1. Introduction

In nature, there are many examples of unlikely but highly symbiotic relationships. We say “unlikely” because, at first blush, the parties seem like unusual companions. For example, plover birds and crocodiles. Ordinarily, one would assume that little birds would be well-advised not to fly into the open mouths of crocodiles and that, on their part, crocodiles would more likely than not find these visitors tasty appetizers. However, Egyptian plovers perform a helpful dental hygiene for crocodiles and, in return, crocodiles don’t eat the plovers. Both parties derive a benefit. One could point to similar symbiotic arrangements in the capital markets, including the prime brokerage relationship.

Prime brokerage refers to the bundle of services provided by full service broker-dealers to hedge funds and other institutional customers, including clearance and settlement of securities trades and back office functions. Prime brokerage involves three distinct parties: the prime broker, the executing broker, and the customer. The prime broker clears and finances customer trades executed by one or more executing broker-dealers. The prime broker is also responsible for all applicable margin and Federal Reserve Board Regulation T (“Regulation T”) requirements for the customer.

A prime brokerage arrangement is advantageous for a hedge fund because the prime broker acts as a clearing facility and a source of financing for the customer's securities transactions wherever executed, as well as a central custodian for the customer's securities and funds. Prime brokers offer other services, such as margin loans and risk management services, as well as “capital introduction” services, which range from sponsoring investor conferences to arranging individual meetings and preparing informational documents, aimed at bringing hedge fund managers together with potential investors. Many prime brokers also provide hedge fund customers with technology services, including algorithmic trading or compliance and tracking systems.

Going back to our example, as the prime brokerage business has evolved, it is not entirely clear who is/was the plover bird and who is/was the crocodile. Perhaps it is fair to say that the roles and relative balance of power between the parties changed and will continue to change. As both the prime brokerage industry and the hedge fund industry grew over the last decade, so did their dependence on one another. Smaller, newly formed hedge funds sought out the services of well-established and respected prime brokers and found that, vis-à-vis their hedge fund investors, there was a validating effect to working with a large prime broker. Over time, the prime broker arms of large broker-dealers earned billions of dollars in fees as hedge funds became increasingly more important players in the capital markets. Investment banks seemed more focused on growing their relationships, including corporate finance and private equity relationships, with hedge fund customers than their traditional relationships with “corporates.” In an unlikely twist, issuers came to wonder whether their investment bankers were representing their interests or the interests of hedge fund investors. Hedge funds became more dependent on
prime brokers as they began investing in increasingly complex securities and transactions and required financing to boost leverage. Prime brokers began to rely on rehypothecating hedge fund client assets held as collateral to lend to other clients. Prime brokers earned fees from these lending activities, which did not depend on their own balance sheets. Prime brokerage became increasingly competitive--new participants entered the market and larger hedge funds established relationships with multiple prime brokers.

However, with large amounts of money being made on both sides, it was almost inconceivable for either party to contemplate what would happen if their counterparty engaged in fraudulent practices or, worse, if their counterparty failed. In recent years, prime brokers have faced increasing regulatory scrutiny and been subjected to liability in respect of the services provided to hedge funds. A number of prime brokers have been sued when their hedge fund customers failed. Individual hedge fund investors came after prime brokers because they were the only remaining deep pockets. Given the difficulties associated with regulating hedge funds, regulators contemplated additional oversight of prime brokerage activities as a de facto alternative to direct oversight of hedge funds. More recently, hedge funds and their investors are dealing with the challenges associated with having their prime brokers fail. These developments have highlighted the sometimes confusing tangle of relationships between hedge funds and prime brokers.

2. Prime Broker Regulation

As a registered broker-dealer, a prime broker is subject to regulatory oversight by various entities, including by the U.S. Securities and Exchange Commission (the “SEC”), the Financial Industry Regulatory Authority (“FINRA”), state securities regulators and, to the extent that the prime broker is a bank, by the Federal Reserve Board. In addition, the prime broker also must comply with the rules and regulations of various securities and commodities exchanges. There are a number of rules and regulations that are intended to protect the rights of prime brokerage customers, including regulations promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), including Rules 15c3-1, 15c3-2, and 15c3-3, and various state laws. The provisions of the U.S. Bankruptcy Code and the Securities Investor Protection Act (“SIPA”) are intended to protect prime brokerage customers upon the failure of a prime broker. We summarize the principal applicable regulations below.

2.1 Regulations Affecting Prime Brokers

2.1.1 Regulation T

Margin lending regulations, including Regulation T, are applicable to prime brokers. Regulation T restricts the extension of credit by a broker-dealer to a customer for the purchase of securities. If a customer wishes to engage in short selling, the customer must deposit into its margin account at least 50% of the value of the securities to be sold short, in addition to the cash generated by the short sales of borrowed stock. In part, by requiring a customer to maintain enough margin in its brokerage account to cover short positions, the margin rules protect the broker-dealer from having to use its own capital for this purpose and limits a broker-dealer’s risk in respect of
customer losses.\(^1\) If securities purchased on margin decline in value, the customer must deposit additional funds into its margin account within a certain time period, or the broker-dealer may sell the securities bought on margin without notice to the customer. These sales may result in losses.

2.2. **Regulations Protecting Prime Brokerage Customers**

2.2.1 **Rules 15c3-1, 15c3-2, and 15c3-3**

Rule 15c3-1, or the net capital rule, requires that a broker-dealer maintain assets in excess of its liabilities so that, in the event of a failure, customers can get their cash and securities back.\(^2\) Rule 15c3-2 prohibits a non-bank broker-dealer from using funds arising out of any free credit balance carried for a customer account for its own business, unless the broker-dealer has established adequate procedures for doing so. A broker-dealer is required to provide or send a customer a written statement informing the customer of the amount due to the customer by the broker-dealer, and advising that (a) such funds are not segregated and may be used by the broker-dealer for its own business activities, and (b) such funds are payable upon the customer’s demand.\(^3\) Rule 15c3-3, or the customer protection rule, limits a broker-dealer’s use of customer funds except for certain designated purposes. The rule requires that a broker-dealer maintain “physical possession or control” of most customer securities, typically through third parties, such as a clearing corporation, bank or broker-dealer in compliance with Regulation T.\(^4\) The rule is designed to protect customers in the event of the failure of a broker-dealer by ensuring that the broker-dealer has sufficient reserves and securities on hand so that customers promptly receive their property. A registered broker-dealer must segregate customer funds and securities from its proprietary holdings in order to facilitate an orderly liquidation.\(^5\) A customer’s funds should be able to be identified easily and transferred to another broker-dealer. The customer protection rule also limits the amount of customers’ securities that a broker-dealer can pledge to third-party lenders to support margin loans owed to the broker-dealer.

2.2.2 **Securities Investor Protection Act**

SIPA authorized the creation of a nonprofit, private membership corporation, the Securities Investor Protection Corporation ("SIPC"), to protect broker-dealer customers from losses in the event of the failure of a broker-dealer.\(^6\) SIPA requires each registered broker-dealer to be a SIPC member. SIPC administers a reserve fund to protect securities investors. SIPA provides an alternative to liquidation under the U.S. Bankruptcy Code for registered broker-dealers. Under SIPA, a regulator may notify SIPC that a broker-dealer is in financial difficulty and SIPC may file for a court protective decree if SIPC determines that the broker-dealer may fail to meet customer obligations. In connection with such a liquidation, the broker-dealer’s assets will be examined to identify securities registered in the name of customers, which will be returned to the

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\(^1\) 12 CFR §220.  
\(^2\) 17 CFR §240.15c3-1.  
\(^3\) 17 CFR §240.15c3-2.  
\(^4\) 17 CFR §240.15c3-3.  
\(^5\) Id.  
\(^6\) 15 U.S.C. §78aaa et seq., as amended. In addition to creating SIPC, SIPA sets forth rules for the distribution of funds to customers and limits on such distributions.
applicable customer, and cash and other securities held for customers (including securities held in street name), which will be divided pro rata among customers. After a prime broker’s customer assets have been distributed, SIPC replaces only those securities and cash that are missing from a customer’s account. SIPC does not compensate investors for declines in investment value or worthless securities, and also does not compensate investors for certain money-market fund shares, commodity futures contracts, foreign currency, precious metals, investment contracts (limited partnerships), or fixed annuity contracts that are not “securities.”

The SIPC fund will cover any shortfall owed to customers up to a maximum of $500,000 (only $100,000 of which can relate to a recovery for cash held at the broker-dealer), subject to certain limitations. Customers will be considered general unsecured creditors of the failed broker-dealer for shortfalls not paid from the reserve fund. As of December 2007, SIPC had advanced $508 million in order to make possible the recovery of $15.7 billion in assets for an estimated 625,000 investors, with no fewer than 99% of persons eligible being made whole in the failed brokerage firm cases that it has handled to date.7

3. Prime Broker Case Law

Although prime brokers are subject to federal and state securities regulations, and in many cases, banking regulations, the prime broker-customer relationship is primarily governed by contract. The prime broker agreement sets forth the obligations of each party, including the scope of the customer’s and the prime broker’s permissible activities, and the prime broker’s services, as well as termination events. Most prime brokers impose additional conditions on the hedge fund customer, which are designed to safeguard the prime brokers from hedge fund failures. For example, most agreements impose margin requirements in excess of those required by Regulation T, and grant the prime broker a security interest in certain customer assets. Moreover, most prime broker agreements permit the prime broker to rehypothecate customer securities as collateral for loans in the prime broker’s name. The prime broker earns fees by financing the portfolios of its hedge fund customer, which, in turn, allows the prime broker to lend to the hedge fund customer at more favorable rates. Until recently, the terms and conditions of prime broker agreements had not been the subject of close scrutiny.

3.1. Bear, Stearns Securities Corp.

Manhattan Investment Fund Ltd. ("Manhattan Fund"), a hedge fund, filed for bankruptcy in 2007 amidst allegations that the hedge fund was involved in a Ponzi scheme. The bankruptcy trustee filed a lawsuit against Bear, Stearns Securities Corp. ("Bear Stearns"), the hedge fund’s prime broker, in an attempt to reclaim approximately $160 million in margin payments to Bear Stearns. The trustee, on behalf of hedge fund investors, sought to recover directly from Bear Stearns despite Bear Stearns’ non-participation in the hedge fund’s fraud. The case was premised on the theory that transfers of hedge fund assets undertaken by Bear Stearns in its prime broker capacity were voidable “fraudulent transfers.”

On June 27, 2008, on appeal from the Southern District of New York bankruptcy court (the “Bankruptcy Court”), the Southern District Court of New York (the “District Court”) affirmed

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the Bankruptcy Court’s findings that (1) prime brokers could be “initial transferees” under Section 550(a) of the U.S. Bankruptcy Code (the “Bankruptcy Code”); and (2) transfers made with actual intent to hinder, delay or defraud the hedge fund’s creditors by prime brokers who are deemed “initial transferees” are subject to avoidance. However, the District Court held that whether or not Bear Stearns acted in “good faith” and, therefore, was entitled to plead the “stockholder’s defense” was a question of fact that required a jury trial. Subsequently, as we discuss below, a jury found that Bear Stearns acted in “good faith” in its role as prime broker for Manhattan Fund. The District Court’s ruling and jury findings resulted in the District Court issuing an order on June 30, 2008 dismissing the complaint against Bear Stearns and vacating the Bankruptcy Court’s previous order requiring Bear Stearns to pay approximately $160 million to Manhattan Fund’s creditors. Although the dismissal was a victory for Bear Stearns, the Bankruptcy Court’s findings (affirmed by the District Court) leave prime brokers exposed to liability, far exceeding any fees they may earn, any time one of their hedge fund clients files for bankruptcy.

3.1.1. Bankruptcy Code

Section 548 of the Bankruptcy Code allows any transfer of an interest in property made by the debtor in the year prior to the filing of its bankruptcy petition to be avoided as a fraudulent conveyance provided that the transfer was made with an actual fraudulent intent or with the badges of fraud constituting constructive fraud of the debtor’s creditors. Manhattan Fund’s founders were convicted of operating a Ponzi scheme. A Ponzi scheme itself evidences an intent on the part of the operators to “hinder, delay or defraud creditors,” which constitutes fraud.\(^8\)

Under Section 550 of the Bankruptcy Code, a trustee may recover a fraudulent transfer if the trustee establishes that the alleged recipient was an “initial transferee” under the Bankruptcy Code.\(^9\) The Bankruptcy Code does not define “initial transferee,” but the term has been understood to mean a transferee that is more than just a conduit or an intermediary. In determining whether a transferee is an “initial transferee,” courts have focused on whether the transferee has “dominion and control” over the assets in question.

3.1.2. Initial Transferee Analysis

Various industry groups, including the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association (“SIFMA”), filed amicus briefs with the District Court. In their briefs, they argued that prime brokers are financial intermediaries, and that their control of client accounts is restricted by federal regulation and account agreements. Therefore, prime brokers should be treated as “mere conduits.” The District Court

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\(^9\) Section 550 of the Bankruptcy Code states in relevant part, “(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under [S]ection 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the District Court so orders, the value of such property, from (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee. (b) The trustee may not recover under section (a)(2) of this section from (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or (2) any immediate or mediate good faith transferee of such transferee.”
acknowledged that Exchange Act Rule 15c3-3 prohibited Bear Stearns from using monies from Manhattan Fund’s account for its own proprietary investments; however, the District Court reasoned that “unfettered control” is not necessary in order to be considered an “initial transferee.” The court concluded that a party can be deemed an “initial transferee” even if it cannot use received funds for endeavors unrelated to the underlying transaction. In reaching its conclusion that Bear Stearns acted as an “initial transferee,” the District Court relied heavily on Bear Stearns’ ability to protect itself from Manhattan Fund’s trading losses.

The court focused on provisions in the prime broker agreement that are considered “standard” in a prime broker agreement and necessary in order to provide the prime broker with certain rights and remedies. The prime broker agreement: (1) granted security interests to Bear Stearns that permitted Bear Stearns to apply Manhattan Fund’s property in order to satisfy outstanding liabilities to Bear Stearns; (2) permitted Bear Stearns to close out Manhattan Fund’s short positions or liquidate its long positions as necessary for Bear Stearns’ protection; and (3) required Manhattan Fund to deposit the required margin in its customer account and pay any debit balances owing under its margin accounts. The District Court reasoned that these industry-standard provisions gave Bear Stearns “dominion” and “control” over Manhattan Fund’s accounts.

3.1.3. Good Faith Defense Analysis

Section 550 of the Bankruptcy Code prevents a trustee from recovering from a transferee that takes for value in good faith and without knowledge of the voidability of the transfer. The District Court determined that whether Bear Stearns acted in “good faith” was a factual matter to be decided by a jury. Determining whether Bear Stearns acted in “good faith” required that the trier of fact undertake the following two-part analysis: whether Bear Stearns was on inquiry notice of Manhattan Fund’s fraud, and whether Bear Stearns was diligent in its investigation of Manhattan Fund. The District Court advised that this analysis should consider the steps that would have been undertaken by a reasonably prudent prime broker under similar circumstances.

This case raised the question whether, as a general matter, a prime broker should undertake some inquiry into the activities of its hedge fund customer and whether such investigation would be considered reasonable in hindsight. Bear Stearns had noted certain anomalies in Manhattan Fund’s results, made inquiries and was told by Manhattan Fund that these resulted from having accounts with several prime brokers. Bear Stearns then contacted Manhattan Fund’s auditors to urge caution during its upcoming audit. In addition, Bear Stearns continued asking investors and other third parties about Manhattan Fund. Several months later, after receiving additional information about the fund from a third party, Bear Stearns contacted credit agencies and other prime brokers and obtained Manhattan Fund’s financial statements to determine if Manhattan Fund used other prime brokers. Once Bear Stearns determined it was the exclusive prime broker, Bear Stearns closed Manhattan Fund’s account and contacted the SEC. The District Court held that since Bear Stearns continued its investigation as more evidence was learned from

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11 12 C.F.R. § 220.12(c)(1).
12 See In re Manhattan Fund Ltd., 359 B.R. at 524-25 (citing Hayes v. Palm Seedlings Partners (In re Agric. Research and Tech. Group, Inc.), 916 F.2d 528, 535-36 (9th Cir. 1990)).
the auditors and investors, and since prime brokers are not subject to “know-your-customer” responsibilities, when there is an introducing broker involved, Bear Stearns set forth enough evidence that a jury could find that Bear Stearns was diligent in its actions. And, on June 27, 2008, a jury did just that.

Due to the implications of the District Court’s decision, Bear Stearns filed an appeal with the Second Circuit Court of Appeals (the “Second Circuit”) seeking to overturn the District Court’s decision that prime brokers have the requisite “dominion and control” to be considered “initial transferees.” On November 19, 2008, SIFMA and the Futures Industry Association filed an amicus curiae brief with the Second Circuit in support of Bear Stearns. The appeal is currently pending.

3.2. Effect of Bear Stearns - The Cases Against Goldman Sachs Execution & Clearing, L.P., UBS Securities, LLC and JPMorgan Chase

3.2.1. Goldman Sachs Execution & Clearing, L.P.

Numerous hedge funds already have filed for bankruptcy and many others are expected to file for bankruptcy as a result of the financial crisis. Of the major bankruptcy filings, at least two debtors were found to have committed actual fraud by Ponzi schemes, Manhattan Fund and Bayou Group LLC (“Bayou”). In both cases, the prime brokers had “deep pockets” from which creditors could seek to recoup lost investment monies. After the District Court affirmed the Bankruptcy Court’s findings that Bear Stearns was an “initial transferee” and that, as a result, the transfers to Bear Stearns’ accounts could be voided, the unsecured creditors of Bayou filed a similar suit against Goldman Sachs Execution & Clearing, L.P. (“GSEC”), Bayou’s prime broker. In the Bayou case, the individual hedge fund investors claimed that GSEC was negligent in failing to detect the Bayou principal’s fraud. The case against GSEC has been temporarily stayed pending arbitration.

3.2.2. UBS Securities, LLC

Within months of the Bankruptcy Court’s ruling in the Bear Stearns case, investors in Wood River Partners, LP (“Wood River”) sued UBS Securities, LLC (“UBS”). UBS acted as clearing broker, prime broker and a custodian for Wood River. Investors claimed UBS committed fraud and breached its fiduciary duties as Wood River’s prime broker, which allegedly caused the collapse of Wood River. The lawsuit against UBS was dismissed on July 23, 2008. The Supreme Court of the State of New York determined that investors in a hedge fund do not have standing to sue the hedge fund’s prime broker. The fiduciary duties of the prime broker are owed to the hedge fund, not to the individual investors. Investors have appealed the court’s decision. The appeal is now pending in the Appellate Division of the New York Supreme Court, First Department.

3.2.3. JPMorgan Chase

13 “Know-your-customer” duties require a broker to “use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted....” See De Kwiatkowski v. Bear, Stearns & Co., Inc., 306 F.3d 1293, 1310 (2d Cir. 2002).

14 See In re Bayou Group, LLC, et al., 06 B 22306 (ASH), U.S. Bankruptcy Court, Southern District of New York.
After the Bear Stearns ruling, Amaranth Advisors (“Amaranth”) filed suit against its prime broker, JPMorgan Chase (“JPMorgan”). Amaranth alleged, among other things, that JPMorgan breached its client agreement when it refused to release money Amaranth had in its prime brokerage account so that Amaranth could close a deal with another investment bank. Amaranth made huge gains trading in energy derivatives through early 2006. However, by August 2006, significant energy sector losses had caused Amaranth to lose more than $2 billion in one month. Amaranth made deals with Merrill Lynch and Goldman Sachs pursuant to which Amaranth agreed to sell its energy derivatives exposure. The deal with Merrill Lynch closed, but the deal with Goldman Sachs did not. Another JPMorgan entity eventually completed the deal with Amaranth at a higher cost to Amaranth, and only after Amaranth lost many hundreds of millions of dollars. JPMorgan then sold the energy derivatives to another hedge fund, Citadel, for a profit. Amaranth claimed JPMorgan refused to release funds in Amaranth’s margin account in order to interfere with the Goldman Sachs deal, in breach of the prime brokerage agreement. JPMorgan argued that the prime brokerage agreement and NYMEX exchange rules required JPMorgan to retain Amaranth’s funds in order to comply with applicable margin account requirements.

On November 10, 2008, the Supreme Court of the State of New York dismissed all counts against JPMorgan except for Amaranth’s claim that a breach of contract by JPMorgan derailed a potential business deal between Amaranth and Goldman Sachs. The court ruled that whether or not JPMorgan acted properly was a question of fact, not law, and therefore the claim could not be decided on a motion to dismiss. The breach of contract claim against JPMorgan is still pending.

4. Prime Broker Bailouts and Bankruptcies

In the aftermath of the Bear Stearns rulings and the various prime broker cases that followed, market participants predicted that there would be significant changes in the prime brokerage business. Industry insiders expected that prime brokers would (1) remove provisions from customer agreements that could be viewed as evidence of “dominion” and “control” on the prime broker’s part; (2) strengthen their risk management procedures and step up their diligence efforts in order to ensure that they would be able to prove that they acted in “good faith” if a bankrupt hedge fund client were found to have committed fraud or to have engaged in other improper practices; and (3) charge higher fees for the increased financial risk exposure. Many observers noted that, as a result of increased competition for business, prime brokerage had become commoditized. A few financial institutions reasoned that the fees were not sufficient to compensate them for the financial and reputational risks associated with costly litigation. Others speculated that the business would become more highly regulated, increasing operating costs and reducing profits. Many of these predictions did come to pass. However, there were a number of unanticipated developments, which are vastly more significant and which will have more lasting impact on the prime brokerage business. Prime brokers have failed. Failed hedge funds were no longer suing prime brokers in attempt to recoup losses for investors. Instead, hedge funds are failing because their prime brokers have collapsed.
4.1. Refco

In October 2005, a week after announcing that financial statements dating back to 2002 should not be relied upon, Refco Inc., along with 23 subsidiaries including its prime brokerage unit (“Refco”), filed for bankruptcy. Refco’s CEO was arrested for securities fraud. The assets of the prime brokerage unit were frozen immediately and court cases were filed to determine if the assets in the off-shore prime brokerage unit belonged to the bankruptcy estate or to the prime broker customers. Richard Deitz, founder of VR Capital Group Ltd., which was Refco’s largest prime broker client, had $800 million frozen during the bankruptcy proceedings. Ultimately, the fund received all of its money and assets. Another fund, the Rogers Raw Materials Fund, filed a lawsuit against Refco upon learning that over $350 million in cash and securities were frozen. The hedge fund was relegated to the position of an unsecured creditor because the funds were not held in a segregated account by the regulated futures brokerage subsidiary. Over a year of legal battles paid off when the hedge fund was awarded securities customer status and along with a settlement and received almost 96% of its assets. It is unclear how many prime brokerage clients had their funds in segregated accounts and how many were reduced to unsecured creditor status. Secured creditors had 100% of their assets returned. Securities customers with accounts at the prime brokerage subsidiary received 86% of their assets back. Unsecured creditors received approximately 30% of their assets back.

4.2. Bear Stearns

At the beginning of 2008, Bear Stearns was one of the top three U.S. prime brokerage firms, with its prime brokerage unit estimated to be worth approximately $3 billion, with revenues in 2007 of approximately $1.2 billion. In July 2007, hedge funds began moving their money and investments away from Bear Stearns after two internal Bear Stearns’ funds collapsed. Although most clients remained loyal to Bear Stearns and did not terminate existing prime brokerage agreements, many moved at least part of their money to other prime brokers. In February 2008, rumors about Bear Stearns’ liquidity caused a flood of short selling against its stock, much of it by hedge funds according to an ongoing SEC investigation into the demise of Bear Stearns. By March 2008, the financial institution was forced to agree to a takeover offer by JPMorgan orchestrated with federal government assistance. JPMorgan informed Bear Stearns’ prime brokerage clients that JPMorgan would guarantee all of the failed institution’s trading obligations in an attempt to keep other prime brokerage clients from leaving. In an industry where reputation is king, only time will tell if these reassurances and the retention of key personnel from Bear Stearns will bring hedge fund clients back.

4.3. Lehman Brothers Holdings Inc.

The U.S. government did not step in to save Lehman Brothers Holdings, Inc. (“Lehman”). Lehman’s demise also can be traced to rumors regarding the institution’s liquidity, which caused

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15 Tom Cahill, Lehman Hedge-Fund Clients Left Cold as Assets Frozen (Update 3), Bloomberg News, October 1, 2008.
18 Id.
Lehman’s shares to drop by more than 30% in value in one session of pre-opening trading. In March 2008, ING predicted that the federal government would not step in to save Lehman because, unlike Bear Stearns, Lehman did not have the large prime brokerage business that made it “too big to fail” in the wholesale payment, clearing and settlement systems. Although some hedge funds began closing out trades and moving money away from Lehman, it does not appear that many hedge funds shared in ING’s dire predictions. On the day of the holding company bankruptcy announcement in September 2008, hedge funds were reported to have had over $40 billion in cash and securities, which were held by Lehman Brothers International (Europe)’s prime brokerage unit (“LBIE”). Many of those assets served as collateral for complex loans and were subject to rehypothecation by LBIE. Assets used as collateral in stock-loan or repurchasing markets were no longer segregated in customer accounts and were commingled with Lehman’s own funds.

Most prime broker agreements (including those with non-U.S. prime brokers) require that the client maintain a margin account with the prime broker. The margin account is a segregated account. Although the prime broker is granted a security interest in the margin account in order to minimize the prime broker’s risk, the assets in the account are customer funds. Having the customer funds in a segregated account also protects the customer from having its assets become part of the prime broker’s estate upon the prime broker’s failure. However, as we discuss above, many prime brokers rehypothecate assets held as collateral. Approximately $22 billion of the $40 billion in customer assets held in LBIE’s prime brokerage unit had been rehypothecated. Hedge fund customers of the prime brokerage unit recently learned that once their assets were used as collateral or rehypothecated by LBIE, they were not kept in segregated accounts. These assets were commingled with LBIE’s own funds and are now frozen pending the result of bankruptcy proceedings. Hedge funds trying to reclaim the rehypothecated assets are now in the position of unsecured creditors and must join the queue. Numerous hedge funds have filed formal complaints with the bankruptcy court.

Several hedge funds also dispute a transfer of $8 billion that Lehman made from its U.K. operations to its New York operations the night before it filed for bankruptcy. Bay Harbour Management has filed a lawsuit challenging the quick sale of the Lehman brokerage arm to Barclays Capital. Smaller hedge funds, such as MKM Longboat Capital Advisors, have closed due to the combined effects of the financial crisis and the write-down of assets frozen in bankruptcy. Other hedge funds, such as Oak Group Inc., are reported to be on the verge of collapse. Salida Capital Corp. has had to halt redemptions on three of its funds. Newport Global Opportunities Fund tried to move its funds to Credit Suisse five days prior to the bankruptcy filing but Lehman did not execute the transfer. Those funds are now frozen. For year-end 2008 financial reporting purposes, many funds will write-down the value of assets frozen at Lehman to zero until it can be determined what funds are available for distribution and when that distribution will take place. Given the generally poor performance of hedge funds in 2008, these write-downs may cause other funds to close.

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22 Id.
U.S.-based hedge funds chose LBIE’s prime brokerage unit due to favorable tax laws and the greater leverage allowed in the U.K. compared to the United States. However, in addition to trying to determine where their assets are located, the hedge funds are now dealing with bankruptcy laws that are less open to creditor input than those in the United States.23 The U.S. system is designed to return funds to creditors as quickly as possible. The U.K. system does not shield the bankruptcy administrator from personal liability if funds are returned to the wrong people; thereby creating a process that is slow and deliberate, especially when dealing with the estate of a complex financial institution. PricewaterhouseCoopers, the LBIE bankruptcy administrator in the U.K., has stated that it could take months or years to determine the rightful owners of assets and to return the assets.24

Recently, a number of creditors filed suit in the U.K. courts hoping to speed up the work of the bankruptcy administrator. RAB Capital Market (Master) Fund filed a lawsuit attempting to gain immediate access to securities that it claimed were improperly hypothecated so that the fund could publish its net asset value. Although sympathetic, the court cited precedent, and the possible creditor chain reaction that could be set off if the court did not follow such precedent, in deciding in favor of LBIE.25 Shortly after, a group of four private investment funds filed lawsuits attempting to obtain information about their securities, claiming that the administrator was not responsive to their information requests. The U.K. court once again ruled in favor of LBIE making it clear that it would not intervene with the administration process absent improper or wrongful conduct.26 Although there seems to be little left for creditors to do but wait, some progress is being made. A creditors’ committee was recently established in the LBIE bankruptcy to assist the administrator and sign off on certain administrative actions on behalf of all creditors; and the Lehman bankruptcy judge, at the creditors’ request, recently appointed a bankruptcy examiner to supervise Lehman’s asset liquidation and investigate the circumstances that led to the company’s collapse.

5. Prime Brokerage Going Forward

The events surrounding the recent financial crisis will inevitably lead to changes in business practices, risk management practices and increased regulation. Already, it is clear that many hedge funds, including smaller funds, are moving toward using several prime brokers. Many hedge funds remain concerned about the financial stability of investment banks and have moved funds to the prime brokerage arms of commercial banks.27

24 *Id.*
In addition to managing credit and counterparty risk, hedge funds also increasingly focus on their prime brokerage’s practices—in particular, those relating to maintenance of segregated accounts and rehypothecation. Given that fees earned from rehypothecation historically have permitted prime brokers to extend financing to their hedge funds customers at attractive rates, it is unlikely to disappear. Nonetheless, we may soon see regulations relating to this and other prime brokerage practices. Hedge funds also are considering alternatives to investment banks for certain prime brokerage services, such as using custodians to maintain collateral accounts. A recent report issued by research firm Celent found that hedge funds, especially larger ones, are also looking for ways to raise permanent capital in order to reduce future reliance on prime brokers.  

As with other sectors of the capital markets, the financial crisis may simply result in reducing the overall level of leverage in the system. Standard provisions included in prime broker agreements will need to be revisited as prime brokers assess their risk exposure for fraudulent practices of hedge fund customers. On November 13, 2008, the House Committee on Oversight and Government Reform held a hearing on hedge funds and financial markets. Although the panel discussed the hedge fund industry generally, the panel’s focus on the impact of hedge funds in the current financial crisis and their relationships with institutions that are too big or too interconnected to fail is another signal that we should expect additional regulation of prime brokers. On January 15, 2009, two reports outlining best practices for the hedge fund industry were presented to the President’s Working Group on Financial Markets. And, on January 29, 2009, Senators Charles Grassley and Carl Levin introduced legislation to promote registration and transparency of hedge funds in line with the recommendations set forth in Paul Volker’s Group of Thirty report, “Financial Reform: A Framework for Financial Stability” that was released on January 15, 2009. If this regulation is carefully conceived and enforced, neither the plovers nor crocodiles are likely to be a danger to one another.