

SPONSORED SECTION



BNY MELLON

PRIME CUSTODY AND PRIME BROKERAGE WORK TOGETHER TO PROVIDE HEDGE FUNDS AND INVESTORS WITH TRANSPARENCY

The risks exposed by the financial crisis of 2007-08 prompted investors to press hedge fund managers to appoint third-party custodians. Service models offered by prime brokers, fund administrators and custodians range from basic fund administration and custody servicing to full outsourcing. The Alternative Prime Custody Services group at BNY Mellon has responded with a portfolio of services that aim to do more than facilitate the movement of cash and securities between prime brokerage and custody accounts. They include fully integrated middle-office, securities lending, in-house and third-party cash and collateral management services, as well as custody and asset servicing. Editor-in-Chief Dominic Hobson spoke to Brian Ruane, CEO of BNY Mellon Alternative and Broker-Dealer Services, and Michele Cottone, managing director of global product management at BNY Mellon, about how well the combination is playing with hedge funds

DH: How big is your prime custody business?

Ruane: The value of the hedge fund assets in custody with us has increased sixfold since 2007 to approximately \$130 billion in assets under custody. Finadium estimated that at the end of 2010, the total pool of eligible assets for prime custody services was approximately \$700 billion. We continue to see this trend increasing. So, the business is growing very quickly, and much of this can be attributed to our existing relationships with prime brokers and their recognition of the changing dynamic with their clients.

DH: Prime custody means many different things. What does it mean at BNY Mellon?

Cottone: It is a service we offer to hedge funds that want a safe and sound alternative to their prime broker. We hold their unencumbered securities and cash, but in a way which is familiar to them from their experience of holding assets under custody with a prime broker. One significant difference is the manner in which assets are held for our clients in segregated accounts. This resonates positively not only with the risk managers at the hedge funds, but with investors as well.

DH: You mention cash. Is it not stretching the definition of prime custody to include cash?

Cottone: Certainly prime custody was initially focused on securities. Interestingly, hedge funds are now turning to us to service their cash as well. We offer hedge funds the choice of holding their cash in either onshore or offshore vehicles.

Ruane: Cash is so embedded into all of our investment services that it is easy to miss the fact that every investment always starts with cash. All activities such as subscriptions, redemptions, margin calls, etc. need to flow through a bank account. Embedding cash payment and cash management services into our custody and fund administration services makes settlement of transactions more convenient, and makes it easier for clients to track assets and comply with AML regulations. If funds have large pools of short-term cash awaiting investment or pledged as collateral to swap counterparties, these need to be managed. Some hedge funds may not want to hire a short-term cash manager of their own. They can opt to manage their cash at the same bank that already handles their payments and custodies and administers their assets.

DH: Asset valuations apart, the synergies between fund administration and

prime custody are not that obvious. What are they?

Ruane: Prime custody is driven by investors, who are demanding more transparency. What makes us central to the relationship between a hedge fund and its investors is the fact that our fund accounting and administration business provides the monthly statements to investors. At the end of the year, we also provide the financial statements to the auditors of the fund. It was that partnership with our hedge fund clients to service investors which created the opportunity for us to expand into prime custody. The financial crisis, on the other hand, enabled us to grow in reverse. In order to meet investors' requests for more information, funds started to use us as a prime custodian even though they did not use us as an administrator. However, over time many opted to outsource their internal operations to us and use BNY Mellon as an administrator. Large funds which still self-administer are now appointing us to provide an asset validation and price verification service, which we call AV/PV, mainly to confirm the whereabouts of assets and the prices of assets that do not trade regularly. It is almost certainly a staging post on the way to appointing a full third-party administrator. We have a number of those relationships now,



SPONSORED SECTION



Brian Ruane

and most of them started as prime custody clients, which are naturally migrating to our administration services.

Cottone: Large and successful hedge funds were never going to change their whole operating model overnight because of market events. Investors seeking greater transparency have influenced hedge funds to seek services such as AV/PV, which provides hedge funds with a solution to meet their investors' demands. As they continue to grow, and recognize the efficiencies that can come from outsourcing certain functions to a third party, they may choose to go over to a full third-party administration service. Since we are already familiar with their portfolio, it is relatively easy for them to make the transition.

DH: How powerful an argument is operational convenience?

Ruane: Look at our market share and presence in collateral management. Many of the exchanges and CSDs and CCPs of the world manage their collateral with us, so a hedge fund can pledge assets to CME or Euroclear through BNY Mellon conveniently. The vast majority of the prime brokers also have their principal clearing and collateral management relationship with us, and even those who do not use BNY Mellon as their

principal clearing agent will maintain an account with us. Operationally, it is very easy for us to move assets from an account in the name of one prime broker to an account in the name of another prime broker or a depository or a clearing house. We saw very early in the crisis the natural synergies between the broker-dealer clearing services we already provided and the hedge fund services we could provide.

Cottone: If you look at who hedge funds interact with, nine times out of ten their counterparty has a direct relationship with us. It is not only reassuring for hedge funds to know that their counterparties are working with us as well as themselves, but also makes it operationally efficient to work with us. They both can access securities and derivatives clearing and collateral management services through one business.

DH: Do you mean hedge funds are using BNY Mellon as an independent third-party collateral manager?

Cottone: Hedge funds look to us to help with collateral management in two main ways. First, on the initial margin or independent amount, they are looking for tri-party arrangements between themselves, us and the prime broker as counterparty. Secondly, the derivative margin management product offered by our broker-dealer services group is attracting interest from hedge funds ahead of the switch to compulsory centralized clearing of OTC derivatives. Because we have assets in prime custody, we can handle variation margin payments to CCPs seamlessly. Even in OTC derivative transactions that cannot be cleared, hedge funds are already insisting that collateral pledged to them as the counterparty be held by us in a segregated account.

Ruane: Prime custody is itself a form of collateral management. We are holding the assets, and play a major role in creating the desired risk profile as we manage the flow

of assets between a custody account with us and a brokerage account with their prime broker as they are needed as collateral for leverage. The operational efficiency that results is an important factor in winning the business. Pure collateral management is used mainly by the largest alternative managers, many of which control all or part of their own funding.

DH: Full collateral management would encompass securities lending. Do you lend the stock of your hedge fund custody clients?

Ruane: In past, we typically did not receive requests for security lending services from our hedge fund clients. In general, hedge funds borrow stock from their prime brokers, not lend. However, we have recently received a number of requests from hedge funds clients that are asking us to lend their collateral as if they were an institutional investor. Time will tell if this trend continues.

DH: What about securities financing?

Cottone: Larger hedge funds are shopping around and looking at ways to self-finance. They view us as an agent to help them borrow or lend assets, and offset their short sales. In other words, we are seeing the larger hedge funds set up in-house funding desks to conduct their own basic financing



Michele Cottone



SPONSORED SECTION

- ALTERNATIVE PRIME CUSTODY**
- EXECUTION AND CLEARING
 - PORTFOLIO CUSTODY AND SERVICING
 - CASH MANAGEMENT / LIQUIDITY SERVICES
 - AGENT LENDING
 - SELF-DIRECTED FINANCING
 - TRI-PARTY SERVICES / COLLATERAL MANAGEMENT
 - FOREIGN EXCHANGE CURRENCY HEDGING

while continuing to do the more esoteric or complicated financings with their prime brokers. We are not principal to those trades in the same way as a prime broker is, but we can facilitate them. Smaller funds are obviously not yet in a position to self-finance, but the growth of self-financing by larger hedge funds does represent an opportunity for BNY Mellon.

DH: If hedge funds are using your services to custody their cash collateral, lend their stock and finance their portfolios, are you not competing with the prime brokers?

Ruane: We offer an alternative solution to hedge funds who seek a third-party provider for services such as custody, cash management and processing of their self-financing activity. We partner with prime brokers, who are also clients on the broker-dealer side. We provide hedge funds with the ability to work with our own prime broker affiliate, Pershing LLC. So when we look at it from that aspect, we don't compete, we offer various solutions.

Cottone: It is true that, when it comes to cash collateral, prime brokers normally would enter into a bilateral versus a tri-party arrangement. They would rather hold the collateral themselves. But the major prime brokers that engage in swap transactions have become familiar with BNY Mellon's tri-party service and its terms. Primes understand that as an independent third party we will work in offering standard terms to all prime brokers, without giving preferential treatment to a competitor.

DH: It is not surprising that prime brokers claim hedge funds have lost their appetite for prime custody since 2008.

But have you noticed any slowdown in the growth of your balances?

Ruane: We have had hedge funds coming to us for prime custody and the associated asset servicing ever since the financial crisis. Clearly, we are not in the same situation as we were in 2008. The flow of new business is more orderly than it has been in the past when there was a great deal of anxiety and volatility. We have seen an increased and consistent demand for this service since last summer.

Cottone: Investors are still in the driver seat. They want increased transparency and diversification of counterparty risk, and they are pushing their hedge funds to provide it. We have large funds coming to us at the insistence of their investors, who have made further investments contingent upon the appointment of a third-party custodian and administrator. The manner in which assets are segregated in the name of the hedge fund with an Aaa-rated provider gives a level of comfort to investors. If something happens, they know their assets are held separately and can be easily identified.

DH: Do you worry that much of the growth you are seeing is cyclical?

Cottone: The model has shifted since the early days from a multi-prime-only to a multi-prime-plus-custodian model, and I do not believe we are going to see the industry go back to the way things were. Hedge funds now need a custodian as well as a prime broker to service their business.

Ruane: The industry as a whole is growing at a fast pace. We now have relationships with many of the top 100 hedge fund managers globally. We provide them

with various services such as AV/PV, collateral management or full administration services. These are some of the most important clients that we have. Already, the average hedge fund client is buying more than one service from BNY Mellon, and as they grow we are prepared to service their changing needs.

DH: Are you effectively developing a one-stop shop for hedge funds, in which custody, administration, financing, stock loan and other services are offered on a bundled basis?

Ruane: We view our products as flexible options to our hedge fund clients. Each value-added service can be leveraged as a standalone or full service offering.

CONTACT DETAILS

BRIAN RUANE
CEO of Alternative and Broker-Dealer Services
212-635-1160

MICHELE COTTONE
Head of Alternative Prime Custody Product Development
212-635-8294

