CLIENT ALERT: JULY 25, 2006 SENATE BANKING COMMITTEE HEARING ON THE REGULATION OF HEDGE FUNDS

Introduction

Before a standing-room-only audience, Senator Richard Shelby (R-AL), Chairman of the Senate Committee on Banking, Housing, and Urban Affairs ("Committee"), on Tuesday chaired a hearing on the operation and regulation of hedge funds. This hearing comes in the wake of *Goldstein v. SEC,*[1] the decision handed down last month by the U.S. Court of Appeals for the District of Columbia vacating the SEC's highly controversial hedge fund manager registration rule.[2] The Committee heard testimony from three members of the President's Working Group on Financial Markets ("PWG"): Christopher Cox, Chairman of the Securities and Exchange Commission ("SEC"), Randal K. Quarles, Under Secretary for Domestic Finance at the Department of the Treasury ("Treasury"), and Reuben Jeffery III, Chairman of the Commodity Futures Trading Commission ("CFTC").

Post-*Goldstein* Fallout

In his opening remarks, Committee Chairman Shelby suggested that the decision in *Goldstein* may provide a starting point for potential legislation designed to enhance the regulation of hedge funds. Several Republican members of the Committee disagreed, maintaining that additional regulation of hedge funds is not needed. The Committee members and witnesses uniformly acknowledged the significant and beneficial role that hedge funds play in today's market by contributing to market diversification, efficiency, and liquidity, but several expressed concern about a lack of information and transparency.

Chairman Cox expressed the view that current hedge fund regulation is "inadequate" and that the SEC lacks the means to acquire basic census data to monitor hedge fund activity for the purpose of mitigating systemic market risk. He told the Committee that hedge funds today remain subject to SEC regulations and enforcement under anti-fraud, civil liability, and other provisions of the federal securities laws, but maintained that the principal reasons behind the SEC's adoption of the hedge fund manager registration rule -- the growth of the industry, the potential of harm to retail investors, and the growth in hedge fund fraud -- remain serious concerns. Various participants in the hearing also expressed their continuing concern with regard to potential hedge fund fraud and market manipulation. Chairman Cox emphasized to the Committee that the SEC will continue to vigorously pursue enforcement actions against hedge funds and hedge fund advisers that violate the federal securities laws.

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[1] No. 04-1434 (D.C. Cir. 2006).

[2] *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (Codified at 17 C.F.R. pts. 275, 279).

Future Outlook

Chairman Cox was clear in his statement that the SEC must move quickly to address what he termed a "hole" in the regulation of hedge funds left by *Goldstein*. He described several initiatives designed for this purpose: (1) promulgating a new anti-fraud rule under the Investment Advisers Act of 1940 ("Advisers Act") that would in effect reverse the conclusion of the *Goldstein* court that a hedge fund manager has a fiduciary obligation to the fund and not to investors in the fund; (2) restoring a series of transitional and exemptive rules contained in the hedge fund manager registration rule and beneficial to hedge fund managers but rendered void by *Goldstein*; (3) restoring to hedge fund advisers newly registered under the Advisers Act a qualified exemption contained in the hedge fund manager registration rule from the Advisers Act's recordkeeping requirement for certain performance data; (4) restoring a provision of the Advisers Act's custody rule,[3] which had been added by the hedge fund manager registration rule, affording a fund of hedge funds manager 180 days, rather than 120, to provide investors with audited financial statements so as to be able to take advantage of an exception from the custody rule; (5) addressing the disincentive for offshore fund advisers to register voluntarily under the Advisers Act in the face of doubt created by *Goldstein* regarding whether registered offshore advisers will be subject to all the provisions of the Advisers Act; and (6) analyzing the definition of "accredited investor" in rules under the Securities Act of 1933, on which many, if not most, hedge funds rely, so as to increase the monetary threshold investors must meet in investing in hedge funds. Chairman Cox also confirmed to the Committee that the SEC staff would continue to conduct compliance examinations of hedge fund managers registered under the Advisers Act.

Taken as a whole, Chairman Cox's testimony seemed to indicate that the SEC would not appeal the *Goldstein* decision. In a media interview after the hearing, however, the Chairman asserted that an appeal of the *Goldstein* ruling is not "off the table." He noted that the Commission is continuing to evaluate the cost and resources required for an appeal and that the SEC has until August 7, 2006 to make its final decision.

In response to Senator Chuck Hagel's (R-NE) question regarding the need for further legislation on hedge fund regulation or SEC rulemaking authority, Chairman Cox answered that it is the prerogative of the legislature to pass laws as it sees fit and that his focus is on exercising existing statutory authority on this matter. The Chairman's written testimony, however, maintained that any legislation and rulemaking regarding hedge funds should be non-intrusive to avoid interference with the investment strategies and operations of the funds and their characteristics of creativity, liquidity, and flexibility. In addressing questions about the statutory authority of federal agencies to deal with hedge funds, Chairman Cox suggested that whether the SEC had sufficient authority to promulgate further rules to regulate hedge funds continues to be an open question. He added that the SEC staff is reviewing the relevant legal authority, and emphasized that the current regulatory regime of hedge funds is inadequate.

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[3] 17 CFR § 275.206-4 (2006).

CFTC Chairman Jeffery's testimony asserted that the CFTC will remain vigilant as hedge fund participation in the futures markets continues to expand in upholding the agency's investor protection regime consistent with its statutory responsibilities. He told the Committee that the CFTC plans to continue examining commodity pool operators and commodity trading advisors in relation to fraud allegations.

Under Secretary Quarles stated that Treasury continues its consideration of alternative courses of action following the *Goldstein* decision through a comprehensive review chaired by Treasury and involving the participation of the SEC. All three witnesses expressed a willingness to work together as PWG members on the regulation of hedge funds.

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If you have any questions concerning the foregoing or would like additional information, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Roger D. Blanc (212-728-8206, rblanc@willkie.com), Larry E. Bergmann (202-303-1103, lbergmann@willkie.com), Michael S. Didiuk (202-303-1280, mdidiuk@willkie.com), Y. Rachel Kuo (202-303-1288, rkuo@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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