REGULATING HEDGE FUND MANAGERS: THE INVESTMENT COMPANY ACT AS A REGULATORY SCREEN

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The Blackstone IPO signaled a new strategy of exploiting all of the advantages of a public offering while avoiding critical regulatory constraints. Hedge fund managers such as Blackstone are the functional equivalent of private investment companies in which only sophisticated investors are eligible to invest. Regulators have ignored this economic reality, however, in permitting hedge fund managers to evade all of the restrictions that Congress imposed on publicly offered investment pools. Hedge fund managers should be subject to the Investment Company Act, which uses a combination of statutory and regulatory exemptions as screens to ensure the optimal level of regulation for investment companies such as Blackstone. Internal inconsistencies in regulators’ positions and the operational needs of hedge fund managers make inevitable their ultimate regulation under the Act, which will in turn stimulate further liberalization of private offering rules to improve the practicability of raising capital in private markets.

INTRODUCTION

Hedge fund manager Blackstone Holdings’ $4.1 billion initial public offering in June was the largest IPO in five years, the sixth largest in U.S. history, and possibly the most controversial of all time.\(^1\) Blackstone’s top executive received $450 million in the IPO and wound up holding shares worth approximately $8 billion,\(^2\) which triggered a public outcry and

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\(^1\) See Kristen A. Lee, Blackstone IPO to Rank High, AUGUSTA CHRON., June 21, 2007, at C09; (“The size of the deal has been matched only by the controversy surrounding the offering.”); Blackstone Prices 133m Shares at $31, IPOHome, June 21, 2007 at http://www.ipohome.com/marketwatch/iponews2.asp?article=5962 (last visited Aug. 16, 2007). If one includes that $3 billion in units that Blackstone issued privately to a Chinese investment company in connection with the IPO, it would be the third largest in history, behind only the AT&T Wireless Group ($10.6 billion) and Kraft Foods ($8.7 billion). Biggest IPOs, IPOHome, at http://www.ipohome.com/marketwatch/biggestALL.asp (last visited Aug. 16, 2007).

\(^2\) See Marilyn Malva, Blackstone Up 13% As Investors Buy In To The Buyout Giant, INVESTOR’S BUS. DAILY, June 22, 2007 (describing payments received by CEO Stephen Schwarzman). Schwarzman also received a cash distribution at the end of 2006 of $398 million. See Registration Statement, The Blackstone Group, at 198 – 99 (June 21, 2007) (“Blackstone Registration Statement”) at
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Congressional hearings on the tax treatment of hedge fund managers’ compensation and – the subject of this article – their legal status under the Investment Company Act of 1940 (“ICA” or “Act”). Some critics, including this author, argued that Blackstone and similar hedge fund managers are investment companies that should be regulated under the Act. For the time being, however, Securities and Exchange Commission (“Commission” or “SEC”) has accepted the hedge fund industry’s position that hedge fund managers are not investment companies. The SEC’s position will continue to generate controversy as two major hedge fund managers have filed registration statements for billion-dollar IPOs since the Blackstone offering.

Leaving the taxation of hedge fund managers to other commentators, this article explains why hedge fund managers should be regulated under the Investment Company Act. Hedge fund managers fall squarely within the definition of “investment company” under the Act and raise precisely the concerns that Congress intended the Act to address. The Act is designed to address the heightened risks associated with the public offering of pools of securities. Hedge fund managers such as Blackstone are the functional equivalent of pools of securities. Their assets are comprised primarily of direct or indirect investments in the hedge funds they manage. Because of the heightened risks posed by unregulated investment pools, small investors are normally ineligible to invest in hedge funds. Hedge fund manager IPOs, however, offer small investors an opportunity to invest indirectly in the very hedge funds from which they are supposed to be excluded. In fact, hedge fund managers can be substantially riskier


2 See After Blackstone Hearing, supra (testimony of Mercer Bullard and Joseph Borg, President, North Am. Ass’n of Securities Administrators); Letter from Richard Trumcka, Treasurer, AFL-CIO, to John White, Director, Division of Corporation Finance, SEC and Andrew Donohue, Director Division of Investment Management, SEC (May 16, 2007); Steven Diamond, corplaw.blogspot.com (May 16, 2007).

3 See After Blackstone Hearing, supra note 3 (testimony of Andrew Donohue Director Division of Investment Management, SEC).


The financial media generally has promoted the perception that hedge fund managers provide access to hedge funds for retail investors. Joe Bel Bruno, Stakes High in IPO Game, S. FLA. SUN-SENTINEL, June 22, 2007, at 1D (“The IPO gives investors a rare chance to invest in private equity, which previously was restricted to billionaires looking for a place to park their cash. For most investors that get in on the IPO, it is giving exposure
The Regulation of Hedge Fund Managers

investments than their funds, which means that small investors are prevented from investing directly in hedge funds but are permitted to invest indirectly in riskier equivalents.

The debate regarding the legal status of hedge fund managers under the Investment Company Act turns on the characterization of the incentive payments that hedge fund managers receive. Hedge fund managers typically receive “carried interests” in the funds that they manage, which entitle the managers to receive part of the funds’ gains. For example, hedge fund managers often receive the right to 20 percent of the investment performance of a fund that exceeds a minimum performance floor, or “hurdle rate.”8 The critical issue for ICA purposes is whether these carried interests are “securities.” The definition of investment company depends primarily on the percentage of a company’s assets and income that are attributable to investments in securities, and counting a hedge fund manager’s carried interests as securities is likely to push the firm into the definition of investment company. Notwithstanding that a carried interest is essentially an investment in a hedge fund, the SEC has accepted hedge fund managers’ arguments that carried interests are not securities, and that the managers therefore are not investment companies. To the contrary, as discussed in Part I, carried interests are clearly securities under the Act.

As discussed in Part II, treating hedge fund managers as investment companies would serve the purposes of the Investment Company Act. Congress designed the Act to address the particular abuses associated with companies comprised of liquid pools of securities, including disadvantageous transactions with affiliates, extreme leveraging, excessive fees, inordinately complex capital structures, unfairly differential treatment of shareholders, and inflated valuations.9 While the Act’s restrictions were considered unnecessary for sophisticated investors, they were considered essential for unsophisticated investors. Hedge fund managers – the functional equivalent of hedge funds – routinely engage in precisely the practices that the Act prohibits or substantially restricts.10

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8 Implications of Hedge Fund Growth, Division of Investment Management, SEC, at 61 – 63 (September 2003). Hedge fund managers often also receive a payment equal to 2 percent of the fund’s assets, id., and this payment combined with the carried0020interests is often referred to as the “2 and 20.” See, e.g., Jeffrey Birnbaum and Lori Montgomery, Democrats Target Millionaires’ Tax Break, FT. WORTH STAR-TELEGRAM, Aug. 5, 2007, at F8.

9 See supra Part II.

10 See id.
This does not mean that regulation under the Act would prevent the public offering of hedge fund managers, however, because Congress also anticipated the need for flexibility by granting the SEC broad authority to exempt companies from some or all of the provisions of the Act. As discussed in Part III, the popular view that regulation under the Act signals the death knell for an operating company misunderstands the SEC’s long history of extraordinary flexibility in granting individually tailored and industry-wide exemptions to firms that fall under the Act’s purview. Microsoft, Enron and Yahoo! obtained exemptions from the ICA; it should not be surprising that hedge fund managers need them as well. If hedge funds managers were regulated under the Act, the SEC undoubtedly would grant them broad exemptive relief from the Act that was consistent with both the Act’s purpose and structure and the practical business needs of hedge fund managers.

As discussed in Part IV, some regulatory reforms to address hedge fund manager IPOs are inevitable, and the Investment Company Act would provide the most efficient for accomplishing them. The most significant concern raised by hedge fund managers’ IPOs is their adoption of governance practices that fall below the minimum standards applicable to publicly traded U.S. firms. Hedge fund managers rely on exemptions granted by national exchanges to partnerships from key governance requirements – such as the requirement for a majority of independent directors. These partnership exemptions are based on the conception of a partnership as a participatory form of business organization, which is both archaic and inconsistent with the practices of hedge fund managers such as Blackstone. Hedge fund managers have essentially cut their shareholders out of any participatory role in the governance of the firm, and the trading of their units on a national exchange makes a mockery of the exchanges’ governance rules. Adding insult to injury, hedge fund managers have availed themselves of Delaware laws that permit managers to absolve themselves from liability for violations of their fiduciary duties. Although neither the SEC nor the exchanges have acknowledged the double governance-standard for publicly traded partnerships, it is likely that members of Congress who already have hedge fund managers in their sights will not allow regulators to slide this issue under the rug.

Two considerations suggest that hedge fund manager IPOs will result in more than changes to exchange governance rules. First, the SEC inevitably will have to revisit its position on hedge fund managers’ status under the Investment Company Act. The line that the SEC has drawn between a hedge fund manager’s direct investments in its funds, which the SEC counts as securities under the ICA, and carried interests in its funds, which do not count as ICA securities, is inherently arbitrary and unsustainable. Hedge
fund managers with less exposure to their funds than Blackstone has to its funds may nonetheless fall under the ICA simply because they hold units in a fund rather than carried interests. Such hedge fund managers will not accept being arbitrarily singled out for heightened regulation. Another stimulus for the SEC may be the eventual collapse of a publicly traded hedge fund manager attended by substantial losses incurred by its small investors, which will generate political pressure on the SEC to reconsider its decision to permit such investors to buy shares in unregulated hedge fund managers. By avoiding the reality that carried interests must be counted as securities in at least some circumstances, the SEC has simply delayed a final reckoning on this issue. The SEC ultimately will have to treat some hedge fund managers as investment companies and work through appropriate exemptive relief for them from the ICA. It would be more efficient to craft such relief in the current environment rather than waiting until forced to do so under the distorting influence of political exigencies.

The second consideration that makes reform likely is that the issue of hedge fund managers’ status under the Investment Company Act will create more incentives to facilitate the development of markets for unregistered securities. The ICA-status issue exists only because hedge fund managers seek to raise capital in the public markets, and this need arises in part because of the perceived inadequacies of markets for privately sold securities. If hedge fund managers, or any issuer for that matter, could issue securities on a highly liquid exchange for private offerings, many would do so, thereby avoiding regulatory issues that arise as a result of small investors’ access to public markets.11 Blackstone raised most of its proceeds from institutional investors,12 which means that the private markets would have provided sufficient capital (if not liquidity) to meet its needs, and its most direct competitor may be switching from a public to a private offering.13 A vibrant secondary market for unregistered Rule 144A debt securities already exists,14 and securities firms have recently announced plans to sponsor formal markets for private securities.15 Further

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11 In fact, Oaktree Capital Management LLC, a hedge fund manager, took this route in May 2007 when it used a private market operated by Goldman Sachs to sell shares, see Emma Trinca, The Best Way to Go Public is Private, HEDGEWORLD NEWS, July 27, 2007 (also discussing pros and cons of public and private offerings for hedge fund managers), and buyout firm Apollo Management plans to follow suit. See Ben White, Discount on Apollo Unregistered Share Issue Reflects Market Strife, FINANCIAL TIMES USA, July 25, 2007, at 15 (also partly attributing discount on Apollo shares to Blackstone shares to limited liquidity).

12 See Some Question Blackstone, supra note 7 (“Nearly all the shares sold in the Blackstone IPO were expected to go to institutional investors and the occasional well-connected individuals.”).

13 See The Best Way to Go Public is Private, supra note 11.


15 Anuj Gangahar, Wall Street Banks Create Private Placement Markets, FINANCIAL TIMES USA, Aug. 15,
regulatory reform is needed, however, to enable the optimal development of such markets, and the problems raised by hedge fund manager IPOs will increase pressure on regulators to accelerate initiatives in this direction. Thus, hedge fund manager IPOs raise important issues regarding their status under the Investment Company Act as well as broader considerations regarding the regulation of securities offerings in the United States.

This article is organized as follows:

I. The Legal Status of Hedge Fund Managers under the Investment Company Act
   A. Carried Interests
   B. General Partnership Interests as Securities
II. The Structure and Purpose of the Investment Company Act
III. The Investment Company Act as a Regulatory Screen
IV. Predictions and Proposals for Hedge Fund Manager Regulation
   A. Amendments to Exchange Rules
   B. Regulation of Hedge Fund Managers as Investment Companies
   C. Development of Private Markets
V. Conclusion

I. THE LEGAL STATUS OF HEDGE FUND MANAGERS UNDER THE INVESTMENT COMPANY ACT

Regulation under the Investment Company Act generally is triggered when a firm satisfies one of the Act’s definitions of “investment company.”16 Two of the Act’s definitions of investment company are relevant to hedge fund managers,17 and hedge fund managers such as Blackstone satisfy 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.”18 Hedge fund managers hold themselves out as asset managers, not investment

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17 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.” 15 U.S.C. § 80a-3(a)(1)(B). Hedge fund managers do not issue face-amount certificates.

companies,\textsuperscript{19} which leaves the inquiry under this definition as to whether – notwithstanding how they hold themselves out – hedge fund managers 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 value exceeding 40 percent of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.”\textsuperscript{20} An issuer is excluded from the second definition if it is “primarily engaged . . . in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.”\textsuperscript{21}

Hedge fund managers generally have claimed not to be investment companies because they are primarily engaged in a business other than investing in or holding securities.\textsuperscript{22} Two also have claimed that they are not investment companies because their only assets are general partnership interests.\textsuperscript{23} One claims not to be an investment company under rule 3a-1 under the ICA,\textsuperscript{24} which generally excludes a company from the second definition of investment company if no more than 45 percent of its assets consists of, and no more than 45 percent of its net income after taxes is derived from securities.\textsuperscript{25} As discussed in Part A immediately below, each of these positions ultimately turns on whether and to what extent carried interests are treated as securities for purposes of the definition of investment company. Part B discusses separately the significance of the use of a general partnership structure under the Investment Company Act.

\textsuperscript{19} See, e.g., Blackstone Registration Statement, supra note 2, at 60 (“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.”).
\textsuperscript{21} 15 U.S.C. § 80a-3(b)(1).
\textsuperscript{22} See KKR Registration Statement, supra note 6, at 48; Och-Ziff Registration Statement, supra note xx, at 49; Blackstone Registration Statement, supra note 6, at 60; Registration Statement, Fortress Investment Group LLC, at 48 (“Fortress Registration Statement”) (Feb. 8, 2007) at http://www.sec.gov/Archives/edgar/data/1380393/000095013607000793/file1.htm
\textsuperscript{23} See KKR Registration Statement, supra note 6, at 47 (“because we believe that the capital interests of the general partners of our funds in their respective funds are neither securities nor investment securities, we believe that less than 40% of our partnership's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis after this offering will be comprised of assets that could be considered investment securities.”); Blackstone Registration Statement, supra note 2, at 60 (“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.”).
\textsuperscript{24} See Fortress Registration Statement, supra note 22, at 48.
\textsuperscript{25} See 17 C.F.R. § 270.3a-1.
A. Carried Interests

Hedge fund managers are commonly compensated through a flat percentage of assets and carried interests. The term “carried interest” generally refers to a hedge fund manager’s right to part of the gains and income received from a fund. The status of carried interests is important to the status of hedge fund managers under the ICA because a large part of a hedge fund manager’s assets and income may be attributable to carried interests, and the nature of a company’s assets and income is the dominant factor in determining whether a company is in the business of investing. As noted supra, the first definition of investment company turns on whether a company is primarily engaged in the business of investing, and the second turns on whether 40 percent of more of a company’s assets are securities and whether it is primarily engaged in a non-investment business.

The SEC has long analyzed whether a company is primarily engaged in the business of investing (or some other business) based on the following factors, with primary emphasis on the last two: (1) the company’s historical development; (2) its public representations of policy; 3) the activities of its officers and directors; 4) the nature of its present assets; and 5) the sources of its present income. Blackstone’s and similar hedge fund managers’ assets, income, activities and history all squarely favor finding that they are primarily engaged in the business of investing. Their assets and income are primarily attributable to investments and carried interests, they describe their personnel as being essentially exclusively engaged in maximizing the value of their investments and carried interests, and they typically have exhibited these characteristics throughout their history. The only factor what weighs against finding that hedge fund managers are investment companies is their public protestations that they are primarily engaged in managing their clients’ money.

This analysis assumes that carried interests are securities. Hedge fund managers’ investments alone may not be sizeable enough to establish either that they are primarily engaged in the investing business or that 40 percent

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26 See Carried Interest I Hearing, supra note 3 (testimony of Peter Orszag, Director, Office of Management and Budget). A manager of a registered investment company is prohibited from collecting a carried interest. See supra note 74 and accompanying text.


28 See Fifth Avenue Coach, 289 F. Supp. at 27-28 (company may “find itself a given point in time to actually engaged primarily in this [investing] business, even though it originally did not intend to be so engaged.”)
of their assets are investment securities. For example, Blackstone’s registration statement shows only 30 percent of its $17.2 billion in assets are securities,\(^{29}\) and only 14 percent of its income was attributable to income from investment gains.\(^{30}\) Adding Blackstone’s carried interests tips the balance. Carried interests accounted for 24 percent of Blackstone’s assets\(^ {31}\) and 44 percent of its income,\(^ {32}\) bringing total assets and income attributable to securities to 54 and 59 percent, respectively.\(^ {33}\) If carried interests are

\(^{29}\) As of March 31, 2007, Blackstone held $17.2 billion in assets, of which $5.2 billion (30 percent) were categorized as “Investment, at Fair Value.” Blackstone Registration Statement, supra note 2, at 89. The category of Investment, at Fair Value includes investments in Blackstone’s funds and co-investments in the funds’ portfolio companies. Id. at 181. Blackstone “make[s] significant investments in the funds [it] manage[s].” Id. at 108. The precise amount of assets that qualify as securities is uncertain. The SEC staff testified that it received confidential information from Blackstone regarding the nature of the firm’s assets that was “critical to its determination” that Blackstone was not investment company. After Blackstone Hearing, supra note 3 (testimony of Andrew Donahue, Director, Division of Investment Management, SEC). It is unclear why, if the SEC staff considered the information it received regarding the makeup of Blackstone’s assets to be “critical” to its determination that the firm was not an investment company, the staff did not require disclosure of that information in Blackstone’s registration statement.

\(^{30}\) In 2006, Blackstone’s total income was $2.7 billion in revenues, of which $385 million (14 percent) were “Net Gains from Investment Activities.” Blackstone Registration Statement, supra note 2, at 95. 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.” 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.

\(^{31}\) As of March 31, 2007, Blackstone held $17.2 billion in assets, of which $4.1 billion (24 percent) were categorized as “Other Intangible Assets.” Blackstone Registration Statement, supra note 2, at 89. The category of Other Intangible Assets substantially comprises carried interests. Id. at 91 (“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.”).

\(^{32}\) In 2006, Blackstone’s total income was $2.7 billion in revenues, of which $1.2 billion (44 percent) were “Net Gains from Investment Activities.” Blackstone Registration Statement, supra note 2, at 95.

\(^{33}\) In the first quarter of 2007, Blackstone received $1.3 billion in income, of which 68 percent comprised the combination of $653 million in Performance Fees and Allocations and $228 million in Net Gains from Investment Activities. Id. at 96. Blackstone concedes that its “ability to generate carried interest is an important element of [its] business and carried interest has historically accounted for a very significant portion of [its] income.” Id. at 180. 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, id. at 95, which represents 41 percent of its total income. The fact that Blackstone is also engaged in the asset management business, however, does not change the fact that it is “primarily” engaged in the business of investing, as indicated by the predominance of investing in its assets and income.

The foregoing asset analysis is analysis is quite conservative 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. 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.) The Deferred Tax Asset therefore does not reflect any business activity apart from the 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). Id. at 90 - 91. (Blackstone’s “allocation [between intangible
treated as securities, then Blackstone is an investment company: (1) under the first definition of investment company because a majority of its assets and income are derived from its investing business, and (2) under second definition because more than 40 percent of its assets are investment securities and it is not primarily engaged in a noninvesting business (it is primarily engaged in the investing business under the first definition).34

Thus, whether carried interests qualify as securities, the gains and income from which therefore would be deemed to derive from the business of investing, is the central issue in evaluating whether hedge fund managers such as Blackstone are investment companies. One reason that carried interests are securities is that they fit within the ICA’s definition of security.35 The term “security” is defined to include an “investment contract,”36 which is an investment of money in a common enterprise with the reasonable expectation of profits solely from the efforts of others.37 When an investor buys shares of a hedge fund manager, to the extent to which the purchase price reflects the value of carried interests the investor has: (1) paid 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 the hedge fund manager and the management of the companies. The ownership of a carried interest is functionally no different from the ownership of shares in a mutual fund that entitled the holder to part of the fund’s future capital gains and income. The success of an entity that invested in such mutual fund carried interests would depend solely on the efforts of the fund’s board of directors, its fund manager, and the management of the companies in which the fund invests, but that would not convert the entity from an investment company to an asset manager.

Another reason that carried interests are securities is that they are the functional equivalent of options, which are, like investment contracts,

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.) Goodwill therefore 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-percent test in the second definition of investment company). Thus, the 37 percent 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 percent, which shows that it is engaged almost exclusively in the business of investing.

34 The level of Blackstone’s assets and net income after taxes appear to exceed the 45 percent minimums necessary for it to rely on Rule 3a-1. See supra note 25 and accompanying text.


36 Id.

expressly included in the definition of “security.” Their equivalence is best illustrated by comparing an option to a carried interest that entitled its holder to receive a 20 percent of the value of a security or portfolio that represents an annualized investment return in excess of a 10 percent return (the hurdle rate), after a specified period (hereinafter, a “20/10 carried interest”). For example, if a portfolio that was worth $386 million at its inception had an annual return of 10 percent, it would be worth $1 billion at the end of ten years. At that point, the holder of a 20/10 carried interest would be entitled to 20 percent of the value of the fund in excess of $1 billion (which would equal zero). If the portfolio grew at an annual rate of 20 percent, it would be worth approximately $2.4 billion after ten years, and the carried interest holder would receive $280 million (($2.4 billion - $1 billion) * 0.2).

A 20/10 carried interest is the functional equivalent of an option to purchase 20 percent of a security or pool of securities (“call option” or “call”) at a strike price equal to 20 percent of the fund’s ending value assuming a 10 percent return. Using the foregoing example, the option holder would be entitled to purchase 20 percent of the fund for $200 million after ten years. If the fund’s annual return were 10 percent or less, the option would be worthless. If the fund’s annual return were 20 percent, the option holder would purchase 20 percent of the $2.4 billion for $200 million (0.2 * $2.4 billion) - $200 million), leaving the holder with the same $280 million profit received by the owner of a 20/10 carried interest.

A call and a carried interest are equivalent not only at the end of a fund’s life, but also during its life. For example, if one person held a 20/10 call on the fund, another person held a 20/10 carried interest on the fund, and each transferred his call/carried interest to separate public traded partnerships (PTPs) at the end of the fund’s fifth year, the PTPs 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. For example, if the fund’s return were 10 percent in each of its remaining five years (rather than the 20 percent assumed above), its ending value would be $1.5 billion, and the liquidation value of each PTP would equal approximately $100 million (call: (0.2 * $1.5 billion) - $200 million; carried interest: ($1.5 billion – $1 billion) * 0.2).

That carried interests are the functional equivalent of options is widely accepted. Virtually every witness in hearings before the Senate Finance

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39 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.
Committee characterized carried interests as the functional equivalent of options, including representatives of the hedge fund industry. 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...” 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. Professor Coffee disagrees, arguing that analogizing carried interests to options:

proves too much. If it is valid, every parent corporation holds a call option on its subsidiary, and its actively managed subsidiary would thus become an investment security. At this point the ICA applies to everything.

In fact, this is precisely the effect of the definition of investment company, and to avoid its being triggered in the circumstance that Professor Coffee describes Congress specifically excluded “securities issued by majority-owned subsidiaries of the owner” from the definition of “investment security.” Nonetheless, Professor Coffee’s concern that the definition of investment company applies to a wide range of entities is a fair one, but, as discussed in Part III infra, Congress made the ICA flexible enough to avoid unintended results of the broad reach of the Act.

The leveraged nature of carried interests further distinguishes them from compensation for asset management services. For example, the economic characteristics of a 1 percent asset-based fee are dramatically different from those of a carried interest. The 1 percent asset-based fee rises and falls not only with the value of the managed portfolio, but also with the value of assets under management. In other words, a 10 percent decline in the value of a portfolio that is accompanied by a 10 percent increase in assets under management (i.e., new money from investors) will leave asset-based fee revenues unchanged. In contrast, a 10 percent 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. A carried interest on new assets under management has no value unless and until the portfolio’s

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40 See Carried Interest I Hearing, supra note 3; Carried Interest II Hearing, supra note 3.

41 Registration Statement, The Blackstone Group, at 84 (May 1, 2007).

42 After Blackstone Hearings, supra note 3 (testimony of John Coffee, Adolph A Berle Professor of Law, Columbia University School of Law).

performance exceeds the hurdle rate.

The leveraged nature of the carried interest arises from its heightened sensitivity to changes in the performance of the fund. A 10 percent decline in a fund’s value causes a 10 percent decline in an asset-based fee, whereas the effect of such a decline on the carried interest can range from zero to many multiples of the 10 percent decline in the fund’s value. To illustrate, consider a hedge fund with $1 billion in assets at its inception that pays its manager a 1 percent asset-based fee and 20/10 carried interest.\textsuperscript{44} 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; the receipt of $100 million in new assets would have no effect on its value because the fund’s performance would not have exceeded the hurdle rate. 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 percent 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 percent – 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 percent 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 percent 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 geometrically. 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 would increase in value from $20 million to $60 million (20\% \times ($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

\textsuperscript{44} For simplicity, these illustrations assume that the carried interest is not valued taking into account the likelihood that the fund’s future 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.
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. Carried interests present substantial downside risk.

When public investors purchase units of a hedge fund manager that owns substantial 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 percent annually), would produce an expected liquidation value of $100 million at the end of the third year. If the investors paid $100 million for the carried interests at the end of the second year, they would incur a $100 million (100 percent) 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 amount. The “clawback” to which

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45 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 percent return.

46 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 percent 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 percent 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 percent 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 million 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 percent loss, in comparison with the 100 percent loss on the purchase of the carried interest.
carried interests are subject is the fulcrum that creates the leverage that renders carried interests wholly alien to conventional notions of compensation.

The argument that a carried interest is not a security, but compensation for services, fails under close scrutiny.\textsuperscript{47} Although the hedge fund manager may view a carried interest as compensation for asset-management services,\textsuperscript{48} this perspective in applicable to an investor in the hedge fund manager. The investor pays money and in return receives a right to the capital gains and income of one or more funds managed by the hedge fund manager. That these gains and income depend, in part, on the efforts of the hedge fund management does not change the fact that, to the investor, the carried interest satisfies all of the criteria of an investment contract. The purchaser of a carried interest owns an interest in a portfolio, not an interest in future compensation received by the hedge fund manager. Indeed, if carried interests were compensation there would be no investment companies. When an investor purchases shares of a mutual fund, the investor acquires a right to future capital gains and income from the fund’s portfolio that depend on the efforts of fund management. If reliance on the efforts of fund management converted an investment in a mutual fund into an investment in an asset-management business, then there would be no such thing as an investment company, because every investment company could converted to an asset-management firm on the same basis.

Professor Coffee argued that carried interests more closely resemble compensation than an investment in the hedge fund manager’s funds because:

\begin{quote}
[t]he investors in the hedge fund manager share the ‘upside’ with the investors in the hedge fund, but not the ‘downside’; that is, the investors in the hedge fund can lose
\end{quote}

\textsuperscript{47} See After Blackstone Hearing, supra note xx (testimony of Andrew Donohue, Director, Division of Investment Management, SEC, and John Coffee, Adolph A. Berle Professor of Law, Columbia University School of Law).

\textsuperscript{48} In addition, the hedge fund manager’s investment of labor rather than money does not necessarily preclude a carried interest from being an investment contract. See Internat’l Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 560 n.12 (1979) (“This is not to say that a person’s ‘investment,’ in order to meet the definition of an investment contract, must take the form of cash only, rather than of goods and services.” (citing United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 n.16 (1975))). The courts have not clearly resolved the question of whether an investment of labor, rather than of money, in return for an ownership interest in an enterprise could be an investment contract. See generally Robert Anderson IV, Employee Incentives and the Federal Securities Laws, 57 U. MIAMI L. REV. 1195 (2003). In Daniel, the Court found that interests in a noncontributory, compulsory pension plan were not securities primarily because the interests were “a relatively insignificant part of an employee's total and indivisible compensation package,” and there was no “investment by the employee.” 439 U.S. at 560 – 61. In contrast, carried interests are a significant component of a hedge fund manager’s compensation and investment gains are its executives’ primary motivation for their investment of labor. In contrast, an asset-based fee rewards not investment gains so much as asset-gathering efforts.
their capital, but the investors in the hedge fund managers will simply not receive their share of the non-existent profits from that fund (but may still profit from their share in other funds). 49

Again, this analysis confuses the perspective of the hedge fund manager with the perspective of the investors in the hedge fund manager. Although a carried interest might not be considered to present a downside risk for the hedge fund manager who has not paid money for it (the manager who lost the value of his services might disagree), 50 a carried interest has significant downside potential for one who purchases it and assumes the risk of loss of his entire investment. The illustration provided above provides a concrete example of downside risk in the form of a complete loss of a $100 million investment. 51 Investors in Blackstone similarly could lose almost the entire value of their investment if the firms’ hedge funds collapsed. Although this is unlikely in light of Blackstone’s highly diversified set of client funds, the hedge fund industry has many hedge fund managers with only a small number of funds the collapse of which would bring down the manager with them. 52 As discussed above, carried interests, like options, present heightened downside risk because their downside is leveraged to the performance of the relevant fund.

There is nothing new about the status of carried interests as securities, as the SEC has long considered the right to receive payments on cash flows on financial assets, known as asset-backed securities, to be securities for purposes of the definition of investment company. In 1992, the SEC adopted rule 3a-7 under the ICA, which specifically excludes certain asset-backed securities from the definition of investment company. 53 The SEC believed that Rule 3a-7 was necessary to prevent asset-backed securities from triggering regulation under the ICA because “[m]ost, if not all,

49 See After Blackstone Hearing, supra note 3 (testimony of John Coffee, Adolph A. Berle Professor of Law, Columbia University School of Law).

50 As an economic matter, however, a carried interest presents downside risk in the form of the opportunity cost of expending one’s labor in return for carried interests that may be worth nothing. See Carried Interests I Hearing, supra note 3, (testimony of Kate Mitchell, Managing Director, Scale Venture Partners, stating that carried interests present “downside” risk). See also supra note 48 (discussing whether an investment of labor satisfies the definition of investment contract).

51 See supra text accompanying notes 45 – 46.

52 The collapse of Long-Term Capital Management, for example, brought down its manager as well and resulted in some of its executives declaring bankruptcy. See generally Roger Lowenstein, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000).

structured financings meet the definition of investment company under section 3(a) of the [ICA], because they both issue securities and are primarily engaged in investing in, owning, or holding securities. . . . In the context of the [ICA], the financial instruments held by the issuers in structured financings generally have been considered to be securities.54 Rule 3a-7 accordingly exempts asset-based securities from the definition of investment company provided that the securities are fixed income securities or they entitle their holders to the cash flow from eligible assets, provided that the securities are not redeemable and they are highly rated by nationally recognized statistical rating organization.55

The essential characteristics of carried interests are indistinguishable from asset-backed securities. A carried interest represents a right to receive the cash flows in accordance with the particular terms of the instrument. If a hedge fund manager were to package and sell the carried interests for a particular client fund, the package would constitute precisely the kind of asset-backed securities for which the SEC determined an exemptive rule was necessary to avoid regulation under the ICA. The issuer of interests such packages of carried interests would be an investment company unless it qualified under rule 3a-7, as would an investment fund that invested only in interests of such an issuer. Both the issuer and the fund would be the functional equivalent of a fixed income fund that held a portfolio of financial instruments the income stream on which depended on fluctuations in the value of the funds to which the carried interests were tied. If carried interests were not securities, rule 3a-7 would be unnecessary.

B. General Partnership Interests as Securities

As noted supra, an alternative basis on which hedge fund managers have claimed to be excluded from the definition of investment company is the theory that their general partnership interests are not securities for purposes of the definition.56 The two hedge fund managers that have made this claim are structured as publicly traded limited partnerships whose only material assets are general partnership interests.57 This position presumably relies on the general presumption that a general partnership interest is not an investment contract.58 If the presumption holds, the hedge fund managers

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55 See 17 C.F.R. § 270.3a-7.

56 See supra note 23 and accompanying text.

57 See id.

58 See Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981).
therefore could not be considered to be in the business of investing or to hold securities with a value in excess of 40 percent of the manager’s total assets. The general partnership presumption argument cannot be sustained on a number of grounds.

First, there is no economic reality to the general partnership interest. 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.” In the case of the two hedge fund managers, however, the economic reality is that its public investors will have no influence, no access to information, and no protection against dependence on management. For example, although investors in Blackstone have own 100 percent of the economic interests in the firm, they have no effective control. A separate entity controlled exclusively by Blackstone management acts as the sole general partner of Blackstone, and the public investors have no ability to remove the general partner. With respect to the limited matters on which Blackstone investors are entitled to vote, the public investors hold only a tiny minority interest. The investor influence, access and protection on which the general partnership presumption is based are wholly absent vis à vis Blackstone.

Second, the application of the general partnership presumption in this context would render meaningless the definition of investment company. If the general partnership presumption applied to hedge fund managers, virtually any investment company could evade regulation under the ICA simply by holding interests in the company 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

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Tucker, 645 F.2d at 422.

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.”)

Blackstone operates through a series of subsidiaries of which it is the 100 percent owner and general partner. See Blackstone Registration Statement, supra note xx, at 16. The subsidiaries are 22 percent owners of the various entities that directly manage Blackstone’s client funds. Id.

Tucker, 645 F.2d at 422 – 23 (“If, for example, the partner has irrevocably delegated his powers, or is incapable of exercising them, or is so dependent on the particular expertise of the promoter or manager that he has no reasonable alternative to reliance on that person, then his partnership powers may be inadequate to protect him from the dependence on others which is implicit in an investment contract. Thus, a general partnership in which some agreement among the partners places the controlling power in the hands of certain managing partners may be an investment contract with respect to the other partners.”). Blackstone’s governance structure is not unheard of and may even be considered common among real estate partnerships, for example. A broad analysis of the general partnership presumption under the definition of investment company is beyond the scope of this analysis except to note the following analysis would apply equally to such entities to the extent that their assets – after passing through the general partnership veil – are securities.
traditional investment company 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 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 percent 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 investment company 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.

Third, Congress anticipated and prohibited the use of structures such as Blackstone’s to evade regulation under the ICA. Section 48(a) of the Act forbids any person, “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 hedge fund managers’ general partnership presumption argument would permit them to use an “other person” (the general partnership) to accomplish indirectly what they would be prohibited from doing directly. 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 facts and circumstances of the entity’s assets, income, activities, historical operations and public representations – the same functional analysis long applied to evaluate the true nature of the business to which investors are committing their funds. This analysis, as applied in Part A *supra*, demonstrates that Blackstone is an investment company.

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64 See *supra* note 60.
II. THE STRUCTURE AND PURPOSE OF THE INVESTMENT COMPANY ACT

The conclusion that hedge fund managers are investment companies is consistent with the structure and purpose of the ICA. Congress designed the ICA “to prevent abuses which may grow out of the unregulated power of management to use large pools of cash,”65 and hedge fund managers such as Blackstone are precisely the kinds of large pools of cash that Congress had in mind. Hedge fund managers’ operations trigger virtually all of the concerns that provided the ICA’s impetus: extreme leverage, unfairly 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 interests in an 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.

The practices and structure of hedge fund managers provide a veritable roadmap of the abuses that the ICA is designed to address. For example, 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.66 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.67 Blackstone management retained control over the general partner and effective control over all other decisions by reason of its ownership of 86 percent of the voting units in Blackstone Holdings.68 The units sold to the China investment company have no voting rights on any
matter and were purchased at a 5 percent discount to the public offering price. The shares sold in the IPO have voting rights, but they are very limited.

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. Blackstone conceded that employee compensation “will increase prospectively” after the IPO and public investors would 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 federal securities laws strictly prohibit. 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 Investment Advisers Act of 1940 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

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69 See id. at 4.


71 See Blackstone Registration Statement, supra note 2, 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.

72 Id. at 108.


74 See 15 U.S.C. §§ 80a-17 (generally prohibiting or restricting transactions with affiliates) & 10(f) (restricting purchases of securities in an underwriting in which an affiliate is a member).
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.\textsuperscript{75} Hedge fund managers engage in such potentially abusive transactions as a matter of standard practice.\textsuperscript{76} For example, Blackstone receives “monitoring” and “disposition” fees from portfolio companies\textsuperscript{77} 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.\textsuperscript{78} Such co-investments 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,\textsuperscript{79} 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.\textsuperscript{80} As discussed above, carried interests create leverage with respect to

\textsuperscript{75} See Protecting Investors, supra note 54, at 474 - 75.

\textsuperscript{76} See, e.g., John Hechinger, Hedge Funds’ Gift Grabs, WALL ST. J., June 28, 2007, at C3 (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]”).

\textsuperscript{77} Blackstone Registration Statement, supra note 2, at 180. Blackstone also receives transaction fees on fund acquisitions, id., that may be paid by the portfolio companies.

\textsuperscript{78} Id. at 181.


\textsuperscript{80} See Blackstone Registration Statement, supra note xx, at 11.
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. 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. This prevents funds from holding substantial amounts of illiquid securities, which are particularly difficult to value because their price can change dramatically in response to market conditions. In contrast, hedge funds may hold substantial amounts of hard-to-value illiquid securities that in times of market stress can only be sold at fire-sale prices. A number of hedge funds recently suspended redemptions because they were unable to value their illiquid fixed income holdings. Pricing risk is further exacerbated for hedge funds that use leverage because leverage has the effect of multiplying small pricing errors. These factors played a significant role in the collapse

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83 The SEC has informally required mutual funds to limit illiquid securities to no more than 15 percent of their assets. See Implications of Growth of Hedge Funds, supra note 8, at n.333.

84 See generally Lessons of Long-Term Capital Management, supra note 81, at 12. (“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).

85 See, e.g., Ron Scherer, U.S. Debt Jolts World Markets, CHRISTIAN SCI MONITOR, Aug. 17, 2007, at 1 (describing suspension of redemptions in three Paribas funds that were unable to value their holdings).

86 See Lessons of Long-Term Capital Management, supra note 81, 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, WAT ST. J. June 26, 2007, at A1 (“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.”).
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.87

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.88 Its valuation approach thereby raises precisely the risks that the 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,89 whereas Blackstone management has complete discretion in the pricing of its securities.90 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,91 and the law of averages dictates that there will be publicly offered hedge fund managers who will do the same.92

87 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.”).

88 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 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, supra note 2, at 113; see also id. at 138 - 140.

89 See 15 U.S.C. § 80a-2(a)(41) (requiring board oversight of fair value pricing); 17 C.F.R. § 270.12(b)(1) (one of many exemptive rules requiring a majority of independent directors).

90 Blackstone Registration Statement, supra note 2, 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 percent 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.”).

91 See Implications of Growth of Hedge Funds, supra note 8, at n. 257 (citing cases).

92 See Smoothing May Explain Bears? HEDGE FUND DAILY, July 6, 2007 (citing study finding that 30 percent
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 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,93 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 failure of two Bear Stearns hedge funds illustrate this risk.94 If Bear Stearns’ only business had been managing those hedge funds, its shareholders 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

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93 See Lessons of Long-Term Capital Management, supra note 81, at A-4 (finding that fewer than three-fifths of sample of 397 hedge funds existing in 1994 survived to the end of 1998); Editorial Staff, Large Hedge Fund Collapse Possible: Moody’s, MONEY MGMT EXEC., Aug. 17, 2007 (citing Moody’s vice chairman statement that there was a 50 percent chance that a hedge fund the size of Long-Term Capital Management would collapse within the next six months) at http://www.mmexecutive.com/members/detail.cfm?articleId=13972.

offering without obtaining an exemption, the SEC has issued a free pass to all hedge fund managers, regardless of their level of risk.\textsuperscript{95} 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.

III. THE INVESTMENT COMPANY ACT AS A REGULATORY SCREEN

To some, the threat of small investors losing their life savings in a failed hedge fund manager pales in comparison to the threat of financial paralysis brought on by the application of the ICA. Practitioners and academics alike routinely warn managers that triggering investment company status is functionally equivalent to walking the plank.\textsuperscript{96} In its testimony on Blackstone’s status under the ICA, the SEC reinforced the impression that hedge fund managers could not enter the world of ICA regulation and emerge alive.\textsuperscript{97} Admittedly, when applied in full the ICA imposes an extremely intrusive, pervasive set of rules that probably finds no peer in the universe of broad federal regulatory schemes. In fact, the ICA is an extraordinarily flexible regulatory scheme that is ideally suited to address the concerns raised by hedge fund managers.

Much of the opposition to treating hedge fund managers as investment companies may derive from a misunderstanding of the hospitality of investment company regulation. Congress structured the ICA to facilitate the accommodation of a wide variety of companies through complete or partial exemptive relief from its provisions. Under its statutory authority, the SEC has issued thousands of individual exemptive orders and promulgated dozens of rules that exempt companies and practices from all or part of the ICA. A company’s falling within the definition of investment company only begins a multi-staged process of determining which, if any, ICA provisions will be taken off the shelf and applied to it. In practice, the ICA operates more as a screening process for companies that share some of the core characteristics of investment companies, than as the one-size-fits-

\textsuperscript{95} 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 percent of the value of its total assets excluding government securities and cash. On this basis, Blackstone’s securities represent only 34 percent of its assets.

\textsuperscript{96} See, e.g., After Blackstone Hearing, supra note 3, (testimony of John Coffee, Adolph A Berle Professor of Law, Columbia University School of Law); Kerr, The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act, 12 Stan. L. Rev. 29, 30 - 31 (1959) (the ICA “bows to none in the details of its regulation”).

\textsuperscript{97} See After Blackstone Hearing, supra note 3, (testimony of Andrew Donohue, Director, Division of Investment Management, SEC).
Regulation under the ICA is a multi-step process that typically only begins with a company’s triggering the definition of investment company. As often as not, entities that fall squarely within that definition are substantially or entirely removed from the ICA’s coverage by other ICA provisions or rules thereunder. A company that falls within the second definition of investment company because more than 40 percent of assets are investment securities (but does not fit within the first definition because it is not primarily engaged in the business of investing) is generally referred to as an “inadvertent” investment company.\textsuperscript{98} This term reflects an understanding that the definition is designed to include companies that are not primarily engaged in the investing business, but are engaged in sufficient investing activities to trigger the 40 percent test. Common victims of the inadvertent investment company definition are companies that have sold assets and hold much of their assets in securities pending their use in acquisitions, and companies engaged in substantial research and development for which they maintain a large pool of liquid securities as a source of ongoing funding.\textsuperscript{99} Just as inadvertently as these companies fall within the second definition of investment company in section 3(a)(1)(C), they may be expelled from it by section 3(b)(1), which excludes companies that are “primarily engaged . . . in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.” If that exclusion does not work, the company may qualify for rule 3a-1 if less than 45 percent of its assets and income are attributable to investments or for one of the numerous definitional exclusions set forth in section 3(c) and SEC rules, or obtain an order from the SEC finding that the company is primarily engaged in a non-investing business.

Congress designed the definition of investment company as a kind of screening mechanism. The definition of investment company corrals a large number of firms that then are subject to various screens to determine whether the definition should stick. In many cases, the ICA or SEC rules provide for a complete definitional exemption. The ICA excludes banks, insurance companies, brokers, underwriters, qualified employee benefit plans, commercial finance companies, utilities, oil and gas firms, charitable entities, and voting trusts.\textsuperscript{100} The SEC has excluded by rule foreign banks, 

\textsuperscript{98} See, e.g., The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act, supra note 96.


\textsuperscript{100} See 15 U.S.C. §§ 80a-3(c)(3) (banks and insurance companies), 3(c)(2) (brokers and underwriters), 3(c)(11) (qualified employee benefit plans), 3(c)(5) (commercial finance companies), 3(c)(8) (utilities), 3(c)(9) (oil and gas firms), 3(c)(10) (charitable entities), & 3(c)(12) (voting trusts).
foreign insurance companies, and qualifying research and development companies.\textsuperscript{101} In other cases, the exclusion is conditional. As discussed above, the SEC has excluded issuers of asset-backed securities on the condition that the issuer’s securities are “rated, at the time of initial sale, in one of the four highest categories assigned long-term debt or in an equivalent short-term category.”\textsuperscript{102}

The screening process does not end with the consideration of various statutory and regulatory exclusions from the definition of investment company, for even when a company is unable to find a definitional exclusion that fits, it can nonetheless escape many if not all of the ICA’s strictures. The ICA gives the SEC broad discretionary authority to grant case-by-case and rule-based exemptions from the ICA and has a long history of exercising this authority to accommodate companies and transactions for which complete application of the ICA is unnecessary.\textsuperscript{103} For example, Enron, Microsoft, Yahoo!, RealNetworks, Idealab!, and du Pont de Nemours have obtained exemptions from the ICA.\textsuperscript{104}

Many fundamental features of modern investment companies are prohibited by the ICA and owe their existence to the SEC’s exercise 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.\textsuperscript{105} With over $2.3 trillion under management, money market funds have become the dominant short-term cash option for Americans.\textsuperscript{106} Exchange-traded funds, a more recent entrant on the scene that owes its existence to a series of exemptive orders,\textsuperscript{107} have gathered over $400 billion in assets since 1995.\textsuperscript{108}

\textsuperscript{101} See 17 C.F.R. § 270.3a-6 (foreign banks, foreign insurance companies) & 270.3a-8 (qualifying research and development companies).

\textsuperscript{102} See 17 C.F.R. § 270.3a-8(a)(2).

\textsuperscript{103} See 15 U.S.C. § 80a-6(c).


\textsuperscript{105} See 17 C.F.R. § 270.2a-7.

\textsuperscript{106} See ICI FACT BOOK at 127 (2007).


\textsuperscript{108} See ICI FACT BOOK at 104 (2007).
Without SEC exemptive relief, funds would not be able to offer the multiple classes of shares that permit the tailoring of distribution 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 affiliated funds, fund participation in affiliated underwritings, and the use of interim advisory agreements without shareholder approval that would otherwise have been prohibited or severely restricted under the ICA. These rules often have been preceded by dozens or hundreds of individual exemptions that formed the basis for the rule. The substantial body of individual and rule-based exemptions constitutes a virtual ghost statute that stands behind the ICA and without which the modern investment company industry simply would not exist.

The ICA’s flexibility does not derive solely on the SEC’s exercise of its exemptive authority. The Act itself establishes a number of tiers of regulation for different types of investment companies. For example, investment company regulation varies substantially depending on whether the company continuously offers its shares, i.e., “open-end” funds. Open-end funds, commonly referred to as “mutual funds,” are subject to restrictions on the use of leverage, transactions in fund shares, and other aspects of their operations that do not apply to their counterparts, “closed-end” funds. In 1970, Congress amended the ICA to recognize a new kind

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109 See 17 § 270.18f-3; Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Investment Company Act Rel. No. 20915 (Feb. 23, 1995) (adopting rule 18f-3 and noting that approximately 200 individual exemptions had been granted to permit funds to offer multiple classes of shares).

110 See 17 § 270.12b-1.

111 See, e.g., Fred Frailey, Your $12 Billion Burden, KIPLINGER’S PERSONAL FINANCE, Sep. 1, 2007, at 10; David Nicklaus, 12b-1 Fee is a Fund’s Wolf in Sheep’s Clothing, ST. LOUIS DISPATCH, Apr. 18, 2007, at D1.

112 See 17 §§ 270.22d-1 (deferred sales charges), 17a-7 (transactions between affiliated funds), 10f-3 (fund participation in affiliated underwritings), & 15a-4 (use of interim advisory agreements without shareholder approval).

113 See supra note 109.

114 See 15 U.S.C. §§ 4 (classifying investment companies as: face-amount certificate companies, unit investment trusts, and management companies) & 5 (subclassifying management companies as: open-end or closed-end, and diversified or nondiversified).

115 See, e.g., 15 U.S.C. §§ 18 (setting forth different rules regarding the issuance of senior securities for closed-end and open-end funds); & 22 - 23 (setting forth different rules regarding transactions in fund shares for closed-end and open-end funds).
of investment company, the “business development company” or “BDC,” and exempted BDCs from most of the provisions of the ICA.116

In summary, the definition of investment company brings a wide array of companies within the ICA’s purview only to initiate a screening process whereby the optimal combination of structural and operational rules can be selected based on the particular needs of the entity. The ICA first removes companies that are primarily engaged in a non-investing business (the section 3(b)(2) primarily engaged exclusion), with additional, specific exclusions for companies that may be in the investing business but are not appropriately regulated under the ICA (the section 3(c) exclusions for banks, insurance companies, etc.). The ICA then regulates companies that remain under its purview according to a number of different categories (the classifications and subclassifications under sections 4 and 5). The SEC may exercise its statutory authority to exempt companies from all or some of the provisions of the Act. Although the exemptive application process has often been criticized as slow and cumbersome,117 as an alternative to federal legislation it is extraordinarily efficient and flexible.118 If a series of individual exemptions begins to establish a pattern, the SEC can adopt an exemptive rule that obviates the exemptive application process for companies that fall within its coverage.

The SEC and others who have not recognized that hedge fund managers such as Blackstone fall within the definition of investment company have ignored the breadth and flexibility of investment company regulation under the ICA. The argument that the ICA could not be so broad as to include companies that have a substantial non-investment (e.g., asset-management) function ignores the ICA’s expansive structure, which initially brings companies that do not remotely resemble investment pools (Microsoft, Yahoo!, etc.) within its purview and then applies a multi-tiered screening process to sort out those for which something less than full regulation under the Act is appropriate. The argument that applying the ICA to hedge fund managers uses a sledgehammer to kill a flea ignores a long history of extraordinarily flexible and accommodating regulation under the ICA that has produced the mutual fund – the most successful financial services


117 See, e.g., Letter from Craig Tyle, General Counsel, Investment Company Institute, to Paul Roye, Director, Division of Investment Management, SEC (Mar. 28, 2002).

product in history – while providing an effective cafeteria-style framework for the regulation of many other companies.

A determination that hedge fund managers fit within the definition of investment company would barely begin to answer the question of the extent to which they should be regulated under the ICA. If a hedge fund manager applied for exemptive relief, the SEC undoubtedly would find that much of the ICA does not provide a good fit for the particular risks presented by hedge fund managers, and that their regulation under the Act, should be substantially scaled back. Through the exemptive process, the SEC would be able to tailor the conditions of individual exemptions to the particular needs of the hedge fund manager. Over time, patterns of key distinguishing characteristics of hedge fund managers would emerge, along with standard conditions of exemptive relief. At this point, the SEC would adopt an exemptive rule that obviated individual exemptive applications by hedge fund managers that fit within the rule’s definitional and substantive terms. This process is ideally suited to the regulation of the public sale of interests in hedge fund managers. The only potential alternative – regulation by the exchanges on which the hedge fund manager’s stock is listed – would be less efficient, as discussed further in Part IV.

IV. PREDICTIONS AND PROPOSALS FOR HEDGE FUND MANAGER REGULATION

The future of hedge fund manager regulation likely will, and generally should, unfold along three parallel lines. First, members of Congress probably will press the New York Stock Exchange to amend its partnership exemption in order that the same governance rules that apply to publicly traded corporations generally will apply to hedge fund managers. Second, the SEC will be forced to reconsider its position that carried interests are not securities under the definition of investment company and accordingly its position that hedge fund managers are not subject to ICA regulation. Third, the liberalization of private offering rules will accelerate, thereby providing an increasingly viable alternative to the IPO for hedge fund managers. These developments are discussed below.

A. Amendments to Exchange Rules

In view of the level of Congressional interest in hedge fund manager regulation, Blackstone’s aberrational governance practices,119 and the high profile of hedge fund managers in the popular media, it is likely that

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119 See supra notes 125 – 28 and accompanying text.
members of Congress will pressure the NYSE to eliminate the exemption from certain listing governance requirements for partnerships. The House Subcommittee on Oversight held a hearing that was specifically directed at the question of Blackstone’s regulation under the securities laws. Although the hearing was primarily directed at the investment company issue, subcommittee members expressed particular concern at the hearing about Blackstone’s governance scheme and repeatedly queried the SEC witness about this issue. Members also questioned other witnesses about Blackstone’s governance practices, and three of the four witnesses criticized these practices and recommended, by one means or another, regulatory reforms to address these practices.

The New York Stock Exchange permits limited partnerships to opt out of Exchange rules requiring a majority of independent directors and that the nominating/corporate governance committee and compensation committee be composed entirely of independent directors. Blackstone relies on each of these exemptions and will not hold annual meetings of unitholders. Blackstone also has substantially limited its executives’ fiduciary duties to unitholders under Delaware law and denied its minority shareholders any ability to change Blackstone’s general partner.

120 See NYSE LISTED COMPANY MANUAL § 303A.00 (exempting limited partnerships from requirements of § 303A.01, .04 and .05). See also AMEX COMPANY GUIDE §§ (same for §§ 802(a), 804 and 805).

121 See After Blackstone Hearing, supra note 3.

122 See After Blackstone Hearing, supra note 3 (including questions regarding governance by Subcommittee Chairman Dennis Kucinich).

123 See After Blackstone Hearing, supra note 3 (testimony of Mercer Bullard; John Coffee, Adolph A. Berle Professor of Law, Columbia University School of Law; and Joseph Borg, President, North American Association of Securities Administrators).

124 See NYSE LISTED COMPANY MANUAL §§ 303A.01 (requiring a majority of independent directors); 303A.04 (requiring a nominating/corporate governance committee composed entirely of independent directors); & 303A.05 (requiring a compensation committee composed entirely of independent directors); AMEX COMPANY GUIDE §§ 802 (independent majority requirement); 804 (independent nominating/corporate governance committee requirement); & 805 (requiring a compensation committee composed entirely of independent directors or of a majority of independent directors who are also board members).

125 See Blackstone Registration Statement, supra at note 2, at 55. See also KKR Registration Statement, supra note 6, at 43 (same). Although the exemption for limited partnerships does not apply to the NYSE’s requirement that listed companies hold annual meetings, see NYSE LISTED COMPANY MANUAL § 302.00, the NYSE appears to take the position that listed limited partnerships are not required to hold annual meetings. Instructions for Submission of Domestic Company Section 303A Written Affirmations, NYSE Regulation, at Q1 (Apr. 28, 2006) at http://www.nyse.com/pdfs/Domestic_Instructions_FINAL_4_28_06.pdf. In contrast, Nasdaq’s limited partnership exception from the shareholder meeting requirement is express. See Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Rule 4350(E) to Amend the Annual Shareholder Meeting Requirement, Exchange Act Rel. No. 52985 (Dec. 20, 2005) (discussing NASD Rule 4350).

126 See Blackstone Registration Statement, supra note 2, at 55 – 57, 168 - 71. See also KKR Registration Statement, supra note 6, at 44 – 45, 168 - 71 (same).

127 See Blackstone Registration Statement, supra note 2, at 57 - 58. See also KKR Registration Statement,
describing Blackstone’s governance as “pathological,” suggested to members of Congress that the Exchange should close its partnership loophole in its governance rules, and it is likely that some members will pressure the Exchange to do so. Any amendments to Exchange rules would have to be approved by the SEC, which ironically would situate the regulation of hedge fund managers right where it would have been had Blackstone been treated as an investment company under the Act in the first place.

It is unlikely that the SEC will take any action on its own initiative. There is no evidence that the SEC was concerned about Blackstone’s governance practices at the time that it was reviewing Blackstone’s registration statement, and the SEC witness at the After Blackstone hearing expressed no concern regarding such practices when questioned by members except to state that he would raise the issue with the Commission. Nor is it likely that the exchanges will initiate such reform, as they have an incentive to retain the exemption in order to ensure that publicly traded partnerships such as hedge fund managers do not list move elsewhere. Nonetheless, it is likely that interested members of Congress will communicate their desire for reform to the NYSE, which would be hard-pressed to justify the partnership exemption in circumstances such as Blackstone’s.

The basis of the partnership exemption rests on the historical nature of a partnership as a participatory form of business organization in which the owners were actively engaged in managing the

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supra note 6, at 44 – 45, 60 (same). In contrast, investors in Blackstone’s funds have the authority to remove the funds’ general partners. See Blackstone Registration Statement, supra, at 72.

128 See After Blackstone Hearing, supra note 3 (testimony of John Coffee, Adolph A. Berle Professor of Law, Columbia University School of Law). See also Kathleen Pender, Close Look at Risk Businesses, SAN FRANCISCO CHRON., July 12, 2007, at C1 (“If KKR, Apollo Management, Carlyle Group, Bain & Co. were all to go public, we would see an asset class of $100 billion or more of publicly traded partnerships with the worst possible corporate governance.”).

129 See John Armour and David Skeel, Who Writes the Rules for Hostile Takeovers, and Why? - The Peculiar Divergence of U.S. and U.K. Takeover Regulation, 95 GEO. L. J. 1727 (2007) (“The NYSE and other exchanges also have a strong interest in keeping important listed firms happy, even if the firm’s happiness comes at the expense of effective corporate governance. The NYSE was famously unwilling to stand up to GM, for instance, when GM threatened to bolt if the NYSE tried to prohibit its use of stock with differential voting rights.”). But see Onnig Dombalagian, Self and Self-Regulation: Resolving the SRO Identity Crisis, BROOKLYN J. CORP., FIN. & COMM. LAW (2007) (“Exchanges retain the incentives and discretion to promulgate qualitative governance rules and standards that are stricter than Commission requirements as a means of reputationally distinguishing their listed issues.”); Marcel Kahan, Some Problems with Stock Exchange-Based Securities Regulation: A Comment on Mahoney, 83 VA. L. REV. 1509, 1510, 1514 n.30 (1997) (describing the NYSE’s reluctance to enforce its one-share one-vote requirement for fear it would lose listings to NASDAQ or AMEX).

130 See After Blackstone Hearing, supra note 3 (testimony of Andrew Donohue, Director Divisions of Investment Management, SEC). The SEC’s indifference to the governance issues raised by the Blackstone IPO is striking in view of its proposal to expand shareholders’ governance powers, which was issued only one month after the Blackstone IPO. See Shareholder Proposals, Exchange Act Rel. No. 56160 (July 27, 2007) (proposing, among other things, to enable shareholders to propose by-law amendments regarding the procedures for director nominations).
enterprise. Blackstone’s structure excludes its public owners from any meaningful participation in the enterprise and as such presents the same potential for abuse as corporations that are also listed on the NYSE. There is no practical justification for its maintaining an archaic exemption for a type of partnership that is the functional equivalent of the many public corporations listed on the Exchange. The NYSE should – and this author predicts will – eliminate the partnership for publicly traded partnerships such as Blackstone.131

B. Regulation of Hedge Fund Managers as Investment Companies

Although the SEC currently appears to take the position that carried interests are not securities, and hedge fund managers therefore are not investment companies, it is likely that it eventually will have to reconsider this position for a number of reasons. One reason is that the SEC’s position provides no protection from private suits based on claims that hedge fund managers are operating in violation of the ICA. Although courts may defer to the SEC’s analysis, they have not done so in a number of recent, prominent cases.132 It is inevitable that a publicly-held hedge fund manager will collapse, and when this happens the accompanying torrent of private lawsuits against the manager undoubtedly will include claims that it was an illegally unregistered investment company.133 Hedge fund managers may seek exemptive relief from the SEC to provide legal protection against such claims.

Another reason is that maintaining balance sheets consistent with the SEC’s investment company analysis may interfere with hedge fund managers’ business interests. For example, the SEC appears to take the position that approximately 30 percent of Blackstone’s assets are investment securities.134 The SEC has implied that if the value of these investments exceeded 40 percent of Blackstone’s assets, it would be an

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131 This would affect all exchange-traded limited partnerships. There are fewer than 100 publicly traded partnerships, almost all of which are energy companies (e.g., oil, gas and coal). See National Association of Publicly Traded Partnerships, www.naptp.org, at http://www.naptp.org/Navigation/PTP101/PTP101_Main.htm (last visited Aug. 17, 2007).

132 See National Presto v. SEC, 486 F.3d 305 (7th Cir. 2007) (rejecting SEC position that company was an investment company under the ICA); Financial Planning Ass’n v. SEC, 482 F.3d 481 (D.C. Cir. 2007) (vacating SEC rule); Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (vacating SEC rule); Chamber of Commerce of U.S. v. SEC, 443 F.3d 890 (D.C. Cir. 2006) (vacating SEC rules).

133 The litigation risk for Blackstone may be heightened because its registration statement omitted information about its assets that the SEC staff believed was “critical” to the staff’s analysis of Blackstone’s investment company status. See supra note 29.

134 See supra note 95.
investment company under the ICA.\textsuperscript{135} Blackstone may wish to increase its investments in its funds, its funds’ portfolio companies or other securities but will be unable to do so if the investments push it over the 40 percent line. Either Blackstone will have to avoid making desirable investments that would cause it to cross the 40 percent line, or it will have to put legions of lawyers and accountants to work devising new forms of equity stakes that can be passed off as carried interests or other forms of “compensation.” Hedge fund managers such as Blackstone may find it more practicable to obtain exemptive relief than to operate with the 40 percent test perpetually hanging over their heads.\textsuperscript{136}

Alternatively, hedge fund managers may insist that direct investments in their funds should not be counted as investment securities on the ground that the functional equivalent, carried interests, are not counted as such. The ownership of fund shares and carried interests is economically distinguishable only to the extent that the carried interests are leveraged. It is nonsensical that a hedge fund manager could trigger investment company status by investing directly in its funds but could not trigger such status by “purchasing” a carried interest from the fund’s limited partners. Either way the hedge fund manager has exposed itself and its investors to the same economic risks. It is just as absurd that a hedge fund manager could trigger investment company status by converting its carried interests into units of the fund. The conversion would actually reduce the hedge fund manager’s risk to the extent that the leveraged aspect of the surrendered carried interest had been eliminated.\textsuperscript{137} The crossing of the 40 percent threshold and attendant triggering of ICA regulation should not occur as result of a change that leaves unaffected or actually reduces investment risk.

The SEC’s position also makes no policy sense because it discourages hedge fund managers from investing in the funds that they manage alongside their clients. The securities laws should encourage managers to invest in their funds, not punish them for doing so, but an investment in a fund that pushed the manager’s investments over the 40 percent line would trigger regulation. The SEC requires mutual fund directors and portfolio managers to disclose the amount that they invest in their funds precisely because the agency believes that co-investments evidence a stronger

\textsuperscript{135} After Blackstone Hearing, supra note 3 (testimony of Andrew Donohue, Director, Division of Investment Management, SEC).

\textsuperscript{136} Although in theory they could rely, even after triggering the 40 percent test, on section 3(b)(1)’s exemption from section 3(a)(1)(C) for companies that are primarily engaged in a non-investing business, companies customarily are unwilling to take this risk and choose to obtain exemptive relief. See, e.g., supra note 105.

\textsuperscript{137} The leverage might be retained, however, if the manager used borrowed funds to buy out its carried interest.
alignment of interests of fund shareholders and fund management. The SEC’s current position either will discourage public hedge fund managers from eating their own cooking or further promote the artificial creation of equity stakes that look enough like compensation to satisfy the SEC staff and avoid crossing the 40 percent line. Formalistic legal distinctions that are divorced from economic reality are difficult to maintain over time, and the SEC’s artificial treatment of carried interests will be no exception.

As pressure on the SEC’s carried interest position begins to mount, interested parties may come to recognize that, notwithstanding popular rhetoric to the contrary, the ICA is ideally suited to accommodate the particular needs of hedge fund managers while maintaining necessary investor protections. For a number of reasons, regulation under the ICA would be far preferable to exchange rules. An exchange rulemaking is far more cumbersome and time-consuming than the exemptive application process. In an exchange rulemaking: the exchange develops a rule proposal after negotiations with affected hedge fund managers, it submits the proposal to the SEC for approval, the SEC provides the exchange with comments and suggestions, the exchange revises the proposal after further consultations with affected hedge fund managers, a revised proposal is resubmitted to the SEC, this process continues until the SEC is satisfied with the proposal, the SEC publishes the proposal for public comment, public comments are received and the rule is revised again after consultations with affected hedge fund managers, it is resubmitted to the SEC for final approval, and the SEC approves the rule unless it has further comments and suggestions.

In contrast, the SEC exemptive process involves negotiations between the SEC and a single hedge fund manager, thereby cutting the exchange and other hedge fund managers out of the process. The hedge fund manager files an exemptive application that sets forth the scope of the requested exemption and proposed conditions of exemptive relief and explains why the exemption is appropriate, the SEC provides comments on the application, the hedge fund manager submits an amended application, and this process continues until the SEC and hedge fund manager agree on the final terms and conditions of exemptive relief. At this point, the SEC publishes the terms and conditions of the exemption to permit interested parties an opportunity to request a hearing on the application. If no hearing is requested, and hearings virtually never are, an order is issued granting the exemption. Only the initial exemptive application would require approval.

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138 See Items 12(b)(4) (directors) & 15(c) (portfolio managers), Form N-1A.

139 This process must be completed for each exchange, but once the NYSE had enacted new rules, it is likely that similar amendments by other exchanges could be accomplished expeditiously.
by the full Commission; subsequent exemptions would be handled by the SEC staff pursuant to delegated authority.

There are also substantive reasons to prefer the SEC’s exemptive process over exchange rulemaking. Any changes to exchange rules would be limited to governance and other types of listing standards that are primarily governance-related, such as the requirement that the hedge fund manager have a majority of independent directors. In contrast, treating the hedge fund manager as an investment company would subject it to a wide range of disclosure, governance and substantive requirements that cover a wide gamut of abuses to which pools of liquid assets are particularly susceptible. Although exemptive relief from much if not most of the substantive provisions of the ICA would be appropriate, there are important provisions that should be retained.

As a general matter, 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, 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.

There are some essential features of the ICA that should apply to all hedge fund managers, and other features should be reflected in conditions of exemptive relief. The regulation of business development companies under the ICA is particularly instructive as to how 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

140 See NYSE LISTED COMPANY MANUAL § 303A.01; AMEX COMPANY GUIDE § 802.

141 See supra text accompanying note 65.

142 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.”).
only a limited number of provisions under the ICA. 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 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 current diversification standard applied under the ICA would not be adequate for this purpose. Disclosure similarly could

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144 See NYSE LISTED COMPANY MANUAL § 313.00; AMEX COMPANY GUIDE § 122.

145 A “diversified” mutual fund may actually have a fairly concentrated portfolio. A mutual fund generally is “diversified” if it invests in no more than 16 firms and no more than one such investment exceeds 5% of the fund’s assets. See 15 U.S.C. § 80a-5(b)(1) Thus, a “diversified” fund can actually invest 25% of its assets in a
address the presentation of investment performance, such as by requiring the periodic disclosure of standardized investment returns net of fees.

C. Development of Private Markets

The regulation of hedge fund managers also will likely be influenced by the development of private securities markets in which only qualified institutional buyers may invest. The risks presented by hedge fund manager IPOs arise only because hedge fund managers find it necessary to raise capital in the public markets from small investors, which begs the question of why hedge fund managers need to sell shares to the public in the first place. It is seems incongruous that the same managers that raise tens of billions of dollars for their funds from institutional investors find it necessary to raise capital for their own operations from the public markets. Indeed, Blackstone raised $3 billion in a private offering to a Chinese investment company at the same time as its $4.1 billion IPO, and most of the buyers in the IPO were institutional investors. Why not raise the full amount in private placements?

Blackstone must have believed that it could create greater value for its existing shareholders through a public offering. Blackstone sold its units to the Chinese investment company at a 5 percent discount to the public offering price, which reflects both sides' view that privately purchased units were worth less than the public shares (although the discount might be attributable to the inferior voting rights of the private shares). One explanation for the attraction of a public offering is that stocks listed on U.S. stock exchanges historically trade at a premium to their valuations on other markets. There is no definitive explanation for this premium. It might be attributable to the exchanges' high governance standards, but Blackstone's reliance on the partnership exemption for key NYSE governance rules should eliminate any governance premium it expects to enjoy. Perhaps the premium is attributable to exchange listing standards, in combination with the complex web of federal and state statutory, administrative, and common law rules that apply to public markets. The

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146 See supra note 12.


149 See id.
attraction for Blackstone might not be the premium at all, but the added liquidity of public markets, or the greater opportunity to use company stock as incentive compensation.

Whatever the explanation for the appeal of public markets, there is no obvious reason why their advantages could not replicated by private markets. The majority of U.S. equities are owned by institutional investors, virtually all of whom would be qualified buyers in private placements. To the extent that the public market advantage is attributable to the regulatory environment, private markets could replicate it. One might argue that private markets could actually improve on public market regulation because of their greater flexibility. There is no strong evidence that including small investors in public markets it necessary to achieve optimal liquidity. Institutional money should be more than adequate to provide private markets with the kind of liquidity offered by public exchanges. The position of traditional exchanges is hardly unassailable. Advances in technology have substantially eliminated many economic barriers to entry in the market place for exchanges, as evidenced by the inroads that new electronic exchanges have made on the exchanges’ traditional market-maker trading systems. Goldman Sachs has announced that it will create such a private label exchange, and a number of its competitors have announced that they will create a competing private exchange.

There are significant impediments to the development of private exchanges, however. Companies with 500 or more shareholders generally must register under the Exchange Act and comply with its extensive reporting requirements. This restriction unnecessarily limits the ability of companies to raise capital in the institutional markets and presents a particularly difficult barrier to the use of company stock as

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151 Many companies have stated that one reason for their going private is the burden of public company regulation, with the requirements of the Sarbanes-Oxley Act being the favorite target. J. Bonasia, SarbOx Controversial, But Seen Doing the Job, INVESTOR'S BUS. DAILY, Aug. 17, 2007.

152 See John Authers and Norma Cohen, Rivals close in on New York's Big Board, FIN. TIMES, Sep. 13, 2006; Glen Fest, Irreconcilable Differences? BANK TECH. NEWS, June 1, 2005, at 42.


154 See generally, Letter from ABA Section of Business Law to John White, Director, Division of Corporate Finance, SEC 1617 PLI/Corp 11 (Mar. 22, 2007).

155 See 15 U.S.C. § 78l(g)(1) (requiring Exchange Act registration for issuers with 500 or more shareholders and minimum amount of assets).
The idea that investor protection correlates magically with the number of shareholders that a company has is an anachronism of a time when the breadth of company’s float could be correlated with ownership by small investors. Developments in technology and communications have rendered obsolete any necessary connection between how widely company shares are offered, sold or held and the exigencies of investor protection. This fact has been reflected in the absence of any limit on the number of accredited investors in private offering under Regulation D, purchasers of private investment shares by qualified investors under section 3(c)(7), and purchasers of shares under Rule 144A by qualified institutional buyers. If the 500-shareholder trigger is not repealed by Congress, it should be eliminated by the SEC for institutional investors and a bright line safe harbor created for sophisticated employees. This reform should be accompanied by the elimination of restrictions on public offers (as opposed to public sales), which are similarly a holdover from a time when the scope of distribution activities also might have correlated positively with sales to unsophisticated investors.

If such reforms were to proceed apace, the question of how to regulate hedge fund managers might well be rendered moot by their migration to private exchanges to raise capital. Hedge fund managers that already have extensive experience raising capital from private sources for their funds are ideally suited to forego the disadvantages of public offerings and raise capital for their own purposes in large, liquid private markets. Blackstone’s public offering generated an enormous amount of adverse press coverage and stimulated interest in raising tax rates for hedge fund managers, all of which probably would have been avoided by making a private offering. With hedge fund managers leading the way, operating companies would be sure to follow.

Some might argue that such a transition would disadvantage retail shareholders by ultimately excluding them from many securities offerings, but there is no evidence that this view reflects anything more than a romantic, archaic notion of the markets. There is no reason to believe that

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156 See Column, Apollo’s Mission, FINANCIAL TIMES, July 25, 2007, at 14 (noting that the 500-shareholder registration trigger prevents use of private offerings to attract or retain employees); Christopher Paci, Recent Developments in the Securities Laws: Securities Offering Reform, Practising Law Institute, 1556 PLI/Corp 723 (2006) (listing among “main drivers for [regulatory] reform,” “SEC's strong interest in drawing back into U.S. registered public markets the significant deal volume that is now issued in private placement markets in reliance on Rule 144A.”).

157 See 17 C.F.R. § 229.506; 15 U.S.C. § 80a-3(c)(7), 17 C.F.R. § 229.144A. In contrast, the private offering exception for private investment companies with fewer than 100 shareholders should be repealed, see 15 U.S.C. § 80a-3(c)(1), as it bears no logical relationship to the protection of investors other than that it limits the potential harm to a small number of investors.

158 See supra note 11.
the participation of retail investors in securities markets leads to more accurate valuations. If anything, the evidence suggests that retail investors generate little more than trading noise that does nothing to direct capital to higher uses,\textsuperscript{159} create harmful pressure on public companies to overemphasize short-term performance,\textsuperscript{160} and increase stock price volatility.\textsuperscript{161} Nor is there persuasive evidence that retail investors materially improve the liquidity of markets.\textsuperscript{162} Where there is widespread agreement is that the most persistent conundrum in securities regulation is created by the participation of retail investors in the securities markets. It is the participation of retail investors that justifies the mandatory disclosure requirements about which securities commentators have been arguing for decades. The development of private exchanges with privately ordered disclosure rules avoids the problem of mandatory disclosure necessitated by the participation of investors who are least likely to understand it. Hedge fund manager offerings illustrate the kind of complexity and risk that mandatory disclosure cannot meaningfully overcome for retail investors through government-mandated rules.

CONCLUSION

The SEC missed a golden opportunity to promote efficient regulation and investor protection when it accepted hedge fund managers’ claims that they were not investment companies under the Investment Company Act. Hedge fund managers such as Blackstone fit squarely within the definition of investment company under the Act, and the Act is well-suited to the regulation of these entities. Although the ICA in its entirety represents a highly intrusive, burdensome regulatory regime under which most hedge fund managers could not operate, it is an extraordinarily flexible statute by reason of the many tailored exemptions included in its provisions and the broad authority that it grants to the SEC to exempt companies from some or all of its requirements. Notwithstanding their initial pass, hedge fund

\textsuperscript{159} See Paul Mahoney, Is There a Cure for “Excessive” Trading? 81 VA. L. REV. 713, 718 – 21 (1995) (discussing noise trading, defined as trading on data that the trader incorrectly believes is not reflect in market prices).

\textsuperscript{160} See David Cho, For Elite Investors, Nasdaq Set to Offer Private Stock Market, WASH. POST, Aug. 14, 2007 (“One of the problems that business faces in America today is what I would call “short-termism,”” said Howard S. Marks, chairman of Oaktree Capital, an investment firm that was the first to list on the private market developed by Goldman Sachs called GSTRUE. “There’s a lot of expense and complication associated with being a public company today. ... Now it is possible to gain most of the advantages of being public while sidestepping the disadvantages.”).

\textsuperscript{161} See id. (“The private market,’ Marks said, ‘shields companies from regulation and from wild-swings in their share prices that are caused by a temporary drop in earnings or a bad rumor.’”).

\textsuperscript{162} See Mahoney, supra note 159, at 728 (discussing noise traders’ potential contribution to excessive liquidity).
managers are likely to trigger regulatory reform. Members of Congress are likely to pressure the exchanges to eliminate the partnership exemption from the governance standards in their listing requirements. Hedge fund managers also are likely to seek exemptive relief from the SEC to protect them from private liability and to resolve the arbitrary operational constraints to which the SEC’s analysis of carried interests has subjected them. Finally, these developments are likely to provide additional impetus for the liberalization of the regulation of private securities markets.