Memorandum for Record (MFR) March 11, 2010

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TAGS: Re-hypothecation of custody assets, hedge fund failures

FCIC Attendees: Greg Feldberg, Jane Poulin, Tom Borgers, Bruce McWilliams

Background: Dr. Malmgren worked for USB Warburg in London as Deputy Head, Global Investment Strategy, and as Chief Currency Strategist for Bankers Trust in Asia. Her CV says that she served as an advisor on international economic issues to George W Bush during his presidential campaign. Then she joined the White House from 2001-2002 and served as special assistant to the President for Economic Policy on the National Economic Council. She was a member of the President's working Group n Financial Markets and the Presidents Working Group on Corporate Governance. She was in charge of liaison between the White House and all financial regulators including the Federal Reserve and the SEC.

Discussion: While she had no current information about the companies or agencies the FCIC is investigating, she did have several opinions about areas the FCIC should investigate.

1. Re-hypothecation of Custody Assets. When Lehman Bros failed, it had pledged assets which were held in its custodial account. These assets are held up by the bankruptcy court she says. She gave the example of UK grocer, Sainsbury, of which 10% of its stock 'has disappeared." She believes that one way to stave off dilemmas in the future is to not allow prime brokers to pledge customer assets.
2. She believes that prime brokers should be regulated vis a vis hedge fund investments and regulations should prohibit inherent conflict of interest in cases where brokers:
    a. Take an equity stakes in a hedge fund manager
    b. Provided trading line as a counterparty to the hedge fund
    c. Sources investors for the hedge funds from its own customer base.
    She cited the case of Tribecca hedge fund which was sourced by Citigroup and eventually failed. She said this was a good example where conflicts of interest caused the hedge fund to fail.
3. Regulators should look to reduction in compliance and documentation functions as an indicator that markets are getting out of hand.
4. Financial Regulators should look to discontinuities in extreme credit markets as an indicator of things to come. She cites that the ITRAX Trading system –which is a monitor of high yield debt- actually failed one day in May 07. Prices were not posted on the system, which, she says, indicated failing markets were ahead.

5. She suggested that it was inappropriate for the Secretary of Treasury to be talking to only one firm during times of financial duress.

She suggested the following people might be interesting to talk to with reference to the re-hypothecation of customer assets: Lisa Polsky, who formerly worked for Greenspan and Morgan Stanley and Gay Evan, vice chair of Barclays, who had information about hedge fund failures.