Hedge Funds: Background and Policy Issues

Hedge funds are asset management vehicles that generally pool accredited investors’ money together and invest it on their behalf for a fee. Hedge funds are often identified by their use of complex investment strategies relative to other conventional funds. They originally deployed hedging strategies to offset the risks of their investment losses by taking opposite positions in related assets, thus receiving their name. Given the industry’s size and complexity, it has been an area of ongoing congressional attention. This In Focus discusses hedge fund operations, regulations, risks, and policy issues.

What Is a Hedge Fund?
The first well-publicized hedge fund was created in 1949 by Alfred Winslow Jones, a sociologist who researched market behavior. Hedge funds typically rely on leverage (i.e., borrowed money) to multiply returns and losses. Some also use short selling (i.e., borrowing a security to sell and buying it back at a later time) to profit from a security’s price drop within a given period of time. These and other hedge fund strategies are less common for conventional public funds—such as mutual funds and exchange-traded funds (ETFs). Thus, hedge funds are often characterized as “alternative investments” given their different investment styles, and they are also subject to a different regulatory framework. Investment styles and the regulatory framework are discussed in more detail below. Hedge funds are private funds, meaning their investor pool is limited to certain institutional and individual investors who are perceived to have more sophistication to understand and sustain financial risks (i.e., accredited investors).

Market Size
Per Securities and Exchange Commission (SEC) filings, the hedge fund industry consists of close to 10,000 funds with nearly $10 trillion in gross assets under management as of the fourth quarter of 2022 (Figure 1).

Figure 1. Hedge Fund Number and Size

Source: CRS using data from SEC Form PF reporting.

Investment Styles
Common hedge fund investment styles include the following: Macro funds base investment decisions on macroeconomic conditions, such as changes in interest rates, security and commodity prices, and exchange rates. Short sales funds focus on short selling. Long-only funds have long positions, meaning direct ownership of the securities (instead of shorts). Market-neutral funds aim to reduce market risk by taking offsetting long and short positions, which is the style closest to the traditional hedge fund investing. Relative value funds profit from perceived mispricing between related financial instruments. Event-driven funds take actions during special situations or distressed scenarios (e.g., bankruptcy, change of management control, and mergers and acquisitions). Sectoral funds focus on a particular industry (e.g., IT, health care, or financial services). Fund of funds are hedge funds that invest in other funds.

Regulatory Frameworks
SEC hedge fund regulation includes investor restrictions, reporting requirements, and other operational compliance.

Investor Restrictions
Hedge funds are private funds, meaning they face investor restrictions and are available only to accredited investors. An individual can qualify as an accredited investor if (1) he or she earned more than $200,000 (or $300,000 together with a spouse) in annual gross income during each of the prior two years and can reasonably be expected to earn a gross income above that threshold in the current year; or (2) he or she has a net worth of more than $1 million (either alone or together with a spouse), excluding the value of the primary residence. Effective December 8, 2020, the SEC expanded the definition of accredited investor to include some natural persons with financial expertise, such as (1) individuals with certain financial credentials (e.g., Series 7, Series 65, or Series 82 licenses); (2) “knowledgeable employees” as defined in Rule 3c-5(a)(4) of the Investment Company Act of 1940 (P.L. 76-768), which includes the funds’ directors and certain employees involved in investments; and (3) “family clients” of a family office as defined in SEC Rule 202(a)(11)(G). Family offices are entities established by wealthy families to manage their assets and provide other financial services to family members.

An institution can qualify as an accredited investor if it owns more than $5 million in investments. Corporations, partnerships, trusts, nonprofits, employee benefit plans, and family offices holding more than $5 million in assets could also qualify. Moreover, a number of entities—such as banks, insurance companies, SEC-registered broker-dealers, SEC-registered investment companies, and business investors—may also qualify as accredited investors.
development companies—automatically qualify as accredited investors.

**Operational and Reporting Compliance**

Hedge funds are generally exempt from the Investment Company Act of 1940 (P.L. 76-768) but are subject to Investment Advisers Act of 1940 (IAA; P.L. 76-768) requirements. Prior to the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank; P.L. 111-203), hedge funds had limited oversight, and regulators were largely unaware of the market’s size, investment strategies, and number of players. Title IV of the Dodd-Frank mandated registration, reporting, and recordkeeping requirements for hedge funds through amendments to IAA.

The SEC finalized major private fund adviser and private fund reporting reforms in 2023. The reforms include new timely reporting requirements for large hedge fund advisers (with more than $1.5 billion under management). These advisers would have to file with the SEC, in addition to the quarterly and annual reports, certain current reports within 72 hours from the occurrence of trigger events (such as extraordinary investment losses, and selected operations and redemption events). Other key regulatory requirements include quarterly statements to investors detailing performance, fees, and expenses; annual audits; and valuation opinions in connection with certain secondary transactions. The fund advisers also face prohibitions from some activities that may harm investors and the public interest.

**Policy Discussions**

Hedge funds have been associated with some disruptive market events that harmed financial stability. They have also drawn policy concerns because of their opacity and high fees.

**Market Event: The Basis Trade and the Collapse of Long-Term Capital Management (LTCM)**

The basis trade was first made famous by LTCM, a large hedge fund run by Nobel laureates that collapsed in 1998, prompting the Federal Reserve to organize a rescue. Basis trading normally refers to a trading strategy that seeks to exploit the difference in prices between a derivative and its underlying instrument. For example, a basis trade in Treasury securities could involve shorting Treasury futures while buying the underlying Treasury securities using borrowed money (often via the repurchase agreement market). Such an arbitrage technique, in theory, is low risk if an asset’s different prices in different markets eventually converge. Specifically, an arbitrager could start by selling the higher-priced asset in one market and buying the same (lower-priced) asset in a different market. When the prices converge, it could capture a profit by selling the formerly lower-priced asset and buying back the formerly higher-priced asset. Because the price differentials are typically very small, a hedge fund must build a large position through borrowed money to make a meaningful profit.

Unfortunately, in the case of LTCM, unexpected events, such as the market distress caused by Russia’s default in 1998, dislocated the expected price convergence. When LTCM collapsed in September 1998, it created more than $1 trillion worth of exposure for other institutions. The event prompted the Federal Reserve Bank of New York to organize a consortium of large banks to invest $3.6 billion to acquire 90% of LTCM’s ownership. Lessons learned from the LTCM failure include the risks of excessive leverage and the need for enhanced disclosure.

In 2023, the build-up in the hedge fund basis trade between Treasury futures and cash Treasury securities led to a new round of financial stability discussions. Multiple financial authorities, including the Federal Reserve and the Bank for International Settlement, have voiced concerns about hedge funds’ potential effects on financial stability.

**Market Event: The Flash Crash and a $1 Trillion Stock Valuation “Near Miss”**

On May 6, 2010, U.S. capital markets experienced an abnormal decline and subsequent recovery of significant scale. Many stocks and ETFs saw price declines and reversals of 15% or even 60% within one day. This event was later referred to as a “flash crash.”

Some attribute the crash to hedge fund trading programs that use automated orders. Because certain algorithms were programmed to execute trades without regard to price or time, they may have contributed to trading pauses and heightened market volatility during the crash. One of the biggest lessons learned was that it took regulators many months (with lingering debates) to clarify what happened. Although the market quickly recovered from a temporary $1 trillion valuation loss, this “near miss” led to policy debates about regulators’ lack of understanding of modern financial markets and their participants.

**Policy Concerns**

Hedge funds play an important role in asset allocation and market participation, but they also raise policy concerns.

**Risks coupled with opacity.** The hedge fund industry is both large and complex. The funds have proven to significantly influence financial markets and the economy. Some observers worry that policymakers and market participants may need more data and disclosure regarding hedge fund activities for risk diagnosis and systemic risk monitoring.

**Effects on financial stability.** As demonstrated by LTCM, hedge funds have the potential to pose financial stability concerns, particularly through the use of leverage and their interconnectedness with other financial markets. Hedge funds’ concentrated trades and rapid exits during market distress could spread shock waves and amplify stress.

**High fees.** Hedge fund fee structures often include an annual asset management fee of 1% to 2% of assets under management and an additional 20% performance fee on any profits. This fee structure could motivate a hedge fund manager to take greater risks in the hope of generating a larger performance fee, yet only the investors—not the hedge fund—bears the downside risk.

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