April 30, 2009

Greg Tanzer
Secretary General
IOSCO
Financial Entitites@iosco.org

Re: Hedge Funds Oversight – Consultation Report

Dear Mr. Tanzer:

On behalf of the Securities Industry and Financial Markets Association's ("SIFMA")[1] Prime Brokerage Committee[2] we would like to offer the Task Force on Unregulated Financial Entities (the "Task Force") our comments on the Consultation Report on Hedge Funds Oversight (the "Consultation Report"). Our comments are primarily directed to those aspects of the Consultation Report that directly impact prime brokers and/or other regulated counterparties ("prime brokers") of hedge funds.

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Overview

In its letter to the Heads of State of the G-20 last November[3], IOSCO set out its commitment to taking steps to ensure that its *Objectives and Principles of Securities Regulation* were adapted to deal with the current financial crisis, identifying those principles as "primary instruments to … reduce global systemic risk."[4] The Consultation Report cites the systemic risk that institutions and individuals have been exposed to during the crisis as a proximate cause leading to the formation of the Task Force. While we certainly agree that attention to systemic risk by both the private and public sectors is warranted, we also believe that a careful analysis of systemic risk[5] leads to the necessary

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.
[2] The constituent member firms of the Prime Brokerage Committee are active in providing prime broker services in the U.S., Europe, and in all global markets, and reflect a comprehensive perspective on issues impacting this business line.
[3] Letter from IOSCO to Messrs. Draghi, Mantega, and Meirelles, Nov. 12, 2008.
[4] *Supra*, p.1.
[5] While no uniform definition of the term exists, we believe that the definition provided by Sir Andrew Large while Chairman of the U.K. Securities and Investment Board is an excellent one: 'The risk that something

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conclusion that while prime brokers – as is true for any significant participant in the financial markets – are an important factor in addressing systemic risk in a comprehensive fashion, they can not serve as a ersatz "regulator" of other market participants, such as hedge funds. We believe at least three reasons supporting that conclusion.

First, for this form of "indirect regulation" to work would seem to require that the interests of prime brokers and the goals of the regulatory community be perfectly aligned. However, clearly this will not always be the case. For example, in a stressed market a prime broker may conclude that it is in its prudent self interest to restrict credit to a particular hedge fund, or to the sector as a whole. In fact, prime brokers may be required by applicable law or regulations – such as margin regulations or safety and soundness principles – to restrict credit. In sharp contrast, at the same point in time the public sector may wish to avoid a deleterious bout of dynamic deleveraging by ensuring a continuing flow of credit to market participants as a means of providing additional financial stability to the markets.

Second, there is an increasing trend of hedge funds to use multiple prime brokers. Information concerning a hedge fund's positions held at another prime broker is held by the second prime broker on a confidential basis. Consequently, prime brokers in virtually all cases will have access only to a limited picture of the exposures of their customer hedge funds, particularly those funds that are larger in size and more likely to be of systemic importance. They will not see positions held at other prime brokers or financing counterparties. Hedge funds may take on risks through means other than traditional margin accounts. Any consideration of regulating "indirectly" must consider the multiple ways a hedge fund can obtain position exposure or leverage, as well as the different counterparties that can provide such exposure or leverage, such as derivative transaction counterparties. Further, an individual hedge fund's risk profile will include risks beyond leverage, such as liquidity risk, and those risks may look very different to an individual prime broker than they would to someone in a position to see the fund's exposures on a consolidated basis. Thus, the prime broker is unlikely to be privy to a number of material risks, including the liquidity risk associated with redemption rates and terms. Therefore, while each prime broker will have sufficient information to make its own risk decisions, expecting a prime broker to implement official policy on controlling systemic risk solely through reference to the limited information it has would create a gap between means and ends.

Lastly, systemic risk cannot be addressed at the level of individual firms: by its nature, systemic risk is focused on the *interdependencies between market participants* and their *collective exposure to common risk factors*. Attempting to remedy systemic risk concerns at the individual firm level – much less through an incomplete picture of an individual firm's exposures – is doomed to fail.

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which goes wrong in one firm or market will, because of the close linkages which now exist between firms and markets, spill over to affect other firms and markets.' *Systemic Risk and the Securities Regulator*, March 27, 1996.

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Below we have answered a number of the questions posed in the Consultation Report where the issue directly concerns prime brokers.

**Question [p. 20]**: Do you believe that Chapter 1 appropriately identifies and describes the relevant risks/issues associated with hedge funds and their operations?

**ANS**: Although there is no universally accepted definition of "prime broker," we believe that the description of this term in footnote 10 of the Consultation Report is at a minimum confusing, if not mistaken. In particular, the sentence "Prime brokers also act as clearing facilities and accountants for all of a customer's securities transactions wherever executed." The exact meaning of the sentence is unclear, but the implication that a prime broker as a matter of course acts as an "accountant" is mistaken.

We believe that paragraph 52 (reproduced below) might be viewed by some in a misleading fashion. We do not believe that there is anything particularly unique to "hedge funds" with respect to systemic risk. "Disruptions or failures" with respect to any significant market participant or sector may transmit instability through its counterparties to the "real economy." Insofar as the paragraph may suggest that hedge funds are *sui generis* with respect to interaction with the wider economy, it is misleading.

> 52. The main mechanism through which disruptions or failures in hedge funds may transmit themselves to the wider market and hence increase systemic risk is through the banks/prime brokers, who are their creditors and may also offer them trading facilities. These banks then transmit the instability to the rest of the banking sector through which, by virtue of its provision of credit, payment and clearing services, they impact directly on the real economy.

**Question [p. 33]**: Do you share the views that this type of information [set forth in ¶117] should be obtained from hedge funds counterparties? Do you support the call for strong risk management controls at these entities?

**ANS**: We agree that the information listed in paragraph 117 is appropriate. In addition, we fully support the proposal that prime brokers should maintain strong risk management controls.

**Question [p. 33]**: Is direct regulation of hedge funds the best approach to addressing investor protection and systemic risk concerns raised by hedge funds?

**ANS**: If regulators have determined that hedge funds present systemic risk concerns that need to be addressed, our position is that this cannot be accomplished "indirectly" by delegating supervisory responsibilities to prime brokers.

**Question [p.36]**: Do you agree with the proposed approach [described in ¶127] to ongoing supervision?

**ANS:** With respect to subparagraph iv (Adequate segregation and protection of client fund assets) we believe that hedge funds should be able to maintain their assets at a regulated custodian (e.g., a prime broker) of their choosing. With respect to independence of the custodian, we believe that can be addressed through appropriate disclosure to investors of any affiliate or similar relationships between the fund's advisor and the custodian.

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We appreciate the opportunity to comment on the Consultation Report. Should there be any question about our comments or an interest in further amplification of our views, please do not hesitate to contact us.

Sincerely,

Jeffrey C. Bernstein
Chairman
Prime Brokerage Committee