CLIENT ALERT: MAY 16, 2006 SENATE BANKING SUBCOMMITTEE HEARING ON THE ROLE OF HEDGE FUNDS IN U.S. CAPITAL MARKETS

Introduction

The forecast for future oversight of the hedge fund industry seemed sunny at yesterday's Senate Subcommittee hearing, as regulators called to testify appeared in agreement that at least for now, the hedge fund industry was not in need of additional legislation or regulation. Before a standing-room only audience, Randal K. Quarles, Under Secretary for Domestic Finance at the Department of the Treasury, Susan Wyderko, Former Acting Director of the SEC's Division of Investment Management, Patrick M. Parkinson, Deputy Director of the Division of Research and Statistics at the Board of Governors of the Federal Reserve System, and Dr. James Overdahl, Chief Economist at the Commodity Futures Trading Commission, all spoke positively about the benefits of hedge funds, both to the economy at large and to investors, while acknowledging potential concerns, including the use of leverage by these vehicles. Senator Chuck Hagel (R-NE), Chairman of the Subcommittee for Securities and Investment of the Senate Banking, Housing, and Urban Affairs Committee, led the hearing entitled "The Role of Hedge Funds in our Capital Markets," which also featured academics Richard McCormack, Senior Advisor for the Center for Strategic and International Studies and Dr. Adam Lerrick, Visiting Scholar at the American Enterprise Institute and Professor of Economics at Carnegie Mellon University; investor advocate Kurt Schacht, Managing Director of the Centre for Financial Market Integrity of the Chartered Financial Analyst Institute; and industry participant James Chanos, President of Kynikos Associates and President of the Coalition of Private Investment Companies.

No Current Need for More Oversight

Both senators and the witnesses acknowledged the beneficial role hedge funds play in the marketplace by providing an important source of liquidity, risk distribution, price efficiency and investor choice. In their testimony and when asked, most witnesses advised that despite tremendous growth in assets under management experienced by many hedge funds, the industry should be studied before any potential legislative or further regulatory action is initiated. Senators Mike Crapo (R-ID) and John E. Sununu (R-NH) both criticized the latest regulatory action taken in this arena, the controversial new SEC rule under the Investment Advisers Act of 1940 requiring most hedge fund managers to register with the SEC as investment advisers. Susan Wyderko of the SEC, when asked about the preliminary effects of the new rule, responded that the SEC was monitoring the "basic census data" it had received from the additional registration of more than 1,200 hedge fund advisers and that no further action was needed at this time. Emphasizing the theme of "wait and see," several senators seemed concerned that any "over-regulation" could lead to hedge fund advisers moving their operations offshore or their investment activities away from the U.S. capital markets. Mr. Lerrick responded that in his experience, most hedge funds could begin operating offshore in a matter of hours, highlighting the need to guard against excessive regulation.

Potential Concerns

Witnesses acknowledged areas of concern associated with hedge funds, such as the risks that accompany the use of leverage, hedge funds' valuation of investments and portfolio reporting, and the familiar worry about retailization of hedge funds, particularly through the use of funds of funds that may be registered as investment companies under the Investment Company Act of 1940. Mr. Quarles, when addressing the specter of the failure of Long Term Capital Management that perennially dogs the industry, noted that substantial progress had been made in "counterparty risk management" to address hedge funds' use of leverage and that "private sector discipline" had evolved to temper the use of leverage by hedge funds in general. Both Mr. Quarles and Mr. Chanos said that in addition, the industry has become substantially more "institutionalized" in response to the needs of its growing base of investors which include pension plans, endowments and other institutional investors demanding high standards of risk management and transparency. Nonetheless, the lack of guidance and industry consensus regarding both the frequency of, and the standards to be applied to, valuations of often illiquid investments and portfolio and/or performance reporting were cited by some witnesses as areas to watch. The worry that unsophisticated individuals may be able to invest in hedge funds through funds of funds was also raised, which Senator Sununu was quick to moderate with a call to raise the accredited investor standards. Others noted that the investment minimums for those funds were generally high enough to effectively limit the investor pool to fairly wealthy individuals.

Future Outlook

Senator Hagel remarked that this hearing was intended to gather information and monitor developments related to the hedge fund industry at the congressional level; it was not clear what future action, if any, might result. Noting the interest generated by the hearing as reflected in the senators' high attendance levels, Senator Hagel implied that the Subcommittee would continue to ask for input from regulators and the industry at future hearings on this topic.

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If you have any questions about the hearing, please contact Karrie H. McMillan (202-303-1202, kmcmillan@willkie.com), Jennifer R. Suellentrop (202-303-1281, jsuellentrop@willkie.com), Eric C. Goldstein (202-303-1286, egoldstein@willkie.com) or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, D.C. 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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