

STATUS OF BLACKSTONE GROUP AS AN INVESTMENT COMPANY

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Mercer Bullard¹

At the same time that the Securities and Exchange Commission has a proposal pending to make it more difficult for retail investors to invest in hedge funds, it apparently has decided to make hedge funds available to everyone. The Blackstone Group L.P. has filed a registration statement for a public offering of limited partnership units in the functional equivalent of a hedge fund. The partnership is in reality an investment company (popularly known as a mutual fund) and should be subject to investment company regulation, but Blackstone's lawyers apparently have persuaded the SEC staff that it is really in the business of selling asset management services.

Blackstone's IPO inevitably will result in retail investors experiencing first-hand the sudden and painful downturns to which hedge funds are exposed. It will be only a matter of time before a publicly traded hedge fund such as Blackstone suffers a collapse reminiscent of Long Term Capital Management's spectacular blow-up in the late 1990s and the collapse of two Bear Stearns' hedge funds that is unfolding as these words are being written. It is both the blessing and curse of hedge funds that they take large risks; the same risks that can create substantial wealth can result in catastrophic losses for unsophisticated investors. Much of the unique value of hedge funds derives from the limited regulation to which they are subject, but limited regulation is part of a quid pro quo under which hedge funds may only be sold privately to sophisticated investors. Blackstone's IPO – initial *public* offering – violates this quid pro quo and undermines the regulatory structure under which private and public investment funds are regulated.

BLACKSTONE IS AN INVESTMENT COMPANY

Under the Investment Company Act, a company is an "investment company" if it is primarily engaged in the business of investing securities. Blackstone has not explained why it does fit this description other than to state that it is in the asset management business. A company is also an investment company if it is engaged in the business of investing in or holding securities and owns investment securities with a value in excess of 40% of the company's assets, excluding cash. Thus, simply holding securities representing 40% of a company's assets qualifies it as an investment company. Blackstone essentially argues that it does not fit this second definition because it has interposed a general partnership between itself and the underlying hedge funds. If a company meets either of these definitions of "investment company," it is subject to investment company regulation, which would prevent Blackstone's management from employing the complex corporate structures, extreme leverage, transactions with

¹ President and Founder, Fund Democracy; Assistant Professor of Law, University of Mississippi School of Law.

affiliates, unauthorized fee increases, non-pro-rata distributions and one-sided performance fees that investment company regulation prohibits.

In fact, Blackstone triggers both definitions of “investment company.” As the following chart illustrates, the vast majority of Blackstone’s assets are “securities” under the first definition. Blackstone held \$17.2 billion

in assets as of March 31, 2007, of which \$5.2 billion are investments and \$4.1 are carried interests. These assets are securities, which means that \$9.3 billion, or at least 54%, of Blackstone’s \$17.2 billion in assets are securities. This excludes \$3.7 billion of goodwill, which also partly reflects the value of Blackstone’s investments, \$1.8 billion in cash, which could just as easily be invested in securities, and a \$1 billion deferred tax asset. These three asset categories reveal little about the nature of the business. If they are excluded, Blackstone’s \$9.3 billion in securities are virtually the only assets left.

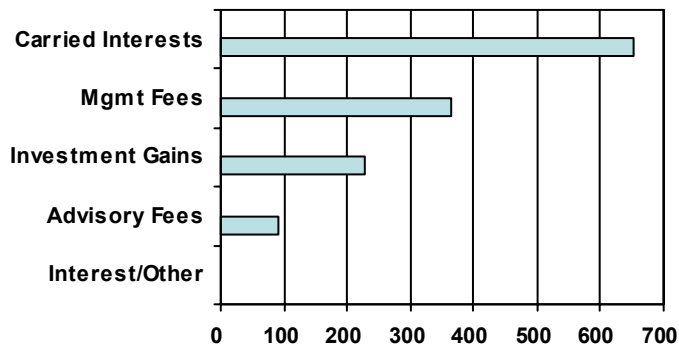
Blackstone Assets (3/31/07) (\$ billions)



Blackstone’s revenues are similarly lopsided, as illustrated in the following chart. In the quarter ending March 31, 2007, Blackstone received \$1.3 billion in revenues, of which carried interests and other investment gains represented \$781 million, or 58%.

Blackstone’s registration statement describes management as being fully engaged in managing the funds’ portfolios, *i.e.*, Blackstone’s own assets. Thus, Blackstone’s assets, revenues and activities all indicate that it is primarily engaged in the business of investing. This is consistent with investors’ expectations that Blackstone’s performance will be directly linked to the value of its portfolio.

Blackstone Revenues (3/31/07) (\$ millions)



Blackstone is also an investment company under the second definition cited above. As described immediately above, Blackstone’s assets, revenues and activities all indicate that it is primarily engaged in the business of investing in securities. Blackstone therefore is engaged in the business of investing in and holding securities under the second definition.

Blackstone passes the second definition's 40% test because 60% (\$9.3 billion) of its assets, exclusive of \$1.8 billion in cash, are investment securities. These securities are investment securities because Blackstone acquired and holds them for the purpose of investment, *i.e.*, to receive the benefit of their investment returns.

POTENTIAL CRITIQUES OF BLACKSTONE'S INVESTMENT COMPANY STATUS

As noted, Blackstone does not explain in its registration statement why it is not an investment company. The following discusses potential critiques of the argument that Blackstone is an investment company. These are as follows:

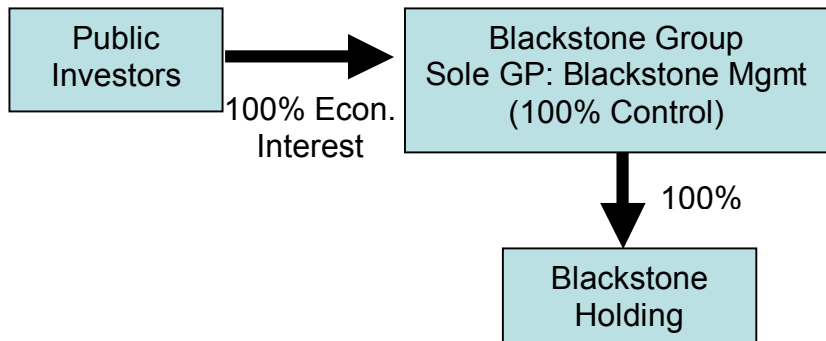
- Blackstone's general partnership interests are not securities.
- Carried interests are not securities.
- Carried Interests are compensation for asset management services.

These arguments are discussed in turn below.

Blackstone's General Partnership Interests Are Securities

Under the two definitions of investment company discussed above, Blackstone would have to be investing in or holding securities to be an investment company. Under the federal securities laws, there is a presumption that a general partnership interest is not a security. Blackstone therefore might argue that, because it holds virtually all of its assets in and receives virtually all of its revenues through a general partnership interest, it does not invest in or hold securities. This argument fails because in the Blackstone context the general partnership interest is clearly a security. Moreover, if the general partnership interest were a security, investment company regulation could easily be evaded by virtually any entity.

The following discussion illustrates how Blackstone may be attempting to use a general partnership interest to escape investment company regulation. The publicly traded partnership acts as general partner to a series of companies that directly or indirectly manage a series of hedge funds. The diagram at the right provides a simplified version of the significant aspects of Blackstone's structure (more detailed diagram appears in Blackstone's registration statement). The public investors own 100% of the economic interests in Blackstone, a publicly traded partnership of which Blackstone management acts as the general partner.



Blackstone management has complete and exclusive control over Blackstone. The public investors have no ability to remove the general partner or otherwise exercise any control over Blackstone. The public investors' lack of any control means that they also have no control over the Blackstone's actions in its capacity of the general partner of Blackstone Holding.

This illustrates the first difficulty with Blackstone's general partnership argument. 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."² The courts have a long tradition of interpreting "security" under the federal securities in a way that reflects the economic reality of the instrument in question,³ however, and in Blackstone's case the economic reality is that its public investors will have no influence, no access to information, and no protection against dependence on Blackstone management. Although technically Blackstone itself is the general partner of Blackstone Holding, and Blackstone as general partner does have influence, access and protection, that influence, access and protection reside entirely within Blackstone management and do not extend to the public investors in Blackstone because they have no influence, access or protection *vis as vis* Blackstone, much less *vis a vis* Blackstone Holding.

This is not to say that in every case a similar structure is used the general partnership presumption will necessarily be overcome. In the context of an operating company, the presumption might hold. In the case of a general partner, however, that is primarily engaged in the business of investing in securities and owns substantially more than a general partner's nominal interest in the underlying partnership, the general partnership presumption cannot be reconciled with the definition of investment company. Blackstone's general partnership argument would, in effect, render meaningless the definition of investment company. Section 48(a) of the Act prohibits any person from, "directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of [the Investment Company Act]." Accepting Blackstone's general partnership argument would permit it to use an "other person" (the general partnership) to accomplish indirectly what Blackstone would be prohibited from doing directly.

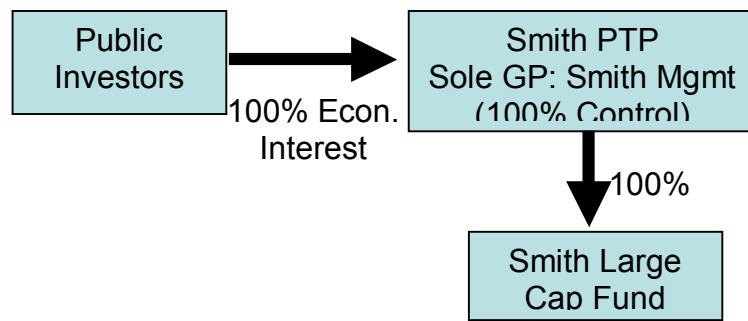
An investment in an investment company does not change merely because the investment is held through a general partnership interest. An analysis of a traditionally structured mutual fund shows why this must be so. In a traditional mutual fund structure, public investors own shares that represent a pro rata interest in the net assets of the fund. In this example, the Smith Management Company ("Smith") provides advisory services to the Smith Large Cap Fund ("Smith Fund").

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

³ See, e.g., 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.")

If the general partnership presumption applied to a structure such as Blackstone’s, then Smith could easily reorganize the fund to avoid investment company regulation while also stripping investors of any control over the fund. This could be accomplished by organizing the Smith 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, and Smith PTP would offer 100% of the economic interests in Smith PTP to public investors, thereby creating a new mutual fund structure (see below) in which the Smith PTP would not own any securities – assuming the general partnership presumption holds – and therefore would not be an investment company. The economic interests of the investors would be identical, however, to the interests they held as direct shareholders in the fund. The only change would be that the public investors would have no control over Smith PTP. Ironically, the general partnership presumption is based on the investor’s authority, yet the effect of interposing the general partnership structure would be to remove what authority the public investors had.

Thus, the mere interpositioning of a general partnership interest between a publicly traded partnership and a fund does not answer the question of whether the publicly traded



partnership is an investment company. Whether the presumption holds depends on the nature of the general partnership assets, revenues and activities, in other words, on the application of the definition of investment company at the general partnership level. As discussed above, these indicia demonstrate that the general partnership interest is a security.

Carried Interests are Securities

A substantial part of Blackstone’s assets and revenues are derived from carried interests. If carried interests are not securities, then Blackstone is probably close to being, but not quite, an investment company. Blackstone’s carried interests are, however, securities for purposes of the definition of investment company. The value of a carried interest is entirely derived from the value of the security against which it is measured. It is the functional equivalent of an option, which is an acknowledged security, and Blackstone itself has recognized the similarity of these instruments. Gains from carried interests are subject to capital gains tax, which is consistent with their characterization as securities.

For purposes of this analysis, a carried interest is a contractual right to receive a specified portion of the value of a security or portfolio that represents an annualized investment return in excess of a fixed minimum return, or “hurdle rate,” after a specified period. For example, a carried interest might entitle its holder to receive 20% of a portfolio’s return

in excess of an annualized return of 10% after 10 years (“20/10 carried interest”). If a portfolio was worth \$386 million at its inception and had an annualized return of 10%, it would be worth \$1 billion at the end of ten years. A 20/10 carried interest would entitle the holder to 20% of the balance after 10 years in excess of \$1 billion. If the portfolio grew at an annualized rate of 20%, it would be worth approximately \$2.4 billion after ten years, and the carried interest owner would experience a gain of \$280 million.

The foregoing explanation alone demonstrates that carried interests have the characteristics of a security. The value of the interest is completely leveraged against the portfolio’s value. The value of the carried interest rises and falls with the value of the portfolio. Indeed, the carried interest is a leveraged security in the sense that its value rises and falls at a greater rate than the portfolio. If the portfolio’s one-year return increased from 12% to 14%, this would reflect a 17% increase in the fund’s return (2%/12%) and a 100% increase in the value of the carried interest (4%/2%).

A carried interest is the functional equivalent of a call option (“call”), which is recognized as a security. Both are contractual rights to a part of the future appreciation of a security. The value of a call represents the difference between the underlying security’s strike price and its market value (spot price). A carried interest represents the difference between a security’s value assuming a minimum rate of return (hurdle rate) and its market value. A carried interest might represent the right to receive 20% of the difference between the value of a portfolio as the end of its ten-year life and its value assuming a 10% annual return during its life (a “20/10 carried interest”). This is functionally identical to a call where the holder owns the right to purchase 20% of the portfolio at a strike price equal to the portfolio’s value assuming 10% return (“20% call”).⁴

To illustrate, imagine a fund with \$385.8 million in assets at its inception. If its annual return over its ten-year life were 10%, it would grow to \$1 billion. If its annualized return were 20%, it would grow to \$2.389 billion. An investor purchases an option exercisable after 10 years to buy 20% of the fund for \$200 million (the strike price), which equals the value of the fund assuming a 10% annual return. At the end of 10 years, the call would be exercised for a gain equal to the difference between \$200 million and \$478 million (20% of \$2.389 billion), or \$278 million. The gain on the 20/10 carried interest would also be \$278 million (20% of \$1.389 billion).

The equivalence of carried interests and options applies equally regardless of the point in the portfolio’s life at which the financial interest is purchased. For example, if one general partner of the fund held a call with a strike price of \$1 billion, and the other general partner of the fund held a 20/10 carried interest, and each transferred all of their rights in the call/carried interest to a public traded partnership (PTP) at the end of the fund’s fifth year, the holders in the PTP would be identically situated. The unrealized

⁴ In the May 1 version of its 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.

value of the call/carried interest 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.⁵ For example, if the fund's return were 10% in each of its remaining five years, its ending value would be \$1.547 billion, and the value of each PTP would equal \$109 million.

Blackstone seems to agree that carried interests should be viewed as call options. 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. These statements reflect the position that carried interests are functionally similar to call options. In addition, carried interests are subject to capital gains tax, which further discredits the view that they represent compensation rather than a return on capital.

Carried Interests are not Compensation for Asset Management Services

Blackstone might argue that the value of a carried interest depends on the value of asset management services provided and therefore should be viewed as compensation.⁶ If this analysis were sufficient, however, there would be no such thing as an investment company. An investment company is itself an asset manager, and its returns could just as well be viewed as compensation for services. For example, a mutual fund (a kind of investment company) is in the business of managing a portfolio of investments, and the value of an interest in a mutual fund depends on the value of the asset management services provided by the fund's board of directors.

To illustrate, it is helpful to return to the illustration above that shows the alternative structure for a mutual fund that Blackstone believes would remove the mutual fund from the definition of investment company. One could argue that all of the gains realized from the Smith Fund were compensation for the services provided by Smith, and the public offering of Smith PTP was simply a mechanism by which public investors could invest in Smith's asset management operation. As discussed above, such an interpretation proves too much, as it would convert every mutual fund from an investment company to an asset manager.

There is a significant difference between Blackstone and the Smith PTP, however, in that Blackstone's assets and revenues are not derived exclusively from direct investments in its hedge funds or other businesses (although \$5 billion of its \$17.2 billion in assets are direct investments). Blackstone's assets and revenues are also attributable to carried interests and asset-based management fees, as shown in the illustration below. At some

⁵ 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.

⁶ Of course, the manager could have negotiated to be paid in the form of a call. The name of the instrument should not matter if it is identical for economic purposes.

point, the amount of asset-based management fees would be large enough that Blackstone could be considered a traditional asset manager, but it is nowhere close to that point. A brief comparison with a traditional asset manager illustrates this point. T. Rowe Price, a publicly held mutual fund manager, is a traditional asset manager. In the first quarter of 2007, its total revenues were approximately \$525 million, of which 81% (\$425 million) were attributable to advisory fees. In contrast, of Blackstone's first quarter revenues of \$1.3 billion, only 27% (\$364 million) were attributable to advisory fees.

The market appears to agree that traditional asset managers such as T. Rowe Price are fundamentally different from entities such as Blackstone. Morningstar's Jeff Ptak notes that Fortress Investment Group, the hedge fund prototype that went public in February, trades at 33% of assets under management, in contrast with Legg Mason's and T. Rowe Price's 1.4% and 3.7%, respectively. Blackstone, with a market cap of around \$30 billion and its assets under management of approximately \$90, appears to reinforce the message in Fortress's market valuation that Fortress and Blackstone are not traditional asset managers.

The market's different valuation of Fortress and Blackstone may reflect the fact that both are heavily leveraged to the capital markets, that is, perceptions of their value are closely tied to the value of their portfolios. If Blackstone's only asset were a contractual right to an asset-based fee, its value would be minimally leveraged to the performance of the fund. To illustrate, if the portfolio increased \$1 in value, Blackstone's revenues would increase only \$0.01. In contrast, if Blackstone's only assets were its \$5 billion in direct investments, a \$1 increase in the value of those investments would result in a \$1 increase in Blackstone's value. In the latter case, Blackstone would be fully leveraged to market performance.

Blackstone's carried interests can have the effect of increasing its leverage to the markets. To illustrate, if a \$1 billion fund increases in value to \$1.1, \$1.2, \$1.3 or \$1.4 billion, the annual income from a 1% asset-based fee will increase by \$10, \$20, \$30 or \$40 million, respectively. In contrast, the value of a 20/10 carried interest for that year will be as follows: \$0, \$20 million, \$40 million or \$60 million. The increase in the fund's performance from 20% to 30% increases the total asset-based fees by an additional 10% (\$10 million), in comparison with a 100% increase in the amount of the carried interest received. As discussed, the purchase of a carried interest involves leveraging similar to the leveraging effect of buying calls.

Another way to compare asset-based fees and carried interests is to compare the extent to which they are leveraged to the manager's ability to attract assets. Asset gathering is a core asset management activity and therefore should affect the value of a genuine asset manager. This assumption holds in the case of asset-based fees, which are increased by all asset growth, whether attributable to an increase in a fund's value or by new investment. A carried interest, however, is received only on the increase in a fund's value above the hurdle rate. Asset gathering is central to the asset management business, but carried interests have only an indirect relationship to asset gathering. A new investment of \$100 million results in a \$1 million increase in income when it is subject to

a 1% asset-based fee, but no increase in income when it is subject to a carried interest. The new investment might never result in carried interest gains because the ability to attract assets has no necessary relationship to the value the carried interest. In contrast, every dollar of new assets increases income under an asset-based fee. Just as the higher leveraging of a carried interest to market performance reveals its nature as a form of equity investment, the essentially nonexistent leveraging of a carried interest to asset gathering reveals its nature as having a limited relationship to asset management.

In summary, Blackstone's value depends on the value of its portfolios. Blackstone is highly leveraged to market performance and its value bears only a limited discernable relationship to the metrics for asset management companies, the value of which are driven primarily by asset-based fee flows. Blackstone is an investment company because it is functionally much closer to an investment in the hedge fund portfolios than an investment in an asset management business.

WHY BLACKSTONE'S STATUS MATTERS

Public offerings such as Blackstone's pose a threat to retail investors and to the structure of our regulatory system. The limited regulation of hedge funds is premised on their being sold only to sophisticated investors who are able obtain the information they need to fend for themselves, in contrast with retail investors for whom the disclosure system it ill-equipped to enable a fully informed investment decision. Congress designed the Investment Company Act to address the particular susceptibility of investment pools to abuses. The Blackstone IPO effectively unravels the regulatory regime Congress has carefully constructed to protect investors.

The Investment Company Act was adopted to respond to a number of potential abuses that are particular to liquid pools of securities. The Act prohibits or severely restricts extreme leverage, differential treatment of shareholders, complex corporate structures, side deals beneath 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. These rules are largely responsible for making mutual funds that most successful investment vehicle in the history of financial services. Permitting the public offering of hedge funds poses a significant threat to continued efficacy of mutual fund regulation and the benefits of limited regulation afforded to hedge funds.

Blackstone intends to engage in practices that would violate virtually all of the fund rules described above. A sampling of these practices is provided below:

- Blackstone management receives fees from companies included in Blackstone's hedge funds. This creates a potential incentive for Blackstone to choose investments that will generate fees for itself at the expense of investors in its hedge funds and in Blackstone itself.
- Blackstone uses a complex capital structure in which different investors have different rights, as illustrated by the differences between the rights attached to the

units sold to the Chinese investment company and those sold to retail investors. These structures create the risk of one class of securities obtaining benefits at the expense of another.

- Blackstone management's exclusive control over Blackstone effectively gives management the authority to increase its compensation at the expense of the public investors. Its registration statement reveals that such an increase is already expected and future increases generally will not be subject to shareholder approval.
- Blackstone reserves the right to use substantial leverage to increase returns or otherwise as management deems appropriate, thereby greatly increasing the risk of a collapse similar to what occurred with Long Term Capital Management in the late 1990s.
- Blackstone's carried interests are a form of senior security that increases risk by leveraging the company's value against the value of underlying security. A severe downturn in the value of Blackstone's hedge funds could quickly wipe out the value of its carried interests.
- Blackstone does not value its securities based on the amount it could receive for them within seven days, which increases the risk that it will not realize the carrying value of its investments, carried interests and other assets.
- Blackstone's performance fees create an incentive to take greater risk because its fees are not reduced if performance falls below a minimum standard.

To reiterate, all of these practices may very well benefit investors in Blackstone, but they also provide opportunities to benefit Blackstone management or favor large investors (such as the China investment company) at the expense of retail investors. Investment company rules prohibit these practices because of the difficulty of fully and fairly disclosing the risks involved. The Blackstone offering proves this point, as only an expert could determine from its registration statement the full range of risks that this investment entails.

To conclude, regardless of one's view of the legal question of Blackstone's status, the inescapable truth is that Blackstone reflects a way for retail investors to invest directly in hedge funds. Retail investors previously have benefited as investors in hedge funds, but only through their interests in institutional investors, such as public and private pension plans. Retail investors are protected in this situation because their institutional proxies are sufficiently sophisticated to evaluate hedge fund risk. This protection will not be available to investors in Blackstone or any of the public hedge fund offerings that are likely to follow. Hedge funds play an important role in our economy, and the relatively light regulatory regime under which they operate plays an important role in their success. If hedge funds are permitted to access public markets directly, however, they should be recognized for what they are: investment companies that raise the same concerns that prompted the Investment Company Act of 1940.