



Counterparty Risk—The Real test

In our August 2008 newsletter, we addressed the overlooked counterparty risk faced by hedge fund managers. The focus of our article was on the risks embedded in the funds contractual relationship with their prime broker(s) ([read here](#)). In this newsletter, we will provide more details on the current legal framework in place to protect clients' assets, the liquidation framework and additional counterparty risks.

Lehman Brothers bankruptcy provided us with a live test of the real assets protection provided by brokers/dealers. According to the appointed liquidator of Lehman Brothers (Europe), PWC, a major issue lays on the fact that Lehman, like others brokers do, used its right for re-hypothecation for an approximate amount of \$22bl. The bank's clients concerned by those funds will have to line up with the failed entity's other general creditors to claim for this part of their cash that was held in margin accounts.

According to the US Securities Exchange Act of 1934, Rule 15C3-3 (Customer Protection – Reserves and custody of assets), Brokers/Dealers are required to maintain physical possession or control of all fully-paid securities and excess margins securities carried by for the account of Client. The expression "excess margin securities" generally means securities held in a margin account having a market value in excess of 140% of the total of the debit balance in the margin account. Other securities and property held in the account may be carried in the broker/dealers' general loans and may be pledged or re-hypothecated. The right for re-hypothecation is also commonly used by banks outside the US. The pledged or re-hypothecated amount is no longer deemed as "customer name securities". Brokers/Dealers also have a right for re-hypothecation on repurchase agreements.

In the US, liquidation of a broker-dealer is handled by a Securities Investor Protection Corporation (SIPC) trustee under the Securities Exchange Act of 1934 (SIPA). In general, the trustee may sell or transfer theacated amount is no longer deemed as "customer name securities". Brokers/Dealers also have a right for re-hypothecation on repurchase agreements.

has the option of staying at transferee broker-dealer or moving its account. Customers may request that the SIPC trustee approve transfer of their accounts to another firm. If accounts are not sold or transferred, the SIPC trustee will return all of the customers name securities (defined hereinabove) to the customer. Each customer then submits a net equity claim. In the case where there are insufficient assets to cover all customers net equity claims, the trustee will determine what securities need to be distributed to customers and may do any of the following: distribute existing securities on a pro rata basis to customers who held those positions, sell existing securities and use proceeds to purchase and distribute securities held long by customers or sell existing securities and distribute the proceeds to customers. Until customers' net equity is paid out in full, general creditors of broker-dealers cannot access customer assets. In the event that the broker/dealer does not have sufficient assets to meet customer's net equity claims, SIPC will pay out of its own customer protection funds to meet any shortfall, to a maximum of \$500,000 per customer (\$100,000 limit for cash). Some brokers/dealers maintain an excess insurance policy, like the one provided by CAPCO. Lehman Brothers was a subscriber to the CAPCO's excess insurance policy.

Another exposition of hedge funds to the risk of a counterparty failure rests with unsettled Over-the-Counter ("OTC") transactions. Usually, funds have signed standard ISDA (International Swaps and Derivatives Association) agreements with several counterparties with whom they transact over OTC products (FX forward contracts, Total return swaps, Options, etc.). In the case of liquidation (brokers/dealers cannot fill for the chapter 11 protection but rather have to fill directly a chapter 7 liquidation), the administrator can choose not to pay the gains from those OTC products, to which the failed broker/dealer was the counterparty, to the clients.

Hedge fund managers who trade Futures contracts usually do not

have a counterparty risk since all transactions are cleared through an exchange clearing house. However, the margin accounts with the Futures broker will be protected differently according to the client choice to hold his assets in a "Securities account" or "Futures account". The "Securities account" will be protected by the Securities Exchange Act of 1934 when the "Futures account" will be protected by the Commodity Exchange Act Section 4d. Some Futures brokers/dealers propose to their client either to have their cash held in a segregated account that will not be mixed with the broker/dealer assets in the case of liquidation, or in a non-segregated account. The first option will carry a lower interest rate, but nowadays the extra protection is worth considering.

In conclusion, we would like to share with you an interesting idea. At Hedge Fund Appraisal, we noticed that Hedge fund size seems to be an important factor in the effective management of counterparty risk for two reasons. Firstly, smaller funds could be less prepared to handle this type of risk since they often don't have the adequate resources and knowledge to handle it properly. Secondly, we observed that larger funds seem to have better bargaining power and knowledge to negotiate with their counterparties extra protective terms beyond the ones included in the standard brokerage agreements.

The following managers have been named in the press as having some assets frozen in the Lehman Brothers bankruptcy:

- Oak Group Inc.
- MKM Longboat Capital Advisors LLP
- LibertyView Capital Management Inc.
- Diamondback Capital Management LLC
- Harbinger Capital Partners
- Amber Capital LP
- Bay Harbour Management LLC
- RAB Capital Plc
- GLG Partners Inc.
- Olivant Ltd.
- Darden Capital Management
- Newport Global

New Product

Counterparty Risk Analysis

Now produced as a stand-alone product by Hedge Fund Appraisal.

- Full map of your hedge fund portfolio exposures by counterparty
- Analysis of the assets at risk with each counterparty
- Verification of each underlying fund's counterparty risk management

Latest Additions to our Library

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