

By FINalternatives

Published: October 10, 2008

Prime Brokers Benefit From Market Turmoil.

While hedge funds struggle to navigate choppy regulatory and market waters, one group of financial professionals is feeding off the frenzy in a big way. Some prime brokers are enjoying an increase in business from hedge fund clients that have been left blowing in the wind by the demise of Lehman Brothers Holdings and others that are scared to swim in the murky waters surrounding Morgan Stanley.

One Broker, Multiple Primes

Ron Suber, head of global sales and marketing and a senior partner at Merlin Securities, says that recent events have proven the need for the multi-prime brokerage model.

"No hedge fund with over \$50 million in assets under management should be single-primed," explains Suber, adding that investors—especially separate account allocators, such as funds of funds—demand that funds use multiple primes with transparent reporting capabilities. He explains that Merlin's technology allows funds to aggregate data from different prime brokers on one system. "That has led to Merlin picking up dramatic new business given its multi-prime services."

Dramatic indeed: Merlin has picked up 35 new funds in the last 30 days alone, and is expecting to take on at least another 70 by the end of the year.

"One fund moved \$450 million over [to Merlin] in three days," says Aaron Vermut, senior partner and chief operating officer at the firm. "We are small and nimble and can move money much faster than the big guys."

Much of Merlin's new business is coming from funds that were once loyal to the "name brand" prime brokers. Vermut explains that funds have realized the importance of having multiple custodians—Merlin works with JPMorgan Chase and Goldman Sachs—and state-of-the-art reporting capabilities.

"People are now saying, 'I don't care about brand, I care about safety,'" says Vermut.

Mike Murray, a partner at Shoreline Trading Group, agrees with Suber and Vermut that prime brokers that are able to help hedge funds diversify counterparty risk have a huge advantage in this market. Shoreline offers hedge funds a choice between four clearing firms—Goldman Sachs Execution & Clearing, JPMorgan, Credit Suisse and Fortis—through one introducing broker-dealer.

"The multi-prime brokerage model will become the standard for all asset managers, not just for the larger hedge funds," says Murray, who adds that his firm has also been busy taking on new clients. "It doesn't matter what size a fund is, they still have a fiduciary responsibility to their investors to be mindful of custodial risk. Our clients have the choice of multiple custodians all through one broker-dealer."

Meanwhile, Murray says that there will be fewer bulge bracket prime brokers to handle the still-growing hedge fund industry, and the asset under management cut-offs at the remaining bulge bracket prime brokers will increase.

"These firms simply do not maintain the resources to properly service funds of all sizes and will rely on Shoreline Trading to service those managers that fall below their internal thresholds," he says.

A Tri-Party Movement

Jeremy Todd, a director at Pershing Prime Services, says that over the last four weeks hedge funds have been focused on establishing relationships with their counterparties, which has "played very nicely" into the firm's business.

"The growth overall has been tremendous for us and we're establishing dozens of relationships with multi-billion dollar-plus hedge funds," says Todd, who declined to comment on whether or not Pershing, which is owned by the Bank of New York Mellon, has picked up any former Lehman clients.

According to Todd, a major trend is the tri-party arrangement where the long positions are being held at custodial banks and short and margin financings are done at the primes. "All of these billion-dollar plus managers are doing tri-parties as a way to help diversify counterparty risk, and that fits nicely into our business model," he says.

Going forward, Todd says primes that offer flexibility in terms of financing and their securities lending needs, and hold their assets within different parts of the bank are going to have an advantage in gaining new market share.

Smaller Primes Hold Their Own

Smaller primes, which used to receive referrals from Lehman, are actually reaping the benefits of that bank's demise.

Mark McGoldrick, a member of Alaris Trading Partners, admits that Lehman's prime brokerage group was "good" to Alaris. "They referred startup business our way and kept us on their short list of trusted 'introducing primes'," says McGoldrick.

"Coincidentally, though, we have had some growth in balances from the shakeout street wide, not just with Lehman. The idea of partnering with a boutique that can offer the stability and confidence of Goldman Sachs is resonating with funds of all sizes across all primes."

As the hedge fund industry works its way through the bumpy marketplace, McGoldrick says Alaris is staying the course and highlighting its strengths.

"Our pricing model assumes a long-term relationship and thus affords pricing proposals that give our clients the benefit of where they'll be in asset size, not where they are today. This is a major difference in our approach and has fueled our recent growth," says McGoldrick.

Steven Simmons, director of prime services at Terra Nova Financial, offers a different take on the Lehman situation. Simmons says the type of carnage that has hit the Street unfairly paints all prime brokers with the same tainted brush. However, he admits that his firm has been fortunate in the current environment, attracting new clients who want to work with a prime broker "that is responsive to their needs, and most importantly, is safe."

However, Simmons, who labels Terra Nova as an "under the radar" kind of firm, says the firm's best source of new business continues to be word of mouth from current satisfied clients.

"Hedge funds will continue to seek service providers like Terra Nova Financial who are stable, and still committed to the ideals of providing individual attention to service and support, while offering state-of-the-art, customizable technologies."