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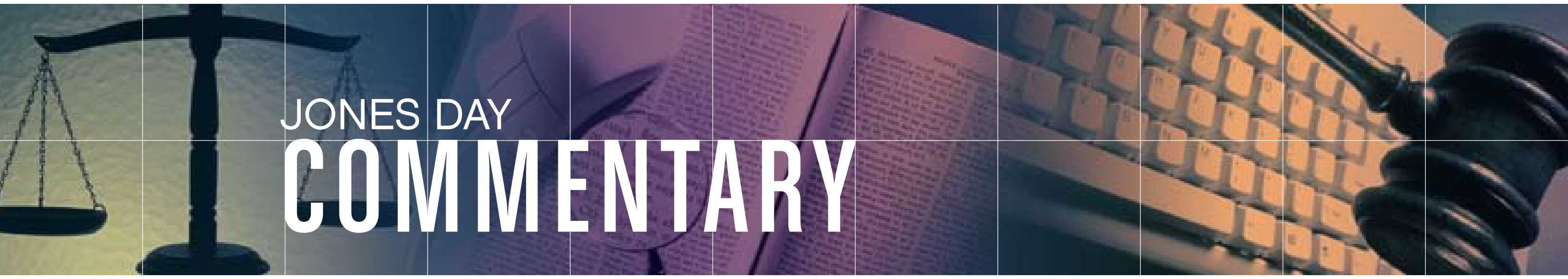

HOUSE OVERSIGHT AND GOVERNMENT REFORM COMMITTEE HEARING ON HEDGE FUNDS AND THE FINANCIAL MARKET

On November 13, 2008, the House Oversight and Government Reform Committee, chaired by Congressman Henry Waxman (D), held a hearing on hedge funds and the financial market. The witnesses at the hearing were Professor David Ruder, Northwestern University School of Law, Former Chairman U.S. Securities and Exchange Commission; Professor Andrew Lo, Director, Laboratory for Financial Engineering, Massachusetts Institute of Technology, Sloan School of Management; Professor Joseph Bankman, Stanford University Law School; Houman Shadab, Senior Research Fellow, Mercatus Center, George Mason University; John Alfred Paulson, President, Paulson & Co., Inc.; George Soros, Chairman, Soros Fund Management, LLC; James Simons, President, Renaissance Technologies, LLC; Philip A. Falcone, Senior Managing Partner, Harbinger Capital Partners; and Kenneth C. Griffin, Chief Executive Officer and President, Citadel Investment Group, LLC. The witnesses testified about the responsibility of hedge funds in the recent financial crisis, the systemic risk hedge funds may pose to the economy, and the role that regulation should play in the future of the hedge fund industry. The general points from the witnesses were their conclusions that hedge funds are beneficial to the financial system and are not to blame for the current crisis. Rather, they cited the poor capital regulation of financial institutions and the lack of data regarding many complex financial instruments as the primary causes, while they acknowledged some benefits of regulation of the hedge fund industry.

KEY POINTS FROM THE WITNESSES

Hedge Funds Are Beneficial. The witnesses generally agreed that hedge funds are beneficial. They acknowledged that hedge funds create innovative financial products that bolster market efficiency. Some, but not all, of the witnesses theorized that hedge funds, as rational actors, may stabilize the market by being less prone to the financial euphoria and hysteria that trigger the economy's boom-bust cycle.

Hedge Funds Are Not to Blame For Current Crisis. Likewise, the witnesses largely did not see hedge funds as having played a direct, major role in causing the current crisis. They agreed that the primary culprit was the real estate bubble and the overleveraging of banks and other market participants, noting that most funds have significantly less leverage than highly regulated banks. The witnesses suggested that hedge funds were no more likely than other players to overvalue real estate or mortgage-derived assets. A few witnesses presented evidence that, at the height of the bubble, hedge funds were more real estate averse than other players and that their resulting short sales of mortgage-derived assets prevented even more real estate speculation and mortgage defaults. Most witnesses stated their belief that "shorting" was an important practice in achieving price discovery.

Need for Hedge Fund Regulation. The witnesses agreed that to prevent future crises, hedge funds must yield to some regulation. Currently, hedge funds are not required to disclose the identity of their investors, the contents of their portfolios, or their leverage to any regulatory authority. The majority of the questioning focused on whether the funds would support a requirement that they report holdings data to a regulator. While there was some variation in the responses, most agreed that, despite the cost and cumbersome nature, reporting of positions on a confidential basis to a regulator was needed. There was some discussion and minor disagreement on whether position reporting should be done to the SEC and then provided to the Fed for purposes of aggregation, or simply directly to the Fed. This increased transparency would allow the regulator to more closely monitor systemic risk. The participants generally favored the clearinghouse model for collateralized default swaps and increased standardization of swap instruments, although some acknowledged that improved standardization would not in the long run impede innovation.

Bank Capital, TARP, and Other Topics. The hearing testimony also covered several other topics. The witnesses generally viewed banks as lacking capital and thus favored the changes to TARP that focused that program on the acquisition of preferred and other forms of equity of financial institutions, as opposed to buying troubled assets. Questions concerning capital gains taxation highlighted more general disagreement on broader tax issues between Republican and Democratic congressmen. The witnesses generally favored continued capital gains treatment for assets held for longer than one year, although one fund manager spoke in favor of elimination of tax loopholes that allow fund managers to report carried interest as capital gains. Not surprisingly, the hedge fund witnesses did not favor increased regulation of executive compensation, although they acknowledged that it may be the price of government subsidies to troubled institutions.

POSSIBLE RECOMMENDATIONS FROM THE HEARING

The precise form, timing, and nature of the committee's recommendations from the hearing and other sources are not clear. Hedge fund regulation as a general matter raises complex jurisdictional and political issues given the topics covered, including capital and leverage regulation, executive compensation, and tax policy. Notwithstanding the above, the following points were discussed as possible next steps.

Regulation. The witnesses and committee members appeared to recognize the need for increased regulation. Many witnesses generally acknowledged that hedge funds should provide more transparency, should be subject to SEC registration and inspection, and should report large positions. In their view, many large hedge fund managers already self-regulate, either by disclosing information to their investors and creditors, or by voluntarily registering with the SEC. The fund managers reported that this self-regulation is not overly burdensome. The committee members, in this hearing at least, appeared to appreciate the risks of increased regulation—impeding hedge funds' productive financial innovation, lessening beneficial market impacts, and draining jobs from the U.S. economy—and did not seriously challenge any participant's position. All but one witness favored leaving capital regulation of hedge funds to the financial institutions from which they borrow.

Clearinghouse for CDSs. Most witnesses proposed clearinghouses for credit default swaps, although they acknowledged that the legislative changes needed for a public as opposed to private solution would be more difficult to enact.

Final Observations. This particular hearing is only part of a broader contemplation of reform that is in the wind. While the formation of a clearinghouse for CDS trades and large position reporting on a confidential basis are relatively benign in the current environment, the issues quickly spill over into matters that concern long-entrenched political forces. To that end, we note that all the witnesses appeared voluntarily, and, having just settled a historic election, none of the congressmen were seeking to use the hearing to bolster support from their traditional constituencies.

LAWYER CONTACTS

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