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Just Released -- US Government Accountability Office Report on Hedge Funds

On February 25, 2008, the US Government Accountability Office (GAO) – self-described as “the investigative arm of Congress” – released to the public its long-awaited Hedge Funds Report. The GAO Report summarizes the work performed during the GAO’s year-and-a-half-long performance audit with respect to regulators’ oversight of hedge-fund related activities, and the report’s title captures GAO’s conclusion: *Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline but Continued Attention Is Needed.*¹

The Report Is Not a Regulatory “Call to Action.” The key question in many observers' minds was whether the GAO Report would be a regulatory "call to action" that would prompt increased focus on, and government intervention in, the hedge fund industry. The Report is in fact measured in tone and neither an indictment of the industry nor a regulatory call to action. In its Report, the GAO (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.

Measured Congressional Response. None of the members of the US Congress that requested the GAO’s audit has called for new legislation based on the Report, which has been in Congressional hands for a month. They have instead indicated that they are awaiting an additional GAO report on pension funds’ exposure to hedge fund risks before deciding whether to propose any responsive legislation. One of the members described the Report as detailing improvements made recently in the hedge fund industry, but also observed that the Report concluded that there is still the potential for systemic risk. That member suggest that the US Congress, in response, needs to remain “very watchful.” Another observed that the Report illustrates that even with the combined expertise of all the relevant regulators, the US Congress still lacks the data necessary to judge the full risks associated with hedge funds.

A Key Observation Is That “Market Discipline” Has Constrained Hedge Fund Risk Taking and Leverage, and Resulted in Enhanced Disclosure and Transparency Regarding Operational Risks and Risk Management. The GAO’s Report identifies “market discipline” as playing the primary role in constraining risk taking and leveraging by hedge fund advisers, supplemented by indirect regulatory oversight of commercial banks and securities and futures firms. The Report points to (1) recent increases in investments by institutional investors with fiduciary responsibilities, such as pension plans, and (2) guidance that is being provided by regulators and industry groups, as key drivers for hedge fund advisers to both disclose credible information about their funds’ risks and prospective returns, and make more transparent their funds’ operations, including risk management practices.

At the same time, the GAO Report identifies several factors limiting market discipline or illustrating failures to properly exercise it. These factors include that total leverage used by a hedge fund may be unknowable, given large hedge funds’ use of multiple prime brokers as service providers; creditors’ and counterparties’ risk controls themselves may be behind-the-curve, given the increasing complexity of hedge funds’ strategies and investments; and competition for hedge fund business may cause creditors to relax their credit standards.

A Second Key Observation Is That Questions About Systemic Risk Remain. With regard to systemic risk, the GAO Report highlights counterparty credit risk and co-related trading behavior as potentially leading to losses or a liquidity crisis that could aggravate financial distress. This would be the case in a simultaneous liquidation of similar positions by hedge funds that hold large positions on the same side of the trade. The GAO Report emphasizes that regulators are taking steps to understand better the potential for systemic risk and respond more effectively to financial disruptions that can spread across markets. The sharper focus on systemic risk is evidenced by, among other things, international multilateral efforts that examine particular hedge fund activities across regulated entities and the work of the President’s Working Group on Financial Markets (“PWG”) that has resulted both in guidelines that provide a framework for addressing the risk associated with hedge funds, and in the development and implementation of protocols to respond to market turmoil. Those protocols were used to handle the fallout from the Amaranth losses in 2006 and the losses from subprime mortgage investments by two Bear Stearns hedge funds this past summer.

The Report concludes with a description of the PWG’s creation of two private sector committees – one comprised of asset managers, and the other of investors – tasked with developing best practices on disclosure, valuation, due diligence, risk management, risk management systems, and reporting, with the goal of enhancing investor protection and systemic risk safeguards. It ends on the optimistic note that the GAO auditors view the PWG’s recent initiatives as “positive steps taken to address systemic risk,” but cautions that “it is too soon to evaluate their effectiveness.”