Foreign Exchange Prime Brokerage

Product Overview and Best Practice Recommendations

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Overview

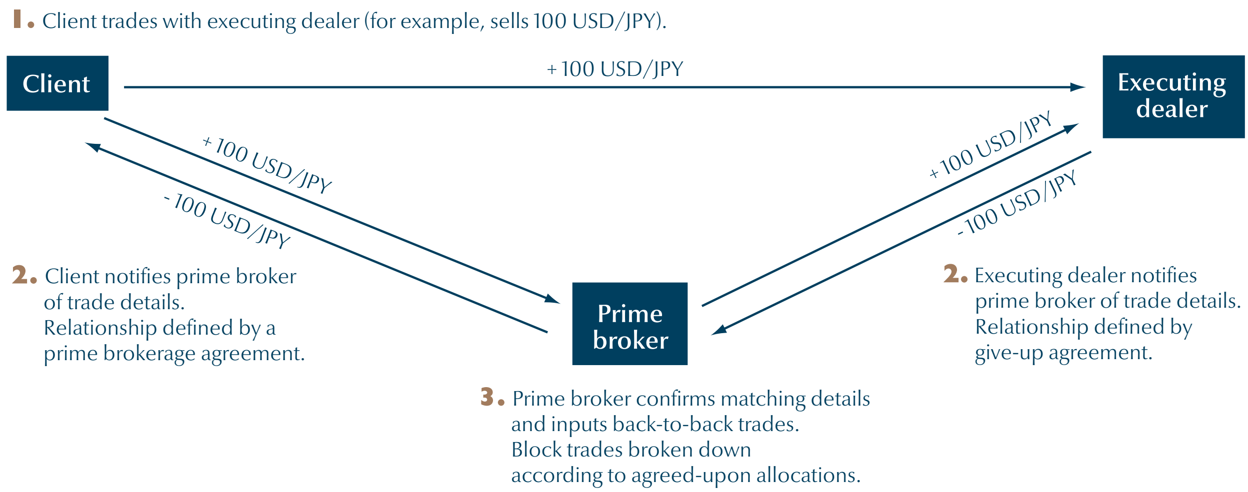
Foreign exchange prime brokerage allows a client to source liquidity from a variety of executing dealers while maintaining a credit relationship, placing collateral, and settling with a single entity—the prime broker.

As illustrated in the figure on the following page, a prime-broker client conducts a trade with an executing dealer (also known as a "spoke bank" or "give-up bank") in the name of its prime broker. When the prime broker is informed of and accepts the transaction by the client and executing dealer, the prime broker, rather than the client, becomes the party to the transaction with the executing dealer. In addition, the prime broker will contemporaneously enter into an offsetting transaction with the client (or funds managed by the client or banks holding accounts managed by the client). The prime broker and the executing dealer confirm and settle the trade, while the prime broker settles with the client on a net basis. In exchange for the authority to trade in its name, the prime broker typically charges the client a fee on a volume basis for the trades conducted according to this arrangement.

Product Participants and Evolution

Prime brokerage emerged in the early 1990s with the use of semi-formalized "give-up" arrangements initiated by a few financial institutions. The product gained momentum in the late 1990s when several banks entered the prime brokerage business with dedicated market and sales efforts, as well as tighter and more formal operational

FX Prime Brokerage Deal Process



controls, procedures, and processes. This focus laid the foundation for a rapid expansion of the client base.

Clients

Foreign exchange prime brokerage has typically been used by hedge funds and commodity trading advisors (CTAs). Prime brokerage allows these market participants, despite their limited credit history or higher risk profile, to use the prime broker's (presumably) higher credit rating to gain access to new counterparties. Generally, these firms also maintain low headcounts and prefer to outsource or centralize as much trade processing as possible. The hedge fund industry has come to rely on prime brokerage to such an extent that new hedge fund managers include appointing a prime broker among their first business decisions.

While the growth of the hedge fund industry has contributed to the development of the prime brokerage business, it is important to note that the client base is quite diverse. In addition to hedge funds and CTAs, prime brokerage clients include small banks, other asset managers, endowments, foundations, partnerships, private family offices, and pension funds. The service is less frequently used by corporations and large banks.

Prime Brokers

Although the prime brokerage client base has broadened in recent years, the rapid growth of hedge funds is the main driver behind the development of the prime brokerage service. Currently, the hedge fund industry is estimated to represent $875 billion in assets and to be growing at about 20 percent per year, with approximately 8,350 active

hedge funds.[1] According to one source, in 1997, fewer than ten organizations in the global marketplace used a foreign exchange prime broker, and the market was dominated by four banks. In 2005, market participants estimate that between 450 and 600 clients use the prime brokerage service, and at least twenty different banks offer the service as a core foreign exchange product. Despite the large number of institutions establishing prime brokerage functions, the market has become increasingly concentrated in recent years. According to the Hennessee Group's tenth annual survey, the market share of the six largest prime brokers increased to 83 percent in 2003, from 70 percent in 1999.

Typical Service

The core services offered by the prime broker to a client are leverage, access to market liquidity, and consolidated settlement, clearing, and reporting. In addition to allowing a client to trade in its name, the prime broker can provide a range of services, which may include commission accrual and payment, statement and confirmation generation, and housing and administering of client accounts.

Some prime brokerage providers have begun to offer more sophisticated services, with the goal of becoming a "one-stop shop" for hedge funds. These include start-up services, capital introduction services, front- and back-office systems and technology, research, and cash management services. Market participants have noted increased demand for end-to-end technology to support hedge funds—including risk analytics and portfolio management and reporting systems—so that portfolios can be actively monitored and analyzed.

The nature of prime-brokered trade execution has also evolved. In the traditional model, foreign exchange prime-brokered transactions are initiated manually by the client. While the client trades in the name of the prime broker—using the prime broker's credit line with the executing dealer—the execution of a transaction involves direct communication between the client and executing dealer in which the identities of both parties are known.

More recently, prime brokers have begun to provide trade execution via electronic communication networks and electronic broking platforms. These platforms allow for automated program trading, which typically involves the use of an application programming interface that provides access to executable prices via two-way message interface between the foreign exchange market and a client's internal trading infrastructure. Notably, in the electronic prime-broker model, there is typically no identification of the trade as being prime-brokered at the time of execution—the executing dealer only sees the name of the prime broker. The identity of the client initiating the trade is not known to the executing dealer—providing an element of anonymity to the client.

[1]Hedge Fund Association. Friedland, D. *Facts About Hedge Funds* <http://www.thehfa.org/AboutUs.cfm>.

Value Proposition

Benefits to the Client

Prime brokerage allows the client to maximize its credit relationships and activities while improving efficiency. In addition, prime brokerage streamlines the credit and documentation process, given that the client is subject to one internal credit review and executes one master trading agreement and credit support annex with the prime broker, rather than many agreements with multiple dealers. A prime brokerage arrangement provides for the more efficient use of collateral for margin relationships. Further, margin positions can be netted as the client needs to manage just one credit relationship to gain trading relationships with many counterparties. In addition, the client is able to access pricing and liquidity from a greater number of dealers and potentially expand the range of its activities.

By outsourcing operational activities, prime brokerage reduces a client's operational and settlement risk while lowering its expenses. A client realizes a reduction in capital expenditures because back-office expenses are outsourced to the prime broker. In addition, trade allocation, confirmation, and settlement are consolidated with the prime broker, allowing firms to maintain a small operations staff and still execute complex and high-volume trading structures.

Prime brokerage allows a client to consolidate positions and improve execution. For example, a client may establish a foreign exchange position with several different counterparties, which are then consolidated into a single position with the prime broker. The client can manage a single position more easily than it can manage many individual positions with a variety of counterparties. In addition, prime brokerage offers the client greater liquidity to execute larger trades.

Benefits to the Prime Broker

For the prime broker, the product generates a new, fee-based revenue stream, which is increasingly attractive as foreign exchange spreads continue to narrow. In addition, the product contributes to an expansion of the prime broker's client base and a strengthening of its existing client relationships.

Prime brokerage provides efficiencies of scale with respect to transaction processing and technology investments and allows an institution to leverage its technology and operating infrastructure. As execution continues to migrate to electronic platforms, prime brokerage presents an opportunity to build a fee business into an institution's electronic foreign exchange platform in order to extract investment costs.

Benefits to the Executing Dealer

The executing dealer benefits from increased execution flows with the ability to transact business with counterparties that would typically require credit enhancement.

Legal Framework and Agreements

The establishment of a prime brokerage arrangement requires specific legal documentation that articulates the rights and responsibilities of the client, prime broker, and executing dealers. A foreign exchange prime broker documents its relationship with the client through a prime brokerage agreement and its relationship with the executing dealer through a give-up agreement.

Prime Brokerage Agreement

Under this agreement, the prime broker agrees that the client may enter into foreign exchange transactions with dealers approved by the prime broker and that the prime broker, rather than the client, will become the party to these transactions if the applicable terms specified in the prime brokerage agreement are satisfied. Generally, these terms are of two types. First, each transaction will have allowable products, such as spot, forward, or option transactions, and a tenor that does not exceed a specified maximum. Second, the transaction will have to be within specified limits, which may include settlement, open position limits, or both. These limits usually apply to the aggregate of all transactions executed by the client with an executing dealer and are typically either specified in the prime brokerage agreement or sent to the client by the prime broker so as to be known to the client at all times.

The prime brokerage agreement typically includes agreement by the client to enter into or, if the client is a manager or advisor, have funds or accounts that it manages enter into (in each case, the "relevant account"), one or more transactions that offset the transaction accepted by the prime broker. This process gives the relevant account the economic benefit of the transaction, as intended, while the prime broker assumes the credit risk of the executing dealer. In addition, the client can achieve efficient use of its collateral by consolidating much of its trading position with the prime broker. Lastly, the prime brokerage agreement describes the procedure by which the prime broker is notified of the transaction by the client.

Give-Up Agreement

In this agreement between the prime broker and the executing dealer, the prime broker agrees to become the counterparty to each transaction executed by the client with the executing dealer, subject to compliance with the specified terms. A give-up agreement is customarily executed as a master agreement and is supplemented by a give-up agreement notice for each prime-broker client that will execute trades with the applicable executing dealer. The give-up agreement notice identifies the client and contains the allowable products, tenors, and specific limits that apply to the trades that the prime broker will accept for that client. The terms specified in the give-up agreement notice are typically either the same as those included in the prime brokerage agreement or sent to the client by the prime broker. Because these terms are specified in the give-up agreement notice, the executing dealer is able to determine, before executing any trade with the prime broker's client, whether the prime broker is obligated to accept the give-up of the transaction. In addition, the prime broker may be contacted and asked to accept transactions that may be outside the limits specified in the agreements.

The Foreign Exchange Committee recently published a Master FX Give-Up Agreement

for use by market participants in documenting foreign exchange give-up relationships. This agreement was the product of in-depth discussions among market participants and contains generally accepted standard provisions addressing most aspects of the give-up relationship between a prime broker and an executing dealer. With respect to a few provisions, the Master FX Give-Up Agreement permits the parties to choose which of several clearly defined alternatives they want to apply in their agreement by selecting them in a schedule that is part of the agreement.

The Master FX Give-Up Agreement is a bilateral master agreement to be entered into by the prime broker and an executing dealer. The bilateral nature of the agreement reflects the need for efficiency and standardization and takes into account the fact that a prime broker may designate a number of clients to engage in foreign exchange give-up transactions on its behalf pursuant to a single master agreement.

Compensation Agreement

The Master FX Give-Up Agreement may be accompanied by a Compensation Agreement, to be executed by the prime broker's client and an executing dealer. The Compensation Agreement provides for the compensation of losses in the event that the give up of a transaction is not accepted by the prime broker.

The Foreign Exchange Committee recommends that executing dealers evaluate the likelihood that prime brokers will reject transactions when they enter into give-up agreements and assess the possibility that they will incur trading losses as a result. In so doing, executing dealers should evaluate the controls that they have in place to reduce the chance of incurring such losses. Such controls can include internal procedures designed to reduce the possibility of executing trades that may be rejected, use of the Compensation Agreement, or some combination of methods. While the risk of a prime broker rejecting a trade has generally been considered by market participants to be minimal, the Committee suggests that executing dealers consider the execution of a Compensation Agreement as a means of addressing that risk. The Committee adds that parties asked to sign a Compensation Agreement should recognize and understand the reasons an executing dealer would ask them to do so.

Best Practice Recommendations

Following is a collection of practices that may mitigate some of the credit, operational, and reputational risks associated with the prime brokerage service. These best practices, consistent with the recommendations and guiding principles set forth in the Counterparty Risk Management Group II report, provide greater clarity regarding the relationship among the prime broker, executing dealer, and client. The implementation of these practices may also help to reduce the level of risk in the foreign exchange market more generally. The recommendations below represent practices already implemented in varying degrees by Foreign Exchange Committee member institutions. The Committee encourages all market participants to strive to adopt these practices.

Of course, each firm should take into account its own unique characteristics, such as transaction volume and role in the market, as it considers the adoption of the recommendations. These best practices are intended as goals rather than binding rules.

The recommendations outlined below should be read in conjunction with the Committee's three primary documents—*Guidelines for Foreign Exchange Trading Activities*, *Management of Operational Risk in Foreign Exchange*, and *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer Participants*.

Credit Risks

Like a standard counterparty relationship, prime brokerage arrangements require active credit-limit monitoring against the limits set forth in the governing legal agreements; however, the prime brokerage model involves an additional layer of complexity given the triparty framework. An executing dealer should execute and a prime broker accept a transaction only if credit lines have been approved and are available for a client.

Best Practice no. 1:

No trade should be finalized without confirming sufficient availability under the give-up line. Give-up line usage information should be updated as soon as a deal is accepted by the prime broker, and the updated information should be accessible to prime brokerage service personnel, risk managers, and executing dealers.

Best Practice no. 2:

Prime brokers should establish real-time credit systems to actively monitor open positions against limits and pending give-up trades. A prime broker's sales area should be able to quickly assess its credit exposure to a client and its systems should automatically update a client's credit status when a trade is accepted by the prime broker.

Best Practice no. 3:

Prime brokers should develop policies and procedures to address credit-limit breaches and should document the approval of limit exceptions. A prime broker should produce reports of credit line excesses and exceptions on a regular basis for review. Exception reports should identify the client and executing dealer involved in the transactions. Persistent credit limit exceptions should prompt a review and possible adjustment of a client's credit limit.

Best Practice no. 4:

Executing dealers should also develop appropriate tools to monitor open positions and limits against pending trades. Use of such tools with straight-through processing features for the acceptance and processing of trades should be encouraged, given the increasing volumes observed in the foreign exchange markets. Real-time give-up line management further enhances the value realized in monitoring positions and limits.

Operational Risks

The prime brokerage transaction process flow is divided into four steps: 1) notification, 2) matching and acceptance or rejection, 3) confirmation, and 4) allocation. The executing dealer and the client are required to notify the prime broker once a trade has been executed—informing the prime broker of the material terms of a transaction. The material terms of a foreign exchange transaction typically include: transaction date, settlement date, amounts of each currency to be delivered by each party, and buying and selling parties. The material terms of an option transaction typically include: amounts of each currency, type of currency option transaction (for example, American or European), strike price, premium, expiration date, and any other terms considered material in the market.

Once the prime broker receives notification of a trade, it has certain rights and obligations with respect to the acceptance or rejection of the trade, and must determine if a transaction meets the applicable conditions of the prime brokerage and give-up agreements. The prime broker may reject a trade given up for any of the following reasons:

1) the trade is not a permitted transaction type as specified in the give-up agreement with the executing dealer,

2) the trade is not within the specified tenor limits,

3) the trade is not within the specified credit limits, or

4) the trade details provided by the executing dealer and the client do not match.

The standards and procedures governing the notification of trade details and the acceptance or rejection of trades are typically the subject of bilateral agreements between the prime broker and the executing dealer and the prime broker and the client. In practice, notifications from the executing dealer to the prime broker are made in a timely manner. However, notifications from the client may not be as consistent and thus can affect the timing of trade acceptance or rejection by the prime broker; late executing dealer notices can have the same effect. The adoption of several best practices can assist in facilitating efficient notification and acceptance processes.

Once a prime broker has matched and accepted a trade, separate confirmations must be exchanged between 1) the prime broker and the executing dealer and 2) the prime broker and the client, as legal evidence of the terms of the transaction. Confirmations are important for the orderly functioning of the marketplace since they minimize market risk and the losses caused by settlement errors. A transaction confirmation should include all relevant data that will allow the two counterparties to accurately agree to the terms of a transaction. In addition, all relevant settlement instructions for each transaction should be identified in each confirmation.

An investment manager or other party acting as an agent may undertake "block" or "bundled" trades on behalf of multiple counterparties. Such trades, once accepted by the prime broker, are subsequently split into smaller amounts and allocated to specific underlying funds or counterparties.

Best Practice no. 5:

The give-up agreement between the prime broker and executing dealer and the prime brokerage agreement between the prime broker and client should clearly specify the permitted transaction types, tenors, and credit limits and the procedure by which such limits are to be calculated. The Master FX Give-Up Agreement published by the Foreign Exchange Committee can be used by the prime broker and executing dealer for this purpose.

Best Practice no. 6:

Executing dealers and clients should have internal controls designed to monitor the permitted transaction types, tenors, and credit limits so that they execute only those trades that were authorized by the prime broker. Because they are legally obligated to accept trades within the terms specified in the relevant agreements, prime brokers should have similar controls to determine whether they are obligated to accept a particular trade when it is given up to them.

Best Practice no. 7:

Executing dealers, clients, and prime brokers should have the proper processes in place to send and receive notices of give ups and should provide the names and contact details of the appropriate personnel to the other parties in a give-up relationship.

Best Practice no. 8:

The executing dealer and client should each notify the prime broker of the details of any trades that they execute for give up to the prime broker as soon as practicable or otherwise within the time frame specified with the relevant legal agreement.

Best Practice no. 9:

Whenever feasible, executing dealers, clients, and prime brokers should use electronic-trade message systems linked to the prime broker's electronic matching system. In this way, prime brokers can automate the matching and validation of executing dealer and client trade notifications, providing timely notice of matched and unmatched trades to all parties through directed communication or available trade blotters.

Best Practice no. 10:

A prime broker should notify the executing dealer and client as soon as practicable if it rejects a trade involving transactions or amounts that were not authorized according to the applicable agreements. Timely notification minimizes an executing dealer's potential loss from the liquidation of a nonaccepted trade. Nonacceptance of an executed trade by the prime broker may place the executing dealer at risk of loss, especially where there is no agreement in place between the executing dealer and the client on the disposition of nonaccepted trades. Accordingly, compensation agreements between executing dealers and clients may be considered.

Best Practice no. 11:

A prime broker should confirm trades if, and only if, the type of trade is permitted under the give-up agreement, the trade complies with the applicable trade type and tenor

and is within the applicable limits, and the prime broker has received matching trade notifications from the executing dealer and client. Confirming trades prior to the receipt of matched notices may raise legal and market risks that should be avoided. For structured transactions, which contain unique features such as special pricing or settlement conventions that affect the valuation of the trade, matching should include all relevant terms. Mismatched trade terms may expose the prime broker to basis risk.

Best Practice no. 12:

All parties should make every effort to exchange confirmations at the earliest possible opportunity. In the wholesale foreign exchange market, parties should make every effort to send confirmations or positively affirm trades within two hours after execution and in no event later than the end of the day. Standard escalation procedures should be in place to pursue and resolve all discrepancies in a timely manner.

Post-Trade Events

Structured transactions involve post-trade events that could give rise to “market” risk or “basis” risk for the prime broker. Basis risk can occur if the parties interpret post-trade events differently. For example, with respect to an exotic option transaction, a situation may arise in which the executing dealer informs the prime broker that the barrier on its trade has been broken and the trade knocked out even as the client contends that its trade with the prime broker remains valid.

A prime broker must determine whether it will assume the basis risk in these situations or “pass through” the risk by requiring the client to accept the decision of the executing dealer. In addition, with respect to options, parties must designate the party responsible for determining the occurrence of a post-trade event.

Best Practice no. 13:

The give-up agreement between the prime broker and executing dealer and the prime brokerage agreement between the prime broker and client should specify the party responsible for the determination and notification of post-trade events.

Best Practice no. 14:

The prime brokerage agreement between the prime broker and client should specify whether the prime broker will assume or pass through the basis risk associated with varying interpretations of post-trade events by the parties.

Best Practice no. 15:

The relevant staffs of the executing dealer and prime broker should be trained to identify potential post-trade issues. All such issues should be raised immediately for timely resolution.

Dispute Resolution

From time to time, a dispute may arise regarding the basic terms of a trade, a post-trade event, or some other aspect of the prime-broker relationship. As a general matter, any dispute will be governed by the terms of any agreements between the parties. However, as a

practical matter, the interaction among the executing dealer, prime broker, and client may give rise to considerations beyond the usual issues raised in direct dealings.

Best Practice no. 16:
The prime broker is obligated to take on a trade only when the material terms of the trade have been agreed upon by the executing dealer and the client. If such details do not match, the prime broker should reject the trade in the manner provided in the appropriate agreements. Assuming this is done, disputes with respect to trade details must be resolved between the executing dealer and the client.

Best Practice no. 17:
If a prime broker rejects a trade because the material terms of the trade submitted by the executing dealer and client do not match, the prime broker should notify the client and, if specified in the applicable give-up agreement, the executing dealer as soon as practicable so that the client can promptly contact the executing dealer and attempt to resolve the discrepancy. Executing dealers, clients, and prime brokers should have authorized personnel available throughout the business day that are able to work to resolve any discrepancies in a timely manner.

Confidentiality

For many clients, confidentiality is a core component of the foreign exchange prime brokerage relationship. Generally, clients expect that a prime broker's front-office sales or trading staff will not have access to information regarding the trades executed or overall positions created through the give-up relationship. The possibility that the sales or trading staff could use the information to the detriment of the client exposes the prime broker to reputational and legal risk.

Best Practice no. 18:
Except in cases of default, clients have the right to expect that their identity, orders, and strategies will be handled in a manner that protects their interests and confidentiality. At the outset of the relationship, the prime broker should determine the client's confidentiality requirements. In the absence of a formal understanding, the prime broker should assume that the client requires confidentiality of its give-up trading activity.

Best Practice no. 19:
Prime brokers should establish and control access to their systems to ensure that only authorized staff are able to access or alter information regarding client give-up trades and positions.

Best Practice no. 20:
Prime-broker client service and operations staff should understand the confidentiality requirements of each client. In addition, front-office staff should be similarly trained so that there is a common understanding between the front- and back-office staffs regarding what is and is not appropriate information exchange.

Reputational Risks

As with any other relationship, a prime broker could face reputational risk with respect to its relationship with clients. A prime broker accepts trades executed by its client on an arm's-length contractual basis and does not assume fiduciary obligations with respect to that client. Nevertheless, the prime broker could incur harm to its reputation if that client or one of its employees were, for example, to engage in fraud or other improper activities through its foreign exchange trading. Improper activities include practices that are designed to disrupt trading or misrepresent current market prices. Even if a situation does not result in litigation, a firm's reputation may suffer as a result of such client activities through adverse publicity or other factors.

Best Practice no. 21:

To mitigate reputational risk, prime brokers should perform due diligence, including an anti-money-laundering review, with respect to their clients.

Best Practice no. 22:

A prime broker should be prepared to investigate a complaint by an executing dealer that a client may have engaged in illegal or unethical trading practices. The prime broker should evaluate the reputational risk posed to it and assess whether it should modify its role or cease acting as prime broker for the client. While this best practice does not impose a legal obligation on the prime broker to the executing dealer or its client, the prime broker should ascertain whether the client's trading activity gives rise to any legal or regulatory obligation on the part of the prime broker.