

SEC CONCLUDES THAT PRIVATE EQUITY FUND MANAGERS ARE NOT INVESTMENT COMPANIES

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In Congressional testimony on July 11, 2007, Andrew Donohue, Director of the Division of Investment Management of the Securities and Exchange Commission, stated that Fortress Investment Group LLC and Blackstone Group LP, two private equity fund managers that went public earlier this year, are not investment companies. Mr. Donohue gave his testimony before the Senate Finance Committee and the Domestic Policy Subcommittee of the House Committee on Oversight and Government Reform in separate hearings examining the taxation and regulation of private equity fund managers that sell their securities in a public offering.

Fortress and Blackstone engage in the business of organizing and managing private funds that pursue a variety of alternate investment strategies, including private equity funds, hedge funds and real estate funds. Their principal assets are ownership interests in the funds they organize and manage. Fortress and Blackstone organize funds as limited partnerships. Subsidiaries of Fortress and Blackstone that manage the assets of the funds hold the general partnership interests; the partnerships sell limited partnership interests to investors. In some instances, Fortress or Blackstone makes a modest capital contribution to a fund and, consequently, holds limited partnership interests. The general partner of a private equity fund receives compensation for its management services in the form of a management fee that is a percentage of the capital investment in the fund and a separate performance fee, called a "carried interest", that is a percentage (customarily 20 percent) of the fund's investment gains above a specified level. The general partner receives most of its compensation as fund manager in the form of the performance fee, and the performance fees paid by all funds, when aggregated, constitute a large portion of each fund manager's assets.

Mr. Donohue testified that as part of the usual review of securities in registration for a public offering, SEC staff determined that neither Fortress nor Blackstone falls within the statutory definition of an investment company that is subject to regulation under the Investment Company Act of 1940 (the "1940 Act"). The 1940 Act establishes two principal tests for determining whether an issuer is an investment company; an issuer that satisfies either test is subject to regulation under the 1940 Act. The first test is whether an issuer is primarily engaged or holds itself out as being primarily engaged in the business of investing in securities. This test encompasses issuers organized for the purpose of investing in a portfolio of securities. The second test is whether the issuer is engaged in the business of investing, reinvesting, owning, holding or trading in securities **and** owns investment securities whose value exceeds 40 percent of the value of its total assets. An issuer can inadvertently satisfy the second test if it holds a large portfolio of investment securities.

Mr. Donohue testified that neither Fortress nor Blackstone satisfies the first test for determining whether an issuer is an investment company because each fund manager is primarily engaged in the business of providing asset management and financial advisory services. In this regard, Mr. Donohue drew a distinction between managing the assets of others, which constitutes an advisory business, and managing the issuer's own assets, which falls within the definition of an investment company. Mr. Donohue explained that the SEC staff reached the conclusion that Fortress and Blackstone are primarily engaged in the investment advisory business principally on the basis of an analysis of their assets, as described in more detail below. The staff also found that other factors traditionally considered to determine the principal nature of an issuer's business supported the conclusion. Both Fortress and Black-

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stone generate their revenues and income principally from their advisory services, not from managing their own assets. In addition, both fund managers hold themselves out as investment advisers, and their senior officers devote most of their time to managing assets that belong to others.

For the purpose of the second test for determining an issuer's status as an investment company, whether Fortress or Blackstone holds investment securities whose value exceeds 40 percent of the value of its total assets, **limited** partnership interests are investment securities. As a result, whether Fortress or Blackstone exceeds the 40 percent limit on investment securities turns on the characterization of the **general** partnership interests each holds. Under applicable precedent, general partnership interests are not securities if the partnership's profits are generated by the efforts of the general partner rather than the efforts of another. Mr. Donohue testified that applying this standard to the general partnership interests held by Fortress and Blackstone, the SEC staff found that the general partner controls the management of the private equity funds through the activities of its senior employees and that the partnership derives its profits from these efforts.

On this basis, the staff determined that the general partnership interests held by Fortress and Blackstone are not securities. The staff also determined that Fortress and Blackstone had properly included in their measurement of the value of the general partnership interests the general partner's right to receive performance-based fees in compensation for its services or the "carried interest". Mr. Donohue testified that in treating the general partnership interests as operating assets that include the value of the "carried interest", the SEC staff had found that the value of investment securities held by each of Fortress and Blackstone constitutes less than 40 percent of the value of the fund manager's total assets and, therefore, concluded that neither Fortress nor Blackstone is an investment company.

If you have any questions about this release or a related issue, please contact Lorna J. MacLeod at +1 202 986 8053 or lmacleod@llgm.com or contact your LeBoeuf relationship attorney. Ms. MacLeod specializes in investment products and securities distribution and formerly was a branch chief in the Division of Investment Management of the Securities and Exchange Commission.

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