HEDGE FUND LAW: ARTICLE SERIES

Prime Brokerage Agreement Negotiation

Everything a Hedge Fund Needs to Know – Part 1

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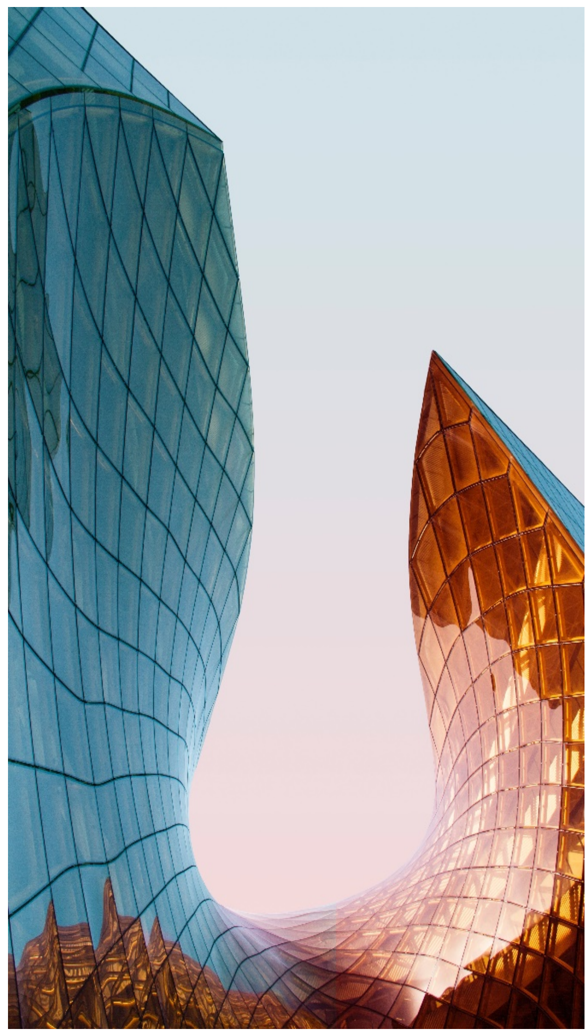
December 17, 2019

INTRODUCTION

The Prime Brokerage relationship serves as a cornerstone in the success of most hedge funds. The Prime Broker ("PB") serves as financier, clearing and settlement agent, custodian, advisor and trade execution counterparty. In good times, the PB can enable a manager to achieve great returns, but in bad times (e.g. market downturns, stress events) the PB can seal a manager's fate. A strong relationship between a manager and the PB is paramount to hedge fund success. This relationship spans the personal relationship, the business terms, and finally, the legal terms – which is what matters most when relationships break down.



This series of articles addresses the prime brokerage agreement ("PBA") and is designed to present hedge fund managers with a structured way to approach their PB relationship – a way which will allow them to better protect their interests and the interests of their investors.

In this first part of this series, we will lay the groundwork to understanding why negotiation is important and how a manager should approach it. We will then delve into the three most important aspects – what we call the "Three Pillars" – of ensuring the stability of a manager's PB relationship: financing, margin and termination.[1]

What is Prime Brokerage

Simply put, a PB provides a centralized place for trading of many product types and provides various services. The PB provides financing, clearing, settlement, execution, technology (via reporting and trading platforms), consulting services, capital introduction, middle and back office support, etc.

There is a wide array of legal agreements (or relationships) that can exist with a PB. This will vary in accordance with the products traded (e.g., cash equities vs synthetic equities). For the purposes of this article, we will focus on cash equity prime brokerage – indeed, the most common form of prime brokerage. The three pillars which we will explain below apply to a greater or lesser degree to other types of prime brokerage but there are nuances which we will not cover here.

Importance of PB Negotiation

PB negotiation is essential because, done right, it can provide efficiency, certainty and stability, thereby allowing for the successful management of the hedge fund's business and strategy. On the other hand, a poorly negotiated PBA can give rise to a host of unexpected risks, since the template PBA is tilted heavily in favor of the PB. Let's examine some of these risks.

A template PBA only requires the PB to extend financing on an overnight basis and gives the PB sole discretion to determine margin requirements. This means that a manager's PB can pull financing or significantly increase the manager's margin requirements from one day to the next – even if the manager is not in default. This discretion could prove detrimental to a fund's performance as it may force the manager to liquidate positions at a moment's notice.

Moreover, consider that template PBAs confer the PB with broad and discretionary default rights against the fund. If the PB puts the fund into default, the show is over. Not only will the PB liquidate the fund's assets, but the effect of this default can also trigger a cascading effect of defaults to the fund's other trading agreements (e.g. other PBAs with other firms, ISDA, repo, futures clearing, etc.). The reason for this cascading effect is that most trading agreements contain a *cross default provision* specifying that a default under any other agreement will be deemed as a default under that agreement as well.

Know What You Want

The first step to any negotiation is knowing what you want. Determine the products, financing needs, and other services (e.g. trading tools such as an order management system, operations, reporting, consulting, cap intro, research, etc.) that the fund's strategy requires.

Understand the liquidity profile of the fund's portfolio and consider what kind of financing term the strategy requires. Have a clear sample portfolio to present to the PB, along with a great story about the manager, the investment philosophy and the potential for future success of the firm.

[1] Please note this article is examining cash equity prime brokerage, and not other types of prime brokerage such as fixed income prime brokerage, FX prime brokerage (or FX intermediation) or synthetic prime brokerage. Although there is some common ground, the service provided and relationship with the PB is different, and so too are the legal terms and approach.

Know What You Represent

The second step is to think about your bargaining power in the negotiation. Are you an attractive client to the PB? Do you represent a solid revenue stream that they cannot pass up?

To a PB, the ideal client is one that makes generous use of leverage, has a market-neutral strategy, shorts hard-to-borrow stocks and has high turnover (quant funds that execute with the PB's trading desks are particularly attractive). Strong support from within the PB's business unit will go a long way to helping a manager achieve more favorable terms in the legal negotiation process.

Nevertheless, even if you are not the most attractive PB client, there is a baseline of terms (call it market standard) that any hedge fund can and should obtain from their PB.

How Does the PBA Work?

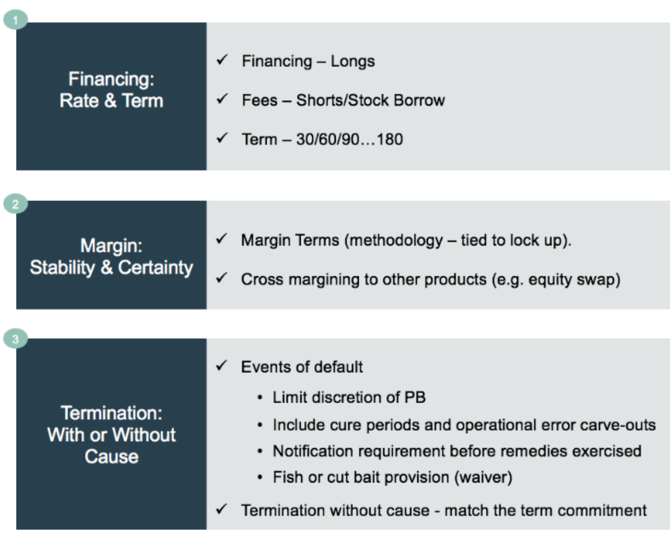
Unlike other common trading agreements – such as the ISDA Master Agreement, the industry has not developed a standard form of PBA. Each brokerage firm has its own proprietary PBA template with a plethora of different formats and terms, each requiring careful review and consideration. However, certain core principles tend to recur across all PBAs. As a result, knowledge of these core principles will allow a manager to better understand the framework of any PBA and more easily navigate its terms.

THREE PILLARS OF PB NEGOTIATION

In the introduction, we alluded to the three fundamental pillars of PB negotiation: financing, margin, and termination (see Figure 1 below). These are the three key areas of every PBA where it is possible and necessary to obtain a degree of certainty and stability from the PB.

Put another way, the three pillars comprise the ways in which the PB can force a manager out of a relationship. Accordingly, knowledge of how to properly align and negotiate these elements is crucial. Weakness at one point in the chain can bring down the entire house.

Figure 1: Three Pillars



Pillar 1 | *Financing – Rate & Term*

The first pillar of PB negotiation is financing, which is one method of deploying leverage. Recall that the starting point in any PBA is that *a PB provides financing on an overnight basis*. Stated differently, a PB initially makes no commitment as to the *rate* that will be charged in respect of borrowings, and the *term* of the loan. That position may be good for a PB, but bad for a manager. Therefore, a manager will want to obtain certainty in these items when negotiating any PBA.

A breakdown of the inner workings of PB financing may be helpful in negotiating these items. Consider the following:

On longs, a PB extends financing, thereby allowing a manager to "lever-up" its fund's positions. Obviously, the more leverage a manager employs, the greater the financing it needs. When lending, a PB will charge the fund an interest rate as follows:

Interest rate = [Benchmark rate] *plus a* [Spread]

e.g.: = [Overnight Bank Funding Rate ("OBFR")] *plus* [35 basis points]

**These rates will vary depending on the markets and currencies involved, but also on the respective bargaining power to negotiate better rates.*

On shorts, a PB lends the fund stocks, which the manager then sells in the market. The PB will charge stock loan fees, often expressed as interest earned on the proceeds generated from the short sales, calculated as follows:

Interest rate = [Benchmark rate] minus a [Spread]

e.g.: = [OBFR] minus [30 basis points]

***The expression "through the middle" refers to the spread on the long financing plus the spread on the shorts. In the example above, it would be a total of 65 bps through the middle (35bps + 30bps).*

In relation to Financing, what elements must be negotiated?

(i) The benchmark rate and the spread;

(ii) The duration for which those rates are locked in; and

(iii) The size/amount of the borrowing line, and how long it will remain available.

Typical timing for (i) and (ii) above is 30, 60, 90 or 120 days – this period is often referred to as the *lock-up* or *term*. The size of the manager, creditworthiness, revenue potential to the PB, volatility, and diversity of the manager's portfolio will be important factors in determining the lock-up period. Larger managers can get up to 180 days or more. For smaller managers, a 30-day lock-up might be appropriate and will usually not result in the PB changing any financing costs. Where a longer lock-up period is requested, and depending on the bargaining power of the manager, the PB may insist on matching the Benchmark component of the interest rate (described above) with the duration of the lock-up. So, if a manager is looking for a 90-day lock-up, the PB will seek to move the Benchmark out to the 3-month USD LIBOR, meaning more expensive financing.

Now, here's the curveball: none of the favorable elements mentioned above are even found in the main PBA. Rather, they are negotiated in a separate legal agreement, referred to as the *Term Commitment* or *Lock-Up*.

Pillar 2 | *Margin – Stability & Certainty*

Obtaining low margin requirements with stability and certainty is the second pillar of PB negotiation – the other side of the same coin as financing. Whenever a fund borrows, the PB will require the fund to maintain a certain level of margin.[2] This begs the next important question: how is a fund's margin requirement determined?

As with financing, a template PBA does not specify how margin is determined. Rather, it grants the PB unfettered discretion to determine margin requirements.

A breakdown of the inner workings of PB margin may be helpful in negotiating PB requirements. Consider the following:

Margin required by the PB is the greater of the…

Regulatory Requirement

and

House Requirement.

Regulatory Requirement is the minimum margin required by regulation. In the U.S., the relevant regulation is either "Reg T" (50% margin requirement, i.e. 2 times leverage) or "Portfolio Margining" (15% margin requirement, i.e. roughly 6.7 times leverage). If a fund needs even greater leverage, there are arranged financing solutions[3] or synthetics (e.g. equity swaps) provided by most bulge bracket PBs for this purpose.

House Requirement is the minimum margin required as determined by the PB from a risk perspective. A manager should request that its PB provide the model the PB is using to determine the applicable House Requirement.

[2] For instance, a hedge fund may borrow $80M with a $20M margin requirement, for a total of $100M. But the PB can force the manager to pony up more cash by increasing the margin requirement. In the above example, the PB could instead require $40M in margin, so the fund would have $60M being financed and $40M in margin. As the example demonstrates, a higher margin requirement limits a fund's ability to borrow.

[3] For such arrangements, a PB often deploys its European arm to extend additional finance. Such arrangements, though they can increase the ability to run leverage, change the counterparty risk and regulatory environment that the fund faces vis-à-vis a U.S. broker dealer subject to 15(c)(3)(iii) 140% rehypothecation, to a UK entity which has no regulatory rehypothecation limit. In the event of a PB insolvency, the chances of the fund incurring losses via arranged financing are increased and the recovery of assets is more complicated. A number of hedge funds were faced with this situation in the wake of the Lehman Brothers bankruptcy, for instance.

In relation to Margin, what elements must be negotiated?

Margin Requirement. How the PB determines the House Requirement should be hardcoded into the PBA (or in the Term Commitment/Lock-up). It should therefore be subject to the same lock-up period before the PB can make any changes to it. Moreover, a manager should negotiate for lower margin requirements to keep more of the fund's cash "unencumbered" and available to be deployed to generate returns.

Margin Transfer Timing. A template PBA will usually provide that sufficient margin must always be maintained in the account. Unless a manager is over-funding a PB account, this will in practice be impossible. It is commonplace to negotiate a 10 a.m. cut-off time for margin to be posted the same day. Timing must coincide with a manager's operational processes. Without negotiated margin transfer timing, the fund is at risk of missing a margin call and being unduly put into default.

Return of Excess Collateral. PBs typically assume no obligation to return excess margin to the fund. A manager should thus include a provision which provides that the PB will return excess margin to the fund in a reasonable timeframe upon the manager's request for both cash and securities; timing for cash should be 1-2 days, and securities should be one settlement cycle.

Minimum Net Equity. The SEC requires USD 500,000 of minimum net equity (comprised of cash and/or securities) in a PB account. The PBA should mention this amount and provide that the PB cannot demand a higher minimum amount.[4]

Cross Margining/Bridging. Many PBs offer the ability to cross margin cash products with synthetic products (e.g. cash equities with equity swaps), which can lower the overall margin requirement.[5]

Pillar 3 | *Termination—With(out) Cause*

In Pillars 1 and 2, we explored the elements of PB negotiation as they relate to financing and margin. Some managers, depending on their bargaining power, may not get favorable terms on those two fronts; that is, the PB will sometimes refuse to provide a Term Commitment/Lock-Up. Now, a manager about to enter the PB negotiating process might be thinking, "If I can't get those, why even bother negotiating anything else?"

True – not obtaining favorable terms in respect of financing and margin is consequential. Such unfavorable terms can force a manager to reduce exposure or transfer balances to another PB (if the manager has one available). But these consequences <u>pale in comparison to being put into default</u>. When put into default, the PB will have the option to liquidate all

[4] For Fixed Income Prime Brokerage, this is typically referred to as a clearing deposit and it is normal and acceptable for the PB to require a significantly higher clearing deposit.

[5] When cross margining, it is important to also assess:

a. the increase in counterparty risk. Usually, cross margining will involve that all assets be held at the PB, and ultimately, the fund will face the credit risk of that entity which is often of weaker credit quality as compared to the OTC Counterparty.

b. the changes in legal terms. When cross margining, PBs will often require additional control over assets and collateral. Cross default provisions are also bolstered in the PBA often negating terms negotiated in other documents (such as an ISDA).

assets in the portfolio in its sole discretion and without notice. Worse still, most of a fund's trading agreements likely contain *cross default provisions*, creating a cascade of cross defaults in all other agreements.

To further highlight the importance of this pillar, we examine below termination without cause and termination with cause.[6]

Termination Without Cause

Termination without cause occurs in the normal course of business without either party being in breach of the agreement. Either party to the PBA, can put an end to the relationship. The fund should be able to end the relationship upon notice to the PB, but the PB should be required to provide advance notice. The timing for the PB's notice should align with any timing the fund has in the Term Commitment/Lock-Up. If fund does not have a Term Commitment/ Lock-Up, a manager should aim to get at least 30 days here. As an aside, where possible (based on the manager's size and wallet) a back-up PB should be set-up and active (or in the least close to being ready). If a manager's main PB pulls the plug, the manager should be able to move balances to avoid a disruption in exposure.

Termination With Cause - Events of Default ("EoDs")

Termination with cause occurs when a manager (or its fund) is in the wrong as per the terms of the PBA. The PB will have the right to terminate the PBA if an EoD occurs. The EoDs stipulated in the PBA are the arsenal that a PB has in order to take complete control of the fund's account. The PBs will seek to include numerous discretionary rights so that they have multiple means of putting the fund into default. In practice, a PB will rarely use this power, but will typically want as many options available in case the PB loses confidence in the manager or otherwise wants out of an agreement. EoDs get triggered when something has gone fundamentally wrong at a fund, or in times of extreme market stress.

When negotiating the EoDs in a PBA, a manager's primary mission is to minimize the number of EoDs, reduce the PB's discretion, and add cure periods/ notification requirements. We explore the most common EoDs below:

Failure to pay or deliver. An EoD will occur if a fund fails to make a payment or a delivery on time. To avoid technical EoDs, a carve-out for administrative or operational errors should be included in the PBA. In other words, if a fund missed a payment (say a margin call) but it was due to an operational or administrative error, that circumstance should not give rise to an EoD. A better position is to have a complete grace period (e.g., one day) for a failure to pay, regardless of the reason, but this provision is quite difficult to obtain.

Non-payment failures. An EoD will occur if a fund breaches any non-payment obligations under the PBA (e.g., delivery of financial information). Here, a manager should obtain a grace period allowing it to remedy the matter within a few days of being notified by the PB.

Adequate assurances or material adverse change provisions. A PB will often include a general provision which gives it the right to put a fund in default if there has been a material adverse change with the fund (or its manager), or if the fund (or its manager) fails to provide the PB with adequate assurances of their performance – and all

[6]The effects of cross default provisions were explored in *Importance of PB Negotiation* above.

of this is determined <u>in the sole discretion of the PB</u>. A manager should delete this clause, full stop. Do not accept this clause in the PBA.[7]

Cross default. PBs will seek to include a provision that any EoD under any other agreement between the fund and PB or its affiliates should give rise to an EoD under this PBA. Although it would be ideal to eliminate this provision entirely, a manager is more likely to be successful by making this a *cross acceleration* provision instead of a cross default provision. Cross acceleration is more favorable to a manager than cross default, since a cross acceleration provision only results in an EoD where (i) a default occurs in another agreement and (ii) that default results in the acceleration of all obligations (i.e., exercise of default remedies and termination) under that other agreement.

Fish or cut-bait. As the name aptly suggests, this type of provision aims at getting the PB to act on an EoD or waive its rights. This is a provision a manager needs to add to its PBA to protect the fund. As surprising as it may sound, the template PBA is structured such that if an EoD occurs today, the PB can trigger (i.e. put the fund in default) at any time they choose, even far into the future. For obvious reasons, a manager does not want an EoD hanging over the fund and threatening the demise of the fund in perpetuity. The Fish or Cut-Bait provision usually provides that the PB has 30-90 days to act on an EoD before the PB is deemed to have waived its rights with respect to the EoD.

Post Default

Once a default occurs, the PB will have broad powers to liquidate a fund's portfolio. Here are some important points to keep in mind to mitigate how and when this liquidation occurs:

Notification requirement. It is crucial to include a notification requirement from the PB before (or at least concurrently with) the PB's exercise of default remedies. The notification requirement can provide a last-ditch effort to save the fund before the PB starts liquidating the portfolio. At a minimum, a notification requirement can potentially allow the manager to take steps to mitigate the damages resulting from a liquidation of the fund's assets.

Default Remedies. A manager should seek to limit the default remedies available to the PB, and in the least, insist that any liquidation be conducted in good faith and in a commercially reasonable manner. Where a PB grants itself the right to private sales with any parties (including their affiliates), a manager should insist that any such sale be conducted reasonably and on an arm's length basis. Such a clause will help ensure that the PB obtains reasonable value for anything liquidated in such a manner.

Provisions as a Sword

To now, we have considered several defensive negotiation strategies with

[7] If the PB insists on including this clause, and the manager is a smaller PB client, then the manager should offer triggers which are tied to real events (e.g. net asset value decline, key person change, change of investment manager) – and push to make this a termination event and not an EoD. A termination event will give PBs the right to terminate and liquidate assets, but it would not be considered an EoD, which could trigger cross default to other agreements (again, the language in the other agreements would be important to check here).

respect to EoDs. But we must also consider what offensive provisions a manager should include in its PBAs:

EoD against the PB. A manager should consider including an event of default against the PB which arises when the PB is insolvent or in bankruptcy. This EoD helps set-off obligations and close out any exposure the fund has to the PB. The provision can help limit the impact of being dragged into an insolvency proceeding.[8]

Representations from the PB. The PB should be required to provide representations, including with respect to the PB's regulatory status, power and authority to enter into the agreement.

Conclusion

When approaching a PBA negotiation, a manager should start by evaluating its needs and bargaining power, as well as how those factors align with the three pillars outlined above (financing, margin and termination). Negotiation with a PB can be a delicate process, and a manager will be far more successful by understanding the inner workings of PBAs, and by making informed, reasonable requests.

In the next part of this series, we will cover other important aspects of the PBA such as asset control, operational concerns, liability and indemnities.

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[8] With the implementation of the US Stay Regulations (regulations issued by the Board of Governors of the Federal Reserve System (12 C.F.R. §§ 252.2, 252.81-88), the Federal Deposit Insurance Corporation (12 C.F.R. §§ 382.1-7) and the Office of the Comptroller of the Currency (12 C.F.R. §§ 47.1-8), this provision has lost some of its clout. To the extent that the US government implements a protection regime in the event of an insolvency of a global systemically important banking organization (G-SIB), these set-off rights would likely not apply.

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About the Firm

HedgeLegal is a boutique law firm dedicated to providing hedge fund managers with industry best practice trading document negotiation. HedgeLegal has extensive experience negotiating a wide array of trading agreements: Prime Brokerage, Term Commitment/Lock-Up, ISDA, Equity Master Confirmation Agreements, Futures Clearing, OTC Clearing, FX PB, Repo, Custody, etc.

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