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PRIME BROKERAGE

Factors to Be Considered by a Hedge Fund Manager When Selecting a Prime Broker

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In the aftermath of the global financial meltdown and the collapse of Lehman Brothers, most hedge fund managers would agree that they expend significant time and effort selecting their prime brokers and subsequently discussing their selections with investors. Given that there are many prime brokers, what criteria should a manager use to winnow down his options?

Definitions

Let's assume prime brokerage means providing central clearing, custodying assets, lending securities, financing and recordkeeping for the purposes of this discussion. For good order's sake, we should clarify that not all hedge funds will require prime brokerage services. Some managers are able to support their businesses by opening accounts with custodians that permit Delivery Versus Payment (DVP) trading; this is often supplemented with additional accounts for specific types of trading like futures or swaps with major dealers.

Capacity to Support Current Strategy and New Business Lines

Before even addressing such criteria as financial well-being, it is important to note that prime brokerage is not a one-size-fits-all business. The vast majority of providers will be able to support a fund with a U.S. long/short equity focus. However, as other factors – such as access to a wider array of markets or automated stock loan locate – are added, the field of candidates will narrow. A manager should determine whether the prime broker has the capacity to service his current strategy as well as new business lines in the event the fund grows or expands. Doing so will save time and money in the long run. In order to properly support an account, the prime broker must understand the market sector and the risks posed by a manager's trading style and strategy. Key credit and risk decisions by the prime broker, such as the amount of permitted leverage, should only be made by persons who truly understand these issues to avoid any future conflicts or misunderstandings. The quality of customer service, back office and systems support will reflect in large measure the prime broker's knowledge of a sector and strategy. Accordingly, thorough investigation of the prime broker's experience can assist in avoiding operational pitfalls such as inaccurate and untimely valuations and reporting.

Risk and Custody

Risk should be a primary consideration. In addition to the obvious, such as financial statements, other information detailing how a particular prime brokerage platform is structured and organized should be requested in writing. As many prime brokers offer onshore as well as offshore platforms, it is important to identify specifically how and where the fund's assets will be custodied. Indeed, consider the Lehman Brothers bankruptcy, in which many hedge funds did not realize that they had executed documentation allowing their assets to be custodied overseas and rehypothecated in excess of U.S. regulatory limits. Applicable laws governing critical issues such as customer protection, rehypothecation and insolvency can vary widely per jurisdiction. In addition, although a prime broker may offer global services, one should not assume that the prime broker itself is custodying the account in each jurisdiction. Access to local markets may be provided through use of an affiliated or unaffiliated local custodian. In those situations, assets are generally held in omnibus accounts commingling various customers' assets. Should the local custodian default, the fund should not assume that its prime broker will act as a guarantor. Most prime brokerage agreements absolve the prime broker of any liability absent gross negligence or willful misconduct, although they may have a duty of reasonable care in selecting unaffiliated subcustodians, or a higher degree of responsibility for their affiliates. Accordingly, a manager should request specific information about these arrangements and conduct due diligence regarding the use of any subcustodians to service his business. In addition, various regulatory organizations publish free information regarding the prime brokers and their personnel including disciplinary, customer dispute, criminal and other relevant data. Obviously, integrity is important. A history of regulatory violations relating to prime brokerage activities may be a red flag and should be explored fully to verify that these issues have been adequately addressed and resolved.

Multi-Prime Arrangements

One way to mitigate risk is to enter into several prime broker relationships or to "multi-prime." This approach can yield other benefits including competitive pricing and enhanced market access. Multi-priming may not work for all managers for the following reasons. First, the expense of opening and maintaining another prime brokerage account can be prohibitive, especially for smaller funds and start-ups. Keep in mind that your original prime broker will have revenue expectations which must be met or else the account may be asked to leave. In addition, the operational costs and effort associated with managing several primes across various platforms can be burdensome. However, several dealers and software vendors offer solutions which may ease the operational challenges and merit investigation should a manager decide to multi-prime. Finally, adding or changing a prime broker will require updating offering materials, adding another cost to the mix. Thus, opening a second prime brokerage account should not be undertaken lightly.

Custody Account at a Third Party Custodian Bank

Opening a custody account at a third party custodian bank is another way that managers have sought to mitigate risk, as custodians are not permitted to lend or rehypothecate assets. Some managers routinely sweep excess collateral into these accounts for safe-keeping, while others keep these accounts open as a safe harbor should another crisis occur in the financial markets. But managers taking this approach face many of the same drawbacks as multi-priming managers (with the exception of updating disclosure documents).

Access to Financing

Access to financing is a core concern. Under the Federal Reserve's Regulation T, a fund can only leverage itself by a factor of two in respect of its margin securities. However, most prime brokers offer enhanced leverage and portfolio margining which may permit more leverage. As maximum leverage will be determined by margin terms, a manager should understand these terms and how they operate, especially in stressed market situations where they may be changed on notice from the prime broker. Historically, term financing agreements locking in margin and pricing for specified time periods – usually 30, 60 or 90 days – have been available to select customers. However, it is likely that access to these arrangements will narrow significantly in the future given new domestic and foreign rules governing bank capital and liquidity. Moreover, price adjustments in pre-existing agreements should be expected as well.

Systems and Technology

The value of understanding the systems and technology offered by each potential prime broker should not be underestimated. Capacity to manage the fund's business is key. In this regard, a manager should verify that the trading tools he uses are fully integrated with the prime broker's systems. Otherwise, one can reasonably expect to expend significant time and effort reconciling trades and addressing errors. Indeed, even where systems are fully integrated, a prime broker may not have the ability to integrate different products into central clearing and may require the assistance of a manager to address operational issues. Other concerns include whether allocations among managed accounts can adhere to prescribed formulae, whether the system can generate real time portfolio testing, whether reports are customizable and permit back testing, and whether an open position analysis can be generated. Moreover, in light of current industry events, related cybersecurity protections undertaken by the prime broker should be analyzed as well. See "Cybersecurity for Hedge Fund Managers: Compliance Best Practices, SEC Examinations and Cyber-Liability Insurance," The Hedge Fund Law Report, Vol. 7, No. 25 (Jun. 27, 2014). A manager may find that the inability of certain primes to support its specific needs in these areas removes them from further consideration, despite excellent pricing and other positive criteria.

Capital Introduction, Research and Other Services

Finally, a manager should be aware that many prime brokers offer additional services such as capital introduction, detailed research, office space and business consulting services which may not be readily apparent when investigating the market. See "Identifying and Mitigating the Chief Legal, Regulatory and Operational Risks in Hedge Fund Manager Office Sharing Arrangements (Part Three of Three)," The Hedge Fund Law Report, Vol. 7, No. 41 (Oct. 30, 2014). The availability of these services varies in large part on the basis of the attractiveness of the client to the dealer.

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