U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

June 16, 2006

The Honorable David M. Walker
Comptroller General of the United States
Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Walker:

We request that the Government Accountability Office (GAO) initiate a review into a variety of questions involving hedge funds and the new regulatory oversight by the Securities and Exchange Commission (SEC). This work will assist in congressional understanding of how this marketplace has evolved and what challenges the industry and regulators now face. This analysis should also examine and build on the issues raised in the SEC's 2003 report, *Implications of the Growth of Hedge Funds*, as well as in prior reports on hedge funds by the President's Working Group on Financial Markets.

Hedge funds, as you already know, made front-page news almost a decade ago with the near collapse of Long-Term Capital Management (LTCM) and the unprecedented recapitalization of the fund by its creditors, which included some of the largest banks in the world. Since then, hedge funds have become the focus of attention from time to time—both from investors and regulators, including the recent increase in hedge fund oversight by the SEC. Growth and change in the world of hedge funds has raised new questions about the role of these little known and even less understood investment vehicles in our capital markets.

While hedge funds represent a relatively small portion of the U.S. markets, they have also grown in both size and significance in recent years. Historically, hedge funds were investment vehicles for very wealthy and sophisticated investors with millions in assets. The barriers to entry by individual investors have eroded, however, as a result of inflation, and the search for higher returns by institutional investors has resulted in growing numbers of pension funds investing greater percentages of their assets in hedge funds. Additionally, pending legislation would increase the percent of assets a hedge fund could manage without being subject to the fiduciary requirements of the Employee Retirement Income Security Act (ERISA).

Together, these changes have resulted in the need to undertake a broad-based review of hedge funds to help Congress to determine what new laws or amendments, if any, are needed to enhance existing oversight of this marketplace. In addition to some limited oversight by federal regulators, market discipline has played an important role in policing the industry. While market discipline is an important mechanism for restraining the risks taken by hedge funds, these funds often provide to the public little information about their investment strategies or financial condition, complicating the ability of investors and creditors to police these vehicles adequately.

The banking institutions that act as lenders and/or derivative counterparties to hedge funds significantly improved their risk management practices after the collapse of LTCM, but bank regulators and market participants have recently raised concerns that renewed scrutiny is needed in this area. Caution in completing this review, however, is appropriate given the complicated relationship between banks and hedge funds, as well as the increasing importance of hedge funds in many areas of our global financial markets.

Specifically, we would like the GAO to initiate a comprehensive review of risks and regulatory framework of hedge funds given the growing importance and continuing evolution of this industry. In addition to any issues the GAO deems appropriate, this review should seek to address the following:

- How is the hedge fund industry evolving? How have the investment strategies employed changed since LTCM? What investment strategies do the large hedge funds generally employ today? Are hedge funds moving into longer-term strategies, blurring the distinctions between hedge funds and private equity or venture capital funds?

- What information is the SEC currently collecting about hedge funds? How is it using this information to provide oversight? Besides registration information, what other sources of information does the SEC rely on to oversee hedge funds?

- Does the information collected by the SEC provide insight into the potential systemic risks associated with hedge funds in the markets? To what extent is this information shared with other financial regulators?

- To what extent are banking regulators able to assess any systemic risk posed by derivatives and lending activities with hedge funds?

- How many SEC-registered hedge funds have dual registration with the Commodity Futures Trading Commission as commodity pool operators? How is information shared among these two regulators?

- What is the focus of the examination program that the SEC has in place for hedge funds? What issues, if any, have surfaced as part of this work? Does the breadth of strategies employed by hedge funds affect the ability of the SEC to oversee hedge fund operations? Are the resources available for this program sufficient to achieve its objectives?

- What are the typical fee structures for hedge funds? How are these structures disclosed?

- Do disclosure requirements for individuals or firms that have accumulated significant ownership of a public company apply to hedge funds? If not, how might this affect the transparency of hedge fund activity in the capital markets?

- What percent of pension funds are currently investing in hedge funds, at what levels, and with what characteristics?

- What are the potential implications of amending ERISA to increase the percentage of a pension fund's assets that could be invested in a hedge fund without the hedge fund manager having to comply with certain aspects of ERISA?

- What are regulators doing to ensure that banks and securities firms are adequately managing their exposures to hedge funds? Has change in the hedge fund industry and the markets made it more difficult for these institutions to manage any exposure? Are banks and securities firms able to obtain adequate, reliable information concerning the total leverage and exposure of the hedge funds with which they do business?

- In the wake of the LTCM crisis, the President's Working Group suggested legislative reforms to increase the transparency of the very largest hedge funds and reduce systemic risk, but these reforms were never enacted. Given the evolution of the hedge fund industry since 1999, should these recommendations be revisited? Are there other mechanisms that could provide needed transparency?

If you have any questions regarding this request, please contact Langston Emerson in Congressman Michael E. Capuano's office at (202) 225-5111, Lawranne Stewart of the Democratic staff of the House Financial Services Committee at (202) 226-1297, or Todd Harper in Congressman Paul E. Kanjorski's office at (202) 225-6511.

Sincerely,

Michael E. Capuano Barney Frank Paul E. Kanjorski

REP. MICHAEL E. CAPUANO REP. BARNEY FRANK REP. PAUL E. KANJORSKI