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Goldman Takes 'Private' Equity To a New Level

Firm's Trading System Lets Unregistered Stock Reach Exclusive Market

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Goldman Sachs Group Inc. ranks as the most profitable securities firm on Wall Street -- reflecting its mastery of trading on the world's public markets.

Now Goldman is turning that franchise on its head, creating its own private system to trade the stocks of companies that don't want the scrutiny and regulatory burdens of going public.

The new system, GS TRuE -- short for **Goldman Sachs** Tradable Unregistered Equity -- was announced two weeks ago and made its debut on Monday with an $880 million sale of a 15% stake in Oaktree Capital Management LLC, an alternative-investment manager.

It is the first of several new, private exchanges like these being considered by Wall Street firms and others. Nasdaq is also planning its own new market for smaller, unregistered securities.

These markets will generally be closed to individual investors. For instance, Goldman's market is open only to large institutional investors with assets of more than $100 million. That is because the stocks traded on GS TRuE aren't registered with the Securities and Exchange Commission and issuers aren't subject to SEC regulations designed to protect individual investors.

It represents the latest step in the creeping exclusion of individual investors from a growing proportion of financial-market activity. For instance, giant private-equity firms are busy buying public companies and delisting them from stock exchanges. The growing importance of hedge funds -- which are generally limited to wealthy investors, institutions and endowments -- also excludes individuals.

The new system is "a manifestation of the growth of private-equity relative to public equity," said Jay Ritter, a finance professor at the University of Florida in Gainesville, pointing to the record-setting pace of private-equity buyouts of public companies recently. (For more on Goldman's product, see Breakingviews column[1].)

Traditional mutual funds -- one of the main investment tools at the disposal of individual investors -- are also limited in the amount of unregistered securities they can buy or sell. Hedge funds, by contrast, have more freedom to buy unregistered stocks and bonds.

Indeed, bankers and capital-markets executives at rival firms say that, at GS TRuE's debut, hedge funds were prominent among buyers for the issue by Los Angeles-based Oaktree.

Some investor advocates criticized the trend of selling more securities faster with less disclosure. "It becomes much more of a buyer-beware marketplace with little regulatory oversight or protection," said Steven B. Caruso, a New York lawyer who represents investors in disputes with Wall Street.

Business Backlash

Goldman's move partly reflects a business-community backlash against increased regulation of public-company accounting practices -- a favorite theme, as it happens, of Treasury Secretary Henry M. Paulson Jr., who is also a former Goldman chief executive.

Wall Street executives said the market offers an alternative to companies that don't want to wait for regulators to approve their financial disclosures needed for an initial public offering, which can take 90 days or more.

They also said it offers a haven for firms that don't want to be subject to what Oaktree described as "the full panoply of regulations applicable to publicly traded companies in the United States." In a memorandum describing the stock sale, Oaktree added that staying private would avoid "pressure to describe the company as one capable of steady growth, whereas our underlying business is actually quite variable."

Although the Oaktree offering was sold to only about 50 buyers, it traded at roughly the same multiple of expected 2008 earnings as Fortress Investment Group LLC, a comparable alternative-investment manager that recently sold stock in a conventional initial public offering, according to Wall Street traders.

In other words, the Oaktree stock traded without a price discount that would reflect the lack of a public market with multiple dealers. In that respect, the new market passed an important first test. If stocks traded at too much of a discount, that might dissuade other companies from listing there.

What History Says

Bankers at rival firms -- many of which are developing similar systems -- predict that there will be consolidation among the different platforms.

"History in other markets would indicate that this will converge into a single platform," said Daniel Simkowitz, a managing director in capital markets at Morgan Stanley, which advised Oaktree on the issue.

Indeed, **Nasdaq Stock Market** Inc. is in the home stretch of getting approval for a similar unregistered trading facility for smaller companies called Portal. Another securities firm, **Friedman, Billings, Ramsey Group** Inc., has sold unregistered stock for numerous companies in real estate, energy and lodging.

Goldman executives said one reason they launched their own system solo, without asking other rival securities firms to participate, was to insure control over the number of investors in any particular security. That is crucial, they said, because any company that goes over 499 investors must register as a public company.

That 499-investor limit, said one executive of a top private-equity firm, is one reason why such buyout firms aren't likely to rush pell-mell into this type of new issue for their portfolio companies. The buyout firms want to attract far more investors to make sure they get the best prices for their stock, he explained.

'New Tool' in the Kit

Rob Pace, a senior capital-markets executive who played a lead role in developing the Goldman system, called such issues "a new tool in the tool kit" for investors, filling out a spot between harder-to-trade traditional private placements and public offerings.

Mr. Pace noted that Goldman still believes "the U.S. public capital markets are the deepest and most liquid," and will continue to represent "a more prevalent way to raise equity capital."

Goldman also said companies that issue stock on its system must promise to issue quarterly, annual and event-related financial reports comparable to those of public companies. However, they don't have the same obligation for widespread dissemination of detailed business information that can be of use to competitors.

Gregg Weinstein, a Goldman trading executive who also worked on the system, said Goldman doesn't "have any expectation that we're going to be able to stand alone in this product forever." But, he said, working with other dealers on the first issue would have risked delays.

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