Prime Brokerage, Collateral Management and Short Selling

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Prime Brokerage Description

A prime broker provides services such as clearing, settlement, custody and financing to hedge funds and other performance-oriented asset managers.
Regulatory Framework

- Primary framework is contained in a SEC 1/25/94 No-Action letter
- Minimum capital requirements for prime broker and executing broker
- Minimum net equity for customers
- Documentation requirements
  - Agreement between prime broker and executing broker (Form 150)
  - Agreement between executing broker and customer (Form 151)
  - Agreement between prime broker and customer
Key Provisions of Agreements

1. Prime broker can DK (don’t know) affirmation request or disaffirm an affirmed transaction. This is a key protection to the PB. DKed or disaffirmed trades are then carried by the executing broker.

2. Executing broker sends confirmation

3. Prime broker responsible for margining

4. Executing broker completes order ticket and is responsible for Reg SHO compliance
Prime Brokerage Clearing/Settlement

- Customer executes at executing broker of customer's choosing

- Executing broker books transaction in an account in the name of the prime broker for the benefit of the customer and confirms transaction to prime broker through the Depository Trust Corporation ("DTC")

- Customer notifies prime broker of the transaction

- Prime broker books trade in customer account, confirms back to the customer via a "notification", and seeks to match the trade details through DTC
Prime Brokerage Clearing/Settlement (Cont’d)

• If the executing broker and the prime broker match, the trade will be “affirmed” and will automatically settle through the National Securities Clearing Corp (“NSCC”) on settlement date.

• Prime broker will then maintain typical cash or margin account including:
  – Long Financing
  – Segregating customers fully paid and excess margin securities and locking up cash balances
  – Rehypothecating non-excess margin securities
  – Short Financing

• Multiple prime brokers is common, especially for larger clients.
Prime Brokerage Financing

Sources of Financing

Extending Margin Loans (Debits)

- Asset based lending provided to hedge fund clients who want to leverage their holdings
- Securities posted as loan collateral can be used as source for short positions or be rehypothecated externally to finance debits
- Amount of leverage available will be largely determined by portfolio risk characteristics

Facilitating Short Sales (Shorts)

- Hedge fund clients short stock resulting in short sale cash proceeds, which Prime Brokerage (PB) retains as collateral for the short positions and pays interest to clients
- Short stocks are either sourced externally (e.g., third party custodians) or through prime broker’s internal pool of available securities
- The cost of borrowing stock is generally determined by security availability. Stock Borrow is typically categorized in two categories: General Collateral (“easy to borrow”) which is charged a fixed rate, and Hard-to-Borrow (“hot”) stocks which have a variable cost

Holding Cash Deposits (Credits)

- Hedge Fund clients not employing leverage may carry excess cash with PB and will be paid interest at market rates
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