

Prime broker power shift

J.P. Morgan expands lead, with Goldman Sachs a close second and Morgan Stanley a distant third. Credit Suisse rises



AR MAGAZINE'S THIRD ANNUAL prime brokerage survey measures prime brokers' market share among hedge funds that report to the AR database. The results here are compiled from an analysis of 2,547 mandates reported by hedge funds. This year 2,156 funds indicated which prime brokers they employ. Many hedge funds report using multiple prime brokers despite doing the bulk of their business with one or two favorites.

In the absence of detailed information on the breakdown of the business among prime brokers used by a fund, AR divides the assets of these shared mandates equally among the listed prime brokers. The survey thus offers a useful but only partial view of the industry, capturing the prime brokerage choices of those funds managing nearly 89% of the total assets covered by the AR database.

As part of AR's prime brokerage survey, "The shifting landscape" (p. 40) explores the new environment for prime brokers, in which hedge funds have cut back on the number of prime brokers they use, as they borrow and short less, making the business less profitable for the brokers.

"Get ready to pay up" (p. 42) explains how Basel III may force prime brokers to raise rates for their hedge fund clients. Finally, "The mini-prime bust" (p. 44) details the demise of the boom in smaller prime brokers that began occurring in 2009.

Hedge fund prime brokerage mandates for the Americas

PRIME BROKER	SOLE MANDATES	SPLIT MANDATES	TOTAL MANDATES	TOTAL ASSETS (\$M)
J.P. MORGAN	147	192	339	93317.72
GOLDMAN SACHS	194	110	381	92052.02
MORGAN STANLEY	108	143	251	67870.07
CREDIT SUISSE	33	87	120	44118.25
UBS	105	86	191	39856.58
DEUTSCHE BANK	26	115	141	30127.84
CITI	37	61	98	19856.34
NEWEDGE	50	60	110	16474.43
BNP PARIBAS	57	62	119	15258.79
BANK OF AMERICA MERRILL LYNCH	25	35	60	10713.52
BARCLAYS CAPITAL	3	47	50	7043.68
NORTHERN TRUST	3	7	10	4095.44
BRDESCO	14	0	14	3693.20
TD SECURITIES	17	7	24	3623.57
FIDELITY PRIME SERVICES	7	10	17	3247.79
PERSHING	8	10	18	2717.80
SCOTIA CAPITAL	11	7	18	2630.38
MF GLOBAL	41	23	64	2298.24
JEFFERIES & CO.	42	11	53	2267.51
CORMARK SECURITIES	1	8	9	2069.09
NONE	181	N/A	181	128508.48
OTHER	193	86	279	17582.72
TOTAL			2547	609423.45

A shifting landscape

IN DEPTH: PRIME BROKER SURVEY /

Hedge funds are *pulling back* on the number of *prime brokers* they are working with, *borrowing less & shorting* fewer stocks

By Katrina Dean Allen

Illustration by Roderick Mills





WALL STREET MAY HAVE COME ROARING BACK

but the once-lucrative business of prime brokerage is facing tough times. Hedge funds, which desperately lined up numerous prime brokers after the collapse of Lehman Brothers made them more cognizant of counterparty risk, are pulling back on the number of firms they are working with. On top of that, they are borrowing less and shorting fewer stocks. And with interest rates so low, lending to hedge funds is less profitable anyway.

"There has been a recovery, but it's a far cry from what it was three years ago," says Paul Germain, global head of prime brokerage sales at Credit Suisse. "The number

of prime brokers being used by the largest funds has been reduced, to the extent that there is less business to award."

One reason hedge funds have cut back on the number of prime brokers is that having too many counterparties can make it more difficult to manage risk. "The basic premise of prime brokerage is centralization and consolidation," says Dean Backer, global head of prime brokerage sales and capital introduction at Goldman Sachs. He explains that having multiple prime brokers can make it harder for a hedge fund to get a complete picture of the risk in its portfolio if each counterparty uses a different technology platform, leaving the fund to piece together various reports.

"That is why we are seeing a slight reversion to a smaller number of prime brokers," Backer says, careful to note that the industry isn't going back to consolidating assets with a single prime broker, but working more with two or three rather than five or six counterparties. About 38% of funds managing \$1 billion or more in hedge fund assets are using only two prime brokers, and 26% are using three prime brokers, according to the AR database.

Even so, the lineup of top-tier prime brokers has stayed the same over the past two years. J.P. Morgan has hung onto its title as the prime broker with the most hedge fund assets—won for the first time last year—and also widened the gap in assets between itself and Goldman. J.P. Morgan is servicing \$93.3 billion, a 10% increase from the \$84.7 billion held last spring, according to the funds reporting to the AR database. Goldman now collectively works on about \$92.1 billion in hedge fund assets, a 9% increase from the \$84.3 billion it held a year ago. (AR measures prime brokers' market share among hedge funds that report to the AR database. Many hedge funds report using multiple prime brokers despite doing the majority of their business with one or two favorites. In the absence of detailed information on the breakdown of their business, AR divides the assets of these shared mandates equally.)

Morgan Stanley's hedge fund client base jumped by close to 9% as well, with a total of \$67.9 billion, which is much less than what it handled precrisis. Those numbers indicate that Morgan Stanley is still struggling to win back business it lost when former chairman John Mack an-

Get ready to pay up

HEDGE FUNDS SHOULD GET ready for higher financing costs. During the past several months, prime brokers have been discussing changing their term financing agreements with some of their most prized clients, including hedge fund firms managing more than \$6 billion.

Term financing arrangements, which allow a manager to lock in rates for borrowing for leverage or shorting—usually rolling 30-, 60- or 90-day periods—are bestowed on less than 20% of the industry, by some estimates. Hedge fund managers without term agreements use demand facilities for financing, which can be called back by the prime broker immediately.

The most highly prized hedge fund clients—those with good pedigrees, good credit standings, attractive portfolios for posting collateral and, probably most importantly, the most lucrative trading relationships with the prime broker—are able to negotiate the lowest rates and longest lockups on their term agreements.

But looming Basel III capital requirements and other regulatory pressures are forcing major prime brokers and their parent banks to take a harder look at their term agreements and to match the liquidity of their lending with their own funding sources.

Prime brokerage executives

and hedge fund finance managers say that despite these pressures, right now competition is so stiff that there has been little to no upward movement in pricing.

A chief financial officer for a multibillion-dollar long/short equity fund manager says his firm, which had been paying the overnight federal funds rate plus a spread for a 90-day term agreement, recently was told by the prime broker that it needed to change the terms to better reflect the liquidity difference between the long equities in the fund's portfolio and the bank's cost of funding at the corporate level.

But the change was minimal.

The 90-day agreement was changed to the three-month LIBOR rate plus a spread, with only a tiny pricing difference, at current market rates.

A chief operating officer at a \$1 billion-plus hedge fund firm said that prime brokers have been discussing potential financing price changes related to Basel III, but not trying to implement them yet. "There is some table setting going on," the COO said. "Banks are starting to let clients know that this is a potential reality."

In the past, a prime broker could fund its 90-day term-agreement client with the excess cash and securities it held on behalf of other hedge fund

gered the industry by blaming his firm's problems on short-sellers during the financial crisis.

What seems counterintuitive is that the total market share of the top three has been sliding. As funds cut down on their prime brokers, they appear to be giving the business to firms such as Credit Suisse and UBS, which have been gaining the most market share, according to AR's data. Credit Suisse's business jumped 12% to \$44.1 billion, while UBS's increased 25% to \$39.9 billion.

"The reason that the top prime brokers aren't seeing an increase in overall market share is because there are more viable prime brokers to choose from," says one prime brokerage executive. "Generally, hedge funds will choose two U.S. banks, like Goldman, Morgan Stanley or J.P. Morgan, and one foreign bank, such as Credit Suisse, Deutsche Bank or UBS."

The top three now service about 41% of hedge fund assets—a big change from precrisis days. For most of the past decade, prime brokerage was mainly a duopoly of Goldman and Morgan Stanley, with Bear Stearns a distant third. Before 2008, those three prime brokers controlled 60% of the

market. J.P. Morgan took over Bear Stearns' assets, but even so, the three have lost their iron grip on the business. Analysts say this reshuffling will continue over the next couple of years, with each top bank's share leveling out to about 20% to 22% of the hedge fund market.

J.P. Morgan and Goldman each control

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Paul Germain, Credit Suisse

about 15% of hedge fund assets, with Morgan Stanley controlling about 11%, according to the AR database. That is a combined total of 41%. Two years ago, Goldman, J.P. Morgan and Morgan Stanley, in that order, were the top three prime brokers, serving 52% of fund assets.

These shifts in percentage of market

share are in line with a prediction made by Brad Hintz, a Sanford C. Bernstein brokerage analyst, in the spring of 2009. Hintz wrote that he expected the industry to fragment over the next five years, resulting in the top three prime brokers controlling about 40% of the market.

And top-tier banks are no longer aggressively hiring. Just over a year ago, firms such as J.P. Morgan, Goldman, Morgan Stanley and Credit Suisse were adding staff to build up their operations. But now that's being done only by those that are still trying to make a dent in the market.

"We hired steadily through the crisis, while also looking for ways to be more efficient," says Credit Suisse's Germain. "We're now increasingly promoting from within." He adds that many banks are trying to figure out how to be more relevant to top clients, as well as be more efficient with their balance sheets. Credit Suisse has about 475 hedge fund clients globally.

Those with the smallest footprint, however, such as Barclays Capital, Citigroup and Pershing, are still investing in the business. Barclays has doubled its share of equity hedge fund clients and increased its client balances by 50%

clients. But because the other hedge fund clients can pull back that cash and securities on short notice, a bank with a 90-day lending agreement would have what's called a liquidity mismatch.

Such liquidity mismatches can cause a bank to run afoul of Basel III requirements proposed by the Bank for International Settlements, as well as requirements or concerns raised by the UK's Financial Services Authority, the Securities and Exchange Commission and the Federal Reserve, among others.

Basel III capital requirements will start to be phased in in 2013, but in December the Basel Committee on Banking

Supervision released the final text of the proposal. Among the requirements will be a liquidity coverage ratio that requires a bank to maintain a reserve of enough high-quality liquid assets to cover net cash outflows in a 30-day stress scenario.

Meanwhile, SEC and Fed sweep examinations dating back to the 2008 credit crisis have been focused on understanding how prime brokerages fund themselves and match that with their lending. And the Tri-Party Repo Infrastructure Reform Task Force, under a committee sponsored by the Federal Reserve Bank of New York, raised concerns in a report last year about maturity mismatches and

risk management practices in the securities lending arena.

Term agreements for most-favored hedge fund clients can lock in rates at the overnight fed funds rate, now ranging between 0% and 0.25%, with no premium, according to an executive at one of the largest prime brokerages.

The executive says that prime brokers and hedge fund managers have been having more conversations over the past three to six months about the effect of Basel III, but those talks haven't resulted in many changes to term agreements yet. Over the long term, however, prime brokers will have to add a premium to their pricing,

even for most-favored clients, to reflect the higher cost of new regulatory requirements, he says.

Pricing isn't the only thing hedge funds look at, say top prime brokers. While some hedge fund managers may look only for the cheapest financing, most look at the quality of the prime broker's complete offering, i.e., its creditworthiness, liquidity and how it might perform in another credit crisis, says Neil Sherman, who is the head of global sales for J.P. Morgan.

"The overall firm-to-firm relationship is very important," says Sherman. "Some obviously bring something more to the table."

Keith Button

since the crisis, says Ajay Nagpal, head of prime services at Barclays, adding the bank continues to make strategic hires. Citi has hired more than 70 people globally in prime brokerage over the past year, 40 of whom are based in the U.S. Pershing is adding more technology staff as well as ramping up in the areas of stock loan and account management.

These prime brokers still think they can make the big time. "There are half a dozen valid competitors out there who have under a 20% share of any one hedge fund client's assets, who can easily move that up to 30%," says Alan Pace, head of prime services in the Americas at Citi, adding that hedge funds spending \$250,000 to

\$750,000 with small brokers are not receiving adequate services at those levels.

"Funds are closely monitoring and considering what they are actually receiving for the dollars they spend. They are looking to reallocate accordingly if they feel they are getting little in return," Pace says.

But how much room for competitive jockeying is there? Financing rates, particularly on the equities side, have become standardized compared with five years ago, making it difficult for prime brokers to undercut one another, say hedge fund managers. There is room for more competition with illiquid strategies, which are less standardized.

And even if a prime broker gets more

business, it isn't necessarily making money off it. Prime brokers measure their business on balances based on debits, credits, shorts and swaps. "Balances for prime brokers are up overall because hedge fund assets under management are up," explains one prime brokerage executive. "But the funding aspect has become more difficult as it has gotten more costly on the prime broker side because the balance sheet has become more precious and the desks are charging more. There has been a return to focusing on the service you are getting from each prime brokerage."

Lending to hedge funds for shorting purposes was traditionally one of the most lucrative aspects of prime brokerage, but hedge funds are shorting less because

The mini-prime bust

THE MINI-PRIME BROKER bubble has burst. A year ago, as many as 70 mini-primes were catering to small hedge funds, but industry insiders say that consolidations and closings should whittle the number down to as few as 10 within six months.

Mini-primes, which typically serve as prime brokers for smaller hedge funds while clearing their trades through larger banks, have announced at least five mergers and one closing in the past 12 months.

First New York sold its EFX Prime Services to Direct Access Partners, another mini-prime, late last year. BNY ConvergEx Group bought fellow mini-prime NorthPoint Trading Partners in April 2010. FBR Capital Markets closed its prime brokerage unit in January, while Cantor Fitzgerald bought the PCS Dunbar prime brokerage unit in February. And I.A. Englander announced plans to acquire mini-prime Alaris Trading Partners in November, but that deal has yet to be consummated.

Others closed their doors almost as soon as they opened for business, according to prime brokerage executives, who add that at least 10 other mini-primes that still present themselves as active businesses are actually struggling to survive or are no longer seeking new business.

Companies getting out of the prime brokerage business "realized that it takes more time, and requires more people and technology and capital than they thought," says Ron Suber, senior partner and head of global sales and marketing for Merlin Securities, a self-described "midprime" with 529 clients with more than \$10 billion under management. "It's a longer runway than they realized."

The mini-prime boom got its start in the early 2000s, when larger prime brokers started pruning hedge fund clients that weren't profitable enough.

Although each bank had a different standard, they all demanded that clients bring in at least \$250,000 in annual

revenues, prime brokerage executives say. The largest prime brokers cut loose hedge fund clients that didn't generate \$1 million per year in combined trading and financing revenues. That meant that in many cases, hedge funds with \$100 million or less under management were suddenly looking at firms like E*Trade and Charles Schwab to handle their accounts.

Enter the mini-primes. BTIG started taking on prime brokerage clients in 2004, followed by Merlin Securities in 2005 and Jefferies in 2006. Those three were the biggest winners of new business in the 2008-to-early-2009 period. Merlin added 190 new hedge fund clients from April through December 2008 alone. BTIG today has more than 300 clients with about \$10 billion under management, while Jefferies has about 400 clients with about \$16 billion.

Mini-primes launched in 2007 or after entered the market as the number of kicked-out clients from the large primes

was dwindling, and these have struggled. By the third quarter of 2010, the largest prime brokers had dropped any hard-and-fast rules about minimum client revenues and were even taking on small start-ups—managers launching with \$10 million, in some cases—to compete directly with the mini-primes.

The Art Nadel hedge fund Ponzi scheme, which collapsed in January 2009, helped spur that movement, prime brokerage executives say. Nadel traded through Shoreline Trading, a mini-prime that cleared through Goldman Sachs. That case raised red flags about potential liabilities of introducing brokers for the five main clearing firms for mini-primes: Goldman, J.P. Morgan, Bank of America, Pershing and Jefferies Group. Pershing, for example, raised capital requirements for Jefferies' clients later that year, demanding security deposits of more than \$1 million each—from the \$100,000 required previously.

Keith Button

“there are less compelling deals,” says the prime brokerage executive. When stock supply is hard to come by, a prime broker can make as much as 400 to 700 basis points lending it out, whereas a so-called easy stock will yield only around 15 to 20 basis points. “The last hard stock deal was Citigroup,” he bemoans.

Tougher regulations on naked short selling also have made it more costly for prime brokers to make money. “In the past, if a hedge fund wanted to short a stock, you would give the okay even if you didn’t actually own that stock because you thought you would be able to get it. You could then be more creative about the settlement date, and you could get the stock for the hedge fund at the last minute,” this prime brokerage executive explains.

New rules about locating a stock before lending it prohibit that. For a prime broker to okay a short, it has to prove and document that it has those shares available. So many prime brokers will try to predict what will be hot stocks and pre-borrow them. “What can happen is at the end of the year you may see that you spent \$30 million to borrow stocks that no one ended up using [shorting],” he adds.

Leverage is also slight, with U.S. long/short equity funds ending February with an average leverage of 1.52, according to a Morgan Stanley report. But leverage may be on its way back up and is dependent on the fund and the strategy, says Lou Lebedin, global co-head of prime services at J.P. Morgan, whose clients have increased their leverage.

Still, to make up for the loss of some of the traditional business, some prime brokers are pitching administrative services alongside their prime brokerage capabilities. Goldman and Morgan Stanley are both actively cross-selling between administration and prime brokerage services.

“If you are running an administration business, you can offer a discount [on administration services] which is attractive to hedge funds right now,” says one operations executive at a start-up hedge fund with more than \$100 million. But J.P. Morgan and UBS, which also have large administration businesses, are not actively cross-selling those lines of business.

The number of hedge funds launching is also fueling the competition for mar-

ket share, as high-quality start-ups represent a pipeline of potential billion-dollar funds. Last year, new launches in the U.S. amassed a combined \$17.4 billion in assets, a growth of 17% compared with the amount new fund launches pulled in in 2009, according to AR’s New Funds Survey.

Credit Suisse, Goldman and Morgan Stanley appear to be getting a lot of this business. All three were listed as prime brokers on some of the biggest headliners from last year’s start-ups, including Edoma Capital, RoundKeep Capital Advisors and Route One Investment.

J.P. Morgan and UBS are also players in the new fund launch arena. UBS insiders attribute the firm’s massive growth over the past year its aggressive push to win start-up business.

J.P. Morgan’s Lebedin says the bank has had the most success with new funds

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Alan Pace, Citigroup

being rolled out by existing clients. It has also spent the past year expanding its infrastructure, particularly on the international side, in distribution, consulting, technology, product development, capital introductions and equity financing.

Although new hedge fund launches are still down from the peak, those funds that do get off the ground tend to be strong ones, leading Morgan Stanley’s global head of prime services Alex Erhlich to call today “another golden age in hedge fund formation.”

While many of the prime brokers in AR’s recent survey were able to boost their market share, some struggled. Deutsche Bank’s hedge fund assets rose less than 1% to \$30.1 billion, but the firm was still able to retain its sixth-place spot. The same did

not hold true for Bank of America Merrill Lynch, whose assets fell to \$10.7 billion from \$25.7 billion a year ago, moving the bank to 10th place.

BofA Merrill is now on a tear to recoup that business and recently announced that Stu Hendel, the former global co-head of prime brokerage at UBS who previously ran Morgan Stanley’s business, will join BofA Merrill in June as global head of that firm’s prime services business. Hendel will be joined by UBS alums Jon Yalmokas, the former head of U.S. prime brokerage sales, and Charlotte Burkeman, the former head of prime brokerage sales for Europe, the Middle East and Africa. Both Yalmokas and Burkeman will join BofA Merrill in June and under similar titles.

The bank, which has had more success with hedge funds that employ strategies such as statistical arbitrage, is counting on the experience of its recent hires to help ramp up its share of business with long/short equity hedge funds, says Mike Stewart, the global co-head of equities.

Still, other smaller firms were able to make a dent in market share last year. Citi’s prime brokerage unit jumped up a slot to seventh place, with \$19.9 billion in hedge fund assets. Newedge knocked BNP Paribas out of eighth place, growing its share of hedge fund assets in the AR database by 9% to \$16.5 billion. BNP Paribas’s share fell to \$15.3 billion from \$16.2 billion.

And there is room for more players. “Prime brokerage is not as commoditized as it seems,” says Josh Galper, a managing principal at specialist research and advisory firm Finadium, who adds that reasons to choose one prime broker over another can also be driven by the size of the hedge fund and the strategy it is employing and not just by personal relationships or price.

That is why prime brokers are competing more on the quality of service, says Gerald Tamburro, a managing director at Pershing Prime Services, a BNY Mellon company.

At the end of the day, the foundation for a good prime brokerage business has not changed much from the days before Lehman Brothers fell. Says Goldman’s Backer: “It’s about good technology, strong risk management skills, the ability to borrow stock and short it, and quality capital introductions.” **AR**