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Highlights

Highlights of GAO-09-677T, a testimony to Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

Why GAO Did This Study

In 2008, GAO issued two reports on hedge funds—pooled investment vehicles that are privately managed and often engage in active trading of various types of securities and commodity futures and options contracts—highlighting the need for continued regulatory attention and for guidance to better inform pension plans on the risks and challenges of hedge fund investments. Hedge funds generally qualified for exemption from certain securities laws and regulations, including the requirement to register as an investment company. Hedge funds have been deeply affected by the recent financial turmoil. But an industry survey of institutional investors suggests that these investors are still committed to investing in hedge funds in the long term. For the first time hedge funds are allowed to borrow from the Federal Reserve under the Term-Asset Backed Loan Facility. As such, the regulatory oversight issues and investment challenges raised by the 2008 reports still remain relevant.

This testimony discusses: (1) federal regulators' oversight of hedge fund-related activities; (2) potential benefits, risks, and challenges pension plans face in investing in hedge funds; (3) the measures investors, creditors, and counterparties have taken to impose market discipline on hedge funds; and (4) the potential for systemic risk from hedge fund-related activities. To do this work we relied upon our issued reports and updated data where possible.

View GAO-09-677T or key components.
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HEDGE FUNDS

Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges

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. 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. The federal government does not specifically limit or monitor private sector plan investment in hedge funds. Under federal law, fiduciaries must comply with a standard of prudence, but no explicit restrictions on hedge funds exist.

Pension plans invest in hedge funds to obtain a number of potential benefits, such as returns greater than the stock market and stable returns on investment. However, hedge funds also pose challenges and risks beyond those posed by traditional investments. For example, some investors may have little information on funds' underlying assets and their values, which limits the opportunity for oversight. Plan representatives said they take steps to mitigate these and other challenges, but doing so requires resources beyond the means of some plans.

According to market participants, hedge fund advisers have improved disclosures and transparency about their operations as a result of industry guidance issued and pressure from investors and creditors and counterparties. 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. Further, if the risk controls of creditors and counterparties are inadequate, their actions may not prevent hedge funds from taking excessive risk and 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 observers 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. Although hedge funds generally add liquidity to many markets, including distressed asset markets, in some circumstances hedge funds' activities can strain liquidity and contribute to financial distress. In response to their concerns regarding the adequacy of counterparty credit risk, a group of regulators had collaborated to examine particular hedge fund-related activities across entities they regulate, and the President's Working Group on Financial Markets (PWG). The PWG also established two private sector committees that recently released guidelines to address systemic risk and investor protection.