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Counterparty Risk Following the Collapse of MF Global *FINalternatives, Nov 2011*

The alternative investment world was shocked again recently by the relatively sudden collapse of MF Global, Jon Corzine's broker-dealer and clearing firm, which was brought down by bad bets in Europe. Even more damaging has been the revelation by the Commodity Futures Trading Commission that around $600 million is flat-out missing from segregated accounts at MF Global, which represents approximately 11% of the total segregated account balances at the firm. The fact that this failure could in part be the result of outright fraud, and not simply poor management, adds a troubling layer to an ever-escalating problem.

While MF Global has been the most visible victim, it is certainly not alone. Morgan Stanley had to defend itself in September from rumors of a substantial exposure to European debt, as did Jeffries at the beginning of November. While both firms have found solid footing and, thus far, successfully deflected these concerns, there is no doubt that the rumors have impacted their prime brokerage businesses.

While hedge funds have been relatively unscathed by the downfall of MF Global and the direct impact to the industry was minor, the spotlight has once again returned to counterparty risk as investment managers re-evaluate their primes and custodians in search of any threats to their operations. Indeed, all external service providers have been coming under a watchful eye as risk management becomes not only the concern of investment managers, but also the investors they service.

During operational due diligence reviews, an increasingly astute investor base is asking tough questions concerning counterparty risk, probing to find out precisely how investment managers are managing this threat. To be sure, the sting felt by the collapse of Lehman Brothers in 2008 remains (not to mention the subsequent use of side pockets) and investors, wary of illiquidity, are looking to avoid the repeat of such an event.

In response to these new counterparty concerns, managers have been taking additional steps to manage risk. There has been a renewed focus on a multi-prime model for funds, which seeks to spread the risk of a single counterparty. While this is certainly not a new concept, what is different today is the way in which funds are approaching this method. The middle and back office operations of a fund become much more complex under a multi-prime model, so many investment managers are outsourcing these tasks to external parties, often fund administrators, as a way to decrease costs, increase independence, and improve the reporting and reconciliation process.

Another more extensively utilized risk management tool has been the amendment of the terms and language in prime brokerage agreements. A classic example has been the increased usage of "amber" terms, which seek to trigger certain events if the prime broker's CDS spread exceeds a particular

threshold. Assuming the CDS spread breaks the agreed-upon figure, the fund's assets are moved to a separate account. This allows the fund to have a contractual solution in the event that the credit worthiness of their prime broker deteriorates beyond an acceptable level.

In addition, as an extension of the risk management process, investment managers are seeking to better understand the consolidated underlying exposures that their prime brokers and custodians have as organizations. Previously, it was rare that an investment manager would study at length these exposures or perform any sort of stress test analysis, but that has certainly changed following the collapse of MF Global. As mentioned, the firm was, at least in part, brought down by large, one-sided bets in Europe; these are the sort of business-altering exposures which investment managers are now considering during the due diligence examination of their counterparties.

Finally, investment managers are taking actively hedged positions to protect against counterparty risk, most notably through credit default swaps. As mentioned above, there is an increasing use of language in prime brokerage agreements relating to the credit worthiness of a counterparty, however some managers are going a step further and actually purchasing protection through CDS contracts. While not all managers feel this is a particularly necessary step, especially given the costs associated with it, others see it as simply a cost of doing business. This would seem to be especially necessary for managers that have a single prime broker relationship; in theory, it is operationally cheaper to simply purchase CDS protection rather than maintain multiple prime brokers.

Investment managers can no longer dodge the need to formally and adequately manage counterparty risk. While certainly no manager can make their operational decisions based on rumor or predict far-reaching, global events, it has become necessary to make contingency plans. Though some counterparty risk management tools are presented above, they are just a few of the options that are at the disposal of an investment manager to mitigate risk and satisfy the ever-expanding needs of their investor base.

Just a few years ago, the idea of counterparty risk was given little thought; the downfall of a prime broker was seen as an outlier. Given the number of Wall Street icons that have notably gone down in flames over the last three years, these external shocks are not as remote as once thought. It is critical that an investment manager performs the necessary due diligence, not simply at the outset of initiating a relationship, but as part of their ongoing operations.

It is additionally important to note, as mentioned briefly at the outset, that this due diligence must be applied to each and every counterparty and external service provider with whom an investment manager is engaged. To be sure, a prime brokerage relationship requires a solid footing, however a fund's auditors, fund administrator, legal counsel, and a host of other parties must be equally strong and stable. There are many examples from recent history (Arthur Andersen immediately comes to mind) where a failed third party had a major impact on investment managers and investors. To sidestep such an issue, or at the very least to avoid as best as one can, the same scrutiny applied to prime brokerage due diligence should be applied to all external parties related to an investment manager.