



CONSULTATION PAPER NO 37

SEPTEMBER 2006

USE OF PRIME BROKERS BY HEDGE FUNDS

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Why are we issuing this paper?

1. This Consultation Paper seeks public comments on the DFSA's proposals to amend the Collective Investment Rules in the DFSA Rulebook. These amendments, set out in Appendix "A", are designed in a manner that will, subject to certain safeguards, allow the appointment of prime brokers by Operators of Private Hedge Funds upon terms that permit commingling and hypothecation of Fund assets.

Who should read this paper?

2. The proposal in this paper would be of primary interest to Operators of Hedge Funds and persons who wish to establish Hedge Funds in the DIFC as well as those who wish to act as prime brokers to Hedge Funds in the DIFC.

How is this paper structured?

3. In this paper, we set out:
 - (a) What are prime broker arrangements (paragraphs 6 – 8);
 - (b) Current restrictions relating to prime broker arrangements (paragraph 9);
 - (c) Risk/benefits relating to the use of prime brokers (paragraphs 10 – 13); and
 - (d) Proposals to address prime broker risks (paragraphs 14 – 16).

How to provide comments?

4. All comments should be forwarded to the person specified below. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

What happens next?

5. The deadline for providing comments on these proposals is **13 November 2006**. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to enact the changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We will issue a notice on our website telling you when this happens.

Comments to be addressed to:

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What are prime broker arrangements?

6. Prime brokers are used by Hedge Funds. Typically, the services provided by a prime broker to a Fund encompass custody and depository services, trading and execution services, clearing and settlement services, performance monitoring and market research and most importantly, cash and stock lending facilities to support Hedge Fund investments.
7. Prime broker services differ from the traditional custody and clearing and settlement services because prime brokers pool assets of different Funds and use those assets as collateral to support their cross lending activities to a number of Funds, generally with similar investment strategies. It is said that this level of flexibility and authority are needed for prime brokers to be able to provide greater benefits arising from a larger volume transactions and the flexibility to use as collateral, assets of a number of Funds to generate lower cost financing available to those Funds.
8. The powers given to the prime broker to use the assets of the Fund to support its lending and borrowing activities are known as re-hypothecation powers. Re-hypothecation enables prime brokers to raise capital speedily and on competitive terms from third party providers using as collateral the assets of those Funds for which it acts as the prime broker. To be able to do so, the prime broker is given access to the clear legal title to the assets of the Fund and the ability to commingle those assets with other assets held by the prime broker.

Current restrictions relating to prime broker arrangements

9. Currently, an Operator of a Hedge Fund in the DIFC cannot appoint a prime broker under terms of agreements that have widespread acceptance in the industry. This is because they cannot strictly comply with the requirements in CIR App 1.2.2(f), which do not permit any arrangements that allow combining the assets of one Fund with any other assets held by the Custodian such as a prime broker. The current provisions read as follows:

App A1.2.2 Before an Operator or Trustee passes, or permits to be passed, the property of the Fund to an Eligible Custodian it must have procured a written acknowledgement from the Eligible Custodian stating:

.....

- (f) that all Investments standing to the credit of the account are held by the Operator as agent and by the Trustee on trust and that the Eligible Custodian is not entitled to combine the account with any other account or to exercise any charge, mortgage, lien, right of set-off or counterclaim against Investments in that account in respect of any sum owed to it on any other account of the Operator or Trustee.

Risk/benefits relating to the use of prime brokers

10. To assess the risk and benefits arising from the use of prime brokers, we have undertaken a review of:
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- (a) industry practices relating to the use of prime broker arrangements in other onshore Hedge Fund jurisdictions, notably Ireland, Hong Kong, France and Spain (see Appendix B); and
 - (b) recommendations made to the European Commission on the regulation of Hedge Funds made by an Expert Group in July 2006 (see Appendix C).
- 11. Some industry participants claim that without the flexibility provided by the prime broker's ability to commingle the assets of a Fund with other assets held by the prime broker and to use those assets as collateral to support its financing activities involving a range of Funds for which it acts as a prime broker, it is not possible for a prime broker to secure lower cost financing. Such financing would include margin credit to purchase equity securities by the Fund or securities lending to support the Fund's short positions. It is also claimed that prime brokers are able to manage market and credit risks more effectively because they have the ability to transact more speedily under these flexible arrangements. There have been counter claims that these benefits are offset by higher fees charged for trading and execution services provided by the prime broker, but disclosure of charges is already provided for in CIR.
- 12. There appear to be two inter-related key risks arising from the prime broker's ability to collateralise the assets of a Hedge Fund, particularly to secure financing for a range of Funds for which it acts as a prime broker:
 - (a) In the event of the prime broker's insolvency, the third party lender's rights to the assets used as collateral, crystallise. The Funds whose assets are used as collateral do not have any priority rights to those assets. Instead, the prime broker only has a contractual indebtedness to the Funds that is equivalent to the value of the assets that are used as collateral. To the extent of that indebtedness, the Fund becomes an unsecured creditor of the prime broker; and
 - (b) Inter-fund exposure arising from cross collateralisation. For example, if the prime broker lends to one hedge fund ("Fund 1") capital it has raised using as collateral the assets of another hedge fund ("Fund 2"), default by Fund 1 may have an adverse impact on the prime broker's solvency which would in turn impact on Fund 2.
- 13. In addition to the above risks, the use of prime brokers by Hedge Fund Operators may result in difficulties in monitoring fund investments and their performance. This risk is enhanced where Fund assets of different Funds are commingled. Also, where a Hedge Fund permits investments in complex financial products, this risk is further heightened.

Proposals to address prime broker risks

14. The current restrictions against commingling assets in different accounts in App 1.2.2(f) aim to minimise the risk of loss of Fund assets and the difficulty in tracing Fund assets and their performance, particularly in the event of the insolvency of the person having the custody of the assets. However, persons investing in Hedge Funds expect higher returns by taking higher risks. We are of the view that the current restrictions in App 1.2.2(f) can be relaxed to allow the necessary degree of flexibility for such Hedge Funds to pursue higher returns without compromising the integrity of our regulatory regime as long as certain safeguards are in place. Such an approach is consistent with the practices in comparable jurisdictions which allow the use of prime broker arrangements for onshore Hedge Funds.
15. The safeguards we propose entail allowing Operators of Hedge Funds to use prime brokers with powers to commingle and cross collateralise the assets of the Fund only where all the following conditions are met:
 - (a) Private Hedge Fund Restriction – i.e. restricting the use of prime broker arrangements that permit commingling of and creation of charges over Fund assets to Hedge Funds that are Private Funds. This means that only Qualified Investors can participate in such Funds under private placement arrangements and, with the benefit of enhanced disclosure measures that are discussed below;
 - (b) Eligible Custodian requirements – i.e. requiring prime brokers to meet Eligible Custodian requirements in CIR 6.3.2 (see Appendix E) even if they do not hold the custody of Fund assets. This is because some prime broker arrangements do not require the prime broker to be the custodian but instead allow the Fund assets to be charged to the prime broker so that the prime broker could use the charged assets to finance its lending and borrowing activities. This measure ensures that prime brokers themselves are subject to adequate prudential supervision regardless of whether or not they provide custody services to the Fund so that it mitigates the risk of prime broker insolvency. It also provides flexibility for Operators of Hedge Funds to use prime brokers located outside the DIFC provided they are subject to equivalent regulation as provided by the DFSA regulation;
 - (c) Enhanced disclosure – i.e. requiring, in addition to the current Prospectus disclosure requirements, specific disclosure and warnings as set out below to enable Qualified Investors who are permitted to invest in such Funds, to clearly understand the risks associated with such prime broker arrangements. The specific requirements proposed include:
 - (i) the disclosure of the identity and profile of the prime broker, including where it is located and how it is regulated;

- (ii) the disclosure of the services which the prime broker provides to the Fund and the nature and extent to which the prime broker has the power and authority to combine the assets of the Fund with any other assets held by or available to the prime broker as collateral for any financing activities undertaken by the prime broker; and
 - (iii) a prominent health warning in the Prospectus to alert prospective investors to the facts that:
 - (A) the Fund's appointed prime broker has the power and authority to collateralise the assets of the Fund in conjunction with any other assets held by or available to the prime broker; and
 - (B) where the prime broker uses Fund assets in conjunction with any other assets pursuant to the above power, the investors may lose all the assets of the Fund in the event of the insolvency of the prime broker;
 - (d) Ceiling on collateralisation – i.e. restricting the ability of a prime broker to cross-collateralise the assets of the Fund for only up to 140% of the level of the Fund's indebtedness to the prime broker. It is noted that while Hong Kong places the relevant ceiling at 100% of the indebtedness of the Fund to the prime broker, we propose the higher ceiling at 140% as adopted in Ireland, because the Hong Kong regime permits retail investor participation in Hedge Funds using prime brokers. The higher flexibility is considered more appropriate under the DFSA regime because of the Qualified Investor and Private Fund restrictions that are to apply in this context;
 - (e) Valuation requirements – i.e. requiring that a Hedge Fund using a prime broker must have adequate valuation procedures to mark positions to market daily in order to ensure that the requirement in (d) above relating to the ceiling on the use of Fund assets as collateral is met on an ongoing basis;
 - (f) Contractual Rights of set-off – i.e. requiring that the contract between the prime-broker and the Operator contains an irrevocable and enforceable right which entitles the Fund to set-off all its indebtedness to the prime broker against the prime broker's obligation to deliver fund assets or its cash equivalent that has been hypothecated by the prime broker. Such a right of set off, if held effective in the event of the insolvency of the prime broker, is likely to ensure that where the prime broker has re-hypothecated assets of a Fund in excess of the funds it has advanced to that particular Fund, the Fund will become an unsecured creditor only to the extent of that difference; and
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- (g) Additional notifications to the DFSA – Unlike Public Funds, Private Funds are neither required to be registered with the DFSA nor required to be lodged their Prospectus with the DFSA. Private Funds are only subject to a notification requirement to inform the DFSA of the name of the Fund and the nature of its investments 10 days prior to making an issue or offer of the Fund interests to Qualified Investors. We are proposing that additional information relating to the use of a prime broker such as the identity of the prime broker and its location be provided to the DFSA, together with a legal certification that all the requirements relating to the use of prime brokers have been complied with by the Fund.
16. The CIF regime already contains specific requirements relating to Hedge Funds and also guidance relating to the use of prime broker arrangements (see Appendix F). Therefore, the proposed requirements, when applied in conjunction with the other requirements that already apply to Operators of Hedge Funds, can be seen as providing an adequate level of protection to persons who intend to participate in such Funds by assuming higher risks in the expectation of higher returns.