



SEMINAR BRIEF: HEDGE FUND LEGAL/REGULATORY UPDATE

Hedge Fund Legal/Regulatory Update

This Brief summarizes the key observations and insights from the SEI Knowledge Partnership seminar held on December 18, 2008. The topics examined during the seminar are noted below. Georgia Bullitt, Andrew Gottfried, Thomas McManus, Louis Singer and Jedd Wider, all partners at Morgan Lewis, comprised the distinguished panel. Phil Masterson, managing director of SEI, moderated the panel.

KEY TOPICS EXAMINED

PRIME BROKERAGE ARRANGEMENTS & BEST PRACTICES POST-LEHMAN

REDEMPTION PRACTICES

INVESTOR PERSPECTIVE POST-FINANCIAL CRISIS

SHORT SELLING RESTRICTIONS/REPORTING UPDATE

PRIME BROKERAGE ARRANGEMENTS & BEST PRACTICES POST-LEHMAN

Background. The financial crisis has had a profound impact on prime brokerage arrangements. There are fewer prime brokers today with Bear and Lehman gone, for example. Among hedge funds there is a heightened awareness of the risks in dealing with a prime broker outside the U.S., as well as the risks relating to far-reaching documentary terms providing prime brokers with significant discretion to apply client assets to both secure extensions of credit by a variety of affiliates, and to the prime broker's own business. Further, the Lehman insolvency posed significant challenges for Lehman prime brokerage clients and highlights several of the material risks associated with prime brokerage arrangements.¹

¹ There are two primary U.S. cases pending that concern Lehman Brothers. One is the Chapter 11 reorganization case of Lehman Brothers Holdings Incorporated, LBHI. There is simultaneously a case under the Securities Investor Protection Act of 1970 (SIPA) for one subsidiary of LBHI and that is Lehman Brothers Incorporated, which was registered broker/dealer. Registered broker/dealers cannot reorganize in bankruptcy. They are usually liquidated under SIPA. In contrast, LBHI and its various U.S. subsidiaries are debtors in possession in Chapter 11.

In the LBI case, most of the client accounts of LBI have been transferred to other brokers and bar dates or last dates for filing proofs of claim have been set. Most importantly, **January 30, 2009** was the deadline for all customer claims to be filed with the trustee. There is a second bar date in the LBI case of **June 1, 2009**, which is the last date for filing all non-customer claims against the broker-dealer.

In the Chapter 11 cases, that is the cases of all of the other U.S. Lehman Brothers entities, a bar date has not been set yet and may not be set for a year or more. In the Chapter 11 case, the debtor is attempting to marshal the bankruptcy estate assets. Lehman's position in un-terminated derivatives contracts is estimated to be in excess of 900,000.

Enhanced Agreement Terms. Specifically, from an agreement perspective, the Lehman insolvency highlighted a number of risks that funds and managers should consider and, if possible, address when negotiating prime brokerage agreements and other types of trading or custody arrangements. They include seeking to:

- *Restrict re-hypothecation rights.* Re-hypothecation rights allow a prime broker to use client assets in the broker's own business, including for funding purposes. Re-hypothecation exposes prime brokerage clients to greater credit risk as the clients are general, unsecured creditors of the broker. In addition, use by the prime broker of the assets can make it more difficult for a bankruptcy trustee to identify the extent of the client's claim against the prime broker since the assets are co-mingled with those of the debtor. Although restrictions on these rights protect clients from a credit perspective, limiting the ability of a prime broker to use client assets and posted collateral likely will result in higher pricing for many of the services provided by the prime broker.
- *Restrict the ability for PB to transfer client assets to affiliates.* Most prime brokerage agreements include a general lien over all client assets held at the prime broker or one or more of its affiliates in favor of the prime broker and all of its affiliates. In addition, agreements generally allow a prime broker to transfer client assets, including out of a segregated account, to an affiliate of the prime broker in order to secure obligations of the client to the affiliate. These provisions expose the client to the credit risk associated with the affiliate, complicating a fund's risk management practices at a minimum, and fundamentally exposing the fund to the credit risk of a different entity. Clients may want to consider limiting the right of prime brokers to freely move their assets without consent or, at least, limiting the ability of a prime broker to move assets only to other U.S. based affiliates where the bankruptcy laws are more favorable to the client, and where broker-dealer-affiliates would be subject to minimum net capital requirements and customer protection rules.
- *Include comprehensive default, cross-default and cross-acceleration provisions.* One of the documentation issues that surfaced in the Lehman debacle was that the United States (US) broker-dealer (which was the entity in the US that acted as prime broker) was not insolvent, and did not seek bankruptcy protection until five (5) days after the parent company.² In addition, many of the other Lehman entities, such as Lehman Brothers Special Financing Inc. or Lehman Brothers Commercial Corp., that acted as trading partners to hedge funds in connection with swap transactions or foreign exchange, also did not file for bankruptcy until some time after the filing by LBHI. As a result, unless the documentation provided trigger provisions that tied to a bankruptcy of the parent company, counterparties to such Lehman entities were not able to declare a default against these entities under their current agreement. Prime broker agreements typically did not provide any special termination rights but, instead, required notice. In negotiating agreements prospectively, it is useful to incorporate early warning triggers into agreements (much like the Additional Termination Event provisions often included by dealers in schedules to ISDA Master Agreements), as well as to ensure that the agreements include the ability to declare a default upon the bankruptcy of the parent or a material affiliate of the counterparty or prime broker.
- *Limit recourse against fund assets.* Funds should consider seeking to limit the prime broker's lien only on assets posted as collateral against loans (e.g., assets in margin account).
- *Include cooperation covenants.* It may be useful to negotiate into prime brokerage agreements specific undertakings for the prime broker to cooperate with the client in transferring assets promptly to another prime broker upon request (and satisfaction in full of the client's obligations to the prime broker). As a practical matter, establishing a strong relationship with prime brokerage personnel may be helpful in accomplishing this, and in getting the attention of the prime broker.
- *Sub-custody arrangements.* Clients should understand their sub-custodial arrangements, including those used by prime brokers, and seek appropriate indemnities by the prime broker or primary custodian. It may also be useful to select as

² In response to this concern, some prime brokers are emphasizing the strong balance sheets of their affiliates and/or parents and emphasizing that, unlike Lehman, the prime brokerage contracts are with their bank affiliates, which are subject to additional regulation and protections.



a sub-custodian in a foreign country the branch office of a U.S. regulated bank both to facilitate information flow and to enhance credit risk.

- *Repo and Stock Lending.* Ensure that collateral levels are appropriate to satisfy buy-in requirements upon a counterparty insolvency or other default. In addition, a client is significantly better positioned from a risk perspective if collateral is held in the client's own name rather than in a co-mingled account in the name of the agency repo or stock lending bank. With respect to collateral management, clients should carefully review the investment mandates of their agency lenders, and evaluate whether the investment guidelines satisfy their risk criteria. Rather than opt for collateral management by the agent bank, clients may wish to have cash collateral invested in a Treasuries-only money market fund or FDIC-insured bank account.

In light of the declining number of prime brokers and the remaining prime brokers' focus on their own risk management priorities, negotiating the foregoing terms may be difficult. To help streamline the process and increase the probability of successful negotiations from the fund's perspective, managers should consider using a term sheet that highlights upfront the provisions the fund seeks and creates a roadmap for negotiations. In light of the time-sensitive nature of implementing trading strategies and the dilatory nature of legal negotiations, a fund should seek an undertaking from the prime broker to continue to negotiate in good faith provisions that the fund may not have time to negotiate in the short timeframe necessary to move assets from one prime broker to another, or to commence a new prime brokerage relationship.

In general, managers should consider that, given their fiduciary status, they have an obligation to ensure safe custody of the fund assets they manage. As a result, there is the potential for investor claims in situations for losses related to prime brokerage arrangements. This risk is heightened to the extent a manager has a soft dollar arrangement whereby investors could claim a breach of a manager's duty of loyalty due to a conflict of interest. It is important to keep in mind courts and regulators often judge managers in conjunction with prevailing industry standards. Therefore, it is incumbent for managers to be aware of market standard practices against which a manager's compliance with duty of care may be judged. There is currently a trend by money managers to focus on risk management and on negotiating more protective prime brokerage and custody arrangements.

Another matter to consider is that both US and United Kingdom (UK) prime brokerage relationships tend to get negotiated in tandem. It is important to carefully evaluate the applicable UK's Financial Services Authority terms, because there are important differences between the US and UK regulatory and, in particular, bankruptcy regimes. For UK agreements, funds generally may want to maximize protections under the client money and customer property rules. One possible way to do this may be to seek retail client status and to avoid transfer of title collateral arrangements. While there has been talk in the UK about changing its bankruptcy regime, the difficulty that creditors and clients of Lehman Brothers' UK broker-dealer have had in withdrawing their assets or even obtaining information about their assets, has highlighted some of the shortcomings with the current regime. Clients of Lehman Brothers' US broker-dealer and futures commission merchant (FCM), by contrast, were able to withdraw their assets relatively soon after the SIPA filing (clients of the FCM were able to move their positions immediately whereas broker-dealers clients experienced a short delay – approximately 10 days).

Enhanced Risk Management. From a general risk management perspective, funds should consider enhanced risk management procedures including diversification among prime brokers and other custodians; close monitoring of credit related information about the prime broker or other custodian (e.g., based on ratings agency data or surrogate data such as credit default swap spreads, stock price volatility or commercial paper spreads); monitoring for excess margin and arranging for periodic sweeps of excess margin into a customer account; ensuring accounts are registered in the fund's name; confirming segregation of assets; considering the use of a letter of credit in lieu of initial cash margin; and engaging in trading strategies designed to mitigate risk exposure to the entity, such as credit default swaps or short selling of the custodian's securities.



REDEMPTION PRACTICES

Redemption Trends. According to Hedge Fund Research, hedge funds experienced record redemption requests and fund liquidations in 2008. In many cases, redemptions were unrelated to poor performance but rather an investor's need for cash to rebalance the investor's portfolio or for other purposes. Nonetheless, the imposition of gates or suspension of redemptions reflects a general lack of market liquidity as well as a lack of available credit.

General Issues to Consider. Before instituting gates or suspending redemptions, it is critical to carefully analyze the redemption provisions in a fund's underlying documentation. Unfortunately, in many cases the documentation does not clearly delineate how various redemption provisions operate, not only with respect to when investors are entitled to redeem from the fund, but more importantly what happens in the event of a suspension or gating. For example, it is critical that funds and managers understand how redemptions are treated once a suspension is lifted. This fact pattern has resulted in several lawsuits over the last several months.

Specific Issues to Consider. Under what circumstances can redemptions be suspended? How are redemption requests treated in the event of a suspension? If redemption requests are submitted before or after a suspension is implemented, how are those respective redemption requests treated once the suspension is lifted? Are they treated on a first in/first out basis? Are all investors treated equally on a pro rata basis? These are critical questions that managers must evaluate with counsel based on the fund's organizational documents, governing documents and offering memorandum, as well as a manager's fiduciary obligation to investors.

A related issue is the distribution of available cash. In the event there is a suspension and there is a limited amount of available cash left in the fund, where the fund may have segregated illiquid assets into a side pocket, it is critical to evaluate under what circumstances the manager has the right to distribute available cash to investors that have submitted redemption requests. Again, managers must evaluate this issue with counsel based on the fund's underlying documentation.

There have been numerous instances in the last several months where available cash has been distributed on a pro rata basis to all investors, irrespective of whether or not those investors remained subject to a lockup. The justification for these distributions has largely been driven by the manager's interpretation of what its fiduciary duty was to the partnership and the limited partners. These circumstances could lead to allegations of a breach of fiduciary duty with respect to the underlying investors who have satisfied their redemption notifications appropriately if distributions of available cash are made to investors who are still subject to a lockup, and therefore warrant careful consideration with counsel.

Side Letters and Interplay with Redemptions. Institutional investors frequently seek comfort on any number of points. Over the last several years, the United States Securities and Exchange Commission (SEC) has provided guidance with regard to what are appropriate side letter provisions and what terms would draw further scrutiny from the SEC.

Those provisions that should not raise fiduciary concerns, per SEC guidance in various testimonies over the last couple of years, are those relating to statutory and regulatory related provisions such as bank-holding and ERISA related provisions. Additional non-problematic provisions are those related to capacity, most favored nation treatment, and different fee schedules. At the other end of the spectrum are potentially problematic provisions including those related to preferential treatment with regard to redemption rights and preferential transparency or preferential informational rights.

Therefore, with respect to the use of side letters, it is important for managers to pay particular attention to preferential terms being provided to investors. Managers must be careful with preferential terms as they may inadvertently create new classes of interests or may be forced to create new classes of interests.



INVESTOR PERSPECTIVE POST - FINANCIAL CRISIS

Investor Expectations to Anticipate. Despite investor expectations of enhanced diversification and absolute returns with a low correlation to broad markets, hedge funds, with a few exceptions, were not immune to the damage wreaked by the global financial crisis. Most hedge fund strategies produced double-digit losses in 2008, making it the worst year on record for hedge fund performance according to Hedge Fund Research. In light of the general performance of hedge funds, managers should anticipate modifications in investor expectations.³ Managers should anticipate the investor trends discussed below.

First, because of the declines in other parts of their portfolios, institutional investors may be exceeding their hedge fund target allocations and may need to rebalance. Second, anticipate greater scrutiny of strategies and side pockets in particular.⁴ Whereas investors used to accept side pockets as part and parcel of the hedge fund investing, investors today are concerned about hedge funds that have large side pockets of illiquid securities – both from illiquidity and valuation perspectives as well as potential strategy drift.

Third, managers should anticipate further emphasis on terms and conditions. There are two topics that investors are extremely focused on – management fees and transparency. Investors are not only concerned about the amount of management fees, but also how the management fees are being allocated among the portfolio management team. Additionally, expect pressure to justify fees when a fund maintains a high degree of cash for an extended period of time. In any case, issues related to fees have risen to the institutional investor board level.

The second topic investors are focused on with respect to terms and conditions is transparency. The Institutional Limited Partner Association, which has in excess of 1,000 members, has made transparency evaluation its number one topic in the current environment. In addition, in a recent survey conducted by SEI and Greenwich Associates, institutional investors identified portfolio transparency as the number one investment selection criteria demanding more weight in light of hedge fund performance in 2008. In fact, among investors planning to *decrease* allocations by at least 10 percent, the top-ranking reason was lack of transparency.⁵

Investment Structure Trends. Some institutional investors have begun to rethink the manner in which they access a manager's strategy (e.g., through managed accounts or a customized structure).⁶ Some institutional investors active in the hedge fund space have begun to seek customized products, where they can customize the underlying investment strategies of the fund, either through captive oriented funds or managed account programs where they can have custody of the assets themselves or

³ For a more detailed discussion of the attitudes of institutional investors attitudes toward hedge fund investing, see "Hedge Funds under the Microscope" (January 2009), a joint publication of SEI Investments and Greenwich Associates. This white paper identifies three key takeaways for hedge fund managers in light of the financial crisis: (i) expect more rigorous due diligence (both initial and ongoing); (ii) focus on the 4 P's (performance, people, process and philosophy); and (iii) commit to transparency and enhanced client service.

⁴ Always concerned with the factors that drive the pattern of portfolio returns, investors are intensifying their scrutiny of hedge fund investment processes and organizational structures. Additionally, the Lehman insolvency and the fundamental nature of the Madoff allegations have highlighted issues related to hedge fund operations, counterparty risk, and risk management generally. Investors will be conducting wider-ranging and more in-depth evaluation of hedge funds than before. Investors will have an intensified focus on operations, risk management, and key non-investment functions in addition to investment processes. Investors increasingly prefer a separation of investment and non-investment functions (e.g., administration) as it contributes to operational quality and risk management. See "Hedge Funds under the Microscope."

⁵ See "Hedge Funds under the Microscope" (January 2009), a joint publication of SEI Investments and Greenwich Associates.

⁶ With respect to the Madoff allegations, it is important to note that Madoff was not using managed accounts. Key attributes of managed accounts include: an investment advisor who enters into an investment management agreement with clients; assets are held by a third party custodian or prime broker in an account opened by the client; account is in the name of the client; and client has complete transparency and control over the assets.

direct custody to a custodian of their choice. They also can customize the level and nature and frequency of the underlying reporting and transparency they desire.

These types of structures also enable them to direct the underlying investment strategies by placing investment restrictions or limitations with respect to those strategies, including use of leverage. Such a structure also allows investors to influence and control counterparty risk to a certain extent.

SHORT SELLING RESTRICTIONS/REPORTING UPDATE

Background. During the market slide in the fall of 2008, short-selling came under heavy criticism – targeted by several regulators and politicians. The end result was new regulation of short-selling. This regulation comes on the heels of deregulation of short-selling with Regulation SHO. In essence, Regulation SHO eliminated the up-tick rule, although the SEC did attempt to tighten up the locate rules and the delivery rules as part of Regulation SHO. As part of the deregulation, the SEC prohibited self-regulatory organizations such as the Financial Services Regulatory Authority from imposing their own short-sell restrictions.

Nonetheless, the recent market volatility put tremendous political pressure on the SEC to impose measures, at least on an interim basis. The most draconian of these measures, a ban on shorting financial stocks and requiring pre-borrowing as opposed to merely obtaining a locate, have expired.⁷ There are two remaining interim rules implemented in September of last year, both of which are likely to become permanent.

Reporting. The first remaining interim rule relates to short-sale reporting. Interim Rule 10a-3(T) under the Securities Exchange Act of 1934 requires institutional investment managers with \$100 million equity securities under discretionary management to report on a weekly basis short selling activity on Form SH for the previous calendar week.⁸

Naked Short Selling Ban. The other interim rule that is likely to be approved on a permanent basis is the closeout and borrow rule, which is Rule 204, under Regulation SHO. The rule requires a broker/dealer to settle long and short transactions by T+3, and in the event that there is a fail the rule requires the broker/dealer to close out the transactions by T+4 either by purchasing or borrowing.⁹

Anti-fraud Rule. The SEC also adopted Rule 10b-21 under the Exchange Act, a new anti-fraud rule that considers it to be fraudulent for a short seller to deceive a broker/dealer or another purchaser about its intention or ability to deliver the shorted security on settlement day. In essence it would involve characterizing a position as long when it's actually short or claiming to have a locate when in fact there is no locate. For a violation to occur there must also be an actual failure to deliver the security or settle the trade by T+3.

Possible Future Short Selling Regulation. There has been some discussion, although not too serious, of a permanent move to pre-borrowing, in replace of locates. Also possible but not likely, a temporary short sale ban based on intra-day or from close-to-close downward movements of particular stocks. That proposal that was floated in mid-October and drafted by the SEC, would potentially result in a possible two week ban on short-selling of any securities that have declined by a specified amount.

⁷Unfortunately, the SEC did not include an exception for hedging of converts to the detriment of convertible arbitrage strategies.

⁸ There is a de minimis exception. The filings are considered confidential although theoretically confidential treatment is subject to being challenged.

⁹ Broker/dealers are subject to penalties for failing to close out a fail by T+4, requiring the broker/dealer to pre-borrow in connection with any short sales until the fail has been satisfied by a purchase, which has to settle. Such a situation can effectively leave the broker/dealer on the sidelines for several days.



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Insights for Investment Managers

There also has been some consideration of a revival of the up-tick rules, and the new SEC chair, Mary Shapiro, has indicated her support for revival of the up-tick rules.

Other jurisdictions adopted similar rules (reporting and short-selling bans) to those adopted in the US, and some of those restrictions remain in place. In light of this global patchwork regulation, the International Organization of Securities Commissions (IOSCO) has formed a taskforce to deal with short-sale regulation on a global basis so that regulatory gaps that exist between the various approaches to short-selling, and in particular naked short-selling, are potentially closed, addressing delivery requirements and disclosure in particular. The IOSCO taskforce is expected to deliver a short selling report by the end of the first quarter of this year.

CONCLUSION

In 2008, the hedge fund industry experienced the worst year on record for average hedge fund performance, a record number of fund liquidations, significant gating and suspending of redemptions and the initial fallout from the Madoff allegations. In 2009, the industry should anticipate significant public policy changes, including the likely registration of hedge funds and hedge fund managers, the possible merging of the SEC and the Commodities Futures Trading Commission and a possible self-regulatory organization for investment advisors – possible new regulations all supported by the likely new chair of the SEC. The SEI Knowledge Partnership will proactively analyze these issues and engage industry experts to help hedge funds navigate the more complex regulatory landscape.

FOR MORE INFORMATION

The SEI Knowledge Partnership strives to deliver actionable business intelligence intended to help shape your strategic business decisions. Visit the SEI Knowledge Partnership website at www.sei.com/ims or contact your SEI Relationship Manager for more information on our upcoming SEI Knowledge Partnership Strategy Briefs, research, events and conferences.

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