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HEDGE FUND LAW: ARTICLE SERIES

Prime Brokerage Agreement Negotiation

Part 2 – Protecting Against Prime Broker Failure; 12 Years After Lehman

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Introduction

It's Friday September 12th, 2008. Lehman Brothers ("**Lehman**"), one of the world's largest prime brokers ("**PB**"), is on the brink of collapse. Lehman's clients are nervous and many are trying to call back their assets.[1] Unfortunately, Lehman's operations teams are overrun and cannot process the volume of requests flooding in.

Months earlier, a larger PB, Bear Stearns ("**Bear**") was on the brink of collapse. However, Bear received a bailout from the government and was scooped up by JPMorgan at an incredibly steep discount. Many are expecting a similar fate for Lehman, a bailout must be coming.[2] But it isn't.[3]

The day ends, the weekend comes, and on Monday September 15, 2008, Lehman files for chapter 11 bankruptcy, with $613 billion in debt and $639 billion in assets,

[1] See Helen Avery, "Prime Brokerage: The Day the Music Stopped" (29 Oct 2008) Euromoney, online: https://www.euromoney.com/article/b1322h65c9hbf8/prime-brokerage-the-day-the-music-stopped ["***Avery***"].

[2] See J.S. Aikman, When Prime Brokers Fail (Bloomberg Press, 2010) at page 8.

[3] Despite claims made by regulators at the time, scholars argue that the Federal Reserve had the power to prevent the fall of Lehman but did not do so for reasons that were primarily political and because they underestimated the consequent problems that the failure would cause such as the ensuing run in the money markets. See Lawrence M Ball, *The Fed and Lehman Brothers* (Cambridge: Cambridge University Press, 2018).

making it, by far, the biggest bankruptcy in US history.[4]

Lehman's hedge fund clients are caught in the middle of this. What does this mean for them? Where are their assets? When and *will they* get them back?

For many, a collapse of this nature was unforeseen and not prepared for. Many US-based managers assumed that a variety of SEC protections would apply to them.[5]

However, in many cases, their assets are not with Lehman's US arm and are thus not subject to SEC 15c3-3 protection.[6] The assets are with Lehman Brothers International Europe ("**LBIE**") overseas, where SEC protections do not apply.

Why? Well, a number of Lehman's clients required more leverage than what could be provided under the SEC rules by US-registered broker-dealers (i.e., US PBs), and so, they employed a practice known as arranged financing. This meant that financing was provided by LBIE in the UK and assets were transferred to LBIE as collateral in support of such financing without the protection of US rules. In the UK, LBIE has no regulatory limit on rehypothecation, and at the close on September 12th, LBIE has rehypothecated most of its clients' assets.[7] When Lehman files for bankruptcy, all LBIE assets become frozen and locked into lengthy insolvency proceedings as administrators sort out the tangled web of claims and assets in the hopes of returning them to rightful creditors.

Lehman's hedge fund clients suffered as they witnessed their assets being tied into insolvency proceedings that took years to resolve. All the while, their assets were frozen and they could not trade with them. This is why funds that had used Lehman as their PB were twice as likely to fail compared to other hedge funds.[8]

The lessons learned from Lehman's fall were many. For fund managers, the episode is a cautionary tale about understanding *counterparty risk*, the legal and regulatory frameworks that apply to their business, and the negotiated terms in their PB agreements ("**PBAs**").

Today, precisely 12 years from the date that Lehman fell into insolvency, we find ourselves battling a global pandemic with an uncertain economic crisis looming. Although the pandemic and economic fallout has not yet revealed weaknesses within the banking sector, should this crisis remain protracted it will put strain on financial institutions, and we could find ourselves again facing banking failures. Managers need to be proactive, mitigating risks and preparing for the possibility of a PB failure.

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[4] Sam Mamudi, "Lehman folds with record $613 billion debt" (15 Sep 2008) Marketwatch, online: https://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt. Previously, the largest American bankruptcy filing was for the communications giant Worldcom that had approximately $100 billion in assets when it failed.

[5] Some managers, like John James of the Oak Group, believed that their assets were in the US and that they were facing Lehman's US PB and did not understand the nuances and the risks involved in the prime brokerage arrangement. See Avery, *supra*.

[6] Under the Securities Exchange Act of 1934, this rule regulates how PBs segregate and rehypothecate the collateral held for a client's trades, including a limit on the rehypothecation of collateral at 140% of the loan amount, as discussed later in this article.

[7] We use the concept of rehypothecation here to describe what LBIE did, but in the UK the concept does not exist as it does in US. Here, we use 'rehypothecation' to refer to the fact that LBIE has taken title of client assets and used them for its own purposes, primarily by relending them for a profit.

[8] See George O Aragon & Philip E Strahan, "Hedge Funds as Liquidity Providers: Evidence from the Lehman Bankruptcy" (2009) NBER Working Paper No w15336, online: http://jhfinance.web.unc.edu/files/2016/02/Hedge-Funds-as-Liquidity-Providers-Evidence-From-The-Lehman-Bankruptcy.pdf at 25.

Right now, *before* any fear spreads of a banking crisis, is the best time for managers to revisit their PB arrangements, to understand where their assets are held, how their assets are protected, and the risks posed to their funds if a PB fails.

Part 1 of this series focused on negotiation points for ensuring stability in the PB service offering – namely, financing, margin and termination rights. The focus was therefore to look at means to protect a fund from having its PB intentionally pull the rug out from under it.

In this second part of the series, we focus on protecting funds against their PB's failure. We will cover the key negotiation points and legal constructs which are critical for managers to understand if they are to protect their fund's assets against failure at their PB. We will divide this analysis into three parts: (i) the regulatory regime, (ii) important points to negotiate in PBAs and, (iii) principles of counterparty risk.

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Regulatory Regime

The first question a manager should ask is which regulatory regime governs the PB relationship. Is the PB in the US or another jurisdiction, such as the UK? Are we using any type of arranged financing platform? Different jurisdictions have varying degrees of regulation and protection built into their framework. For instance, the US regime is more robust and favorable to clients than the UK's.

US Regulatory Framework

Customer Protection Rule. The Securities Exchange Act regulates how US PBs (i.e., US broker-dealers) segregate and rehypothecate the collateral held for their clients, including a 140% limit on the rehypothecation of collateral under Rule 15c3-3, known as the "Customer Protection Rule."[9] PBs in the US must maintain physical possession or control over clients' fully paid and excess margin securities. The goal behind this rule is to facilitate the recovery of a PB's client assets and limit their shortfall should the PB fail.

In practice, when securities are fully paid, they are not rehypothecated and are identified as customer property on the books and records of the PB.

On the other hand, when a fund borrows from a PB, only securities having a market value in excess of 140% percent of the total of the debit balance must be kept at the PB (i.e., not rehypothecated). Put another way, the PB can rehypothecate securities up to a value of 140% of the client's debit balance.

Rehypothecation is a practice whereby PBs use client securities posted as margin for their own purposes. The securities are sold or lent out to third parties by the PBs to generate additional returns.[10]

SIPC Protection. If a US PB fails, its clients will share pro rata in the portion of their claims. In other words, the claims of all PB clients will be added together, and each client will have a percentage of outstanding valid claims, that percentage then gets applied against all assets in the pool. Where there are insufficient funds available to repay all claims, the Securities Investor Protection Corporation ("**SIPC**") supplements the distribution up to USD $500,000 per PB Customer, including a maximum of $250,000 for cash claims.[11] This guaranteed amount will be of little solace to most funds who have significantly more than $500,000 in balances at their PBs.

Limits on Leverage. There are limits on the amount of leverage (i.e., margin lending) which can be extended by US PBs.

Regulation T allows for 2 to 1 leverage – in other words, a fund may borrow up to 50% of the purchase price of a security while the rest of the purchase must be funded with cash (i.e., a margin requirement of 50%).[12]

This was the applicable limit until 2008 when portfolio margining was made

[9] See United States Securities and Exchange Commission, "Customer Protection Rule Initiative" Web page accessed 6 Sep 2020, online: https://www.sec.gov/divisions/enforce/customer-protection-rule-initiative.shtml.

[10] Another way to look at this is that the PBs are rehypothecating these assets to defray the costs of financing the purchase of the asset. If the PB cannot rehypothecate, this loss in revenue would be passed along to its clients in the form of higher financing spreads.

[11] See Securities Investor Protection Corporation, "What SIPC Protects" Web page accessed 6 Sep 2020, online: https://www.sipc.org/for-investors/what-sipc-protects.

[12] See Financial Industry Regulatory Authority, "Margin Account Requirements" Web page accessed 8 Sep 2020, online: https://www.finra.org/rules-guidance/key-topics/margin-accounts.

available to US PBs. Portfolio margining, allows for 6.67 to 1 leverage (i.e., a margin requirement of 15%).[13]

Before portfolio margining was available, financing was rather restricted for clients of US PBs by Regulation T (since it only allows 2 to 1 leverage). This contributed to the rise of arranged financing solutions that pushed funds to gain access to additional financing overseas.

UK Regulatory Framework

In stark contrast to the US, the UK's Financial Conduct Authority ("FCA") places no limit on the amount of leverage that can be extended, and similarly no limit on the amount that a PB can rehypothecate. Furthermore, there is nothing equivalent to SIPC in the UK.

Under the FCA's Client Assets Sourcebook ("CASS") PB clients either retain title to the security – in which case they are kept segregated from the PB's assets – or, as is often the case, there is an outright title transfer to the PB. There is no regulatory limit on the value of assets which the PB can take under an outright title transfer, and as such, PB clients must negotiate a contractual limit.

In the event of a UK PB insolvency, client assets which are subject to outright title transfer will receive no protection and clients of the PB would only have a general unsecured claim against it.

[13] Financial Industry Regulatory Authority, "Portfolio Margin FAQ" Web page accessed 8 Sep 2020, online: https://www.finra.org/rules-guidance/key-topics/portfolio-margin/faq.

Important Negotiated Terms in the PB Agreement

In the previous section we laid the foundation for understanding the regulatory regime surrounding PB failures. In this section, we will cover the key *negotiated terms* concerning PB failure.

Arranged Financing (or Enhanced Leverage Products)

This is the practice of having an affiliate of a US PB extend financing to its clients. Such an affiliate is not subject to the same regulatory constraints regarding leverage for margin lending. The PB client is incentivized to use arranged financing when it requires more leverage than either Regulation T or Portfolio Margining will permit. Moreover, the arranged financing platform can offer the hedge fund client a better risk-based customer margin requirement than could otherwise be offered by the US PB directly.

The additional financing is provided through a non-US entity (typically the UK arm of the US PB), or via a US affiliate which is not a registered broker-dealer. Each PB has a slightly different offering and the contractual framework will therefore vary. The key negotiation points here include the usual PBA negotiation points (events of default, liability provisions, operations, fund obligations, etc.), as well as particular care to rehypothecation limits and the overall structure of the arrangement.

Now, just because arranged financing was a pain point for many hedge funds in the Lehman insolvency, it doesn't mean that it should be avoided at all costs. There can be benefits to using this structure, namely more leverage being granted and lower margin requirements. Some hedge fund strategies benefit from or require this structure since they employ higher leverage (e.g., many arbitrage strategies such as convertible arbitrage[14] or levered quant equity strategies).

Rehypothecation Limits and Transparency

When facing a US PB, there is no need to negotiate rehypothecation limits. However, when facing a UK PB, either directly or through arranged financing, it is critical to insist on using a contractual limit equal to or less than the US regulatory limit of 140%. Moreover, the method in which this rehypothecation limit is determined can also vary, and so more care is needed to ensure that it is determined in a fair, consistent, and commercially reasonable manner.

Affiliates and Parties to the Agreement

PBs will generally seek to include several affiliates as parties to the PBA. This gives other legal entities rights, security interests, and potentially the ability to rehypothecate assets. Since affiliates may not be US broker-dealers, they will not be subject to US rehypothecation limits and regulatory protections. If affiliates are drawn in, we should ask why and limit both the number of affiliates and the rights being afforded to them.

[14] Arbitrage strategies seek to exploit pricing discrepancies in the market, the spreads on which are often only a few basis points. The use of leverage is therefore key to generating returns.

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Limit Assignment Rights

PBs tend to include broad rights to assign their obligations to third parties and affiliates without the fund's consent. Broad assignment rights can result in the fund facing another entity altogether and can therefore greatly change the creditworthiness of the fund's counterparty. Managers should always seek to reduce these rights to: (i) requiring the fund's consent in writing to effect any assignment, (ii) requiring that the PB give notification prior to the assignment (in line with termination without cause timing), or (iii) limiting the PB's ability to assign the obligations to an entity of the same credit quality and regulatory status.

Asset Control – PBs Transfer of Assets Between Affiliates

PBs will want the ability to transfer fund assets sitting in the PB account to its affiliates. Managers should limit the PB's ability/discretion to move the fund's assets between its affiliates or to effect set-off. This should only be permitted if the fund is in default and the PB is terminating the PBA or if the fund has requested some form of cash sweep or cross margining arrangement.

Asset Control – Fund's Ability to Recall Assets

As you would always want to be able to take your deposits out of your bank account, the fund should have an unfettered right to remove cash and fully paid securities from the PB account. This could be important in situations where there is a credit concern with respect to the PB and the fund wishes to call back cash or securities quickly. In some cases, the PB will insist and it is acceptable for a manager to accept that this recall right will be restricted if the fund is in default under the PBA.

Rights of Set-Off

As covered in Part 1 of this series, managers should consider including set-off rights against the PB and its affiliates that become actionable when the PB is either insolvent or in a bankruptcy proceeding. The purpose of this is to allow the fund to set-off obligations (amounts it may owe) to the PB or its affiliates under other agreements. The provision can help limit the impact of being dragged into an insolvency proceeding where amounts owed by a PB or its affiliates to a fund cannot be easily recovered.[15]

[15] 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.

Counterparty Risk

Understanding counterparty risk goes hand-in-hand with the legal analysis covered above. This topic straddles the fields of legal, operations, and risk management. We will not delve into this exhaustively, but rather highlight some key considerations.

Legal Terms and Regulatory Framework

Proper counterparty risk management begins with understanding the regulatory framework and negotiating sound legal terms as we described in the previous sections. A manager must understand which legal entities it is facing and what the risks are in the event of insolvency.

Assess Creditworthiness

As with the funds who failed because they had used Lehman as their PB, the liquidity problems of a PB can become the liquidity problems of the funds who use them. Managers should know what products and business their PBs are exposed to, who their counterparties are, and monitor their credit spreads accordingly and on an ongoing basis.

Assess Operational Risk

Managers should conduct due diligence on their PB's operations to determine the robustness of its processes, technology and cybersecurity, all the while ensuring that the PB is maintaining proper books and records in order to comply with assets being segregated pursuant to their regulatory obligations. Moreover, reporting should be requested that details where assets are held by the PB and identifies which assets have been rehypothecated.

Diversify Counterparty Risk - Multiple PBs

Managers should use more than one PB whenever possible. Prior to 2008, many funds only used one PB, but today it has become common for funds to use multiple PBs. Diversification reduces counterparty credit risks for funds by allowing them to gradually shift their positions if one of their PBs is facing weakness.[16] Using multiple PBs has also been shown to make funds less vulnerable to PB liquidity shocks.[17]

However, there is a delicate balance to strike here as having multiple PBs can: (i) increase operational complexity for a fund, and (ii) negatively impact the level of service and pricing received from each PB as their share of revenue is reduced.

A note of caution should be given to managers when using an additional PB solely as a back-up - that is, where a PB is not actively used but legal docs have been executed. Relying on a such a back-up in times of stress may prove challenging since operational set-ups (reporting, trade files, technology) may not be in place and ready to activate. In addition, the PB may not have the requisite balance sheet capacity or the

[16] See Bank of England, "Hedge funds and their prime brokers: developments since the financial crisis" (2017 Q4) Quarterly Bulletin, online: https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2017/hedge-funds-and-their-prime-brokers-developments-since-the-financial-crisis.pdat 9.

[17] Mathias S Kruttli, Phillip J Monin & Sumudu W Watugala, "The Life of the Counterparty: Shock Propagation in Hedge Fund-Prime Broker Credit Networks" (2019), online: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3140900.

ability to easily integrate the manager in times of stress.

The best practice is to ensure that each PB on the fund's roster is receiving an appropriate share of business and that these relationships remain strong.

Parent Guarantees

Larger managers can, potentially, obtain guarantees from the parent entity of some PBs. This is helpful for reducing credit risk at the broker-dealer level since such entities are often neither rated entities nor well capitalized entities.

Operational Processes – Minimize Assets Left at the PB

Performing cash sweep out of the PB account or removing fully paid assets from the PB account and placing them with a third-party Custodian is another effective means of limiting counterparty exposure. This practice of segregating assets/collateral with 3rd party custodians is increasing in the OTC derivatives space largely driven by regulations known as the Uncleared Margin Rules (see our comprehensive guide on this topic).

Conclusion

The year is now 2020. It has been 12 years since the industry was rocked by Lehman's collapse. Many managers were caught wrong footed with Lehman; they didn't understand their exposure to their PB nor the legal framework which governed the relationship. Since then we have seen much greater attention and focus from managers and investors on understanding how assets are protected at PBs. Managers are more thoughtful about their legal terms, regulatory frameworks, and funds now commonly reduce their counterparty risks through PB diversification and other operational means.

Moreover, we have seen increased regulation imposed on the banking and investment management sectors.[18] With the introduction of portfolio margining in 2008, thereby providing more flexibility for US PBs to provide leverage directly, there is less need for managers to use an arranged financing platform compared to when only Reg T was available.

These changes have led to a more robust banking system. However, it would be unwise to believe that banks are immune from failure. This is evidenced by how regulators in the US and elsewhere have implemented rules to protect global systematically important banking organizations at the time of their failure. Unfortunately, such protections could be to the detriment of creditors and hedge funds who seek to exercise their default rights against a failing PB.[19]

The ghosts of Lehman are beginning to fade in the memory of many and a new cohort of managers are emerging that did not experience the great financial crisis of 2008.

Continued vigilance is necessary since PB failures remain a risk; a risk that may be increasing in the current period of uncertainty that we face.

[18] For instance, The Dodd-Frank Wall Street Reform and Consumer Protection Act; and Basel III.
[19] In the US, these are the US Stay Regulations. See footnote 15, infra.

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