

The New Model of Prime Brokerage - The Multi-Prime Service Platform

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Introduction/Objective

The fallout from the financial crisis of 2008 has caused dramatic changes to almost every facet of the hedge fund industry. A key area that is currently undergoing a rapid transformation is prime brokerage. New, more costly service requirements, combined with a sudden cost consciousness on the part of hedge fund managers, are resulting in a complete rethink of the economics underpinning this business.

Nowhere more urgent is the need for a new model of prime brokerage than in the critical sub-\$500 million segment, where the tension between the new requirements and hedge fund managers' ability to pay is at its most intense. Importantly, it is also here, that we hope to witness the regeneration of the industry, with the entry of potentially thousands of new hedge fund entrants over the next few years.

The objective of this paper is to offer a context for the changes occurring in prime brokerage and to describe a vision for the future that will ensure the continued success of the hedge fund industry.

The sub-\$500 million Segment

This segment represents the majority of all hedge funds and is vital because it serves as the entry point for the vast majority of new entrants to the industry. It has always been a dynamic segment, with hundreds of funds entering and exiting on a yearly basis. These funds follow a cycle of creative destruction, with the lucky ones being able to graduate to multi-billion dollar status. This cycle and the relative ease with which

funds can enter (and exit) is very much the basis for the success of the industry and guarantees that potential investors always have a wide choice of investment opportunities available.

Examining the segment today, we can see that it has suffered its largest contraction ever, one that could potentially set the hedge fund industry back years. It is helpful to divide the segment into what we'll call Survivors and New Entrants:

Survivors - These are the funds that have survived the market turmoil of

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2008. Compared with the glory days of the industry the world has suddenly become a very hostile place. Practically all hedge fund managers have suffered through poor performance and large redemptions. Their promise of absolute returns has not been met with the average fund down more than 18% in 2008. They have faced criticism from their investors and in the press. Everyone is now demanding greater transparency and the prospect of increased regulation is now a certainty. Many funds find themselves significantly below their water mark and will be financing their entire operations on the "2%" component of their total "2 and 20" fees for the foreseeable future.

In the short-term it continues to be about survival. These funds will seek to reduce costs in any way they can. Looking to the future, they understand that their long-term survival will depend on generating returns and

gathering assets. In this new environment, however, potential investors will demand to know much more about the level of risk involved in generating these returns. Fund managers will need to demonstrate that they have an infrastructure in place that allows them to mitigate not only portfolio risk but also counter-party and operational risk.

New Entrants - As has been the case with previous contractions there followed a period of expansion with many new entrants. It is very likely that the hedge fund industry will follow this same pattern, assuming that barriers to entry remain relatively low. These New Entrants will have the advantage of not having to explain poor performance in 2008, but will still face a skeptical investor base. As with the Survivors they will need not only to convince investors that they can generate returns, but also that they have controls in place that allow them to measure and manage effectively all types of risk. These funds will be very much defined by the current environment and are likely to be somewhat different than existing funds. Indications are that they will be smaller, more opportunistic, and less likely to focus on any one strategy or asset class.

The overriding theme shared by both groups is that while they are optimistic about future investment opportunities, they are unclear about how they can meet all the new requirements, and still remain financially viable.

Industry Service Providers

The Prime Broker

The prime broker has always been the industry's most important service provider because they provide many of the tools necessary to generate alpha. The industry evolved around a single captive relationship between the prime

broker and a hedge fund. This single relationship provided everything that a hedge fund required to get up and running. These services included custody, stock loan, financing, execution, reporting, and much of their operational needs including middle and back-office technology. In return the prime broker earned extremely lucrative fees (\$12.4 Billion in 2008), mainly from stock loan and financing, and to a lesser extent trade execution. Funds were for the most part satisfied with this arrangement because it allowed them to focus on establishing a track record and gathering assets. Only when the fund matured well beyond its start-up phase did it consider adding additional prime brokerage relationships. This move to multiple prime brokers was not made with great haste and generally could be motivated by any number of reasons including; the need to acquire another prime broker's unique expertise; competitive pricing; or a desire to appear more "institutional".

The Fund Administrator

The fund administrator is the second most important player in the industry. Their services generally occur post-trade and include aggregating all of a fund's activities into independently generated monthly financial statements with Net Asset Value (NAV) calculations. They have also earned lucrative fees, usually charging their hedge fund clients based on assets under administration. Some fund administrators have recently attempted to differentiate themselves by expanding their offerings to include more frequent daily reporting and an outsourced middle and back-office service.

Three New Requirements

The financial crisis and the resulting new requirements have upset the relatively stable equilibrium between hedge funds and their service providers. A new equilibrium can only be established with the

emergence of a new service model. The three new requirements that are forcing change are as follows:

1. Multi-Prime - The demise of Bear Stearns and Merrill Lynch, and the bankruptcy of Lehman Brothers in 2008, abruptly brought the subject of counter-party risk to center stage. Overnight multiple prime broker relationships became a prerequisite for all funds no matter the size. This change has had huge repercussions for the industry because it undermines the economics of the captive single prime model, which had been so successful in cost effectively supporting early stage funds. To attract (or retain) assets a fund must now demonstrate that they have diversified their counter-party risk. The operational complexity (and cost) involved in building a multi-prime infrastructure should not be underestimated (see "*A Guide to Overcoming the Operational Challenge of Multi-Prime*" by Peter Curley, Nirvana Solutions, October 2008). At the very heart of this complexity is the requirement to collect and aggregate the disparate cash, position, and transaction information, across multiple custodians. Once the data are captured and reconciled the fund must then be able to present the data in reports, in a form that can be consumed by everyone within the firm, from the trader to the CFO. Additionally, the infrastructure must be flexible enough to support new, in vogue, risk reducing structures such as tri-party arrangements and separately managed accounts.

2. Real-Time Systems - The credit crisis and the ensuing market volatility exposed some of the drawbacks of the legacy "T+1" technology used by hedge funds. Managers were forced to navigate the markets with systems that could only offer outdated views (typically end of day reports) of risk and return. These legacy portfolio management systems

(PMS) struggled with the real-time requirement because they pre-date the advent of the FIX (Financial Information Exchange) protocol and therefore cannot not display the real-time impact of executions on a fund's risk and return profile. This lack of real-time transparency can no longer be tolerated. Transparency begins with real-time data. Both managers, and more importantly investors, now demand this fundamental capability.

(It should be noted that to achieve these real-time views of aggregated risk and return is significantly more challenging in a multi-prime environment.)

3. Low-Cost - The final new requirement is cost. Before the crisis, many

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managers had become accustomed to financing their operations with the belief that inflows and performance fees would continue indefinitely. The crisis has meant a complete reversal of fortune, with funds now attempting to survive in an atmosphere of outflows and no performance fees. In the old single prime model much of the operational expense was borne by the prime broker. In this new world of multiple prime relationships and more costly requirements, prime brokers are much less willing to carry the burden. Looking to the future, fund managers can no longer be assured of their current fee structure and may have to aggressively reduce fees to attract investment.

The New Model of Prime Brokerage: The Multi-Prime Service Platform

It is clear that a new hedge fund service model is required for the sub-\$500 million segment. One that allows both Survivors and New Entrants to focus on what they do best, while at the same time meeting all the new requirements, in a cost effective manner. What will this new real-time multi-prime service platform look like?

The future points to a model that will have the following key characteristics:

Outsourced - Historically hedge funds have resisted efforts to use outsourced solutions citing flexibility and privacy concerns. A fund manager faced with acquiring a multi-prime reporting capability typically felt that their only option was to purchase an onsite portfolio management system (PMS) and order management system (OMS). This came at a considerable cost and involved hiring a team of technologists to implement, integrate and maintain these disparate legacy systems. Even with that approach, fund managers, often times felt that the multi-prime data that they demanded was still elusive and that a considerable amount of time had been wasted in building a competency in technology. Firms now understand that the need to aggressively cut costs, and to focus solely on alpha generation, trumps any past concerns about outsourcing. Fortunately, new real-time multi-prime solutions have emerged in the last few years that make outsourced technology much more compelling. These new integrated systems offer the breath of T+1 reporting of legacy systems combined with real-time aggregated views of critical data such as risk and P&L, all made available to a hedge fund manager via a thin client or browser.

Business Process Outsourcing - As with technology, hedge fund managers must now come to the realization that many of their middle and back-office processes should be outsourced. These new service platforms will offer a whole menu of business process outsourcing options all provided on top of their hosted technology offering.

The final consideration for outsourcing is the concept of third party verification. The Madoff scandal has brought home to investors the need for outside oversight and transparency. Fund managers that insist on maintaining their own middle and back-office will be at a disadvantage when it comes to raising capital.

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Integrated - Hedge fund managers do not have the time or resources necessary to deal with multiple service providers. Ideally they want one point of contact through which they can access all of their critical services. The new multi-prime service model will mean that a fund can do business with one partner and still receive all the benefits of multiple prime relationships and state-of-the-art real-time technology. These service platforms could potentially include multi-prime services as well as fund administration on one common technology platform. Taking a step back, we can see that there has always existed incredible duplication of effort across the hedge fund eco-

system. In many cases hedge funds, prime brokers, and fund administrators all conduct the same middle and back-office processes using the same legacy technology. The industry can no longer support this inefficiency. The future points to a more efficient, integrated approach with many of a hedge fund's important functions being handled on one unified common technology platform.

Flexible Pricing -

Flexible Pricing - The economies of scale achieved by an outsourced, integrated approach, will allow the providers of these Multi-Prime Service Platforms the ability to be much more flexible in the way that they charge for their services. Ideally these providers should, as much as practical, mirror the fee structure of their hedge fund clients. Pricing should be variable and based on services consumed, and will be competitive for even smaller hedge funds.

The Providers of the New Multi-Prime Service Platform

We've talked about the new requirements and the likely characteristics of the new model of prime brokerage. Let's now look at some of the leading candidates that could potentially offer this service to the sub-\$500 million segment. The candidates most likely to succeed will be the organizations that meet the following criteria: 1/ already has an expertise in this field, 2/ has a low cost structure and, 3/ has a history of successfully leveraging new technologies:

- **Prime Brokers** - The top tier primes have already signaled to the marketplace that they will no longer compete in this space. They have concluded that without the assurance of the captive single prime model, the economics of servicing smaller funds no longer makes sense. Furthermore, the high-cost-structure

prime brokers understand that their existing “hearsay” multi-prime reporting technology solution cannot scale down market. Some of the leading banks will continue to have exposure to the sub-\$500 million hedge funds through their clearing arms, others will focus solely on much larger and more profitable multi-billion dollar funds.

It is this retrenchment by the leading primes that has created a void at the lower end of the market and presents an opportunity for the providers of the new multi-prime service platform.

• **Fund Administrators** - The dislocation of hedge funds has made an already competitive industry even more competitive for fund administrators. The need to differentiate themselves has never been more intense. At first glance fund administrators would appear to be ideally positioned to offer this new model since they have always been in the business of aggregating hedge funds’ activities. Fund administrators, however, have been trying for a number of years to expand their footprint within the community, notably as middle and back-office outsource providers. To date, these offerings have not been met with great enthusiasm. The typical complaint has been that the reporting provided by the administrator is just not flexible or timely enough for many hedge funds. The reason being that the vast majority of administrators rely on the legacy portfolio management systems mentioned above and therefore struggle with the ability to offer true real-time views of P&L and risk. Finally, a factor not to be underestimated is the cultural mismatch between the accounting mindset of the fund administrator and the trading mindset of many of the hedge fund managers they seek to service. Only time will tell if the well-positioned fund administrators can overcome these

challenges to successfully offer a Multi-Prime Service Platform.

• **Mini-Primes** – Another contender to offer the Multi-Prime Service Platform is a group known as mini-prime brokers. In the past they were charged with serving the funds that the leading prime brokers deemed too small or not sufficiently profitable. This focus on smaller funds has allowed them to evolve their services in a cost effective manner. This has been achieved by successfully leveraging newer, more advanced technology. Additionally, because the mini-prime brokers are not in the custody or clearing business, acting instead as introducing brokers, they have the ability to offer a no-conflict multi-prime broker offering.

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Examining the industry today, we can already observe organizations that are in the early stages of building out these Multi-Prime Service Platforms. Interestingly, these firms could not be described as mini-primes or fund administrators but rather hybrids of both. Through one relationship they can offer a hedge fund an outsourced, multi-prime, real-time infrastructure, all built on a common technology platform. Only time will tell how these service platforms will evolve but we should not be surprised to see this new model of prime brokerage ultimately challenge the top-tier primes for the multi-billion dollar hedge funds.

Conclusion

The dire predictions of the hedge fund industry falling below the \$1 trillion under management level in 2009 have not come to pass. The rate of the recovery, however, is still very much in the balance and will depend on whether the barriers to entry remain low enough to attract a new crop of hedge fund entrants. The new service requirements that have emerged from the crisis, however, risk significantly raising these barriers and have already caused the retreat of the traditional providers of prime brokerage services. It is imperative that this service vacuum be addressed quickly. The new multi-prime service platform represents the best model to ensure the continued vibrancy of the sub-\$500 million segment and the recovery of the hedge fund industry.