

Big spending clients keep providers on their toes

Overview

Much has changed since the credit crisis, writes **Sam Jones**, but hedge funds remain demanding – and lucrative – clients

At the height of the credit boom, prime brokerage was the golden child of investment banking: a high-stakes, elite service for the world's savviest market players – hedge funds – that had the potential to earn banks billions.

Three years on from the collapse of Lehman Brothers – the rapidity of whose demise was directly related to the size of its prime brokerage – the industry, at least superficially, is a greatly altered place.

Two of the biggest prime brokers have disappeared and another two of the leading houses have fallen down the ranks.

“Prime brokerage has changed quite dramatically since 2008,” says Jack Inglis, a managing director in prime services at Barclays – a bank that has been catapulted into providing services to hedge funds thanks to its acquisition of Lehman Brothers.

Be that as it may, the way to succeed as a prime brokerage is proving to be little different to what it was before the crisis. Hedge funds remain demanding and exacting clients.

“It’s a business where experience and pedigree still counts for a lot,” says the head of one large hedge fund based in London. Doing prime brokerage “right”, he notes, is something very few providers seem to get.

All the same, banks of various shades remain keen. And little wonder: carving out a strong position as a provider of leverage and trading services to the resurgent, \$2tn hedge fund industry is still seen as a route to huge flows and revenue with a group of clients that is not afraid to spend big when it wants to.

Hedge funds are no longer regarded as high-risk, frontier traders, gambling with the wealth of billionaires. Instead they are increasingly seen as an integral part of the modern asset management business – one which is set to grow significantly as pension funds, battered by equity market volatility, look to juice-up their returns without betting the farm.

Hedge funds themselves have meanwhile, if anything, become even more strict in their dealings with brokers. With good reason. Even their own end investors now regard a thorough read of prime



Dancing to the customers' tune: prime brokers need to ensure they do not put a foot wrong

Dreamstime

brokerage terms and agreements as an early-stage necessity in any due diligence process.

All of which adds up to a tough and viciously competitive field.

“The days when you could be there at a fund’s launch and maintain business with that firm for 10 years are over,” says the head of one prime brokerage.

Part of the reason for the tough environment is the relatively small pool of clients prime brokers compete for: not more than 400 hedge funds manage assets

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After year of pain, hope is for smoother performance

Hedge fund trends

Capital inflows rise but volatility is still a worry, explains Dan McCrum

Last year was dominated by what investors called the “pain trade”. From the summer onwards, as fears for the future for Europe, the creditworthiness of the US and the strength of the recovery ebbed and flowed, markets came to be dominated by the simplest of investor sentiments.

Fundamentals counted for little as stock, bond and commodity markets were battered by the forces of “risk on” and “risk off”. What made things particularly hard, however, was not the severity of losses for hedge funds, but their consistency.

As the market bounced backwards and forwards it was incredibly hard to time when to buy and sell, or even when to put on and take off hedges.

The result was wide-

spread losses, with the average hedge fund down more than 5 per cent, according to Hedge Fund Research. Long/short equity hedge funds, still by far the largest part of the industry, collectively lost 8.4 per cent in a year that the S&P 500 index returned 2 per cent.

For prime broking it meant a tough year. “Whenever the market is down, fund performance is down, leverage is down and investor interest is down, the prime brokerage business is going to suffer. You have hedge fund clients in cash – investors who are afraid to invest in the market because they don’t see managers with conviction – so it’s a vicious circle,” says Stu Hendel, global head of prime brokerage at Bank of America Merrill Lynch.

By the fourth quarter, investors in hedge funds had also begun to pull out cash as poor performance prompted net redemptions.

But overall, the industry had the best year for inflows since the financial crisis. Hedge funds took in a net \$70bn of new capital, according to HFR, up from

\$55bn in 2010, and a reversal of the \$286bn that flowed out from funds in the preceding two years.

That trend is expected to continue, with three-quarters of respondents to Deutsche Bank’s Alternative Investment Survey predicting positive flows this year.

The bank says that with performance and inflows, investors predict industry assets will rise from \$2tn in January to around \$2.25tn by the end of 2012.

Prime brokers are putting more resources into the additional services they provide

However, another survey, released by Commonfund this month, found that most institutional investors expect simply to maintain their hedge fund exposure this year, with emerging market equities and natural resources by far the most popular asset classes for new capital.

For individual strategies, macro funds took the greatest share of flows last year, attracting \$28bn, while long/short equity saw \$8.6bn walk out of the door in the fourth quarter, wiping out most of the \$10.7bn that had arrived in the previous nine months.

It was a good year for hedge fund launches, however, with Hedge Fund Research tracking 1,113 new funds, approaching the record set in 2007 when 1,197 funds set up.

“While some have suggested that increased regulation may deter new fund launches, many hedge funds are launching not only as a result of increasing investor risk tolerance but also as a result of these regulatory changes to trading activities and risk oversight at financial institutions,” says Ken Heinz, president of HFR.

The trend is likely to continue, particularly as poor performance has left many funds below the point where they can charge performance fees. This encourages portfolio managers to assess their prospects for



Ken Heinz: fund launches were close to record levels in 2011

getting paid and to try setting up on their own.

So while the priorities for hedge funds picking their prime brokers remain the quality of the operations, and the price and availability of capital, prime brokers are putting more resources into the additional services they provide.

“Price is always very important, but it has slid down the totem pole a bit in the last six months and has been overtaken a little bit by capital introduction. Cap intro is definitely a differentiator,” says Murray Roos, Deutsche Bank’s head of prime finance for

Europe, the Middle East and Africa.

With hedge fund investors now insisting funds use multiple prime brokers, the banks are focusing on the value of building loyalty through early support of emerging managers.

“Prime brokerage is not a sprint; it’s a long-term relationship business, so investing in start-ups is important,” says Mr Hendel.

“Covering the seeding community is a much more important part of the cap intro landscape than it used to be; in many instances this is now the first call for start-up managers.”

Big-spending clients keep banks on their toes

Continued from Page 1

significant enough to make the provision of full-service brokerage for them a profitable venture.

Every prime brokerage, nevertheless, has some metric by which it claims to be on the ascendant, and in truth, the industry is too complex for banks to be easily ranked in terms of who dominates the space.

Indeed, while the lustre of Goldman Sachs and Morgan Stanley – the traditional market leaders – is still relatively undimmed, their prominence and profitability is increasingly challenged by others.

Banks such as Credit Suisse, Deutsche Bank, Citi and JPMorgan did well out of 2008 by picking up business shed from Bear Stearns and Lehman as well as clients from brokerages that shrunk such as UBS or Merrill Lynch.

A secular shift of the hedge fund industry away from its traditional US, and equity-market focus is also throwing up challenges to old, established players and opportunities for new entrants to capitalise on.

Prime brokerage now extends well beyond its traditional bounds of equity lending and leverage.

Barclays, for example, may not be regarded as a stalwart of top prime brokerage circles, but it has built on the fixed income and quantitative hedge fund strategy services it acquired through Lehman Brothers and now ranks strongly in those specific fields.

“It’s important to actually consider what the term prime brokerage means these days because we think the model has changed to encompass a broader, multi-asset class approach,” says Mr Inglis.

“If you look at the biggest hedge funds in the UK and the US, they are not users of traditional equity-focused prime brokerage services.”

Non-traditional prime brokerage areas such as ‘delta one’ derivatives trading, exchange traded funds, futures and repo are increasingly central to providing a fully-fledged hedge fund service, and many new players boast that they provide them all under one roof.

All of which, of course, does not mean that the newer prime brokerage players have settled easily into the post-2008 world.

Hedge funds that diversified service providers in 2008, are now beginning to make decisions about whether they stick with them.

“It’s very difficult to compare [different brokerages] from the outside in,” says Marc Gilly, Goldman Sachs’ global head of prime brokerage, adding that “it’s an experiential thing”.

Hedge funds may have sampled other prime brokerages after 2008, but it is perhaps only in the past year that they may have decided they preferred what they used before, after all.

For example, Morgan Stanley, after losing business following the collapse of Lehman Brothers, has seen a spurt in growth in the past two years. “MS came back strong in 2010,” says the head of a rival prime brokerage. “You can never count them out.”

“Financing is a relationship business,” says Barry Busano, Deutsche Bank’s head of equities for the

Americas. And relationships take time both to build and to cement.

“It takes quarters not months to negotiate the terms and conditions of financing,” says Mr Busano. Deutsche, a beneficiary of the hedge fund retrenchment in 2008, has maintained a steady share of the market.

Hand in hand with building such “relationships” goes the provision of a

‘What [hedge funds] are really asking for is access to the entire organisation’

whole array of non-core “value added” services, such as consultancy, help setting up new offices, or help raising funds.

“When I sit down with prospective clients, nobody really asks about prime brokerage. They want to know about how they can access our balance sheet and how I can help them in the distribution of their funds,” says

Nick Roe, global head of prime finance at Citigroup.

“They take the traditional services as universal – for granted. The phrase that gets used a lot now is that they are commoditised. What they are really asking for is access to the entire organisation.”

Credit Suisse, which enjoyed a surge of new mandates after 2008, has been particularly good at capitalising on the demand for such extras. The bank was named on a series of big-name new hedge fund launches in 2009 and 2010 thanks to the strength of the additional services it offered clients beyond its core execution abilities.

So-called “cap intro” services are again in vogue as hedge funds – even big established players – struggle with the demands of attracting more selective investors, such as pension funds or sovereign wealth funds.

The big issue for prime brokerages – and the banks of which they are a part – is regulation, however.

“Basel and other regulation is forcing recognition of the true cost of financ-

The mood music is about to change

Regulation

Sam Jones looks at the probable impact on the sector of extensive reforms – from the broad to the boring

Prime brokerage has been in the sights of regulators ever since the demise of Lehman Brothers.

As the bank collapsed, its bloated prime brokerage, which depended heavily on financing from short-term and even overnight markets, became a weight around its neck. Hedge fund clients pulled out billions and the bank could no longer stand up.

And as contagion spread throughout the world’s markets, and the safety of other banks, including the likes of Morgan Stanley and Goldman Sachs, began to be questioned, regulators noted that prime brokerages were key pressure points in the interconnected financial system.

In times of both panic and stability prime brokers act as “transmission” mechanisms by which banks’ lending policies can have a direct and immediate impact on the liquidity and animal spirits of key global markets.

Regulators in the past three years have rightly judged that by applying rules that would affect

prime brokerages, they might better manage risk in markets themselves, by moderating the amount of leverage the key risk takers – hedge funds – could take.

The impact of far-reaching reforms worldwide – from the Dodd-Frank Act in the US through to Basel III – has yet, however, to make itself seriously felt in prime brokerage, but every banker is aware of what lies on the horizon.

In short, new liquidity regimes – by far and away the broadest regulatory changes with which prime brokers must deal – mean banks must strictly match up their financing.

Lending to hedge funds on a monthly basis and financing that by borrowing on an overnight basis, will, under the new Basel rules, be prohibitively expensive in terms of the amount of capital that must be set aside on a bank’s balance sheet.

“It’s true that there are going to be changes and it’s true that some assets are going to become more expensive across the market as a whole,” says Barry Busano, head of equities for the Americas at Deutsche Bank.

New rules will also mean that esoteric assets – such as mortgage-backed securities, or even convertible bonds – could become harder to get leverage on or may become pricey to trade.

“Things that qualify as tier III [hard to value] assets or that can’t be re-



Setting the rules: the Basel-based Bank for International Settlements plays a key role in banking regulation

Getty

lent in the secured market are likely to become more expensive to finance across the market,” says Mr Busano.

Others are less circumspect. “The new rules could well have the effect of killing some hedge fund trading strategies off altogether,” says one prime brokerage head.

According to Nick Roe, global head of prime finance at Citigroup, “some of the pricing that exists right now is unrealistic”.

Not that most are minded to regard such rules necessarily as a bad thing. Most brokerages have spent the past two years adapting their funding models to meet the new rules, which have been well flagged by local market authorities.

For some, the new rules require funding models that are not far away from what they were doing anyway.

“Basel and other regulation is forcing recognition of the true cost of financing,” says Marc Gilly, global head of prime brokerage

at Goldman Sachs. “This is something we are welcoming and ready for.”

The impact of new liquidity and financing requirements is also, as yet, hypothetical: for now the demand for leverage, and appetite to trade high-risk or difficult-to-value assets simply does not exist

‘The new rules could well have the effect of killing some hedge fund trading strategies’

among hedge funds. According to JPMorgan’s latest survey of its clients’ positions, the average leverage employed at the end of January was just 1.8 times – a number that has, for the past two years, broadly remained the same.

The markets in which banks finance their operations – in spite of the volatility elsewhere – have

also been relatively stable for the past 12 months. “Financing markets really were much calmer than in previous years,” says Mr Gilly.

All banks in the prime brokerage business have nevertheless begun very carefully to assess exactly what lines of business they can compete effectively in, however.

“We look on a client-by-client basis what our risk weighted assets are and what the return on those is,” says Jack Inglis, managing director at Barclays prime services. “There is no one price fits all, however.”

Of more immediate concern to many brokerages are the still-to-be-finalised details of Europe’s controversial Alternative Investment Fund Manager directive, which after much wrangling passed into law in 2010. The directive must be written into the laws of Europe’s individual countries by 2013.

While most of what the directive stipulates has

been accepted by hedge fund industry participants, key rules on custodianship – and the liability sub-custodians must bear for the assets they look after – could yet result in significant costs to brokerages.

One prime broker estimated custody rules in Europe could result in costs passed on to clients that shaved as much as 1 percentage point off annual performance.

The worry from most is that it will be a raft of other such low-profile but high-impact rules from national and international organisations in the coming years that will really bite.

Amid a highly-charged political landscape – with US and French elections imminent and increasing hostility in Europe to banks and finance – the environment is particularly hard.

New regulations – from the broad to the boring – will set the tenor of prime brokerage, and the mood music to the hedge fund industry, for years to come.

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FTfm – Prime broking

Finding a seat at top table is big challenge

The providers

New entrants focus on niches in a market where big names hold sway, writes Sam Jones

It has taken a global financial crisis – the worst in nearly a century – to shake up the prime brokerage industry, and even then, only by degree.

For all the dynamism of the hedge fund world it serves, prime brokerage has for the most part proved itself a staid business, in terms of who ranks where. “It is trench warfare to change your market share by maybe half a percentage point,” says the head of one major prime brokerage business.

Others concur. “You have to earn it – that’s for sure,” says Teresa Heitsenrether, head of prime brokerage for the EMEA region at JPMorgan.

The top table remains dominated by a handful of players. Depending on who you speak to this table has room for four, five or, at a stretch, six. But certainly no more.

And while there is certainly a group of up-and-coming entrants into the market, for the most part, their focus for growth is in niche areas.

Before the collapse of Lehman Brothers, two banks held sway: Goldman Sachs and Morgan Stanley were regarded as the



Teresa Heitsenrether: share has to be earned

undoubted reigning duo at the top end of the market, followed, not necessarily in order, by Deutsche Bank, Bear Stearns and Lehman Brothers.

Now, while few doubt that Goldman and Morgan Stanley remain towards the top, their undisputed dominance has vanished. Other players vying for precedence include Deutsche Bank, JPMorgan – which inherited Bear’s prime brokerage business – and Credit Suisse.

Depending on exactly where you are around the globe, or what your line of trading is, you may, as a hedge fund, have a different idea of who rules the roost. The competition is tight.

Every bank, every prime broking executive, can provide different metrics as to why they trump rivals.

Goldman Sachs has seen its position relatively unchanged post crisis. Certainly, though, it faces a wealth of competition, its reputation and brand is still top of the pack, according to most hedge fund managers and even other rival prime brokerage executives.

“There is definitely a lustre about them,” says the head of one rival prime, on condition of anonymity. “When you get a startup choosing their brokers, they always tend to want to have Goldman as one of them.”

All of which is not to say others are weaker service providers, or smaller service providers, in actual terms.

Morgan Stanley remains a house praised for its “top quality” service and strong pedigree – having been at the top of the pile alongside Goldman for many years – but it has suffered relatively more by being perceived as a financially weaker institution, even if only incrementally.

Such concerns had begun to fade into the background until the last quarter of 2011, when the Greek crisis and the bankruptcy of MF Global caused a sudden rise in concerns over counterparty risk.

“We have really strengthened our business after a dip in 2008 and 2009,” says Alex Ehrlich, global head of



Revolving doors: JPMorgan inherited Bear Stearns’ prime brokerage business

prime brokerage for Morgan Stanley, nevertheless says. “Net net, 2011 was a strong year,” he adds, though the fourth quarter was certainly “challenging”.

Credit Suisse and Deutsche Bank meanwhile both contend for a huge amount of mandates in the post-2008 environment. Both enjoy the luxury of big, stable balance sheets – making them well-placed to provide more flexible financing terms, should they so desire, and to give clients more comfort in their own security.

Both also provide clients with serious, high-spec services as well.

Credit Suisse has picked up a string of high-profile mandates and has worked with almost all the largest startups in Europe in recent months. Deutsche Bank has meanwhile blazed a trail in areas such as UCITS funds.

For JP Morgan, the newest entrant, the past three years have also seen growth – though less evenly distributed.

The bank’s main impediment until recently was its

almost sole – though undoubtedly strong – focus on the US market, a windfall gained in 2008 thanks to its acquisition of Bear Stearns.

JP Morgan is only now beginning to capitalise on its franchise. In 2011, the bank moved to launch a fully-fledged prime brokerage business in Europe – a

Most prime brokers see the industry consolidating rather than changing dramatically in the year ahead

move that will position it to compete on a more level playing field with other major players if it succeeds, but that has yet to begin bearing fruit.

And then there are the second tier firms – many of which still offer highly-competitive services to clients.

Citigroup’s prime brokerage, a relative newcomer

having only been established in 2006, has grown steadily through the crisis and is, by most accounts, within striking distance of the top five players.

“Through 2008 we did exceptionally well,” says Nick Roe, Citi’s global head of prime finance. “The crisis projected us into the revolving top three at that point but unfortunately when people subsequently were concerned about Citi’s and the markets’ credit risk in 2009 we lost ground.”

“We feel that within three years we can penetrate the top tier,” says Mr Roe.

Other large investment banks are pushing strong prime brokerage offerings in specific areas.

Barclays, for example, has concentrated on developing high-technology, ultra-fast trading capabilities for quantitative fund managers and fixed income traders. “In fixed income financing or repo we bid for top honours,” says Jack Inglis, managing director at Barclays prime services division.

Newedge, meanwhile – a joint venture between Société Générale and Credit Agricole – has focused on a specific hedge fund strategy, and is now one of the leading brokers for so-called commodity trading advisers thanks to its specialism in trading futures.

For all such apparent diversity, most prime brokers see the industry consolidating rather than changing radically in the year ahead, however.

There remains a tightly-knit, small universe of top funds – maybe 350 or so – that manage virtually all the industry’s assets.

Most investors and market participants believe big hedge fund firms will continue – regardless of market conditions – to dominate, and while that remains the case, the struggle to service those few key players will naturally be intense.

In prime brokerage, to paraphrase Henry Kissinger’s quip about student politics, the competition is so vicious precisely because the stakes are so small.

Prime broking – FTfm

Synthetic route has real appeal

Delta one

It is not the name of a secret fighter jet but a growing part of the prime brokerage service, writes Telis Demos

When correlations go to one; when securities are hard to borrow; and when banks are looking to do bespoke trades rather than commoditised executions, prime brokers are increasingly turning to a common solution: Delta one.

Delta one is so-named after the Greek symbol that indicates “change”, because it strives to create derivatives for clients that replicate the performance of an underlying instrument – a change of one-to-one. It is also known as “synthetic”, as opposed to “cash”, in which the client owns the underlying instruments directly.

To the extent that the average person ever considers “delta one” – when they know it as a

Delta one strives to create derivatives that replicate the performance of an underlying instrument

financial term, rather than assume it to be the name of a secret fighter jet – they probably associate it with rogue traders or high-flying prop trading that regulators are trying to rein in.

But it is an increasingly common prime brokerage service that most hedge funds and institutions demand. While it was born on proprietary desks and initially offered only to a few large accounts, the benchmark survey by Global Investor/ISF last year found that 44 per cent of hedge funds and institutions say synthetics make up at least a fifth of their prime broking.

The most popular trades are equity return swaps, according to a survey by Greenwich Associates last year of 185 hedge funds and institutions. More than a third of hedge funds surveyed by the consultancy said they used equity swaps with their prime broker. That is nearly double the rate of credit default swaps and three times the rate that use interest-rate swaps.

These derivatives aim to

offer exposures to baskets of shares, to isolate one company’s performance from others in its sector, or to provide exposure to securities that are otherwise hard to own due to scarcity or national barriers.

The banks make money when they can hedge these offerings more cheaply than their clients can trade them. There are risks to such trades, notably if the hedges are imperfect (or if rogue traders are faking the hedges). But they also offer high fees. JPMorgan Chase, for instance, recently revealed that the average equity swap trade generated margins more than twice that of interest-rate swap trades.

The Global Investor/ISF survey ranked Morgan Stanley, Credit Suisse and Deutsche Bank as the providers with the largest footprints in synthetic finance. Greenwich ranked Goldman Sachs, Morgan Stanley and Bank of America Merrill Lynch as the leaders in equity derivatives.

As demand grows, a wider range of prime brokers are emphasising the offering. HSBC, for example, is specialising in building global exposures, increasingly to frontier markets, which leverages their unique local presence in many markets.

“In certain markets, clients can’t get access on a cash basis, only on a derivative basis,” says Paul Hamill, global head of prime services at HSBC. “Delta one traders have that capability and often have deeper local market knowledge.”

For now, synthetic products still must compete with traditional listed derivatives, such as options or futures. Exchange traded funds that replicate indices or attempt to deliver specific exposures, such as leveraged or inverse returns, are also major competitors.

In some instances, the over-the-counter product is cheaper. “If we can create a synthetic exposure efficiently, it’s often much cheaper and more liquid,” says Keith Skeoch, chief executive of Standard Life Investments, who says the manager’s Global Absolute Return Strategies fund generally prefers derivative positions to cash ones.

However, listed products, with their more readily understood risks, are still the default tool. According to Greenwich, about three-quarters of equity options trading is done via listed products rather than via over-the-counter trades. At

present, only clients of banks with which they have documented agreements about collateral and credit risk can do swap trades with the bank.

That may be changing somewhat, as G20 countries have struck an agreement to push more derivatives trades into exchanges and central clearinghouses. The advent of electronic

platforms is also streamlining the creation and clearing of swaps as a way to dampen the risk of a broadening client base and the complications of new regulations.

Some banks, such as Barclays and Deutsche Bank, have created technology to carry out necessary pre-trade risk checks in fractions of a second.

“It really comes down to the institution and their internal technology step-up,” says Andrew Jamieson, head of EMEA equity finance at JPMorgan. “We have traditionally had more of a cash prime brokerage bias, but have invested heavily in technology and are definitely ramping up synthetically.”



Keith Skeoch: synthetic exposure can be cheaper



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Sharing it out: prime brokers arrange loans between agents that have vast warehouses of shares to loan, and clients such as active mutual funds and hedge funds

Dreamstime

Short-selling ban was 'a game-changer'

Securities lending

Telis Demos looks at the impact of regulation and the effect on the whole financial system

In an attempt to rein in what they saw as speculative attacks on their banks, several European countries including Spain, France and Italy late last year adopted bans on short selling of their banks.

It is hard to say whether the bans, which were lifted last month, contributed to the improvement in fortunes for European Union banks – credit would also have to be given to the European Central Banks' refunding operation, plus a general pick-up in risk appetite.

But one thing is certain: it made securities lending even more complicated. It came during what has already been a turbulent period for prime brokers' business of locating securities and lending them to "short sellers", who seek to

sell and then repurchase the borrowed stocks or bonds to repay the loan.

Annual volumes have been down from about \$4.5tn before the financial crisis to some \$2.5tn at the end of last year, according to BNY Mellon, thanks to low interest rates and little M&A volume.

Low rates make it difficult for lenders to earn a spread, and without mergers to arbitrage, short-selling activity withers.

In addition, the financial crisis has seen the model of securities lending changing. Rather than using cash as collateral, which could be invested in illiquid securities and create liquidity crunches during times of stress, other securities are now being used as a way to reduce that risk.

This new model, more widely used in Europe, has put further strain on what is already a shortage of quality collateral, with US Treasuries already trading at a premium, and additional collateral being used to trade swaps as part of a G20 initiative to have more derivatives trades centrally cleared.

The short-selling ban on

European banks only crimped demand further, bankers and traders say, and reduced the number of participants in the market.

It also added complexity to the job of prime brokers who arrange loans between agents, such as State Street and BNY Mellon, which have vast warehouses of shares to loan, and clients such as active mutual funds and hedge funds.

As the ban was not applied to all countries, it meant there needed to be procedures to prevent share borrowers in one country from selling them short in another.

"There is no uniform system whereby a short seller must identify themselves. If I am in France but sell it through my German broker, they can sell it as a normal order," says Georges Ugeux, chairman of Galileo Global Advisors, a boutique banking adviser. "That is why these bans are not effective."

In one respect, bankers say the transition was simple: there was no short selling, in cash or synthetic form, of the affected stocks. "As long as the processes are there, and the traders

are trained in compliance, I wouldn't say it's more complicated. It's totally manageable," says Loic Lebrun, EMEA head of equity finance & delta one at HSBC.

However, there were knock-on effects. There were fewer stocks committed to lending programmes by asset management firms, who feared running foul of the rules, as well as less demand for lending services by hedge funds.

This new model has put further strain on what is already a shortage of quality collateral

According to a survey by Greenwich Associates, hedge funds with at least \$1bn in assets reduced the average number of prime brokers they use, as a result of the declining need to borrow, from 3.7 to 3.3 last year.

The impact was also seen in the cost to trade bank shares. The fees to lend increased, to reflect the

scarcity of available supply. But broader market liquidity also was affected. Bid-ask spreads on shares in the Euro Stoxx bank index have been nearly double that of their US counterparts in the S&P 500 for the past three months, according to Deutsche Bank figures.

"It has been a game changer," says Andrew Jamieson, head of EMEA equity finance at JP Morgan Chase. "Whereas previously for mature, established markets, regulatory changes were done on a consultative basis, these happened overnight. That had an impact both with regards to retroactive changes to insure we were compliant, and for changing strategies from an investor standpoint from that moment hence," he says. Efforts are under way to streamline European rules on short-sale bans.

The European Securities and Markets Authority, the pan-European regulatory watchdog, is engaged in a consultation on technical standards for short selling across countries. It faces a deadline at the end of this month for the

creation of final rules, but does not appear to be close to having a system ready to go.

There is also the potential financial transactions tax under consideration in France and other countries, which could effectively "double tax" short selling by taxing the loan and the short-sale.

Securities lending has, further, been criticised as part of the "shadow banking" system by a report from the Bank of England and the UK's Financial Services Authority.

In the near term, Esma's new rules are likely to establish different rules for securities deemed liquid and those considered illiquid. For illiquid shares, the owner of the shares to be lent out will be required to place a hold on them.

Eventually, that will not be a barrier to trading, once banks agree on protocols for how to manage such a process.

But it will require additional investment in systems to track whether the holds are in place, and could slow securities lending, particularly in Europe, for the foreseeable future.

Making assets safe as houses, almost

Custody

Dan McCrum looks at the structures used by brokerage firms to guarantee safety

Money regularly disappears into thin air with every downward day for stock prices. Hedge funds, used to the whims of the market, accept their investments may be worth less tomorrow, or even worthless in particularly unpleasant circumstances.

However, as well as regular jolts from the market as it gyrated up and down last year, the failure of MF Global produced a high profile reminder of another risk: that their assets could vanish from plain sight. The bankruptcy of the broker dealer left a \$1.6bn hole where supposedly safe and segregated customer funds should have been.

While regulators and receivers have attempted to piece together what happened in the final, frantic days of MF Global, for hedge funds and their investors, it has put the focus firmly back on to the safe custody of assets and what structures the brokerage firms can use to guarantee it.

"It's shocking to me that this could be completely normal, that customer accounts are pledged to finance the firm so that when the default comes the customer doesn't have their assets," says one veteran investor. "There's something about that that is incredibly uncomfortable. It makes me want to pull all my money out of every single brokerage account I have."

But the shock of MF Global simply returned attention to an area that had already been high on hedge funds' radar after many were stuck with cash and assets locked up in Lehman Brothers when the investment bank filed for bankruptcy in September 2008. More than three years later some are still fighting creditors for what is left of the pieces.

As well as forcing managers to learn the importance of terms such as "asset rehypothecation", the failure of the bank also opened up a prime broking field that had been dominated by Goldman Sachs and Morgan Stanley, as hedge fund investors focused on the operational side of the business and demanded greater diversity and transparency in



Upon my oath: former MF Global chief executive Jon Corzine testifying on Capitol Hill. The company's collapse focused attention on custody issues

Getty

prime broking arrangements.

"Since Lehman, and with MF Global as well, there is a much greater level of understanding and therefore scrutiny from investors around 'where are my assets held?' before they write that cheque to a hedge fund," says Chris Barrow, HSBC's head of sales for prime services.

The bank decided to get into the prime brokerage business thanks to the new desire for safe asset custody. It began building out its business in Europe 18 months ago, and has since expanded to clients in Asia and the US.

"Lehman was the catalyst for us entering the business. We had a number of clients who asked us to look after their assets as part of our custody platform and we transformed that demand into a full prime brokerage offering," says Mr Barrow.

The established players have also started to use custody arrangements as a point of competition. Deutsche Bank says it was the first prime broker to offer clients tri-party arrangements with a custody provider, where any free cash or assets are automatically

swept into a safe account each day.

"This gives customers comfort that their unencumbered assets can sit in a tri-party arrangement, so that they always retain control of their assets," says Murray Roos, Deutsche Bank head of prime finance for Europe, the Middle East and Africa. "We take transparency extremely seriously, including, for instance, around how the rehypothecation of assets is controlled and handled."

'There is a much greater level of understanding and therefore scrutiny from investors'

However, the upstart HSBC trumpets its own advantages. "If you use third parties or special purpose vehicles to custody the fund's assets, then you are embedding another layer of risk into the equation, potentially from a legal perspective but certainly you are adding another layer of operational risk in there," says Mr Barrow.

Whether customers vote

with their feet remains to be seen, however, as managers of large funds say they are happy with existing prime broking relationships, utilising separate sub-custodians. Funds have also diversified their prime broking relationships to deal with multiple banks, and are quick to move balances on a sign of trouble.

Meanwhile, there is also the prospect of further regulation in Europe which could also affect the structure of hedge funds' custody relationships. The European Union's Alternative Investment Fund Management directive may set rigorous new standards.

For assets that can be held in custody, the AIFM directive sets a tough legal standard – custodians will have to replace any missing assets, unless they can prove the losses are due to something beyond their reasonable control. It may make it too expensive for prime brokers to consider acting as depositaries.

Brokers have also reacted to greater demands for transparency and up to date reporting, an extension of the trend towards institutionalisation as hedge funds have moved from managing the savings of rich individuals to the vast assets of pension funds that want to see robust systems and procedures in place.

So brokers compete in a minor arms race to offer the most up to date and seamless technology. BNP Paribas this year proudly demonstrated a new iPad app. With a swipe of a finger a hedge fund manager can now get updates on his custody balances, activity and positions on his iPad screen. But irrespective of the gadget, daily reporting of the custody and asset hypothecation details are becoming standard.

Looking to the future, Deutsche Bank is exploring ways for clients to remove entirely their counterparty risk from its core business, providing leverage to hedge funds as they invest.

Doing so presents a challenge, however, as it is at the heart of the relationship between the two. A bank provides the securities in return for margin payments, and the hedge fund lodges its assets with the brokerage as collateral. Deutsche has not yet found a mechanism for customers to post money as part of a tri-partite arrangement, and make this part of its regular operations.

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Smaller funds turn to 'mini-primes'

Consultancy

Ajay Makan finds a more selective approach by the bulge-bracket firms

As profit margins have shrunk post-2008, prime brokers have had to rein in the complimentary services they offer clients. But, facing more intense due diligence by crisis-scarred investors, hedge funds depend more than ever on the consultancy and capital introduction services once provided on tap.

The resulting dynamic of dwindling supply and rising demand has led to shifts in the prime brokerage consultancy model: the largest prime brokers have become more selective about who they provide services to, while fee-charging consultancies are emerging to cater to startups and smaller funds.

The largest hedge funds, which are likely to generate the most fees for prime brokers, can still command a full suite of comp-

For funds with assets of at least \$100m, a huge range of services is on offer

plementary consultancy services.

"We've kept a firm check on the number of funds that we work with, which means we can provide a tailored service to our clients even if there is more demand," says Megan Kenney, who works in capital introduction for Credit Suisse's prime brokerage.

For large hedge funds, generally those with assets of at least \$100m, a huge range of services is on offer. Barclays will send McKinsey-trained consultants to your offices for weeks at a time to support a new fund launch, other brokers will provide accountants and lawyers, and even find office space – tasks which, say, an investment bank proprietary trader may never have thought about before launching a fund.

Capital introduction, above all, has become crucial, even for established funds.

"Traditionally hedge funds were happy to raise capital exclusively from family offices and funds of funds, but those investors were the first to react

during the crisis," says Louis Molinari, head of capital solutions at Barclays. "Now hedge funds are intent upon diversifying their investor base, and increasingly looking at institutional investors who are perceived to be more likely to stay invested."

Once their consultants have brought clients' legal and accounting procedures up to a level expected by institutional investors, the capital introduction team sets up meetings with the pension funds, endowments and other clients, with which the bank interacts.

But when it comes to startup funds, bulge bracket brokers are less interested.

"The barriers to entry have been significantly raised in the past few years," says Anita Nemes, global head of capital introduction at Deutsche Bank. "Instead of launching their own funds, joining an existing platform may be a more attractive option."

One option for would-be new fund managers is to use a "mini-prime" broker. Firms such as Cantor Fitzgerald have established prime brokerages to pick up clients ignored by bigger primes.

"Before the crisis, smaller hedge funds faced a void, because they couldn't get the attention of bulge bracket brokers," says Michael DeJarnette, the president of ConvergeX Prime Services. "Now they face a void, because bulge brokers have so much risk control, they won't consider smaller clients."

As much as 40 per cent of ConvergeX's work is with start-up hedge funds, according to Mr DeJarnette. Consultancy is provided free of charge as a quid pro quo for transaction fees. But whereas a bulge broker may provide clients with direct access to a lawyer, or administrator, mini-prime consultants are likely to refer clients on to providers.

Mini-primes are particularly prevalent in the US, where larger primes are most likely to be turning away clients.

It can take several years before a start-up hedge fund generates sufficient fees for ConvergeX to turn a profit, according to Mr DeJarnette. Given the post-crisis emphasis on steady returns, and the probability that some new funds may fail and never become large fee payers, that is not a risk many are willing to take.

Instead boutique consultancies, which charge upfront fees for individual services, and stand outside investment banks, have

begun to emerge. They cater to startups, and also provide one-off consultancy projects to smaller funds.

KB Associates, an investment consultant, launched a hedge-fund specific service in London two years ago, and is now advising eight funds through the startup process.

"We saw a combination of prime brokers scaling back their offering, and due diligence by investors going through the roof," says Phillip Chapple, who set up the unit.

The focus is on ensuring funds comply with the expectations of institutional investors, and KB Associates also takes

mature funds through a "due diligence" process for a one-off fee.

In the US similar units have emerged. For example, FletcherBennett will, for a fee, raise capital for hedge funds, rather than simply provide "introductions", as well as provide more traditional consultancy offerings.

Bulge bracket brokers, unsurprisingly, argue paid-for consultancies cannot match them for industry knowledge and know-how. "We have unique access to best practices in the hedge fund industry, and the demands of investors," says Anurag Bhardwaj, who heads Barclays' prime brokerage consulting team.

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