

HEDGE FUNDS AND PRIME BROKERS— CONVERGING?

The rescue of Bear Stearns and the collapse of Lehman Brothers have made institutional investors in hedge fund strategies rethink counterparty risk. Highlights from a conversation with Art Certosimo, Senior Executive Vice President, The Bank of New York Mellon.

IT WAS IN 2006 THAT THE BANK OF NEW YORK MELLON

(BNY Mellon) decided to combine its Broker-Dealer Clearing and Alternative Investment Services teams. The logic was compelling. Through its securities clearing and tri-party financing businesses, the bank has strong relationships with the broker-dealers that provided prime brokerage services to hedge funds. Thanks to its Alternative Investment Services arm, BNY Mellon has excellent relationships with hedge fund managers too. The growing convergence between the businesses of hedge fund managers and broker-dealers also suggested there were bound to be synergies which BNY Mellon could help both sets of clients to exploit. By 2006 it was evident that there were close similarities between the investment management strategies of the leading hedge fund managers and the proprietary trading activities of the major prime brokers. In addition, all of the large investment banks had developed hedge fund businesses of their own, either in-house or through acquisition. Simultaneously, the established hedge fund groups had developed broker-dealer arms, which in many instances competed with the prime brokers in the fields of trade execution and securities lending. The result was that by the time the credit crunch erupted in the summer of 2007, BNY Mellon had broker-dealer clients that used its hedge fund administration services, and hedge fund clients that used its broker-dealer clearing, custody and collateral management services. Uniting the services into an integrated business led by a single management made obvious strategic sense.

Two years on, the decision by BNY Mellon to join the Broker-Dealer and Alternative Investment Services groups looks to be a success. In addition, the launch of their prime brokerage division, Pershing Prime Services, coupled with the Bank's strong financial condition, positions them well in the marketplace. Though the credit crisis has driven the pace and course of the convergence between hedge funds and broker-dealers, it has magnified the underlying trends that were driving it. In fact, the major hedge fund

management groups are now looking to further leverage and expand their broker-dealer arms. Several are now acting on their own behalf in both the cash repo and the securities lending markets. An even larger number of hedge fund managers with sufficient operational expertise of their own are reviewing their prime brokerage relationships on the clearing side, and opening accounts on a limited basis directly with global custodian banks such as BNY Mellon to clear and settle their trades. The prime brokers, on the other hand, have understood that the current restructuring of the hedge fund industry is an opportunity to re-think their own strategies and create operational efficiencies. While some expect to return to a full service model once the markets have normalized, others are looking to focus on the more profitable aspects of the business, such as securities lending and financing. Prime brokers are also being more selective about the size and type of client they wish to support. This has created room for a new class of prime brokers to emerge to service smaller hedge funds.

Institutional investors are also having a considerable impact on the relationship between hedge fund managers and prime brokers. Even before the failure of Lehman Brothers, hedge fund managers found themselves under pressure from institutional investors to increase amount of transparency in their operations. The growing institutionalization of investment in hedge fund strategies, and the greater steadiness of institutional investors during the current crisis by comparison with traditional high net worth investors, means this pressure is not only difficult to ignore but unlikely to abate. Yet hedge funds continue to rely on their prime brokerage relationships to supply them not only with trading tools, but with the leverage to finance their investment ideas. They know that their appetite for leverage is bound to increase as markets stabilize. But as long as their institutional investors are requiring increased transparency to facilitate the mitigation of counterparty risk, hedge funds and prime brokers will need to continue to evolve their operating models. So the crucial ques-



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tion for the future of the hedge fund industry is: What can be done to reassure institutions invested in alternative investment strategies that their cash and assets are safe?

The BNY Mellon Broker-Dealer Services and Alternative Investment Services group has devised a solution to this question, by which the bank will intermediate transactions between prime brokers and hedge fund managers. Hedge fund managers are starting to place cash collateral with a BNY Mellon, for use by prime brokers as initial margin, through a tri-party structure. By ensuring cash is deposited with a AAA-rated custodian bank, this new ‘Margin DirectSM’ product enables prime brokers to continue to transact with hedge fund managers, while reassuring all stakeholders that their cash is better protected. BNY Mellon has already put in place legal agreements and the necessary operational procedures to allow hedge fund managers to post cash for the benefit of their prime broker or brokers. In addition to ‘Margin Direct’ cash management services, BNY Mellon is also offering hedge fund managers and their institutional investors the further reassurance of custody services for the buy-and-hold assets in their long books. Under this offering, securities and other assets are no longer safe kept by the prime brokers, but are instead placed in custody with BNY Mellon. Having learned from the Lehman bankruptcy that even unencumbered securities are at risk of being caught up in an insolvency process, institutional investors will be glad to know that long assets are held by a third-party custodian. In terms of servicing those assets, BNY Mellon is prepared to provide either full or partial services.

In other words, the exact division of labor between BNY Mellon and the prime broker will always vary. The Bank will provide cash management, collateral management, custody and fund administration services, while the prime brokers will provide execution, financing and short covering. Different combinations of these services will be brought together and

delivered to hedge funds as a seamless set of services by the joint client service and relationship management teams at the prime broker and BNY Mellon.

This new way of doing business does of course redistribute the rewards as well as the work. For instance, prime brokers can no longer use cash deposited with them as initial margin by hedge fund managers to fund their own business. However, they can utilize BNY Mellon’s tri-party services in order to raise funding in the repo market. In terms of non-cash custody, the advantage of the new arrangements is that a set of services provided to hedge funds by prime brokers on an integrated basis can now be unbundled. Different prime brokers will always have different views on which services they are willing to offer, and in working with BNY Mellon, they have a partner who can offer a complement of services.

To that extent, tri-party is a conventional outsourcing service, which in today’s world is addressing the counterparty risks that could otherwise constrain growth.

It has become clear that the tri-party structure has enabled prime brokers and hedge fund managers to continue to do business with each other in an environment that has changed dramatically. The trust built up over many years with BNY Mellon’s strong relationships with prime brokers and hedge funds has allowed the Bank to create a new partnership, in which the Bank is helping the prime brokers to enhance their service to hedge funds, and hedge funds to do business with prime brokers while giving confidence to their institutional investors.



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