HOUSE FINANCIAL SERVICES COMMITTEE HEARING ON THE REGULATION OF HEDGE FUNDS

Introduction

On Tuesday, March 13, 2007, Congressman Barney Frank (D-MA), Chairman of the House Committee on Financial Services (the "Committee"), presided over a hearing on hedge funds stating that the Committee needed to "know more about things."

Tuesday's hearing is the first of a series of hearings on the linked topics of hedge funds, private equity and the role of derivatives. The topics of the hearings include hedge funds, systemic risk in the financial markets and a subset of investor protection issues principally dealing with the interaction between pension funds and hedge funds. Tuesday's hearing also covered the roles of counterparties, including prime brokers.

Investor Protection

SEC Registration - For or Against? One of the principal concerns was whether SEC registration of hedge fund advisers would be helpful. All of the panelists, with the exception of Kenneth D. Brody of Taconic Capital Advisors LLC, opposed mandatory SEC registration of hedge fund advisers. Mr. Brody believed that mandatory registration is "good policy" because it promotes "self-policing and self-discipline." James S. Chanos, speaking for the Coalition of Private Investment Companies, recommended, in lieu of mandatory registration, that the SEC amend Form D filed pursuant to Regulation D of the Securities Act to require additional information from pooled investment vehicles. Mr. Chanos advised the Committee to "focus on the activity and not the actor." Congressman Richard H. Baker (R-LA) acknowledged that registration does not solve potential problems associated with hedge funds and that hedge fund investors should be those who can afford to lose their investments. To illustrate this point, George Hall of the Managed Funds Association stated: "If you've got a Bentley, you've probably also got a Rolls-Royce. So if you lose the Bentley, you're still going to be okay."

Public Pension Plans - What about the pipefitter? Another principal concern was the impact of hedge funds on pension plans (particularly public pension plans). Chairman Frank and other members of the Committee voiced several concerns about pension plans and hedge funds. One of the Committee members raised concerns about the risk of taxpayers having to compensate the "pipefitter" for potential economic losses resulting from pension plan investments in hedge funds. The witnesses advocated that the government's scrutiny should more properly be placed upon pension plan managers rather than on the hedge fund industry. Chairman Frank noted that he will take a closer look at this issue.

Accredited Investor Standard - Should it be higher? In light of the SEC's recent proposal to raise the threshold and change the asset standard for accredited investors investing in hedge funds, the proposal was discussed at the hearing. When asked by the Committee about whether the net worth figure for meeting the "accredited investor" standard should be higher, three witnesses definitively supported increasing it. Mr. Brody stated that the current $2.5 million threshold is not a bad number but is an "imperfect proxy" for sophistication. Mr. Hall suggested that net worth, income and investment experience should all be given weight when determining whether an investor is an accredited investor.

Systemic Risk in the Financial Markets

Leveraging Practices - "Risk management is more an art than science" (E. Gerald Corrigan, Managing Director of Goldman Sachs & Company and former President of the Federal Reserve Bank of New York). One of the themes of the hearing was the importance of systemic risk management (and the difficulty of managing such risks). Mr. Corrigan strongly believed that the market needs to increase its "shock absorbers." By this, he meant strengthening corporate governance, risk management, financial infrastructure and reputational risk management; enhancing disclosure; and gaining a better understanding of complex instruments.

Jeffrey L. Matthews of Ram Partners LP and Andrew Golden, President of Princeton University Investment Company, both suggested that the increased use of leverage by hedge funds posed the greatest risk to the market. In particular, Mr. Corrigan and Mr. Golden recommended that the Committee focus on the large financial intermediaries, such as prime brokers, that act as the counterparties in lending to hedge funds.

Chairman Frank indicated that the Committee and its staff would examine the aggregate counterparty responsibility issue. Mr. Chanos recommended that they consider the Financial Supervisory Authority's approach to examining major prime brokers in the U.K. The Chairman mentioned establishing a benchmark of best practices for the counterparties and for whoever is "playing" with the hedge funds (*e.g.*, brokers, banks and insurance companies). The Chairman also noted that he would look into imposing obligations on the counterparty to report what a counterparty would view as "ill-advised" hedge fund conduct to the regulators.

Disclosure and Other Proposals

Chairman Frank raised some other notable questions on disclosure including: (1) Is there a role for the government in increasing the flow of information between hedge funds and their intermediaries, investors and the regulatory community? (2) If there were to be a benchmark of best practices on the flow of information from hedge funds to such parties, should a public agency have the responsibility of monitoring whether or not the best practices were being followed?

In his concluding remarks, Chairman Frank asked the witnesses whether they would object to general record retention requirements for both registered and unregistered advisers to hedge funds, and none of the witnesses objected. Based on the recommendation of the witnesses, the Committee may wait before taking any action until the final report from the President's Working Group on Financial Markets is released, provided that it is released within six months.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com), Karrie McMillan (202-303-1202, kmcmillan@willkie.com), Jane H. Kim (202-303-1242, jkim@willkie.com), or the Asset Management 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.

March 15, 2007

Copyright © 2007 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.