CONGRESSIONAL HEARING ON THE ROLE OF HEDGE FUNDS IN THE CURRENT FINANCIAL CRISIS

Introduction

On November 13th, the House Committee on Oversight and Government Reform held a hearing on "Hedge Funds and the Financial Markets," the Committee's fifth hearing on aspects of the U.S. financial crisis. At the hearing, lawmakers were given the chance to question some of the top hedge fund managers and industry experts about their perspectives on the role of hedge funds in the current financial downturn. A major goal of this hearing was to determine the appropriate level of government oversight and regulation of hedge funds in the future. The hearing focused on six areas: (1) the role hedge funds have played in the current financial crisis; (2) the systemic risk posed by hedge funds; (3) the role of government regulation of hedge funds; (4) the need for greater transparency regarding hedge funds; (5) the tax treatment of carried interest; and (6) the compensation structure of hedge fund managers.

The hearing featured two groups of witnesses. The first panel consisted of four industry experts: Professor Andrew Lo (Massachusetts Institute of Technology), Professor David Ruder (Northwestern University and Former Chairman of the U.S Securities and Exchange Commission (the "SEC")), Professor Joseph Bankman (Stanford University) and Houman Shadab (Senior Research Fellow at George Mason University). The second panel was composed of five hedge fund managers:[1] Philip Falcone (Harbinger Capital Partners), Kenneth Griffin (Citadel Investment Group), John Paulson (Paulson & Co.), James Simons (Renaissance Technologies) and George Soros (Soros Fund).

Role of Hedge Funds in the Current Financial Crisis

Members of the Committee attempted to define the role of hedge funds in the current financial crisis, but it quickly became clear from the first panel of industry experts that this task would not be easy. Witnesses on this panel asserted that hedge funds did not create the crisis but may have amplified the negative consequences of the downturn through their lack of transparency, use of leverage and large risk profiles. They agreed that hedge funds play an important role in the economy by providing liquidity and price discovery.

Systemic Risk of Hedge Funds

A major theme of the hearing was the lawmakers' apprehension regarding the potential systemic risk caused by the new multi billion dollar hedge funds, whose total exposure could be even greater depending on their use of leverage. Committee Chairman Waxman (D-CA) opened the discussion by referring to the 1998 collapse of Long Term Capital Management and asked the panel of hedge fund managers whether they believe that the hedge fund industry poses a systemic risk. Chairman

[1] There is speculation that these particular managers were chosen because they were named in Alpha magazine as some of the highest compensated managers and executives.

Waxman called the hedge fund industry a "shadow banking system" that remains practically unregulated. The hedge fund managers generally agreed that the overuse of leverage by certain hedge funds poses a systemic risk. Mr. Falcone, however, cautioned that all hedge funds do not use inappropriate amounts of leverage. As discussed below, the panel made several recommendations to limit and reduce future risks posed by the widespread use of leverage.

The Future of Hedge Fund Regulation

Increased Regulation of Hedge Funds

The Committee members and many of the witnesses unanimously agreed that increased regulation of hedge funds is important; however, the hedge fund managers in the second panel warned against too much regulation. In support of limited regulation, Mr. Soros stated, "It would be a grave mistake to add to the forced liquidation currently dislocating markets by ill-considered or punitive regulations." The Committee probed for how best to increase the regulation of hedge funds and which government organizations should be involved. Mr. Lo and Mr. Ruder, a former SEC Chairman, disagreed about the possible regulatory framework. Mr. Lo supported regulation by the Federal Reserve Bank (the "Fed") of systemic risk because the Fed would be in the strongest position to control and regulate risk associated with leverage and liquidity issues. In response, Mr. Ruder advocated a joint regulatory system in which the SEC would be in charge of investor protection through its use of inspection and understanding of the risk management systems while the Fed would control the systemic risk issues. This joint regulatory effort, he noted, would provide investor protection as well as comfort for the financial markets as a whole. Some members of the Committee questioned the practicability of such a structure. The hedge fund managers for the most part supported increasing the regulation of hedge funds by increasing required disclosure to the regulators. Some of the witnesses suggested imposing margin requirements and leverage requirements. Mr. Griffin and Mr. Paulson disagreed with the view that regulators should focus on hedge funds as causes of financial instability. Mr. Griffin stated, "[W]e've not seen hedge funds as the focal point of the carnage."

Need for Greater Transparency of Hedge Funds

Throughout the hearing, the Committee members raised concerns regarding the lack of transparency in the hedge fund industry. Congressman Cooper (D-TN) even went so far as to state that the withholding of information amounted to a lack of truth in advertising by hedge funds. The concerns of the Committee members ranged from apprehension about properly regulating an industry in which there is little information and investments are made in a "black-box," to the fear that the lack of transparency led investors to make investments without adequate understanding of the level of risk involved. Committee members generally advocated greater transparency and questioned each hedge fund manager about the need for new rules in this area. The hedge fund managers supported the idea of greater transparency. Mr. Falcone stated that investors "have the right to know what assets companies have an interest in whether on or off their balance sheets and what those assets are really worth." Each witness stressed the need to protect proprietary trading strategies, which could be disclosed confidentially to regulators but not to the general public. Mr. Griffin noted that requiring public disclosure of proprietary trading information would be the equivalent of "asking Coca-Cola to disclose their secret formula."

Altering Tax Treatment of Carried Interest

Committee members also questioned the current tax structure, which permits hedge fund managers to report carried interest as long-term capital gain rather than ordinary income in certain instances. Chairman Waxman noted that this situation can result in hedge fund managers being taxed at "a lower tax rate than many school teachers, firefighters or plumbers…" Some of the hedge fund managers did not oppose an increase in the tax rate for carried interest if it results from rules that are applied consistently to all investment professionals and is not targeted solely at hedge fund managers. However, Mr. Paulson and Mr. Griffin expressed reservations about any change in the taxation of long-term capital gains.

Reviewing Compensation Structure of Hedge Fund Managers

Finally, Committee members made reference to the hefty compensation many hedge fund managers have received over the last few years. The Committee members did not explicitly state their intention to regulate compensation, but they did express their concern about both the amount of compensation received and the potential incentives the performance fee structure of hedge funds may create. The hedge fund managers defended their compensation by stating that their own money is invested in the funds they manage. In addition, Mr. Paulson stated that "all of our funds have a 'high-water mark,' which means that if we lose money for our investors, we have to earn it back before we share in future profits." So although the compensation issue arose, the Committee did not explicitly condemn the mechanics of hedge fund manager compensation or suggest any new restrictions for the future.

Conclusion

Though no legislation appears likely to arise out of this particular hearing, it is clear that when the new Congress begins substantive work on financial reform, probably next March, the focus will be on understanding and limiting, through increased regulation, the impact hedge funds have on the U.S. economy. Any such regulation could take many different forms. Hedge funds and firms affected by the activities of hedge funds need to monitor the development of new laws governing hedge funds and to assess the impact of those laws on their businesses.

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

This memorandum was prepared by Benjamin Haskin and Russell Smith. If you have any questions about this memorandum, please contact any of the members of the WF&G New Administration/Congress Task Force listed below or the attorney with whom you regularly work. The New Administration/Congress Task Force has been formed to provide information and targeted advice, and to respond to questions from clients in connection with the legislative, regulatory, and enforcement and compliance initiatives, and potential litigation, that will result from the new U.S. President and Congress elected on November 4, 2008.

NEW ADMINISTRATION/CONGRESS TASK FORCE		
Antitrust	***Corporate and Financial Services***	***Litigation***
Bernard Nigro, Jr. (202) 303-1125 bnigro@willkie.com	Gregory Astrachan (212) 728-8608 gastrachan@willkie.com	David Murray (202) 303-1112 dmurray@willkie.com
William Rooney (212) 728-8259 wrooney@willkie.com	Thomas Cerabino (212) 728-8208 tcerabino@willkie.com	Jeanne Luboja (212) 728-8241 jluboja@willkie.com
Theodore Whitehouse (202) 303-1118 twhitehouse@willkie.com	Steven Gartner (212) 728-8222 sgartner@willkie.com	***Purchases of Real Estate Assets and Real Estate Related Securities***
Asset Management	Bruce Herzog (212) 728-8220 bherzog@willkie.com	Eugene Pinover (212) 728-8254 epinover@willkie.com
Barry Barbash (202) 303-1201 bbarbash@willkie.com	Bruce Kraus (212) 728-8237 bkraus@willkie.com	***Securities Litigation & Enforcement***
Larry Bergmann (202) 303-1103 lbergmann@willkie.com	Jack Nusbaum (212) 728-8060 jnusbaum@willkie.com	Richard Bernstein (202) 303-1108 rbernstein@willkie.com
Benjamin Haskin (202) 303-1124 bhaskin@willkie.com	Steven Seidman (212) 728-8763 sseidman@willkie.com	Gregory Bruch (202) 303-1205 gbruch@willkie.com
Rita Molesworth (212) 728-8727 rmolesworth@willkie.com	***Estate Tax***	Mei Lin Kwan-Gett (212) 728-8503 mkwangett@willkie.com
Biotech/Pharmaceutical Regulation	David McCabe (212) 728-8723 dmccabe@willkie.com	Julie Smith (202) 303-1209 jasmith@willkie.com
Peter Jakes (212) 728-8230 pjakes@willkie.com	***Environmental***	Michael Young (212) 728-8280 myoung@willkie.com
Business Reorganization & Restructuring	E. Donald Elliott (202) 303-1120 delliott@willkie.com	***Tax***
Marc Abrams (212) 728-8200 mabrams@willkie.com	***Government Relations***	Richard Reinhold (212) 728-8292 rreinhold@willkie.com
	Russell Smith (202) 303-1116 rsmith@willkie.com	

Compliance, Investigations and Enforcement	*Insurance*	*Telecommunications and Data Privacy*
Jeffrey Clark (202) 303-1139 jdclark@willkie.com	Mitchell Auslander (212) 728-8201 mauslander@willkie.com	Francis Buono (202) 303-1104 fbuono@willkie.com
Robert Meyer (202) 303-1123 rmeyer@willkie.com	Leah Campbell (212) 728-8217 lcampbell@willkie.com	Thomas Jones (202) 303-1111 tjones@willkie.com
Martin Weinstein (202) 303-1122 mweinstein@willkie.com		Philip Verveer (202) 303-1117 pverveer@willkie.com

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, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

November 14, 2008

Copyright © 2008 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.