



October 13, 2008

The Governor  
Bank of England  
Threadneedle Street  
London EC2R 8AH

**Re: Systemic and industry risk inherent in the currently proposed approach to the Administration of Lehman Brothers International (Europe)**

Dear Governor:

Managed Funds Association (“MFA”) is the voice of the global alternative investment industry, headquartered in Washington, D.C. Our members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. The assets managed by our members include significant amounts of assets belonging to prominent pensions funds, foundations, endowments and government entities (either pursuant to direct asset management arrangements with those investors or, indirectly through their investment in fund vehicles). Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$2 trillion invested in absolute return strategies.

This letter follows multiple MFA committee consultations, each with between 50 to 80 participating members. MFA have also consulted, in relation to the terms of this letter and the issues arising from the LBIE administration, with the senior management of the Alternative Investment Management Association in the UK.

At a time when governments and regulators around the world are making strenuous, urgent and co-ordinated efforts to restore market confidence and liquidity, MFA and its members are extremely concerned that the Administrators of LBIE are setting out on a proposed course of action that threatens to undermine those efforts with consequential damage to both the alternative investment industry and the global capital markets more generally. The proposed course of action relates to last week’s proposals with respect to the return of client assets caught up in the administration of LBIE. MFA believes that the course of action proposed by the Administrators and the resultant lock-up of assets at LBIE has already become an issue of very substantial systemic significance.

The purpose of this letter is to invite the Bank of England to intervene in this respect, with a view to ensuring the rapid release of client assets in the interests of market confidence and the future of the prime brokerage industry in the UK.

No criticism is intended of the Administrators of LBIE. They have a difficult and challenging task to perform. The nature of their appointment is to safeguard the interests of LBIE’s creditors as a whole, and the circumstances of their appointment are such that, if they were to take action to allow the rapid release of client assets in the interests of restoring market confidence and liquidity, they could face criticism and potential liability if those actions subsequently were found to have damaged the interests of creditors. Safeguards need to be in place to address that concern and we discuss these below.

### **The Core Problem**

The administration of LBIE has resulted in client assets held by LBIE under prime brokerage arrangements being taken out of the market, with LBIE clients that are funds unable to access their assets, trade them or properly value them. That, in turn, is leading to suspensions of fund redemptions/NAV calculations in some cases (freezing sections of the market) and in others to pressure to realise other assets (not held by LBIE) that might not otherwise be sold in order to fund redemptions or anticipated redemptions. Additionally, suspensions of fund redemptions/NAV calculations can, in turn, trigger close-out termination rights under trading documentation that the relevant fund has in place with other brokers and transaction counterparties. If those close-out rights are exercised, this may lead to a fire sale of collateral by the relevant counterparty, resulting in further downward pressure on the price of the relevant collateral securities.

Several firms with significant exposure to LBIE are on the brink of failure and the extent of future failures will hang in large part on how the LBIE administration is handled going forward.

Of even greater systemic concern, the LBIE asset lock-up problem is fundamentally impacting confidence in the prime brokerage model generally. Funds are withdrawing assets from their prime brokers (particularly those in the UK), destabilising those other prime brokers and, in many cases, causing institutional investors to withdraw from participating in the markets, further squeezing liquidity – the consequences of which have become apparent over the last week in particular (despite very significant government intervention). The practical reality is that the lack of confidence in prime brokers means that many alternative fund managers are now holding the majority of their assets in cash or as government securities in custody (in a form that does not allow the custodian to use them for its own account) and this is impacting on liquidity and the viability of the government sponsored rescue plans that are currently being put in place.

The handling of the LBIE administration not only has immediate consequences for the LBIE clients whose assets are locked-up, but particularly given the fear of future financial failures, will significantly exacerbate systemic risks if not handled properly. It is obviously a serious matter for a prime broker to fail – but, if there is confidence that the failure will be dealt with quickly and fairly, and in-line with expectations, the impact can be contained. Currently, the market appears to have no confidence in the expeditious handling of the LBIE administration. This could be disastrous for UK plc. Prime brokerage clients are already withdrawing their assets from the UK prime brokers/UK branches of overseas prime brokers. This development is calling into question the future of the UK prime brokerage market. There seems to be a marked discrepancy, in terms of confidence and speed of response, between the Administrators' proposals and the protocol promulgated by James W Giddens, the Securities Investor Protection Corporation Trustee in the US, who is responsible for the liquidation of Lehman Brothers Inc ("LBI").

The scale of the problem is enormous, sufficient, we believe, to have a material negative impact on the prospects of other government sponsored 'rescue' plans and initiatives succeeding. Assets held by LBIE under prime brokerage arrangements are estimated at USD40-70 billion across some 1,300 prime brokerage accounts. The problem is not, however, limited only to those funds with prime brokerage accounts with LBIE. That is for two main reasons. The first is that Prime Brokerage clients of LBI, also appear to have had assets held by LBIE. The second is that funds of funds which have invested in funds exposed to LBIE, share, at one step removed, the problem of the underlying fund. So if the underlying fund has to be suspended, that may in turn lead to the suspension of the fund of funds (due to the inability to value a material proportion of its assets, in the form of the suspended underlying

fund), extending the class of assets frozen within the market beyond those held by LBIE. We stress again that the delays and lack of clarity as to the status of client assets held at LBIE is having significant adverse consequences for the global capital markets.

### **The Administrators' Proposed Approach**

By the third in a series of three statements relating to the issue of client money and assets, the Administrators announced the first steps towards a process for the identification and return of client assets. The process had been the subject of a private application to the English Court, resulting in the process being announced as having Court approval. The only other party understood to have been present at the hearing is the United Kingdom Financial Services Authority (the "FSA"). On October 10, 2008 a redacted version of the Administrators' evidence before the Court was made available by the Administrators.

Attached to this letter are the Administrators' client money and asset statements of September 21, September 26, and October 7, 2008 as well as the redacted statement of Stephen Pearson.

In the current circumstances, the key, and dangerous, features of the proposal from a market perspective are that, while no timetable has been proposed, the process is almost certain to be very slow as it contemplates such matters as the design and installation of a new IT system, a new team being identified and deployed, the identification of the entire population of those having or purporting to have client asset claims, judicial determination of contemplated legal issues and the collation of all client assets.

The process is one which is wholly at odds with the interests of restoring confidence and liquidity in the global capital markets. The most generous estimate would be that the process will take several months. As such, for the reasons explained above, it is a proposal that runs contrary to the UK government's initiatives and contrary to the interests of the UK, and world, financial markets.

Mr. Pearson's statement, given the Administrators' role and responsibilities, gives no weight at all to the interests of UK plc or the markets as a whole. While it may be an articulation of one logical and fair way of achieving the purposes of the particular administration, it wholly ignores the broader context of that administration and the consequences, for UK plc and the global capital markets,. It is unclear whether or not the FSA contributed its views in that regard to the Court. Ultimately, it will not serve the interests of LBIE's creditors if asset lock-up caused by the Administrators' proposed course of action contributes to the collapse of the financial system.

For the Administrators' proposed process to be allowed to be followed in its current form would, we believe, be a fundamental and avoidable mistake with very serious consequences.

### **The Alternative**

In the ordinary course of business, funds move prime brokerage accounts from one broker to another all the time. It is an administrative task that takes some planning and time, but which ought not to take longer than a few working days to execute. The complication in the case of LBIE, comes from the fact of the administration, and the concern that LBIE needs to be sure of not advantaging one client asset creditor over another and risking administrator liability in the process. LBIE's prime brokerage staff are still understood to be in place and to be working with the Administrators.

In order to deal with the systemic risk and unlock as many assets as possible as quickly as possible, we believe that the Administrators should be formulating a plan to prioritise LBIE's prime brokerage clients by reference to the applicable systemic significance of their exposures. For each such client, the Administrators should be engaging with the client to agree (on a non-binding basis) the net sums owed by the client to LBIE (or vice versa) under each agreement to which the client is party with LBIE. Any "live" short positions should also be closed out, if necessary, by a payment of cash from the client to LBIE (after having taken account of any net sums owed by LBIE to the client). The long segregated assets should then be released to those clients.

In the interests of the global capital markets as a whole, and so as not to undermine current government and regulatory initiatives, the risk component for LBIE's Administrators needs to be removed from the equation, so as to allow them to return client assets without fear of liability to other creditors. That appears to be the single factor preventing a more rapid distribution, and it must be one that is capable of being dealt with effectively and efficiently and without significant cost.

In order to achieve this, there needs to be a combined industry and government response to give the Administrators appropriate reassurance in relation to those liabilities. Discussions on this point should be taken forward as a matter of extreme urgency so that the release of assets can begin as soon as is possible. As part of these arrangements, the Bank of England, together with HM Treasury, the FSA and the industry have a role to play. Fundamentally, the Administrators need to be given some form of comfort from the Bank of England/HM Treasury in respect of those liabilities. We consider that the serious systemic implications of the current lock-up are sufficient to warrant this kind of comfort.

We have been discussing this issue with senior officials at the US Treasury Department and understand that they are aware of the systemic risk concerns described in this letter. Co-ordination between the UK Government and the US Treasury Department may help in resolving these issues.

### **Other Important Issues**

In addition to the problem of the lock-up of long assets at LBIE, the other issue that requires urgent resolution to restore market confidence is the lack of transparency afforded by the administration process. There is a time critical need for the situation as regards extant short positions to be clarified and for a protocol for the closure of these positions to be put in place as soon as possible in a transparent manner that allows LBIE clients to manage their exposure to market risk.

Additionally, the situation as regards client assets that were due to be delivered into LBIE in order to close open client positions but where those assets were not capable of being delivered into LBIE (and were consequently delivered to another settlement agent), needs to be clarified as a matter of urgency<sup>1</sup>. Again, the lack of clarity surrounding these positions is also significantly harming market confidence.

### **Summary**

There can be no doubt that the eyes of the industry are focussed on the UK's handling of the LBIE administration. There is a time critical need for the issues outlined in this letter

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<sup>1</sup> We understand that LBIE client statements are being prepared on a trade date basis rather than a settlement date basis and so this is causing confusion and uncertainty as to whether the LBIE positions should continue to be treated as open.

to be resolved through the issuance of appropriate protocols along the lines of those issued by the SIPC trustee, in order to restore market confidence.

We believe that intervention by the Bank of England in relation to this problem is essential, in the present exceptional market conditions, in order to safeguard the UK prime brokerage industry and the financial system.

We wish to discuss these issues directly with you and relevant colleagues as soon as possible. I will be contacting you to arrange a time for us to discuss them. In the meantime, please do not hesitate to contact me (at (U.S.) (202) 367-1140 or [Richard@managedfunds.org](mailto:Richard@managedfunds.org)) if you would like to explore further any of the matters raised in this letter.

Respectfully submitted,



Richard H. Baker  
President and Chief Executive Officer

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Paul Tucker – Bank of England  
Alastair Darling – HM Treasury  
Hector Sants – Financial Services Authority  
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