

January 30, 2009

Re: DG Internal Market – Consultation Paper on Hedge Funds

Dear Sir or Madam:

On behalf of the Securities Industry and Financial Markets Association's ("SIFMA")¹ Prime Brokerage Committee² we would like to offer you our comments on the DG Internal Market – Consultation Paper on Hedge Funds (the "Consultation Paper"). With one exception, our comments are limited to those aspects of the Consultation Paper that directly impact prime brokers. The exception is a suggestion regarding the definition of "short selling" that appears in footnote 7 of the Consultation Paper.

Prime Broker Concerns

Question 4:

Is the "indirect regulation" of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of hedge fund failure? Do we need alternative approaches?

ANS: We believe that there are a number of issues to consider in a proposal that seeks to rely upon "indirect regulation" of hedge funds by prime brokers. First, there is an increasing trend of hedge funds using multiple prime brokers. Information concerning a hedge fund's positions held at another prime broker is held by that 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

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.

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. Further, an individual hedge fund's risk profile includes risks beyond leverage, such as liquidity risk, and these 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. If the European Commission believes "It is essential that front-line regulators are in a position to monitor the build-up of risks in [the] sector"³ it must consider how a prime broker could execute that function based upon a limited universe of information.

Second, one must keep in mind that 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, one must determine whether any form of regulation (direct or indirect) being considered should be applicable solely to hedge funds or should be equally applicable to any trading vehicle that may employ leverage.

Lastly, for this form of "indirect regulation" to work it would seem to require that the interests of prime brokers and the goals of the regulatory community be perfectly aligned. However, clearly this is often not the case. For example, the Consultation Paper notes that "hedge funds may impact wider market dynamics" and discusses potential problems with the pro-cyclical effects of hedge fund activity. In particular, it may well be in the prudent self-interest of an individual prime broker 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, the public sector may wish to avoid a deleterious bout of dynamic deleveraging by ensuring a continuing flow of credit to the sector as a means of providing additional financial stability to the markets. Looking to prime brokers to address and solve this conflict of interest between public and private goals would put them in an impossible situation.

Clarification of definition of "short selling"

Footnote 7 of the Consultation Paper uses the term "naked short selling" in a manner that is potentially confusing to market participants following the issue in the U.S. In the U.S., the SEC has used the term to denote abusive or otherwise manipulative short selling where the selling party does not have the stock for delivery and intentionally fails to

³ Consultation paper, page 5.

deliver stock within the applicable settlement cycle.⁴ It appears that the definition in Footnote 7 is intended as a generic description of “short selling,” in which case revising it to drop use of the pejorative term “naked” may clarify matters and alleviate confusion.

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We appreciate the opportunity to comment on the Consultation Paper. 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,

Michael B. Rogers /s/

Michael B. Rogers,
on behalf of the
Prime Brokerage Committee

⁴ “A seller misrepresenting its short sale locate source or ownership of shares may intend to fail to deliver securities in time for settlement and, therefore, engage in abusive “naked” short selling. Although abusive “naked” short selling is not defined in the federal securities laws, it refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle.” Exchange Act Release No. 34-58774 (Oct. 17, 2008)(“Naked Short Selling Anti-fraud Rule”).