

By Deborah Brewster in New York, Financial Times  
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## **FT REPORT - FUND MANAGEMENT: Small fry make a splash with niche operations**

The lucrative and highly competitive prime brokerage business is dominated by fewer than 10 big investment banks, which focus on the largest 1,000 hedge funds.

Several niche "mini prime" brokers burst out as the hedge fund boom got under way, catering to the hundreds of start-up hedge funds with too few assets under management to appeal to the big prime brokers.

Many "mini primes" rely heavily on profits from stock execution rather than the high-margin lending business that the big prime brokers offer.

With pre-tax margins hovering at above 40 per cent at the best-run firms, it is not surprising that the business is competitive, or that entrepreneurial firms want to squeeze their way in.

However, they are left to find pickings in the ranks outside the big funds. With 350 hedge funds controlling 85 per cent of the assets, that leaves 15 per cent of the business for smaller prime brokers, spread across more than 8,000 funds.

They need to find an outside clearing house, and typically must also offer a speciality of some kind to attract clients.

The most lucrative clients clearly remain the big funds, because they are most likely to do a lot of borrowing - both of money to finance trades, and of securities to sell short - which is far more profitable business than stock execution. The big funds generally want a prime broker with international, cross-product capacities.

"How many firms can clear custody, finance, risk administration and execution on a global basis? The people who can offer that number only about seven or eight," says one prime brokerage executive.

"Also, when times get tough, you need to know who has got the balance sheet to stand behind you," he adds.

That has not stopped a few new entrants from making a good living. Steve Vermut, managing partner of Merlin Securities, one of the largest and most successful recent arrivals, says his firm has used technology to elbow its way into the business.

Merlin uses Bear Stearns as a clearing house, which also gives Merlin access to Bear's balance sheet.

"We see ourselves as complementing the big firms," says Mr. Vermut. "They finance positions, do stock loans, create products for the hedge funds. Our niche, the piece that was missing, is



aggregated reporting technology. We bring all the data together from the funds' multiple prime brokers."

Merlin's main product, Merlin Prime - for those funds that use Merlin as their sole prime broker - has 200 clients. Then there are "a couple of dozen" large funds for which Merlin does the multi-prime reporting.

Meanwhile, an industry that used to be dominated by the big three - Goldman Sachs, Morgan Stanley and Bear Stearns - is undergoing something of a shift as Bear Stearns has fallen away in the past three years.

Goldman and Morgan Stanley remain indisputably on top, but a clutch of firms - Deutsche, UBS, Lehman, Credit Suisse and Merrill Lynch - are jostling for the next tier, followed by Bear, Bank of America and Citigroup. Firms such as Fimat, TD Securities, Barclays and BNP Paribas also have prime brokerage divisions.

Independent market share figures are hard to come by, and various measures - revenue, assets under management or number of clients - are touted at different times if they show a firm to good advantage.