Managing the Risk of Prime Broker Default: A Guide for Hedge Funds

The collapse of Bear Sterns, Lehman Brothers and Merrill Lynch globally and the collapse of Opes within the Asia Pacific Region have brought to the forefront the risk of prime broker default. In the aftermath of these collapses, what steps can hedge funds take to manage the risk of this important counterparty relationship?

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TIMOTHY LOH
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Timothy Loh,
Principal
tloh@timothyloh.com
Hong Kong: +852 2899.0179

Henri Arslanian *
harslanian@timothyloh.com
Hong Kong: +852 2899.0159

Recent Articles

** Not admitted or registered as a foreign lawyer in Hong Kong*

The past months have seen an increased level of discussion of prime broking relationships, both from the perspective of hedge fund managers seeking to minimize fund losses in the event of the default of their prime broker and from the perspective of hedge fund managers whose prime broker had in fact defaulted. Whilst a number of lessons remain to be learned, the experience to date suggests a number of steps that hedge fund managers may wish to consider to manage the risk of loss from such a default.

Credit Review

Most fundamentally, hedge fund managers may wish to assess the creditworthiness of their prime broker(s) on an ongoing basis. It is an obvious point by now that the name and reputation of a prime broker itself is inadequate: Bear Sterns and Lehman Brothers were certainly highly reputable and credible institutions before their demise. Based on such an assessment, they may wish to diversify their prime broking relationships (*i.e.* appoint more than 1 prime broker) or set or vary limits on their amount or type of exposure to their prime brokers.

Legal Review

A credit review however, is not by itself sufficient. The creditworthiness of a prime broker may deteriorate rapidly. No prime broker is immune from insolvency and when strategies to limit credit exposure to a prime broker fail, the legal rights between the hedge fund the prime broker become paramount.

The rights between a hedge fund and a prime broker can vary sig-

nificantly, depending on the regulatory framework of the laws governing the prime broker, the terms and conditions of the prime broking agreement and the presence of other agreements, such as securities borrowing and lending agreements and ISDAs, governing over-the-counter transactions. Consequently, it is important for competent legal counsel to review the arrangements between a hedge fund and its prime broker.

Client Money

The laws and regulations governing the prime broker will often set out the extent to which the prime broker may use client money. If the prime broker is a bank (*i.e.* a deposit taking institution), it will generally be entitled to use funds on deposit. However, even if the primer broker is a securities firm, it is not uncommon for prime brokers to encourage hedge funds to opt-out of client money protection. Where hedge funds opt-out of client money protection, the prime broker is potentially in a position to use the fund's cash for its own purposes. Hedge fund managers may wish to review their prime broking documentation to assess whether they have the benefit of client money protection.

One strategy that is increasingly being used is to split the fund's assets between a custodian and a prime broker, with idle cash being held by the custodian and cash required for margin, settlement and payment of fees being held by the prime broker. This strategy does impose a level of back-office inconvenience for both the hedge fund manager and the prime broker to manage the flow of cash in return for the safety of the custodian.

It should be borne in mind that the custodian is not itself immune to insolvency. Indeed, as custodians are generally banks and funds deposited with banks are generally held in a creditor-debtor relationship, the default of a custodian bank could still leave the hedge fund as an unsecured creditor.

An alternative that hedge fund managers may wish to consider therefore is instead to split the fund's assets between multiple prime brokers, at least one of which is designated primarily as a cash custodian. This cash custodian prime broker should hold the cash in trust (*i.e.* the prime broker should be a securities firm and there should be no opt-out of client money protection) and should not extend leverage to the fund. The latter requirement will avoid the cash on deposit being held as security by the prime broker. In the event of the default of the prime broker, the fund may claim the cash as the property of the fund rather as an unsecured creditor. Whilst any insolvency proceedings will undoubtedly delay the return of such cash, ultimately, the cash would be insulated from claims of the creditors of the prime broker.

An alternative that hedge fund managers may wish to consider therefore is instead to split the fund's assets between multiple prime brokers, at least one of which is designated primarily as a cash custodian.

Naturally, for commercial reasons, prime brokers may resist the idea of serving as a pure cash custodian. Hedge fund managers should therefore consider the extent to which the cash custodian prime broker will provide execution or other services which would not impair the sanctity of the cash holdings.

Client Securities

The laws and regulations governing the prime broker will gener-

ally set out the manner in which the prime broker deals with client securities. In much of the common law world, there remains uncertainty as to the nature of the interest held by a client in securities held by a prime broker, particularly where the securities are held through a depositary or clearing house.

In Hong Kong, the issue was resolved almost 10 years ago with the court holding that client securities may be held beneficially by clients of brokers. However, this holding depends on the specific terms and conditions of the contract between the client and the broker and consequently, it remains necessary to perform a legal review of the prime brokerage agreement to confirm this position.

[W]here the hedge fund may be required by the prime broker to place margin significantly in excess of obligations secured, a hedge fund should prefer to give collateral through proprietary collateralization rather than through personal collateralization.

In some custodial relationships, the custodian may only contract to deliver securities equivalent to those held. In other words, the hedge fund will have no proprietary interest in the securities held and on the insolvency of the custodian, will be no more than an unsecured creditor.

As with client monies, it may be possible to establish multiple prime broking relationships with one prime broker designated to hold cash securities (*i.e.* those securities not subject to any security interests). Again, it is desirable for the designated broker to hold the securities in trust if that is possible under the laws applicable to the broker or, where practical given infrequency of trading, in physical scrip in the name of the hedge fund.

Sub-Custodial Arrangements

Prime brokers themselves (or custodians) may and often do custody assets through sub-custodians, particularly where the assets are held in jurisdictions outside of the prime brokers place of business. These sub-custodial arrangements should, naturally, reflect any proprietary arrangements put in place between the hedge fund and the prime broker.

Security Interests

A more difficult issue arises where the prime broker provides leverage to the hedge fund, such as where the prime broker provides margin financing to the hedge fund or where the prime broker acts as counterparty to the hedge fund in securities borrowing and lending arrangements or other over-the-counter transactions. The structure of collateral package taken by the prime broker in this case may fundamentally affect the rights of the hedge fund in the event of the insolvency of the prime broker.

Broadly, in the English common law world, there are 2 common methods to secure performance of obligations. The first is proprietary collateralization, typically in the form of a charge or a mortgage. The second is personal collateralization.

Proprietary Collateralization

In proprietary collateralization, as a general principle, the grantor has a proprietary and equitable right to redeem all interest in the assets which are the subject of the security interest upon performance of the obligation secured. Thus, where a hedge fund grants a mortgage to a prime broker over securities owned by the fund, upon repayment by the fund to the broker of all amounts due from the fund to the broker, the fund is entitled under equity to full title to the securities. This is so even if the bro-

ker is insolvent. This is because the laws of insolvency would normally treat the hedge fund as being the true owner of the securities and thus, the securities as being outside the pool of assets available to the creditors of the broker.

Where a hedge fund grants a true security interest under proprietary collateralization, the prime broker has no right to use the securities over which the security interest has been granted and may, depending on the hedge's fund place or manner of establishment, face practical inconvenience in perfecting such interests. Consequently, for commercial reasons, prime brokers will often resist accepting true security interests. Nevertheless, standard ISDA documentation for the over-the-counter transactions such as SWAPs does contemplate proprietary collateralization in the Credit Support Deed though standard GMSLA documentation for securities borrowing and lending does not.

Personal Collateralization

In personal collateralization, the hedge fund delivers title to the securities to the prime broker as collateral subject to a contractual obligation of the broker to redeliver equivalent securities. Where the broker becomes insolvent, the hedge fund is an unsecured creditor who has no proprietary interest in the securities over which the collateral has been granted.

Prime brokers will often prefer personal collateralization because they will have the right to use the securities over which the security interest has been granted. Standard ISDA documentation, through the Credit Support Annex, and the GMSLA both contemplate collateral through personal collateralization.

Forward Action

It follows from the foregoing that where a hedge fund may be required by a prime broker to place margin significantly in excess of obligations secured, a hedge fund should prefer to give collateral through proprietary collateralization rather than through personal collateralization. This is because if the prime broker becomes insolvent, under personal collateralization, the hedge fund will normally only be able to claim the excess margin as an unsecured creditor. However, there may be a cost imposed by the prime broker in the case of proprietary collateralization. Furthermore, hedge funds should be cautious in adopting an ISDA Credit Support Deed without further consultation with legal counsel given, amongst others, issues of perfection of the security interests and subject-matter of the security interest and the manner in which the terms and conditions the standard ISDA Credit Support Deed have been drafted.

Conclusion

The insolvency of a prime broker is a catastrophic event for any hedge fund which may result in significant loss in the net asset value of the fund or the demise of the fund itself and the reputation of its sponsor. Hedge funds should consider seriously the means by which the risk of such insolvency may be managed through both non-legal (*i.e.* credit) and legal means. Competent counsel can assist in this latter regard and help the directors of the fund to discharge their fiduciary duties.

TIMOTHY LOH, SOLICITORS serves as Hong Kong and international legal counsel to financial institutions including hedge funds, private equity funds and traditional funds. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200 and it has been recommended each year by the Asia Pacific Legal 500 for its financial services and regulatory practice.