

CUSTOMER'S RIGHT TO THE RETURN OF ASSETS HELD IN PRIME BROKERAGE ACCOUNTS

Due to recent market events, I have been fielding very similar calls from clients and others regarding a prime brokerage customer's right to the return of their securities and cash held in their prime brokerage accounts. They want to know if the PB must return their securities to them when requested. They also ask how the possible bankruptcy of one affiliate can impact the securities in their prime brokerage account and their other contracts with the other affiliated entities.

The following is a response to these two questions based on my understanding of the various dealer agreements. While the broker agreements all may look different in style and language, the substance of the various form PB agreements is fairly similar. When answering these questions with respect to your relationship, you should look to your specific prime brokerage agreement (hopefully negotiated) to determine the rights and issues that are specific to your account, assets, and relationship.

Does a prime broker have an obligation to return customer's securities and cash upon request?

Most prime brokerage agreements do not require the prime broker to return collateral. A customer's right to the return of collateral under the prime brokerage agreement must be specifically negotiated.

Following the market events in 2008, most PB agreements have been modified by the dealers to serve a dual purpose and now also function as master netting agreements. These agreements allow the prime broker to hold the securities in the prime brokerage account as security for the customer's obligations under all other agreements between the customer, the prime broker and any of its affiliates. Therefore, even if the customer has satisfied all of its obligations under the prime brokerage agreement, if the customer has other agreements (ISDAs, futures agreements, etc.) with the prime broker or its affiliates, the prime broker can hold and choose not to return the customer's assets until every other obligation of the customer has been satisfied under every other agreement.

The prime brokerage agreements are broadly drafted so that the provisions of the prime brokerage agreement modify and trump the provisions of all other contracts between the customer, the prime broker and its affiliates. These netting provisions also typically allow the broker to transfer the customer's securities and cash from the PB account to accounts under other contracts with other affiliates, in their sole discretion. This is especially concerning for customers who are very specifically seeking U.S. broker dealer asset protections for their securities. For example, while an ISDA collateral agreement may only allow a dealer to request \$2,000,000 in collateral from a customer, the prime broker can refuse to release additional collateral under the PB account and use it to support the ISDA transactions in its discretion. This effectively allows the prime broker to change the negotiated collateral arrangement under the ISDA. The broker can also move additional cash or securities from the PB account to the ISDA account in its sole discretion to support the customer's obligations without the customer's consent.

So the answer is that the prime brokerage agreement not only restricts a customer's right to the return of collateral, the customer may not even be afforded the broker dealer protections that it is seeking if the collateral has been moved to other affiliates under other agreements. These broad provisions can create instability for a fund in times of stress. If properly negotiated, the prime broker's rights can be appropriately limited and the customer will be provided with a more certain right to the return of its securities and cash under its prime brokerage agreement and all of its other agreements with the prime broker and its affiliates.

How can the bankruptcy of one affiliated entity impact a customer's assets in its prime brokerage account?

Most customers have multiple relationships with a prime broker and its affiliates. For example, a customer may have a prime brokerage agreement with a U.S. broker dealer, a futures agreement with an FCM, 2 or more ISDAs with different affiliates of the prime broker (one organized in the U.S. and the other, outside of the U.S.), and repurchase agreements with international or U.S. entities (typically depending on the type of securities). In this example, the customer has relationships with 4 to 6 affiliated entities. Under the prime brokerage agreement and due to the netting provisions described earlier, each of these affiliates with agreements have a security interest, lien and right of set off across all of the assets held under the other 5 agreements.

Under the same example, if one of the ISDA affiliates files for bankruptcy, the bankruptcy administrator can exercise the rights granted to it under the PB agreement and require the other five dealer entities to hold the collateral until it determines that the customer's obligations under the ISDA have been satisfied. The bankrupt affiliate can also require the other affiliated entities to transfer collateral as it deems necessary for its protection. The customer's assets under all 5 other agreements may also be frozen while the trustee is sorting through the obligations of all of its counterparties to the ISDA.

The U.S. broker dealer regime is organized in a manner meant to protect the customer's assets so that its collateral is segregated and can be quickly ported to another broker if there are signs of instability. However, if a customer has other relationships with affiliated entities, unless the provisions of the PB agreement are narrowed sufficiently to protect the customer, the other relationships can significantly limit the customer's rights to its assets, its ability to port positions away, and could void the protections that it was originally seeking when it sought out the U.S. broker dealer relationship.

The way to narrow the broker's reach is dependent on a number of factors such as the customer's relationship with the broker, the entities involved, leverage utilized, etc. For example, if there is no cross margining across the agreements, these broad rights provided under the PB agreement should be significantly limited. Where there is no cross margining, a dealer requires an amount of collateral under each agreement as if they will not have access to assets under the other agreements. If only two of the agreements and relationships are cross margined, the customer should consider limiting these rights to only those two entities to the exclusion of the others. There are other protections to consider such as



custody arrangements, establishing the specific instances when these rights can be exercised, etc. that should be carefully considered and negotiated depending on the customer's needs and products.

While the PB agreements look like form documents, they are and can be negotiated to remove these provisions that create such instability for the Customers. If you have not negotiated these provisions, you will be wondering about your protections and rights during signs of stress or instability.

Please feel free to contact me if you have any questions or would like to discuss these issues in more detail.

Regards,

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