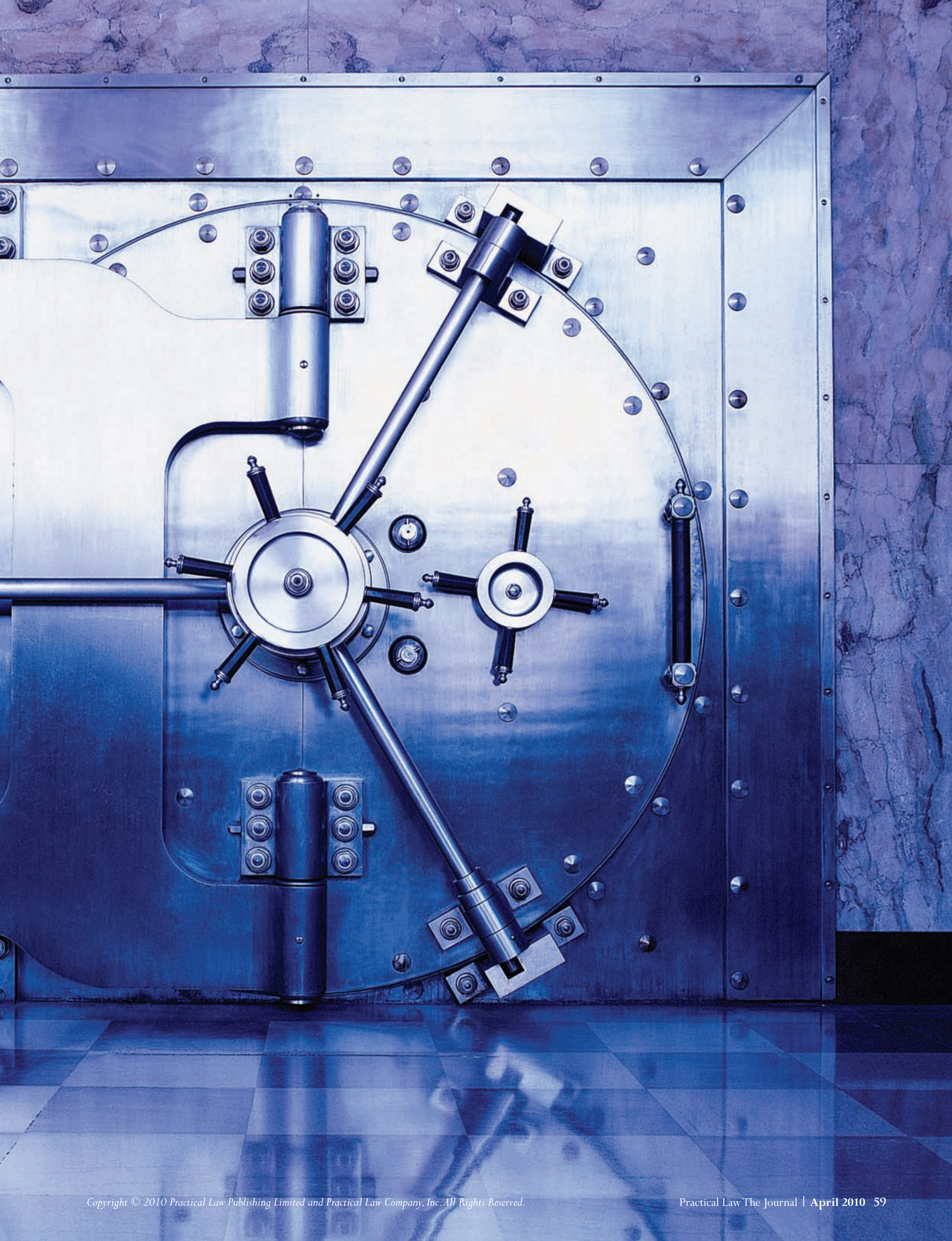
TRENDS IN PRIME BROKERAGE

The swift and unexpected collapse of Lehman Brothers revealed serious shortcomings in the traditional prime brokerage model. Lehman Brothers' prime brokerage clients faced considerable difficulties in retrieving assets that had been posted as collateral and the fallout has resulted in changes to the way prime brokers handle client assets. Alarna Carlsson-Sweeny of Practical Law Company reports.

There have been significant shifts over the past year in the market for prime brokerage services, and particularly in the relationship between prime brokers and their clients. "There used to be a general confidence in the stability of the large broker-dealers," says Steven Lofchie, a partner at Cadwalader, Wickersham & Taft LLP. "As a result, most of the negotiations in prime brokerage agreements tended to focus around the fund trying to minimize the risk of prime brokers prematurely declaring a default, rather than funds looking at the risk of a prime broker going under. Now with the loss of confidence both risks are in the spotlight." This new concern has led to changes to the typical prime brokerage business model, as well as a suite of revisions to typical prime brokerage agreement terms. Unsurprisingly, most of the revisions center on the broad theme of managing counterparty risk.



This article explains:

- The traditional prime brokerage model.
- Contractual issues highlighted by Lehman Brothers' collapse.
- Practices recently adopted by hedge funds and prime brokers.

THE TRADITIONAL PRIME BROKERAGE MODEL

Prime brokers are typically large investment banks or securities firms that offer services such as derivatives trading, margin and stock lending, and arranged financing to their clients, most of whom are hedge funds. Many prime brokerage businesses are self-funding because of their ability to rehypothecate (or re-pledge) the assets that clients post as margin or collateral for trades entered into under prime brokerage arrangements. Most prime brokerage agreements were based on this model. In practice, this meant that the prime broker could use the client's assets, for example, to lend to other hedge funds or post as collateral itself for another purpose.

"The ability to rehypothecate is what made the prime brokerage model profitable and what allowed the prime brokers to offer attractive pricing and efficient services to their clients. That was the commercial arrangement the parties entered into, and in boom times everyone benefited," says Leonard Ng, a partner at Sidley Austin LLP.

Under a traditional prime brokerage arrangement, when the client enters into an agreement with the prime broker, the latter generally takes security over all of the client's assets to secure the client's obligations under the agreement.

In the US, the extent to which a prime broker can rehypothecate a client's assets is limited by the Securities Exchange Act of 1934, as amended (Securities Exchange Act). Prime brokers can rehypothecate assets to the value of 140% of a client's liability to a prime broker. Further, prime brokers cannot use those assets to raise more money than they lend to their customers. This is different from the UK where there are no statutory limits on the value of assets that the prime broker can rehypothecate or how much money it can raise from using those assets. Because rehypothecation is so profitable for prime brokers, some prime brokerage agreements allow for a US client's assets to be transferred to the prime broker's UK subsidiary to circumvent these US rehypothecation limits. "Under the typical prime brokerage agreement the prime broker can use all of the client's assets, even if the value of these is far in excess of the actual obligations owed by the client," says Ng. Under UK law, when the prime broker exercises its right to rehypothecate an asset, the title to that asset transfers to the prime broker (see below *Who Are the Parties to the Agreement?*). For these reasons, prime brokerage agreements are often structured to permit client-asset transfer to the prime brokerage's UK affiliate.

ASSET PROTECTION

When Lehman Brothers went bankrupt many US hedge funds found themselves with significant exposure to Lehman Brothers International (Europe) (LBIE). "One of the most significant issues has been determining where client assets were located to begin with," explains Lofchie. "Were they custodied in the US through Lehman Brothers Inc. or were they custodied in the UK through LBIE? The answer is significant because if their assets were custodied in the UK through LBIE, the US asset protections do not apply, and their retrieval is subject to the UK asset protection regime, and very different rules apply."

According to Robert Colby, a partner at Davis Polk & Wardwell LLP, "Few US hedge funds fully comprehended the repercussions of allowing their assets to be transferred offshore. They did it for the extra leverage, but it meant that they were relinquishing their securities protections under US law. While it is difficult to make a direct comparison, the return of client money and client assets in the US has been more straightforward than in the UK."

In the case of LBIE, the safe and timely return of client assets was hindered because US prime brokerage clients lost their proprietary interests in the assets, and consequently lost client money and client asset protections under the UK Financial Services Authority's (FSA's) Client Assets Sourcebook (CASS). For an explanation of the main regulations dealing with the protection of client assets, see *Box, Asset Protection: US and UK Regulatory Framework*.

PRIME BROKERAGE DOCUMENTATION

The Lehman Brothers cases highlight some of the problems that have arisen concerning the provisions of traditional prime brokerage agreements, particularly in relation to:

- Determining the parties to the prime brokerage agreement.
- The consequences of one-sided documentation.

WHO ARE THE PARTIES TO THE AGREEMENT?

When Lehman Brothers filed for bankruptcy, many funds were taken by surprise by the fact that the vast majority of their assets had been rehypothecated, and that they were therefore in the position of unsecured creditors in the UK insolvency proceedings concerning the value of those assets. The reasons they found themselves in this position are as follows:

- Under the Lehman Brothers US prime brokerage agreements, Lehman Brothers Inc., the prime broker, entered into the agreement for itself and as agent for all of its affiliates.
- Many hedge funds signed margin-lending agreements and securities-lending agreements with LBIE in the UK (the market standard framework agreement for securities lending transactions is the Global Master Securities Lending Agreement (GMSLA) produced by the International Securities Lending Association (ISLA)).
- The agreements allowed the prime broker to transfer client assets between its various affiliates without the fund's express consent. As a result, all or most of the client assets were transferred to and held by LBIE.

As mentioned above, these arrangements, known in the market as "arranged financing," were common practice among prime brokers, allowing them to avoid the 140% limit on the amounts that a US broker-dealer is permitted to rehypothecate under US regulations. As noted, there are no regulatory limits on rehypothecation in the UK. Because the client assets were held by LBIE, the 140% limit did not apply and LBIE was able to (and did) rehypothecate the assets in excess of that limit. "Most US funds knew this was happening but were not cognizant of the implications if something went wrong," says Colby.

The fact that the prime broker's affiliates are parties to prime brokerage agreements also complicated and slowed the return of Lehman client assets, even if they had not been rehypothecated. According to Lofchie, "The cross-liens owed between various Lehman affiliates make the situation infinitely more complex. Before the administrator is willing to return any client assets, it must ensure that the hedge fund does not owe any liabilities, not just to the main prime broker, but to any entity in its group." This is because the Lehman Brothers prime brokerage agreements granted a security interest over client assets in favor of not just the main prime broker, but also to all Lehman Brothers' affiliates.

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THE CONSEQUENCES OF ONE-SIDED DOCUMENTATION

There is no industry-standard prime brokerage agreement; each prime broker has its own form. Before Lehman's collapse, the relationship between hedge funds and prime brokers was one-sided, with prime brokers holding most of the bargaining power.

As a result, prime brokerage agreements tended to be heavily weighted in favor of the prime broker. According to Patrick Buckingham, a partner at Herbert Smith LLP, "These documents were not usually negotiated; clients accepted the one-sided terms because they assumed the prime broker was a safe house. Ultimately, this has backfired and complicated the position on insolvency." Many agreements did not contemplate a situation in which their prime broker would become insolvent, and clients often had no close-out or termination rights at all.

In addition to the absence of termination rights within the customer account agreement, the netting and insolvency provisions of the GMSLA were often disapplied.

ASSET PROTECTION: US AND UK REGULATORY FRAMEWORK

US ASSET PROTECTION

From a regulatory perspective, entities engaged in the business of prime brokerage in the US are registered broker-dealers and are therefore subject to complex regulations and standards administered by several regulatory bodies, including the Securities Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA). According to Steven Lofchie of Cadwalader, Wickersham & Taft LLP, "Investor protection begins with a basic bankruptcy structure which provides for the way in which assets are set aside for customers in the event that the broker-dealer goes bankrupt. There's a moderately complicated system to determine what securities and cash need to be segregated." The main asset protections for investors are found in the Securities Exchange Act of 1934, as amended, and the Securities Investor Protection Act of 1979, as amended (SIPA).

Securities Exchange Act

The two key rules contained in the Securities Exchange Act are:

- The Net Capital Rule (Rule 15c3-1). This rule sets minimum capital levels based on the securities activities of the broker-dealer and a calculation using certain financial ratios.
- The Customer Protection Rule (Rule 15c3-3). The general rule is that broker-dealers cannot raise more money using client securities than they lend to their clients. This ratio is applied to client assets in the aggregate. In addition, on a customer-by-customer basis, the rule requires broker-dealers to maintain possession or control of their customers' fully paid and excess margin securities, to the extent that those excess margin securities exceed 140% of the customer's debit balance. These funds must be deposited into a special reserve bank account, segregated from the broker-dealers' proprietary holdings, for the benefit of the customers.

Lofchie points out that the crucial part of the rule is that it is applied based on the aggregate value of the client's assets. "As long as this test is satisfied the customers as a whole will be adequately protected and the system will function. The 140% rehypothecation limit as to a single customer is less significant than the aggregate limit."

SIPA

If a prime broker fails, it can enter into SIPA liquidation as an alternative to normal bankruptcy. Under SIPA, the Securities Investor Protection Corporation (SIPC) was created. SIPC is tasked with restoring funds and securities to investors with assets in the hands of bankrupt and otherwise financially troubled broker-dealers.

The prime broker's customer assets are divided on a pro rata basis, with assets distributed in proportion to the size of claims. If there are insufficient assets in the firm's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution, up to a maximum of $500,000 per customer, including a maximum of $100,000 for cash claims. "Customer claims for cash and securities are given preference over other claims," says Robert Colby of Davis Polk & Wardwell LLP. "While the reserve fund limits are probably sufficient for retail customers, it is unlikely to be sufficient to pay out prime broker customers, who are typically owed much greater amounts." Colby also points out that shortfalls can be significant if there have been violations of recordkeeping or segregation obligations.

SIPC liquidation proceedings against Lehman Brothers were commenced in federal district court on September 19, 2008. According to Lofchie, "The story is still unfolding, but as far as we can tell the investor protection system has worked reasonably well. Obligations may not have been perfectly implemented, particularly in the last few days before the bankruptcy when the pressure to respond to client requests for cash and securities to be transferred out may have caused processes to break down. Overall, however, the legal structure has proved resilient."

UK ASSET PROTECTION

Chapters 7 and 7A of the Financial Service Authority's (FSA's) Client Assets Source Book (CASS) deal with client money (Client Money Rules), and Chapter 6 of CASS deals with other client assets (Custody Rules).

Chapter 3 of CASS deals with the assets that a firm holds in connection with an arrangement to secure a client's obligations (Collateral Rules).

FSA Client Money Regime

Under the Client Money Rules, prime brokers that receive client money in the course of providing regulated services must hold it in trust, segregate it and place it into an account with a bank or a qualifying money market fund. However, this type of client money protection is only ensured where the client's money can be clearly identified. This was confirmed by *Lehman Brothers International (Europe) v. CRC Credit Fund Ltd. & Ors [2009] EWHC 3228 (Ch)*, in which the British High Court found that the Client Money Rules do not override the basic law of trusts, which requires that cash must be capable of identification for a proprietary interest to survive.

The segregation requirements under the Client Money Rules are incompatible with the prime broker's desire to rehypothecate a client's assets. Before the Markets in Financial Instruments Directive (*2004/39/EC*) (MiFID) (the EU Directive regulating financial instruments markets) was implemented, prime brokerage agreements typically contained a clause stating that client money protections would not apply to client cash held by a prime broker. This contractual opt-out was permitted for clients who were categorized as "market counterparties" or "intermediate customers" (broadly equating to "eligible counterparties" and "professional clients" under MiFID). However, MiFID ended the contractual opt-out mechanism for wholesale clients (institutions or large companies). Nevertheless, Recital 27 of MiFID still acknowledges that funds held under certain security arrangements would fall outside the definition of client money, in which case Client Money Rules are not applied.

For example, the Client Money Rules would not apply under an arrangement where the client transfers full ownership of the cash to the prime broker to secure its obligations under the prime brokerage agreement (*CASS 7.2.3R*). "Cash is fungible, so as soon as the prime broker takes possession of it, title automatically transfers and unless the cash is segregated, client money protections are lost," explains Leonard Ng of Sidley Austin LLP. (Similarly, under the Uniform Commercial Code as in effect in most jurisdictions in the US, a security interest in cash is perfected by possession.) "The consequence of the Client Money Rules not applying is that if the prime broker becomes insolvent, the hedge fund's claim against that prime broker for any such cash would be treated as a claim of a general unsecured creditor," says Ng.

According to Patrick Buckingham of Herbert Smith LLP, in the past, hedge funds rarely insisted on a segregated account because the commercial arrangement was that, in order to provide low pricing, the prime broker needed to use the cash. "Only the large and well-established hedge funds would even have had enough bargaining power to insist on client money protections, but many of them did not because they had confidence in the prime broker's creditworthiness."

FSA Custody Regime

The holding of a client's financial instruments, such as securities, in the course of providing regulated services in the UK is subject to the Custody Rules. The rules require the segregation of the client's pledged assets from the prime broker's assets and the adequate safeguarding of the client's ownership rights in the assets. However, unlike the Client Money Rules, the Custody Rules do not impose a statutory trust over the segregated client assets (although a trust relationship may still arise as a matter of common law).

However, the Custody Rules contain an exception similar to the one in the Client Money Rules: the protections do not apply where full ownership of the asset is transferred to the prime broker for the purposes of securing the client's obligations (*CASS 6.1.6R*). A typical prime brokerage agreement provides that all of the client's assets be assigned absolutely to the prime broker to cover any obligations that may arise under the prime brokerage agreement. The prime broker then typically rehypothecates the assets, the value of which may well exceed the client's obligations to the prime broker (see above *The Traditional Prime Brokerage Model*).

Therefore, once the prime broker exercises its right to rehypothecate these assets, the title to the assets transfers to the prime broker and the Custody Rules no longer apply. "The prime broker's only obligation is to return 'equivalent' assets to the client once it has fulfilled its obligations," says Ng. As with client money, if the prime broker becomes insolvent in the meantime, the client becomes a general unsecured creditor in respect of the value of those assets."

FSA Collateral Rules

The Collateral Rules apply to arrangements, such as prime brokerage arrangements, where a firm has a right to use a client's asset, and treats it as if the legal title and associated rights to that asset have been transferred to the firm, subject to an obligation to return equivalent assets once the client's obligations have been fulfilled. Once the firm has exercised its right to treat the asset as its own, the Client Money Rules and Custody Rules, and the protections under these rules, cease to apply. The prime broker is then only required to maintain adequate records to enable it to meet its obligations to return equivalent assets to the client (*CASS 3.2.2*).

The rationale that the FSA has given for this distinction regarding the treatment of rehypothecated assets is that a lower level of regulatory protection should apply to them once the prime broker has exercised the right to treat the assets as its own, because, at that point, they cease to belong to the client and effectively become the prime broker's assets.

Consequently, Lehman's bankruptcy filings in the US and insolvency filings in the UK did not freeze client positions or terminate the agreements. Many of the agreements are technically still operative.

MARKET RESPONSE: HEDGE FUNDS

While the years preceding Lehman's collapse were characterized by prime brokers dominating the broker/client relationship, hedge funds now find themselves with increased negotiating power relating to prime broker agreements and can make demands on how prime brokers treat their assets. "Prime broker credit risk is an issue that is now firmly on the table," says Allan Yip, a partner at Simmons & Simmons.

The most notable emerging trends relate to demands by hedge funds that prime brokers establish segregated accounts for their cash and assets, so that the hedge funds retain a proprietary interest in those segregated assets.

Many of the emerging market trends are aimed at ensuring the safety of the hedge funds' cash and securities, and at facilitating a faster return of the assets if the prime broker defaults. According to Nora Jordan, a partner at Davis Polk & Wardwell LLP, "Clients are paying greater attention to the fine details contained in the agreements and are being more proactive about protection. However, the large and more established clients will clearly have more bargaining power and be able to negotiate better terms than the smaller funds, which may struggle to get protection at a reasonable price."

The most notable emerging trends relate to demands by hedge funds that prime brokers establish segregated accounts for their cash and assets, so that the hedge funds retain a proprietary interest in those segregated assets. Common practices include:

- Seeking client money protections.
- Increased use of custodians.
- Restricting rehypothecation rights.
- Using multiple prime brokers.

SEEKING CLIENT MONEY PROTECTION

More hedge funds are seeking to benefit from the protection offered by the Client Money Rules, which means that cash must be deposited into a separate account and not mixed with the prime broker's cash. This way, the hedge fund maintains a proprietary interest in the cash. The hedge fund could have its own segregated account or the account could be commingled with other clients' money. The key point is that it must not be commingled with the prime broker's funds.

If the prime broker agrees to segregate the client's money, it is important to check where the deposit will be held. "Some prime brokerage agreements may provide that the cash be held on deposit at an affiliate of the prime broker," explains Ng. "However, to manage your exposure, it may be prudent to request that the cash be held with an unaffiliated bank with a suitably high credit rating."

Many hedge funds are now using custodians to hold both their excess cash and securities (see below *Increased Use of Custodians*).

The flip side of receiving the extra protection is that the prime broker can no longer rehypothecate or use the cash for its own purposes, which has an impact on the pricing of the prime broker's services for the hedge fund.

INCREASED USE OF CUSTODIANS

Recently there has been an increase in the number of hedge funds using custody accounts. Some hedge funds seek to place an obligation on the prime broker to sweep all of its non-collateral assets (that is, any assets in excess of the client's collateral requirements) into a custody account at the end of each day. This account may be with a third-party custodian or a new company set up by the prime broker (see below *Market Response: Prime Brokers*). Custodians simply hold assets; they do not lend, nor do they rehypothecate assets.

However, the safety offered by a custodian comes at a cost. In addition to custody fees, there is also an extra administrative burden because the hedge fund must now deal with two different entities (the prime broker and the custodian), as opposed to just the prime broker.

>> For further information, search Fund Collateral Issues in the Wake of Lehman on our website.

REHYPOTHECATION LIMITS

US funds are now paying much closer attention to where their assets are being held, and many prefer to hold more collateral in the US as opposed to Europe or elsewhere. "US margin rules have been improved by the adoption of the portfolio margin requirements, so as to allow US broker-dealers to extend more credit against liquid assets, which makes funds willing to borrow from a US broker-dealer rather than forcing them to borrow from an offshore lender," says Lofchie.

Jordan says that while initially after Lehman's collapse clients were very wary of their assets going abroad, many are now more amenable to it: "As long as the fund is comfortable that adequate safeguards and limits have been implemented by the overseas affiliate, they are generally allowing international transfers to happen."

In the UK, before Lehman's collapse it was common for prime brokers to have unlimited rights to rehypothecate their clients' assets. Now it is more common for hedge funds to negotiate restrictions on this practice. According to Ng, restrictions can be achieved in two ways: "Hedge funds may refuse to consent to rehypothecation altogether, or they may impose conditions, such as placing a limit on the value of securities that may be rehypothecated across various asset classes. Alternatively, the client could seek to permit rehypothecation only where the prime broker maintains a specified credit rating, although bear in mind this would not have helped in the Lehman Brothers situation" (Lehman's credit rating was not reduced before its sudden collapse).

An additional problem on both sides of the Atlantic was the lack of transparency regarding which assets had been rehypothecated. According to Jordan, "Clients are now routinely requesting that their prime brokers increase their reporting on these activities. Some hedge funds are even insisting on daily reports on where their assets are being held."

While limiting rehypothecation decreases counterparty risk, it inevitably results in higher funding costs for the prime broker, so hedge funds may be faced with higher service fees.

MULTIPLE PRIME BROKERS

It has also become much more common for hedge funds to use multiple prime brokers, rather than just a single prime broker.

"The obvious benefit of using multiple prime brokers is to spread the counterparty risk," says Yip. "If there is a whiff of trouble at one broker you can more quickly move your assets to another prime broker." Many hedge funds struggled to manage counterparty risk during the peak of the financial crisis when Lehman collapsed, and there was concern about the stability of other prime brokers in the market.

Yip continues, "It can take a few months to open a prime broker account because of all the documentation required. However, hedge funds were signing documents without properly analyzing them just to get the account open as quickly as possible. Now they are going back and trying to renegotiate the terms they agreed to. That scenario can be avoided if you have multiple prime brokers to start with."

While there are definite advantages of using multiple prime brokers, it may increase operational complexity and cost. Ng identifies several factors to consider: "Hedge funds will require greater internal risk management procedures as well as systems, controls and appropriate technology to manage exposures across several prime brokers. Another potential downside is that cross-product margining, which may allow for more leverage to be available, would be more difficult to achieve across different prime brokers. Finally, a hedge fund might be reluctant to change its prime broker if that prime broker has access to hard-to-borrow securities that are needed by the fund."

OTHER CONTRACTUAL TRENDS

Much more attention is now being paid to exactly which of the fund's liabilities are being secured by the prime brokerage agreement and to which entity the security interests are being granted. "Many prime brokerage agreements include a grant of all assets of the hedge fund client to secure all liabilities owed to the prime broker and all of its affiliates. This means it is unlikely that any security will be released until the net position with each entity is established, which can be a time-consuming task," says Ng (see above *Who Are the Parties to the Agreement?*).

As a result, many hedge funds are now seeking to narrow the scope of the security interest granted to prime brokers over their assets and to limit the parties to the prime brokerage agreement to avoid creating liability or granting security interests to the prime broker's affiliates. "It is particularly important to examine the definition of 'affiliate' in any brokerage-related documentation," adds Ng.

Hedge funds are also examining prime brokerage agreements to ensure they have adequate termination and close-out rights in the event of the prime broker's insolvency or bankruptcy, or the insolvency or bankruptcy of any major affiliates.

MARKET RESPONSE: PRIME BROKERS

Prime brokers have responded to the changing demands of clients by modifying their business models. While there are several variations, all of the changes involve setting up a separate account for the client. The variations then relate to:

- How the accounts are established.
- Which assets are transferred to the new account.

HOW SEPARATE ACCOUNTS ARE ESTABLISHED

Some prime brokers have set up a new affiliate to act as custodian for their prime broker clients, the sole purpose of which is to hold client assets. These new entities have been designed to be "bankruptcy remote," so that if the prime broker becomes insolvent, the custodian should remain unaffected. Other prime brokers have set up separate prime brokerage accounts for clients, assuming this will provide sufficient protection (it may not).

However, some clients prefer to set up their own separate accounts with a third party custodian that has no connection to the prime broker. Buckingham points out that this practice exposes the client to an additional risk, namely the risk that a third party custodian may become insolvent. "Clients may not always appreciate that client money protections do not apply to deposits held by banks, so in the event of their insolvency the client would be an unsecured creditor. It means that you have to keep track of the creditworthiness of the banks holding your cash deposits."

WHICH ASSETS ARE TRANSFERRED

Some prime brokers now hold all unencumbered assets in separate accounts. Usually the prime broker takes a security interest in all of the client's assets, regardless of the actual liabilities owed by the client. As a result, in most instances the prime broker is overcollateralized. In this case, the assets that exceed the client's liabilities to the prime broker are classified as unencumbered assets (although the prime broker usually also retains a buffer of 5% to 10% of the value of the liabilities). Under this system, the prime broker has no recourse to these assets and no security interest in them.

Other prime brokers have taken a slightly different approach and have moved into these separate accounts all assets that they have not rehypothecated. Under this arrangement, the prime broker retains a security interest in all of the client's assets, but the security interest is lifted the moment the prime broker becomes insolvent or files for bankruptcy.

THE FUTURE OF PRIME BROKERAGE

The full extent of the fallout from Lehman's collapse and the broader impact of the financial crisis on the prime brokerage industry have yet to be determined. While the complex unraveling of client assets and client money has led to significant criticism of the Client Money Rules and Client Asset Rules in the UK, the US asset protection regime has emerged relatively unscathed. "Some of the financial legislation making its way through Congress now could impact prime brokerage, but at the moment it is a wild card — it is too early to tell what, if anything, will end up as law," says Lofchie. "The only thing I can be sure of is that the draft legislation will have many unintended consequences."

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