Testimony
Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House of Representatives

HEDGE FUNDS
Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges

Statement of Orice M. Williams, Director
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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.
Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to participate in today’s hearing on hedge funds. A hedge fund is a pooled investment vehicle that is privately managed and often engages in active trading of various types of securities and commodity futures and options. In general, hedge funds qualify for exemption from certain securities laws and regulations, including the requirement to register as an investment company.\(^1\) When we conducted the two studies on hedge funds in 2007, the hedge fund sector was growing in importance and continuing to evolve within the financial system. Hedge funds, largely driven by investments from institutional investors, such as endowments, foundations, insurance companies, and pension plans, seeking to diversify their risks and increase returns, have grown dramatically over the last decade. From 1998 to early 2007, the estimated number of funds grew from more than 3,000 to more than 9,000 and assets under management from $200 billion to more than $2 trillion globally.\(^2\) An estimated $1.5 trillion of these assets is managed by U.S. hedge fund advisers. Hedge funds have significant business relationships with the largest regulated banking organizations. Hedge funds act as trading counterparties for a wide range of over-the-counter derivatives and other financing transactions. They also act as clients through their purchase of clearing and other services and as borrowers through their use of margin loans from prime brokers.

Much has happened in the financial markets since we issued our reports. Hedge funds have been deeply affected in the financial turmoil. According to an industry survey, most hedge fund strategies produced double-digit losses in 2008 and hedge funds saw approximately $70 billion in redemptions between June and November 2008.\(^3\) Some observers blamed hedge funds for dramatic volatility in the stock and commodity markets last year and some funds of hedge funds were heavily invested in the

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\(^1\)To avoid being required to register as an investment company under the Investment Company Act of 1940 (Investment Company Act), hedge funds typically rely on sections 3(c)(1) or 3(c)(7) of that act. Hedge fund advisers also typically satisfy the “private manager” exemption from registration under section 203(b)(3) of the Investments Advisers Act of 1940 (Advisers Act).

\(^2\)By comparison, assets under management in the mutual fund industry grew from about $5.5 trillion in 1998 to about $10.4 trillion in 2006.

\(^3\)Greenwich Associates and SEI Knowledge Partnership, Hedge Funds Under the Microscope: Examining Institutional Commitment in Challenging Times (January 2009).
alleged Madoff fraud. Nevertheless, an industry survey of institutional investors suggests that these investors are still committed to investing in hedge funds in the long term. Financial regulators’ views on hedge funds appear to be shifting as well, perhaps signaling recognition that hedge funds have become an integral part of the financial markets. For example, hedge funds are allowed to borrow from the Federal Reserve for the first time under the Term Asset-Backed Securities Loan Facility (TALF) intended to support consumer credit. While the Federal Reserve Chairman and Treasury Secretary have supported the position of enhanced market discipline over stricter regulation of hedge funds in 2007, Treasury has recently called for greater regulatory oversight of hedge funds. Despite changes surrounding the hedge fund sector, the issues and concerns related to regulatory oversight of hedge funds and challenges posed by hedge fund investing that were raised in our 2008 reports remain relevant today.

This statement is based on our January 24, 2008 and August 14, 2008 reports. Specifically, I will discuss: (1) the oversight of hedge fund-related activities provided by federal financial regulators under their existing authorities; (2) the 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 and actions regulators have taken to address this risk.

To do this work, we reviewed and analyzed relevant regulatory examination documentation and enforcement cases from federal financial regulators. We also analyzed relevant laws and regulations, survey data, speeches, testimonies, studies, and industry protocols and guidelines about private pools of capital. In addition, we interviewed officials representing various U.S. regulators, as well as representatives from market participants such as commercial and investment banks, large hedge funds, pension industry participants, credit rating agencies, a risk management firm, trade groups representing hedge funds and institutional investors.

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4SEI Knowledge Partnership and Greenwich Associates, Hedge Funds Under the Microscope.

investors, and academics. We conducted these performance audits from September 2006 to August 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Under the existing regulatory structure, the Securities and Exchange Commission’s (SEC) ability to directly oversee hedge fund advisers is limited to those that are required to register or voluntarily register with SEC as an investment advisor. Examinations of registered advisers raised concerns in areas such as disclosure, reporting and filing, personal trading, and asset valuation. SEC also oversees some of the securities firms that engage in significant hedge fund-related activities. The Commodity Futures Trading Commission (CFTC) regulates those hedge fund advisers who are registered as registered as commodity pool operators (CPO) or commodity trading advisors (CTA). Federal banking regulators 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 since the 1998 near collapse of Long-Term Capital Management (LTCM), a large highly leveraged hedge fund, 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 the hedge fund-related activities of regulated institutions. The federal government does not specifically limit or monitor private sector plan investment in hedge funds, and state approaches to public plans vary. Under federal law, fiduciaries must comply with a standard of prudence, but no explicit restrictions on hedge funds exist.

Summary

Banking regulators include the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Federal Reserve), and Federal Deposit Insurance Corporation (FDIC).

Inadequate market discipline is often cited as a contributing factor to the near collapse in 1998 of LTCM.
Pension plans invest in hedge funds in order to achieve one or more of several goals, including steadier, less volatile returns, obtaining returns greater than those expected in the stock market, or diversification of portfolio investments. Nonetheless, hedge fund investments pose investment challenges beyond those posed by traditional investments in stocks and bonds. For example, some investors may have little information on funds’ underlying assets and their values, which limits the opportunity for oversight. Plan officials and others described steps plans can take to address these challenges. However, they said that some of these steps require considerably greater effort and expertise from fiduciaries than is required for more traditional investments, and such steps may be beyond the capabilities of some pension plans, particularly smaller ones.

According to market participants, hedge fund advisers had 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 noted limitations. Regulators and market participants also said that creditors and counterparties had 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 instability in financial markets.

Financial regulators and industry observers remained 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. For example, the concentration created by numerous market participants establishing large positions on the same side of a trade, especially in combination with a high degree of leverage, can contribute to a liquidity crisis if market conditions compel traders to simultaneously unwind their positions. 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, mainly through international multilateral efforts and the President’s Working Group on Financial Markets (PWG). The PWG also has established two private sector committees to identify best practices to address systemic risk and investor protection, which released reports for comments in 2008 and issued final reports in 2009 respectively.

8The PWG was established by Executive Order 12631, signed on March 18, 1988. The Secretary of the Treasury chairs the PWG, the other members of which are the chairpersons of the Board of Governors of the Federal Reserve System, Securities and Exchange Commission, and Commodity Futures Trading Commission. The group was formed in 1988 to enhance the integrity, efficiency, orderliness, and competitiveness of the U.S. financial markets and maintain the public’s confidence in those markets.
Hedge Funds Generally Are Subject to Limited Direct Oversight and the Federal Government Does Not Specifically Limit or Monitor Private Sector Plans’ Investments in Hedge Funds

SEC’s ability to directly oversee hedge fund advisers is limited to those that are required to register or voluntarily register with SEC as investment advisers. Registered hedge fund advisers are subject to the same disclosure requirements as all other registered investment advisers. These advisers must provide current information to both SEC and investors about their business practices and disciplinary history. Advisers also must maintain required books and records, and are subject to periodic examinations by SEC staff. Meanwhile, hedge funds, like other investors in publicly traded securities, are subject to various regulatory reporting requirements. For example, upon acquiring a 5 percent beneficial ownership position of a particular publicly traded security, a hedge fund may be required to file a report disclosing its holdings with SEC.9

In December 2004, SEC adopted an amendment to Rule 203(b)(3)-1, which had the effect of requiring certain hedge fund advisers that previously enjoyed the private adviser exemption from registration to register with SEC as investment advisers. In June 2006, a federal court vacated the 2004 amendment to Rule 203(b)(3)-1.10 According to SEC, when the rule was in effect (from February 1, 2006, through August 21, 2006), SEC was better able to identify hedge fund advisers. In August 2006, SEC estimated that 2,534 advisers that sponsored at least one hedge fund were registered with the agency. Since August 2006, SEC’s ability to identify an adviser that manages a hedge fund has been further limited due to changes in filing

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9Under the Securities Act of 1933, a public offering or sale of securities must be registered with SEC, unless otherwise exempted. In order to exempt an offering or sale of hedge fund shares (ownership interests) to investors from registration under the Securities Act of 1933, most hedge funds restrict their sales to accredited investors in compliance with the safe harbor requirements of Rule 506 of Regulation D. See 15 U.S.C. § 77d and § 77e; 17 C.F.R. § 230.506 (2007). Such investors must meet certain wealth and income thresholds. SEC generally has proposed a rule that would raise the accredited investor qualification standards for individual investors (natural persons) from $1 million in net worth to $2.5 million in investments. See Revisions to Limited Offering Exemptions in Regulation D, 72 Fed. Reg. 45116 (Aug. 10, 2007) (proposed rules and request for additional comments). In addition, hedge funds typically limit the number of investors to fewer than 500, so as not to fall within the purview of Section 12(g) of the Securities Exchange Act of 1934, which requires the registration of any class of equity securities (other than exempted securities) held of record by 500 or more persons. 15 U.S.C. § 78l(g).

10See Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006). In Goldstein, the U.S. Circuit Court of Appeals for the District of Columbia held that SEC’s hedge fund rule was arbitrary because it departed, without reasonable justification, from SEC’s long-standing interpretation of the term “client” in the private adviser exemption as referring to the hedge fund itself, and not to the individual investors in the fund. See footnote 19, supra, for a description of the private adviser exemption from registration under the Advisers Act.
requirements and to advisers that chose to retain registered status. As of April 2007, 488, or about 19 percent of the 2,534 advisers, had withdrawn their registrations. At the same time, 76 new registrants were added and some others changed their filing status, leaving an estimated 1,991 hedge fund advisers registered. While the list of registered hedge fund advisers is not all-inclusive, many of the largest hedge fund advisers—including 49 of the largest 78 U.S. hedge fund advisers—are registered. These 49 hedge fund advisers account for approximately $492 billion of assets under management, or about 33 percent of the estimated $1.5 trillion in hedge fund assets under management in the United States. In an April 2009 speech, Chairman Schapiro stated that there are approximately 150 active hedge fund investigations at SEC, some of which include possible Ponzi schemes, misappropriations, and performance smoothing. In a separate speech in April, Chairman Schapiro renewed SEC’s call for greater oversight of hedge funds, including the registration of hedge fund advisers and potentially the hedge funds themselves.

SEC uses a risk-based examination approach to select investment advisers for inspections. Under this approach, higher-risk investment advisers are examined every 3 years. One of the variables in determining risk level is the amount of assets under management. SEC officials told us that most hedge funds, even the larger ones, do not meet the dollar threshold to be automatically considered higher-risk. In fiscal year 2006, SEC examined 321 hedge fund advisers and identified issues (such as information disclosure, reporting and filing, personal trading, and asset valuation) that are not exclusive to hedge funds. Also, from 2004 to 2008, SEC oversaw the large internationally active securities firms on a consolidated basis. These securities firms have significant interaction with hedge funds through affiliates previously not overseen by SEC. One aspect of this program was to examine how the securities firms manage various risk exposures, including those from hedge fund-related activities such as providing prime brokerage services and acting as creditors and counterparties. SEC found areas where capital computation methodology and risk management practices can be improved.

In September 2008, SEC ended the Consolidated Supervised Entities program, created in 2004 as a way for global investment bank conglomerates that lack a supervisor under law to voluntarily submit to regulation. The agency plans for enhancing SEC oversight of the broker-dealer subsidiaries of bank holding companies regulated by the Federal Reserve, based on a Memorandum of Understanding between the two agencies.
Similarly, CFTC regulates those hedge fund advisers registered as CPOs or CTAs. CFTC has authorized the National Futures Association (NFA), a self-regulatory organization for the U.S. futures industry, to conduct day-to-day monitoring of registered CPOs and CTAs. In fiscal year 2006, NFA examinations of CPOs included six of the largest U.S. hedge fund advisers. In addition, SEC, CFTC, and bank regulators can use their existing authorities—to establish capital standards and reporting requirements, conduct risk-based examinations, and take enforcement actions—to oversee activities, including those involving hedge funds, of broker-dealers, of futures commission merchants, and of banks, respectively.

While none of the regulators we interviewed specifically monitored hedge fund activities on an ongoing basis, generally regulators had increased reviews—by such means as targeted examinations—of systems and policies to mitigate counterparty credit risk at the large regulated entities. For instance, from 2004 to 2007, the Federal Reserve Bank of New York (FRBNY) had conducted various reviews—including horizontal reviews—of credit risk management practices that involved hedge fund-related activities at several large banks. On the basis of the results, FRBNY noted that the banks generally had strengthened practices for managing risk exposures to hedge funds, but the banks could further enhance firmwide risk management systems and practices, including expanded stress testing.

The federal government does not specifically limit or monitor private sector pension investment in hedge funds and, while some states do so for public plans, their approaches vary. Although the Employee Retirement and Income Security Act (ERISA) governs the investment practices of private sector pension plans, neither federal law nor regulation specifically limit pension investment in hedge funds or private equity. Instead, ERISA requires that plan fiduciaries apply a “prudent man” standard, including diversifying assets and minimizing the risk of large losses. The prudent man standard does not explicitly prohibit investment in any specific category of investment. The standard focuses on the process for making investment decisions, requiring documentation of the investment decisions, due diligence, and ongoing monitoring of any managers hired to invest plan assets. Plan fiduciaries are expected to meet general standards of prudent investing and no specific restrictions on investments in hedge funds or private equity have been established. The Department of Labor is

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12 A horizontal review is a coordinated supervisory review of a specific activity, business line, or risk management practice conducted across a group of peer institutions.
tasked with helping to ensure plan sponsors meet their fiduciary duties; however, it does not currently provide any guidance specific to pension plan investments in hedge funds or private equity.

Conversely, some states specifically regulate and monitor public sector pension investment in hedge funds, but these approaches vary from state to state. While states generally have adopted a “prudent man” standard similar to that in ERISA, some states also explicitly restrict or prohibit pension plan investment in hedge funds or private equity. For instance, in Massachusetts, the agency overseeing public plans will not permit plans with less than $250 million in total assets to invest directly in hedge funds. Some states have detailed lists of authorized investments that exclude hedge funds and/or private equity. Other states may limit investment in certain investment vehicles or trading strategies employed by hedge fund or private equity fund managers. While some guidance exists for hedge fund investors, specific guidance aimed at pension plans could serve as an additional tool for plan fiduciaries when assessing whether and to what degree hedge funds would be a prudent investment.
According to several 2006 and 2007 surveys of private and public sector plans, investments in hedge funds are typically a small portion of total plan assets—about 4 to 5 percent on average—but a considerable and growing number of plans invest in them.\(^3\) Updates to the surveys indicated that institutional investors plan to continue to invest in hedge funds. One 2008 survey reported that nearly half of over 200 plans surveyed had hedge funds and hedge-fund-type strategies. This was a large increase when compared to the previous survey when 80 percent of the funds had no hedge fund exposure.\(^4\) Pension plans’ investments in hedge funds in part were a response to stock market declines and disenchantment with traditional investment management in recent years. Officials with most of the plans we contacted indicated that they invested in hedge funds, at least in part, to reduce the volatility of returns. Several pension plan officials told us that they sought to obtain returns greater than the returns of the overall stock market through at least some of their hedge fund investments. Officials of pension plans that we contacted also stated that hedge funds are used to help diversify their overall portfolio and provide a vehicle that will, to some degree, be uncorrelated with the other investments in their portfolio. This reduced correlation was viewed as having a number of benefits, including reduction in overall portfolio volatility and risk.

While any plan investment may fail to deliver expected returns over time, hedge fund investments pose investment challenges beyond those posed by traditional investments in stocks and bonds. These include the reliance on the skill of hedge fund managers, who often have broad latitude to engage in complex investment techniques that can involve various financial instruments in various financial markets; use of leverage, which amplifies both potential gains and losses; and higher fees, which require a plan to earn a higher gross return to achieve a higher net return. In addition to investment challenges, hedge funds pose additional challenges,

\(^3\) We reviewed data from surveys of defined benefit pension plans conducted by three organizations—Greenwich Associates (covering mid- to large-size pension plans, with $250 million or more in total assets), Pyramis Global Advisors (covering mid- to large-size pension plans, with $200 million or more in total assets), and Pensions & Investments (limited to large plans, which generally had $1 billion or more in total assets). Greenwich Associates is an institutional financial services consulting and research firm; Pyramis Global Advisors, a division of Fidelity Investments, is an institutional asset management firm; and Pensions & Investments is a money management industry publication. These data cannot be generalized to all plans.

including: (1) limited information on a hedge fund’s underlying assets and valuation (limited transparency); (2) contract provisions which limit an investor’s ability to redeem an investment in a hedge fund for a defined period of time (limited liquidity); and (3) the possibility that a hedge fund’s active or risky trading activity will result in losses due to operational failure such as trading errors or outright fraud (operational risk).

Pension plans that invest in hedge funds take various steps to mitigate the risks and challenges posed by hedge fund investing, including developing a specific investment purpose and strategy, negotiating important investment terms, conducting due diligence, and investing through funds of funds. Such steps require greater effort, expertise and expense than required for more traditional investments. As a result, according to plan officials, state and federal regulators, and others, some pension plans, especially smaller plans, may not be equipped to address the various demands of hedge fund investing.

Investors, creditors, and counterparties have the power to impose market discipline—rewarding well-managed hedge funds and reducing their exposure to risky, poorly managed hedge funds—during due diligence exercises and through ongoing monitoring. Creditors and counterparties also can impose market discipline through ongoing management of credit terms (such as collateral requirements). According to market participants doing business with larger hedge funds, hedge fund advisers have improved disclosure and become more transparent about their operations, including risk management practices, partly as a result of recent increases in investments by institutional investors with fiduciary responsibilities, such as pension plans, and guidance provided by regulators and industry groups.

Despite the requirement that fund investors be sophisticated, some market participants suggested that not all prospective investors have the capacity or retain the expertise to analyze the information they receive from hedge funds, and some may choose to invest in a hedge fund largely as a result of its prior returns and may fail to fully evaluate its risks. Since the near collapse of LTCM in 1998, investors, creditors, and counterparties have increased their efforts to impose market discipline on hedge funds. Regulators and market participants also said creditors and counterparties have been conducting more extensive due diligence and monitoring risk exposures to their hedge fund clients since LTCM. The creditors and counterparties we interviewed said that they have exercised market
discipline by tightening their credit standards for hedge funds and demanding greater disclosure.

However, regulators and market participants also identified issues that limit the effectiveness of market discipline or illustrate failures to properly exercise it. For example, most large hedge funds use multiple prime brokers as service providers. Thus, no one broker may have all the data necessary to assess the total leverage used by a hedge fund client. In addition, the actions of creditors and counterparties may not fully prevent hedge funds from taking excessive risk if these creditors’ and counterparties’ risk controls are inadequate. For example, the risk controls may not keep pace with the increasing complexity of financial instruments and investment strategies that hedge funds employ. Similarly, regulators have been concerned that in competing for hedge fund clients, creditors sometimes relaxed credit standards. These factors can contribute to conditions that create the potential for systemic risk if breakdowns in market discipline and the risk controls of creditors and counterparties are sufficiently severe that losses by hedge funds in turn cause significant losses at key intermediaries or instability in financial markets.

Although financial regulators and market participants recognize that the enhanced efforts by investors, creditors, and counterparties since LTCM impose greater market discipline on hedge funds, some remain concerned that hedge funds’ activities are a potential source of systemic risk. Counterparty credit risk arises when hedge funds enter into transactions, including derivatives contracts, with regulated financial institutions. Some regulators regard counterparty credit risk as the primary channel for potentially creating systemic risk. At the time of our work in 2007, financial regulators said that the market discipline imposed by investors, creditors, and counterparties is the most effective mechanism for limiting the systemic risk from the activities of hedge funds (and other private pools of capital). The most important providers of market discipline are the large, global commercial and investment banks that are hedge funds’ principal creditors and counterparties. As part of the credit extension process, creditors and counterparties typically require hedge funds to post collateral that can be sold in the event of default. OCC officials told us that

15Counterparty credit risk is the risk that a loss will be incurred if a counterparty to a transaction does not fulfill its financial obligations in a timely manner.
losses at their supervised banks due to the extension of credit to hedge funds were rare. Similarly, several prime brokers told us that losses from hedge fund clients were extremely rare due to the asset-based lending they provided such funds. While regulators and others recognize that counterparty credit risk management has improved since LTCM, the ability of financial institutions to maintain the adequacy of these management processes in light of the dramatic growth in hedge fund activities remained a particular focus of concern.

In addition to counterparty credit risk, other factors such as trading behavior can create conditions that contribute to systemic risk. Given certain market conditions, the simultaneous liquidation of similar positions by hedge funds that hold large positions on the same side of a trade could lead to losses or a liquidity crisis that might aggravate financial distress. Recognizing that market discipline cannot eliminate the potential systemic risk posed by hedge funds and others, regulators have been taking steps to better understand the potential for systemic risk and respond more effectively to financial disruptions that can spread across markets. For instance, they have examined particular hedge fund activities across regulated entities, mainly through international multilateral efforts. The PWG has issued guidelines that provide a framework for addressing risks associated with hedge funds and implemented protocols to respond to market turmoil. Finally, in September 2007, the PWG formed two private sector committees comprising hedge fund advisers and investors to address investor protection and systemic risk concerns, including counterparty credit risk management issues. On January 15, 2009, these two committees, the Asset Managers’ Committee and the Investors’ Committee, released their final best practices reports to hedge fund managers and investors. The final best practices for the asset managers establishes a framework on five aspects of the hedge fund business—disclosure, valuation of assets, risk management, business operations, compliance and conflicts of interest—to help hedge fund managers take a comprehensive approach to adopting best practices and serve as the foundation upon which those best practices are established. The final best practices for investors include a Fiduciary’s Guide, which provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio, and an Investor’s Guide, which provides recommendations to those charged with executing and administering a hedge fund program if one is added to the investment portfolio.

In closing, I would like to include a final thought. It is likely that hedge funds will continue to be a source of capital and liquidity in financial
markets, by providing financing to new companies, industries and markets, as well as a source of investments for institutional investors. Given our recent experience with the financial crisis, it is important that regulators have the information to monitor the activities of market participants that play a prominent role in the financial system, such as hedge funds, to protect investors and manage systemic risk.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

For further information on this testimony, please contact Orice M. Williams on (202) 512-8678 or at williamso@gao.gov. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this statement.
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