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.