

7 December 2001

Investment Products Department
Securities and Futures Commission
12/F Edinburgh Tower
The Landmark
Central
Hong Kong

Dear Sirs

RE: CONSULTATION PAPER ON THE OFFERING OF HEDGE FUNDS

We appreciate the opportunity to comment on the recently issued Consultation Paper on the Offering of Hedge Funds (the "Paper"). We are submitting this comment letter on behalf of the global prime brokerage business of Goldman Sachs. Goldman Sachs International acts as prime broker for a large number of hedge funds domiciled, registered and/or managed in Asia.

We have attempted to keep this letter brief; however, should you wish to discuss any aspect of it in more detail, we should be pleased to do so.

Regulatory Reform

We recognize that any new regulatory framework for the offering of hedge funds in Hong Kong must promote the growth of the hedge fund industry and provide sufficient investor protection. We also believe that it is important, particularly in difficult market conditions such as those we are currently facing, that the regulatory framework does not impose onerous obligations on the industry that can only be discharged through the adoption of significant changes to existing established global practices and the development of new systems by hedge funds and their prime brokerage service providers. Several reform proposals under discussion, including in particular that in relation to the disclosure of interests in shares under the Securities and Futures Bill, would, in fact, impose these obligations on hedge funds and their prime brokerage service providers and could add costs to and detract from the attractiveness of Hong Kong as a market in which to offer and manage a hedge fund, thereby adversely affecting the competitive position of Hong Kong.

Role of the Prime Broker

Prime Brokers provide important services to hedge funds, in the areas of custody, clearing, margin financing, stock lending and reporting. We have attempted to identify and comment on those areas where we feel several aspects of the proposals under discussion impose unnecessarily onerous obligations on prime brokers and will detract from the attractiveness of Hong Kong as a market in which to offer and manage a hedge fund. We have therefore focused primarily on the role of the prime broker as a service provider to the hedge fund community.

Criteria for Prime Brokers

The Paper sets out several criteria that a prime broker of a hedge fund offered in Hong Kong must satisfy:

- i) it must be a substantial financial institution subject to prudential regulatory supervision;
- ii) where assets of the fund are charged to the prime broker for financing purposes such assets should not, at any time, exceed the level of the fund's indebtedness to the prime broker;
- iii) the assets charged to the prime broker must remain in a segregated custody account, in the name or held to the order of the trustee/custodian; and
- iv) there should be clear disclosure in the fund's offering document of its relationship with the prime broker.

Taking i) and iv) first, we recognize and support these criteria and note that they are generally satisfied by prime brokers and funds respectively. Typically, a fund that is appointing a prime broker will include in its offering memorandum a description of the relationship with the prime broker and a summary of the prime brokerage agreement as part of its statutory duty to ensure that the offering document contains such information as is necessary to enable a prospective investor to make an informed decision as to whether or not to invest.

We do have a number of concerns, however, in relation to the other criteria. In connection with iii), we would like to clarify the position in relation to segregation of client assets. We agree that, in the case where a client has simply charged its assets to the prime broker, such assets should be held in an omnibus client sub-account of the prime broker at the prime broker's agent bank/sub-custodian, and such assets should be identifiable on the prime broker's own books and records as belonging to the particular client. However, segregation in separate named client accounts at the agent bank/sub-custodian level adds to the costs associated with servicing the client without offering the client any material increased protection. In contrast, where the

prime broker has actually identified specific assets of the client as collateral in relation to a particular transaction or transactions, the assets should be moved into the prime broker's own name, both on its own books and records and at the custodian/agent, in order for the prime broker to establish clear title to those assets.

Turning to ii), we believe there should be more flexibility in determining appropriate collateral levels than the proposal currently allows. The reason for imposing a 100% cap on the amount of collateral a prime broker can take title to would be to insulate the investor from the credit risk of the prime broker. We acknowledge that, generally, regulators face difficulties in balancing the need to protect investors against the need to allow markets to operate efficiently, but would strongly suggest that in relation to the hedge fund market, the approach the Paper adopts of erring on the side of the investor rather than the prime broker, is a flawed one. The reason for this is that hedge fund investors typically seek to avoid the usual protections afforded in relation to regulated mutual funds (e.g. prohibition on short selling/adoption of leveraged strategies) so that they are able to diversify their portfolios and take positions not correlated to the direction of the market. In doing so, they do not expect to be insulated from risk, but are prepared to assume it, provided appropriate disclosure is made of the risks associated with a particular investment. This is clearly something the Commission is contemplating in providing for investors to receive adequate disclosure of risks.

In principle, therefore, we believe strongly that there is no reason why a prime broker should not have the freedom to take such levels of collateral as it considers appropriate in order to manage its credit risk to the fund appropriately.

There are ways in which the hedge fund can seek to minimize credit risk by performing its own due diligence in selecting a prime broker (or having the manager do so, as contemplated in the Paper). This would involve, for example, evaluating the prime broker's creditworthiness, ensuring there is an enforceable right of set-off on the prime broker's insolvency and negotiating a pre-agreed cap on excess collateral. In addition the fund would, as stated above, ensure that appropriate disclosure is made to investors.

Regulatory restrictions on the level of collateralization would adversely affect the cost at which a prime broker is able to provide services to the hedge fund as a prime broker must actively manage the current market risk it has to the hedge fund and cover its own financing costs, as described below.

Typically, the assets in a hedge fund's account would collateralize margin loans that are extended by the prime broker. If the hedge fund were to default on its obligations

to the prime broker with margin loans outstanding, the prime broker would be forced to liquidate sufficient assets to ensure repayment of the margin loan. In liquidating the assets, the prime broker is subjected to market risk and may not recover sufficient proceeds from the liquidation compared to the value of the margin loan. As a result, the assets that are pledged by the hedge fund for financing purposes need to be greater than the current value of the margin loan.

In addition, a prime broker would be required to post collateral greater than 100% of the value of the loan extended by it to a fund with the third party from whom it borrowed this money. The amount of collateral varies, but is usually between 105-125% of the value of the loan depending upon the nature of the institution and the nature of the collateral that is being pledged. Most prime brokers rely on funding the collateral from the third party as a critical component of their business model.

For the reasons set forth briefly above, we would strongly recommend a flexible regulatory approach to collateral by allowing the parties to negotiate freely the level of collateral posted to secure indebtedness. This would be consistent with the perceived wisdom in the market to protect against the market and credit risks the prime broker is undertaking and will reflect current market practice rather than any arbitrary or artificial cap that may over or under estimate the true risks being undertaken. We would strongly recommend further industry consultation on the levels of an appropriate cap should you still intend to impose one.

Certification by Custodian

Finally, we are concerned at the requirement for custodians to provide a certification to the Commission that suitable control procedures are in place for monitoring the operations of the scheme. A prime broker would typically be appointed by a hedge fund client as custodian or sub-custodian in relation to those assets in respect of which it wishes to receive prime brokerage services. However, a hedge fund may appoint more than one prime broker in relation to the total assets comprising the fund, which would make this proposal unworkable in practice. Further, directors and managers of a hedge fund owe the fund a fiduciary duty to act in the best interests of the fund in making their investment decisions on behalf of the fund. Therefore, it is appropriate that investors conduct their due diligence on the directors and managers of the fund and do not rely on a service provider such as the prime broker to provide such a certification.

While we acknowledge that the prime broker provides limited custodial services to the client as a necessary part of the overall prime brokerage service, for the reasons set forth above we do not believe that prime brokers should undertake the same

monitoring obligations with respect to hedge funds that trustees or custodians are obliged to do in relation to regulated mutual funds, as for example under the Code on Unit Trusts and Mutual Funds. Consequently we do not support this requirement in the Paper.

We hope that you find the above useful. If you would like to discuss any aspect of this letter further, please contact the undersigned on 2978 1473.

Yours Faithfully

For and on behalf of
Goldman Sachs (Asia) L.L.C.