Cent-Test Definition

The second definition of investment company applies to any issuer that is engaged in the business of investing or holding securities and owns investment securities the value of which exceeds 40 per cent of the value of its total assets, exclusive of government securities and cash. If a hedge fund manager is *primarily* engaged in the business of investing, as demonstrated in the immediately preceding discussion, then it necessarily is engaged in the business of investing under the first part of the second definition. The absence of the term "primarily" in the second definition means that the business of investing need not be the issuer's predominant activity. This implies that an asset manager would be an investment company even if its assets and income were substantially less than 50 per cent attributable to its investing business. A hedge fund manager also is an investment company if only engaged in the business of merely *holding* securities as opposed to actively investing. This means that the sale of a package of carried interests tied to a fixed portfolio with a finite life would not disqualify an issuer by reason of its passive, fixed nature.

The first part of the second definition reflects Congress's intent to bring initially within the definition of investment company even those issuers that only inadvertently acquire the characteristics of an investment company while engaging primarily in some

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[53] Under one set of assumptions, the purchaser of three year's of asset-based fees at the end of the second year would lose $3.7 million on a $44.7 million investment (an 8.3-per-cent loss), calculated as follows. Based on the assumption that the third year's expected 22.5 per cent return would increase its value to $1.8 billion, the purchaser would have expected an $18 million payment for that year. Based on a 10 per cent discount rate, this end-of-year payment could be purchased for approximately $16.5 million. The first two years of fees could be purchased for an additional $28.1 million, assuming that the first year's $12 million payment earned 10 per cent during the second year ($13.2 + $15 = $28.2). The total purchase price would be $44.7 million ($28.2 + $16.5). At the end of the third year, the $28.2 in prior fees would be worth $31 million, but the $16.5 million paid for the third year's fee would be worth only $10 million (1% * $1 billion), which produces a final value of $41 million, or a $3.7 million loss on the $44.7 million investment. This represents an 8.3 per cent loss, in comparison with the 100 per cent loss on the purchase of the carried interest.

other activity. The inadvertent nature of the second definition is further evidenced by its requirement that more than 40 per cent of an issuer's total assets represent investment securities.[54] An operating company may have good reason to hold substantial assets in the form of investment securities, such as when it sells a substantial subsidiary and invests the proceeds in investment securities pending their use in a planned acquisition.[55] Congress did not intend that these firms be regulated under the ICA, but it chose to err on the side of caution by including them in the second definition of investment company and then excluding them from that definition either through the application of section 3(b)(1) of the Act, which excludes any issuer that is primarily engaged in a non-investment business, or a finding by the SEC under section 3(b)(2) of the Act that the issuer is primarily engaged in a non-investment business. The SEC has granted dozens of exemptions under this provision, and issued two rules that set forth broad-based, objective tests under which an issuer is excluded from the definition of investment company.[56]

As discussed above, a hedge fund manager is primarily engaged in the business of investing, which, coupled with the fact that more than 40 per cent of its assets are investment securities, establishes that it is an investment company under the second definition. For example, when Blackstone's cash assets are excluded, the value of its investment securities equals 60 per cent of its total assets, far in excess of the 40 per cent maximum allowed under section 3(a)(1)(B). Blackstone does not qualify for the section 3(b)(1) exclusion because it is not primarily engaged in a non-investing business, and it fails the tests provided under SEC rules.[57]

[54] The ICA also defines "investment securities" to include all securities except: "(A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c)." ICA§ 3(a)(2).

[55] *See SEC v. Nat'l Presto Indus.*, 486 F.3d 305 (2007).

[56] *See* ICA rules 3a-1 and 3a-2.

[57] Rule 3a-1 excludes issuers from the second definition of investment company if no more than 45 per cent of their net income over the preceding 4 quarters and no more than 45 per cent of their total assets (excluding cash) are generally attributable to securities. While Fortress Investment Group, a hedge fund manager whose IPO preceded Blackstone's, claims to qualify under this rule, Blackstone does not. *See* Fortress Investment Group Registration Statement at 48 (Feb. 8, 2007).

In summary, hedge fund managers whose assets and income are primarily attributable to investments in securities, including carried interests, fall squarely within two definitions of investment company under the ICA. Hedge fund managers trigger the first definition because they are primarily engaged in the business of investing in securities, as evidenced by the fact that a majority of their assets are securities and a majority of their income is derived from investment gains and investment income. They trigger the second definition because they are primarily engaged in the business of investing in securities and more than 40 per cent of their assets are investment securities. The conclusion that hedge fund managers are investment companies is reinforced by the policy concerns raised by the public offering of hedge fund managers. The structure and operation of hedge fund managers – regardless of whether they fall within the definition of investment company – raise precisely the risks that Congress designed the ICA to address and tasked the SEC to oversee, as discussed in the following section of this testimony.

V. HEDGE FUND MANAGERS AND INVESTOR PROTECTION UNDER THE INVESTMENT COMPANY ACT

Hedge fund managers' structure and operations provide a virtual roadmap of the kinds of potentially abusive activities that the ICA is designed to severely restrict or prohibit. Congress intended that the ICA address to a number of potential abuses that are particular to liquid pools of securities. The ICA prohibits or severely restricts, among other things, extreme leverage, differential treatment of shareholders, complex corporate structures, side deals between fund managers and the companies in the funds they control, fee increases that have not been approved by shareholders, one-sided performance fees, and valuations based on other than the market prices of the fund's portfolio securities. There is nothing necessarily harmful about any of these practices, and the federal securities laws permit private investment companies to engage in some or all of them. The ICA stands for the proposition, however, that such practices should be strictly regulated when the investment company is sold to unsophisticated investors

unless the SEC has made an express determination that exemptive relief from some or all of the provisions of the ICA is appropriate. Some of the practices that the ICA is designed to regulate and their use by hedge fund manager are addressed below.

Many of the abuses that prompted the enactment of the ICA were attributable to the complex capital structures used by fund managers to divert the economic benefits of ownership from investors to managers and their affiliates. The ICA generally prohibits mutual funds from offering different classes of shares with different voting rights or different rights to dividends, capital gains and other economic incidents of ownership. In contrast, hedge fund managers use capital structures that grant or can be used to grant special rights and privileges to favored shareholders. For example, the Blackstone offering separated the firm into three different components. Blackstone management retained control over the general partner and effective control over all other decisions by reason of its ownership of 86 per cent of the voting units in Blackstone Holdings. The public investors have no voting rights as to the identity of the general partner, and their rights as to the limited matters on which they are entitled to vote represent a 14 per cent interest. The units sold to China have no voting rights on any matter but were purchased at a 5 per cent discount to the public offering price.

Hedge fund manager structures also can be used to subvert the regulation of investment company fees. Mutual funds generally cannot increase their fees without the approval of the funds' independent directors and shareholders. A hedge fund manager is controlled by management, which has exclusive authority to increase its own compensation without shareholders' consent. For example, Blackstone does not have a compensation committee or intend to create one; rather, it plans to continue to vest complete discretion over compensation matters to its two founders.[58] Blackstone concedes that employee compensation "will increase prospectively"[59] and public

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[58] Blackstone Registration Statement at 196; *see also id.* at 202 (describing delegation of authority over Equity Incentive Plan to two top executives). Cash distributions to Blackstone's top five executives in 2006 were $398.3 million, $212.9 million, $97.3 million, $45.6 million and $17.4 million. *Id.* at 197 – 98. Although mutual fund directors have no direct say in the compensation paid to the fund manager's executives, such compensation is derived indirectly from the fees paid to the manager and approved by the fund's board.

[59] *Id.* at 108.

investors will have no say in such increases. Needless to say, Blackstone's investors' ability to control management fees will fall far short of the ICA's requirement that any fee increases be expressly approved by shareholders.

In fact, Blackstone's carried interests represent the kind of incentive compensation that the ICA strictly prohibits. Congress believed that incentive compensation that rewarded a fund manager for superior performance but did not punish the manager for inferior performance would create excessive incentives to take risks. The ICA therefore permits mutual fund managers to charge an incentive fee only if the increase in the fee due to good performance is matched by a decrease in the fee for poor performance. Hedge fund managers such as Blackstone collect carried interests, which may create an incentive to take greater risks without the disciplining effect of reduced fees resulting from underperformance.

The heart of the ICA is its provisions that restrict or prohibit transactions between funds and their affiliates. One of principal abuses that occurred prior to the enactment of the ICA was the use of funds by their managers to effect transactions that were disadvantageous to the fund. Hedge fund managers engage in such potentially abusive transactions as a matter of standard practice.[60] For example, Blackstone receives "monitoring" and "disposition" fees from portfolio companies[61] that would be impermissible for a mutual fund manager. Although Blackstone's investors, unlike direct investors in its hedge funds, stand to benefit to the extent that the fees are paid to Blackstone, these fees nonetheless present the potential for abusive side-deals when paid to Blackstone but diverted to Blackstone managers as compensation or paid directly to Blackstone management through affiliated entities they control.

Blackstone managers also co-invest in portfolio companies in which Blackstone owns direct stakes or indirect stakes through carried interests.[62] Such co-investments

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[60] *See*, *e.g.*, John Hechinger, *Hedge Funds' Gift Grabs*, Wall St. J. at C3 (June 28, 2007) (describing Massachusetts complaint filed against broker-dealer for "improperly providing below-market office space, low-interest personal loans and other perks to Boston-based hedge-fund executives if they steered enough business to [the broker-dealer]").

[61] Blackstone Registration Statement at 180. Blackstone also receives transaction fees on fund acquisitions, *id*., that may be paid by the portfolio companies.

[62] *Id*. at 181.

invite abuse because they create a potential conflict of interest between management and other investors in the portfolio companies, including public investors in Blackstone itself. For example, co-investments may be made on terms that are more favorable to Blackstone management or Blackstone affiliates than to Blackstone. These transactions can benefit investors and are permitted to hedge funds, but only because the law presumes that sophisticated investors can fend for themselves. The SEC has granted numerous exemptions subject to strict conditions to permit co-investments by investment company affiliates, but Blackstone managers' will not be subject to such oversight.

The ICA substantially restricts risk-taking by mutual funds by limiting the amount of leverage they are permitted to employ. The ICA limits borrowing and prohibits the issuance of senior securities, which the SEC has interpreted to restrict funds' ability to invest in derivatives that are effectively leveraged. No such restrictions apply to hedge funds. For example, Blackstone reserves broad discretion to use leverage to increase returns, thereby increasing the risk of loss that the ICA was designed to limit. As discussed above, carried interests create leverage with respect to market performance that is the functional equivalent of a call option. Long-Term Capital Management's leverage-to-equity ratio exceeded 25:1, which contributed substantially to its downfall.[63] To the extent that a hedge fund manager holds assets in the form of investments in its hedge funds, leveraged investments in its hedge funds' portfolio companies, or carried interests, its owners will be exposed to risks that Congress prohibited for public investment companies.

The ICA requires that funds value their assets at their market value and, for assets for which there is no readily available market price, at the fair value that could be realized on their present sale. Illiquid securities are particularly difficult to value because their price can change dramatically in response to market conditions. When a hedge fund encounters difficulties, it often must sell securities quickly to meet the terms of loans or redemption demands which may push the value of the securities below their market value. Pricing risk is further exacerbated for hedge funds that use leverage because

[63] *See President's Working Group*, *supra* note 7, at 12.

leverage has the effect of multiplying small pricing errors.[64] These factors played a significant role in the collapse of the junk bond market in the 1980s and Long-Term Capital Management in the 1990s, and the problems recently encountered by two Bear Stearns hedge funds.[65] Hedge fund managers hold precisely the kind of illiquid securities that are difficult to value.[66]

The basis on which Blackstone values its portfolios illustrates the uncertainty of pricing illiquid securities. Blackstone's portfolio companies do not trade in a secondary market, which leaves only fundamentals and valuations of comparable firms as sources of pricing information.[67] Its valuation approach thereby raises precisely the risks that the

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[64] *See id.* at 5 ("compared with other trading institutions, hedge funds' use of leverage, combined with any structured or illiquid positions whose full value cannot be realized in a quick sale, can potentially make them somewhat fragile institutions that are vulnerable to liquidity shocks."); *see also* Justin Lahart & Aaron Lucchetti, *Wall Street Fears Bear Stearns is Tip of an Iceberg*, Wall Street Journal at A1 (June 26, 2007) (*Wall Street Fears*) ("Such securities trade infrequently, which makes it hard to sell them quickly without incurring steep losses. The funds, especially the Enhanced Leverage Fund, used borrowed money, or leverage, to amplify returns. But leverage also amplifies losses when a fund's bets go sour. . . . Still, the increase in illiquid investments raises concerns. For one thing, even in liquid securities like stocks, what can seem like a ready supply of cash can dry up quickly if investors get spooked. Those problems are heightened when leverage is used.").

[65] *See Wall Street Fears*, *supra* (also noting huge losses sustained by Askin Capital Management in 1994 "on leveraged bets on infrequently traded mortgage-backed securities," $6 billion in losses sustained by Amaranth in 2006 "when it couldn't easily exit esoteric trades that went against it," and $560 million in losses sustained by Bank of Montreal "earlier this year . . . with bad bet on natural-gas volatility.").

[66] *See generally id.* ("Unlike stocks or bonds listed on an exchange, such assets can't be readily bought or sold. That makes it hard to establish an accurate price for them. Fund managers have broad discretion in attaching a value to these assets, and often don't reveal many details of their trades. . . . One reason the Bear Stearns funds' troubles worry Wall Street is the fear that other players own similar securities that have similarly been mispriced. If the funds' holdings were auctioned off, as their lenders had threatened to do, there would be a market to mark to -- albeit one that, because of the fire-sale quality of the auction, would value such securities well below what they otherwise might be worth."). The SEC recently reached a settlement with Allied Capital Corporation that illustrates the pitfalls of pricing securities that are difficult to value. *See* In the Matter of Allied Capital Corp., Admin. Proc. File No. 3-12661 (June 20, 2007) (sanctioning business development company for violating pricing rules, which involved, e.g., marking down securities from $20 million to $245,000, $16.5 million to $50,000, and $8 million to $50,000).

[67] Blackstone describes its methodology for valuing net investment gains as follows:

> "Net gains (losses) from our investment activities reflect a combination of internal and external factors. . . . The key external measures that we monitor for purposes of deriving net gains from our investing activities include: price/earnings ratios and earnings before interest, taxes, depreciation and amortization ("EBITDA") multiples for benchmark public companies and comparable transactions and capitalization rates ("cap rates") for real estate property investments. In addition, third-party hedge fund managers provide information regarding the valuation of hedge fund investments. These measures generally represent the relative value at which comparable entities have either been sold or at which

ICA is designed to minimize. The ICA requires that the pricing of illiquid securities be overseen by the funds' directors, a majority of whom generally must be independent of the fund manager, whereas Blackstone management has complete discretion in the pricing of its securities.[68] While there is no reason to believe that Blackstone is manipulating its portfolio valuations, the history of hedge funds is rife with incidences of fraudulent pricing,[69] and the law of averages dictates that there will be publicly offered hedge fund managers who will do the same.[70]

In summary, publicly held hedge fund managers present precisely the risks attendant upon investments in collective investment vehicles that Congress intended to regulate through the ICA. Hedge fund managers are investment companies that fall squarely within the definition of investment company, but even if they do not, they create the same risks that the ICA is designed to address. This is not to say that hedge fund managers should be subject to all of the provisions of the ICA, but rather that it is the SEC's responsibility to ensure that publicly offered hedge funds are subject to appropriate regulation. The SEC's decision to allow the Blackstone offering to proceed without obtaining an exemption from the ICA reflects a short-sighted perspective that will leave future Commissioners to explain why, when a publicly held hedge fund

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> they trade in the public marketplace. . . . Internal factors that are managed and monitored include a variety of cash flow and operating performance measures, most commonly EBITDA and net operating income."

Blackstone Registration Statement at 113; *see also id.* at 138 - 140.

[68] *Id*. at 138 – 39 ("For some investments little market activity may exist; management's determination of fair value is then based on the best information available in the circumstances, and may incorporate management's own assumptions and involves some degree of judgment . . .. ") & 141 ("The determination of investment fair values involves management's judgments and estimates. The degree of judgment involved is dependent upon the availability of quoted market prices or observable market parameters."). On a pre-IPO, consolidated basis, 91 per cent of Blackstone's funds' assets "represent assets for which market prices were not readily observable." *Id.* at 140; *see also id.* at 141 (table showing Level III valuations where "[p]ricing inputs are unobservable for the investment and includes situations where there is little, if any, market activity for the investment.").

[69] *See Implications of Growth of Hedge Funds*, *supra* note 8, at n. 257 (citing cases).

[70] Mutual funds have not been immune to portfolio mispricing. *See generally* Mercer Bullard, *Dura*, Loss Causation, and Mutual Funds: A Requiem for Private Claims? __ Cincinnati L. Rev. __ (forthcoming 2007).

manager inevitably collapses, it was appropriate not to apply any of the regulatory constraints to such entities that apply to their functional siblings – mutual funds.

The history of hedge funds dictates that such a collapse will occur, and as long as investors in these investment vehicles are limited to sophisticated purchasers, their periodic failure can be viewed as reflecting the efficient operation of a high risk market of which colossal failures are a necessary characteristic. The recent travails of two Bear Stearns hedge funds illustrate this risk. If Bear Stearns' only business had been managing those hedge funds, its investors would have experienced even greater losses than the investors in the funds if the firm held substantial carried interests. When a hedge fund collapses and its manager is devoted primarily to managing that fund, the combination of the manager's interests in the fund or its portfolio companies and its carried interests makes it likely that the manager will incur even greater losses than its funds. A manager such as Blackstone may manage a sufficiently diverse set of funds so as to weather the collapse of one or two of them, but less diversified managers will not. The SEC will not be able to treat differently hedge fund managers that are highly leveraged or concentrated because their status under the ICA cannot depend on either factor. By allowing an entity such as Blackstone to make a public offering with an exemption, the SEC has issued a free pass to all hedge fund managers.[71] When a publicly held hedge fund managers fails, the losses will not be limited to sophisticated investors, but will be shared by the same unsophisticated investors whom Congress intended to protect from such risks.

VI. RECOMMENDATIONS: EXEMPTIVE REGULATION OF HEDGE FUND MANAGERS UNDER THE INVESTMENT COMPANY ACT

When a hedge fund manager's assets and income are primarily attributable to carried interests and investments in their funds and their funds' portfolio companies, investors in the hedge fund manager own the functional equivalent of a leveraged

[71] The SEC has not explained its analysis, but it may take the position that a hedge fund manager would trigger the second definition of investment company if units in its funds plus co-investments in fund portfolio companies (and other investment securities) represented more than 40 per cent of the value of its total assets excluding government securities and cash. On this basis, Blackstone's securities represent only 34 per cent of its assets.

investment in the managers' funds. There does not appear to be any serious disagreement on this point, with those objecting to regulation under the ICA basing their arguments solely on technical grounds such as the interpositioning of the general partnership interest and the legalistic characterization of carried interests as compensation for services. As discussed above, these legal arguments fail under close scrutiny, but the more important issue for Congress is the SEC's decision that firms that are the economic equivalent of investment companies should not be subject to any of the investor protection measures that Congress created for such entities. If the SEC continues to decline to fulfill its statutory responsibility to craft an appropriate regulatory scheme for publicly held hedge fund managers, Congress should act promptly to cause it do so.

Two general courses of action are available to ensure that public sold hedge fund managers are appropriately regulated. The first would be to cause the SEC to treat hedge fund managers as investment companies, in which case the SEC would have to grant exemptive relief or regulate hedge fund managers under the ICA. The second course of action would be to amend the ICA to apply selected provisions to hedge fund managers that implicate the concerns that the ICA is intended to address. These options are briefly discussed below.

B. Regulation by Administrative Exemption

As discussed above, Congressional action would be unnecessary if the SEC applied its exemptive authority and substantial expertise in this area to construct an appropriate regulatory regime for hedge fund managers. Although the SEC has declined to accept this responsibility, a number of approaches are available to Congress to cause the SEC to reverse course. One approach would be to require that the SEC provide a full explication of its treatment of carried interests under the ICA, including an analysis of whether carried interests could be sold through a structure finance vehicle without registration under the ICA. This request might cause the agency to recognize that carried interests must be treated as securities in some circumstances and to recognize that certain hedge fund managers therefore are investment companies under the ICA.

If the SEC is inflexibly committed to the position that carried interests can never be considered securities, then Congress could amend the definition of securities for purposes of the definition of investment company to include carried interests. It should be emphasized that the effect of such an amendment would not be to subject hedge funds to the full force of the ICA. Rather, this approach would merely require that hedge fund managers obtain exemptive relief from the ICA as appropriate.

One disadvantage of this approach is that hedge fund managers may simply restructure their compensation so as to fall outside the definition of carried interest, in which case Congressional action again would be needed if the SEC continued to be unwilling to act. Another disadvantage is that the SEC already seems inclined to grant hedge fund managers a complete pass from ICA regulation, and it therefore may grant exemptive relief to hedge fund managers on overly generous terms. This role is one that Congress expressly delegated to the SEC, however, and it should assume that the SEC will exercise its authority consistent with Congress's intent until proven otherwise.

C. Regulation by Statutory Exemption

Congress's second option is to amend the ICA to create a new form of investment company that would be subject to only certain provisions of the Act. This approach, although less flexible and more drastic and administratively burdensome, would not be unprecedented. The ICA itself uses this approach in subjecting unit investment trusts, closed-end funds and business development companies to less regulation than to mutual funds.

The regulation of business development companies under the ICA is particularly instructive as to how Congress (and the SEC) might approach the regulation of hedge fund managers. Business development companies are, in effect, publicly sold private equity funds that operate pursuant to only a limited number of provisions under the ICA.[72] Like BDC regulation, the regulation of hedge fund managers should retain the ICA's core affiliated transaction prohibitions. Affiliated transactions present the greatest potential for self-dealing by management and often are not susceptible to easily

[72] *See* ICA §§ 54 – 65.

understood disclosure. The definition of an affiliated person, however, would have to be modified to accommodate some of the affiliations with portfolio companies that are common for hedge fund managers.

The most difficult accommodation probably would arise in connection with corporate governance, capital structure and fee regulation under the ICA. While exchange listing standards may provide an adequate substitute for independent oversight by an ICA-compliant board, they do not provide comparable protection against management exploitation of the separation of economic and voting interests. It is notable that the separation of economic interests and voting control is prohibited by the major exchanges, but not if the separation occurs prior to a firm's IPO. In the hedge fund manager context, there should be restrictions on management's control over major decisions, including especially decisions that entail a conflict of interest between management and shareholders. Such conflicts would include most obviously decisions regarding management compensation. In addition, although shareholder approval of all increases in executive compensation might be unworkable, such compensation should be subject to standardized disclosure comparable to that provided under the ICA. This would entail fee tables for both the compensation arrangements with respect to managed funds and executive compensation paid by the hedge fund manager to its executives.

Much of the remainder of the ICA's provisions could be addressed through prominent, targeted disclosure. Although some absolute limits on leverage may be appropriate, the risks presented by leverage could be substantially mitigated by standardized, quantitative disclosure. Such disclosure could show potential losses under relevant scenarios, such as the effect of rising interest rates or falling housing prices on a portfolio of subprime loans. Hedge fund managers that oversee a sufficiently diversified set of collective investment pools (or pools that are themselves registered under the ICA) might be entirely exempt from leverage restrictions, although the diversification test applied under the ICA would not be adequate for this purpose. Disclosure similarly could address the presentation of investment performance, such as by requiring the periodic disclosure of standardized investment returns net of fees.

As a general matter, however, the optimal approach to tailoring the requirements of the ICA to fit hedge fund managers should begin with hedge fund managers' views

regarding the aspects of the ICA that are inconsistent with their business models and the reasons that these provisions can be waived or modified consistent with the protection of investors. Hedge fund managers are in the best position to determine whether and to what extent their operations necessitate exemptive relief from the ICA. Just as the ICA itself was the product of a joint effort by regulators and industry,[73] the regulation of hedge fund managers should reflect the realities of industry as understood by the industry, as well as the necessity of effective investor protection.

VII. CONCLUSION

Hedge fund managers fit the definition of investment under the ICA and raise precisely the investment protection concerns that Congress intended the ICA was intended to address. They employ complex capital structures; invest in illiquid; difficult to value securities; use substantial leverage; concentrate their investments; engage in self-dealing transactions with affiliates; permit excessive compensation arrangements; and disenfranchise their shareholders. Nonetheless, the SEC has decided to permit the public offering of hedge fund managers without their regulation under any of the provisions of the ICA.

In the wake of Blackstone's IPO last month, at least two more hedge fund managers have filed registration statements and more are likely to do so in the near future. Congress should act promptly to ensure that publicly sold hedge fund managers are subject to appropriate regulation under the ICA. This can be accomplished by causing the SEC to recognize that these firms are investment companies under the ICA, which would require that they obtain exemptive relief from the agency before offering

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[73] *See* Matthew Fink, ICI President's Report at the 1999 General Membership Meeting (May 21, 1999) ("our industry supported the SEC in helping the Investment Company Act of 1940 become law. This spirit of integrity is captured in the words of an industry leader in the 1930s, Arthur Bunker, who testified before Congress. 'We recognize that abuses have existed and we believe that legislation is necessary to . . . help the better elements of the industry to raise the standards of the industry to increasingly higher levels.' Working together, SEC officials and industry representatives took snapshots of the industry. The law that resulted-the Investment Company Act of 1940-made the fund industry's best practices mandatory for all, and flatly prohibited the abuses of the 1920s. As a result, we have a regulatory system whose core protections-oversight by independent directors, bans on affiliated transactions, daily marking to market of assets, limits on leveraging, and full disclosure-are unparalleled in the financial services world.").

their shares to public investors. Alternatively, Congress could create a new category of investment company that was subject to limited regulation under the ICA.