



Highlights of [GAO-08-200](#), a report to congressional requesters

Why GAO Did This Study

Since the 1998 near collapse of Long-Term Capital Management (LTCM), a large hedge fund—a pooled investment vehicle that is privately managed and often engages in active trading of various types of securities and commodity futures and options—the number of hedge funds has grown, and they have attracted investments from institutional investors such as pension plans. Hedge funds generally are recognized as important sources of liquidity and as holders and managers of risks in the capital markets. Although the market impacts of recent hedge fund near collapses were less severe than that of LTCM, they recalled concerns about risks associated with hedge funds and they highlighted the continuing relevance of questions raised over LTCM. This report (1) describes how federal financial regulators oversee hedge fund-related activities under their existing authorities; (2) examines what measures investors, creditors, and counterparties have taken to impose market discipline on hedge funds; and (3) explores the potential for systemic risk from hedge fund-related activities and describes actions regulators have taken to address this risk. In conducting this study, GAO reviewed regulators' policy documents and examinations and industry reports and interviewed regulatory and industry officials, and academics.

Regulators only provided technical comments on a draft of this report, which GAO has incorporated into the report as appropriate.

To view the full product, including the scope and methodology, click on [GAO-08-200](#). For more information, contact Orice M. Williams at (202) 512-8678 or williams@gao.gov.

HEDGE FUNDS

Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed

What GAO Found

Under the existing regulatory structure, the Securities and Exchange Commission and Commodity Futures Trading Commission can provide direct oversight of registered hedge fund advisers, and along with federal bank regulators, they monitor hedge fund-related activities conducted at their regulated entities. Since LTCM's near collapse, regulators generally have increased reviews—by such means as targeted examinations—of systems and policies of their regulated entities to mitigate counterparty credit risks, including those involving hedge funds. Although some examinations found that banks generally have strengthened practices for managing risk exposures to hedge funds, regulators recommended that they enhance firmwide risk management systems and practices, including expanded stress testing. Regulated entities have the responsibility to practice prudent risk management standards, but prudent standards do not guarantee prudent practices. As such, it will be important for regulators to show continued vigilance in overseeing hedge fund-related activities.

According to market participants, hedge fund advisers have improved disclosures and transparency about their operations since LTCM as a result of industry guidance issued and pressure from investors and creditors and counterparties (such as prime brokers). But market participants also suggested that not all investors have the capacity to analyze the information they receive from hedge funds. Regulators and market participants said that creditors and counterparties have generally conducted more due diligence and tightened their credit standards for hedge funds. However, several factors may limit the effectiveness of market discipline or illustrate failures to properly exercise it. For example, because most large hedge funds use multiple prime brokers as service providers, no one broker may have all the data necessary to assess the total leverage of a hedge fund client. Further, if the risk controls of creditors and counterparties are inadequate, their actions may not prevent hedge funds from taking excessive risk. These factors can contribute to conditions that create systemic risk if breakdowns in market discipline and risk controls are sufficiently severe that losses by hedge funds in turn cause significant losses at key intermediaries or in financial markets.

Financial regulators and industry participants remain concerned about the adequacy of counterparty credit risk management at major financial institutions because it is a key factor in controlling the potential for hedge funds to become a source of systemic risk. Regulators have used risk-focused and principles-based approaches to better understand the potential for systemic risk and respond more effectively to financial shocks that threaten to affect the financial system. For instance, regulators have collaborated to examine some hedge fund activities across regulated entities. The President's Working Group has taken steps such as issuing guidance and forming two private sector groups to develop best practices to enhance market discipline. GAO views these as positive steps, but it is too soon to evaluate their effectiveness.