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Prime Custody Comes Into the Spotlight

Prime Custody is continuing to gain importance during 2012, the result of continued structural shifts in the hedge fund marketplace. The drivers of this growth from the hedge fund side are more fully paid assets, including investments in financial products that themselves contain built-in leverage, and a heightened awareness of the potential for counterparty credit risk. The definition of Prime Custody continues to change depending on the custodian; however, with different clients and providers using the term to mean different things. As their service models evolve, custodians are also growing into the challenge and opportunity of serving a larger hedge fund client base.

Table of Contents

Executive Summary	1
A New Definition for Prime Custody	2
Sizing the Market	5
The Hedge Fund Perspective of Prime Custody	6
The Challenge and Opportunity of Servicing a Hedge Fund Client Base	8

Executive Summary

- We estimate the assets available for Prime Custody services from hedge funds at US\$684 billion in August 2012. This represents an increase of 40% since 2010 and is the result of increasing hedge fund AUM and lower industry borrowing from prime brokers. These assets include exchange-traded products that may contain leverage themselves.
- There are two ways for clients to access Prime Custody Services. The first looks to prime brokers to manage all aspects of moving assets to a custodian and reporting asset positions. The second has opened direct custodial accounts and manages daily positions independently. There are differences of opinions in managing counterparty risk.
- While the costs of Prime Custody are advantageous compared to a prime broker, custodial services do not necessarily come with the same service levels that prime brokers can offer. Hedge funds must accept this trade off as custodians work to refine their service offerings at an ideal price point.

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A New Definition for Prime Custody

When Prime Custody first became an important buzzword in 2009, it was a catchall phrase for any business that hedge funds did with custodians via a prime broker. Most custodians had a service offering that they referred to as “Prime Custody,” although some of these services referred to a sales gateway into the full range of products that a custodian offered, while others referred specifically to accounts set up in conjunction with a prime broker to move excess long positions for safekeeping at a prime custodian. Prior to 2009, hedge funds that had custodial accounts were simply considered clients alongside pension plans, mutual funds and other groups. Following the financial crisis’ however, hedge funds began to pay much more attention to who held custody of their assets and their counterparty risk profiles. Custodians responded by forming new business units to focus on the specific needs of the hedge fund community.

Fast-forward to 2012: most custodians now have dedicated service teams focused on their hedge fund clients. This is the new Prime Custody, with sales and service efforts that seek to recognize hedge funds as a distinct client base with a different set of needs than a pension plan or mutual fund. The services of Prime Custody may still vary by custodian but hedge funds are recognized as a distinct demographic.

Over time, Prime Custody has come to exclude mutual funds and other non-hedge funds that operate both long and short. Long/short mutual funds have been steered towards Enhanced Custody or Self-Lending, a service that allows the custodian under the Investment Company Act of 1940 and similar regulation to offer a self-contained securities borrowing and margin financing operation. Mutual funds may also have ISDA agreements with prime brokers for swaps and financing activities. Other types of funds are usually now considered as simply custodial clients.

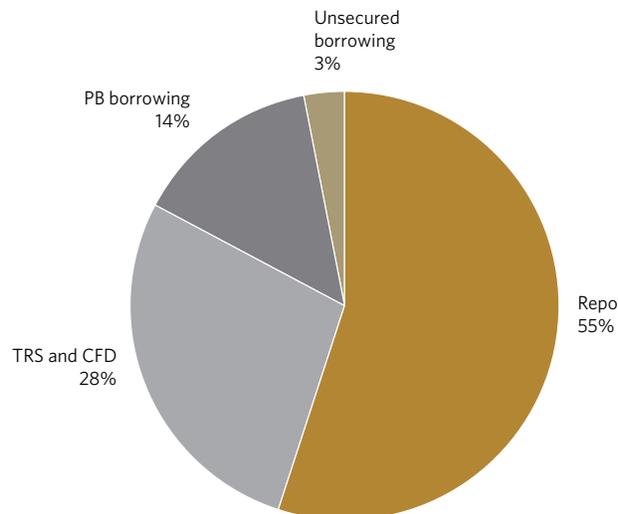
Hedge fund assets take one of two routes to arrive at a custodian’s door. In some cases prime brokers roll over excess long assets to a linked custodial account. The prime broker remains responsible for the account and provides consolidated reporting, however, the assets are safekept at an independent custodian. This option gained popularity as hedge fund investors sought more stable counterparties for their assets during and after the 2008 credit crisis.

More recently, we find evidence of hedge funds opening custodial accounts directly and maintaining control over the daily movement of securities. While a prime broker will automatically roll over securities on a daily basis, some hedge funds actively prefer to manage that process themselves. In this case, custodians have moved from acting as just the holders of assets to being something of a prime broker themselves, albeit with a different product suite.

The lines of Prime Custody can become blurred by the definition of hedge funds and the use of leverage. A hedge fund still typically refers to a legal structure that is now defined by global regulators. In practice these investment managers may look like traditional asset managers but employ more complex strategies or investing in less liquid assets. However, their legal organization had led them to socialize with like-minded managers and do business with prime brokers and other defined sets of counterparties in the “alternative assets” space. As a practical matter; however, these definitions may no longer be as applicable as they were four years ago for setting the parameters of a hedge fund relationship. The expansion of hedge funds as custodial clients is one example of this trend.

Hedge funds have also changed the amount and types of leverage that they use. Besides declining levels of margin borrowing from prime brokers, hedge funds have increased their use of futures, forwards and other exchange traded products that have built-in leverage themselves. According to the UK Financial Service Authority’s (FSA) most recent hedge fund survey, collateralized borrowing from prime brokers decreased from 24% in October 2009 to 14% in October 2011, and has been replaced largely by generating cash from repo-ing out fully paid assets (see Exhibit 1). Total Return Swaps, Contracts for Differences and other kinds of leveraged products account for another 28% of leverage. This trade-off from bank borrowing to product leverage increases what on paper appears to be fully paid assets, decreases the need of hedge funds to use a prime broker’s balance sheet, and makes custodians more attractive to hedge funds as service providers. Custodians are also well placed to manage the collateral associated with an increase in repo borrowing.

Exhibit 1: Sources of hedge fund leverage

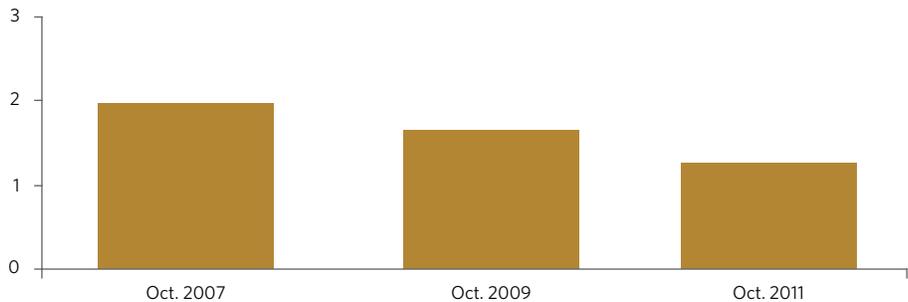


Source: FSA Survey, “Assessing the possible sources of systemic risk from hedge funds,” page 10, February 2012. Available at <http://www.fsa.gov.uk/static/pubs/other/hedge-fund-report-feb2012.pdf>.

Sizing the Market

Prime Custody continues to benefit from what now appears to be a long-term trend towards lower prime brokerage leverage in the investment management market. According to Finadium research, the amount of leverage that hedge funds use from their prime broker (the amount borrowed, as opposed to assets under management) has shrunk from a high of 1.92:1 assets under management in 2007, to 1.6:1 in 2009 and 1.2:1 in 2011, according to the FSA and articles citing prime brokers (see Exhibit 2). This translates into 20% of prime broker-financed margin for each unit of currency under management.

Exhibit 2: Levels of hedge fund prime broker borrowing leverage



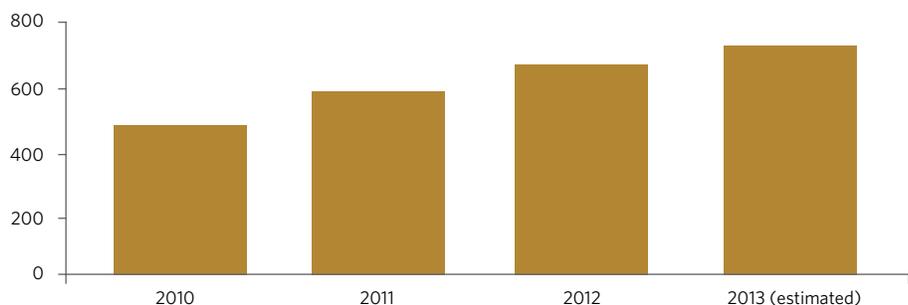
Sources: FSA, Reuters "Assessing the possible sources of systemic risk from hedge funds," page 13, February 2012. Available at <http://www.fsa.gov.uk/static/pubs/other/hedge-fund-report-feb2012.pdf>.

"DEALTALK-Banks offering credit again in hedge fund land grab," Reuters, available at <http://www.reuters.com/article/2009/10/08/dealtalk-primebrokers-idUSL83186020091008>

Lower prime broker leverage levels combined with hedge funds purchasing exchange-traded products, that themselves contain leverage, has created a surplus of fully paid assets in the hedge fund community. This is a substantial change in the business models of hedge funds and a different picture than the highly levered up hedge funds of 2007 and 2008.

Finadium has calculated the market for hedge fund unencumbered long assets – the assets that could possibly be part of a Prime Custody program – at US\$684 billion in August 2012 (see Exhibit 3). This is an increase of 40% since 2010. This figure represents the assets of hedge funds, not including Funds of Hedge Funds, multiplied by an estimate of 38% of excess cash and securities in an average hedge fund's portfolio. The assets available for

Exhibit 3: Hedge Fund Unencumbered Long Assets (US\$ Billions)



Sources: Finadium Projection, 2010 - 2013

Prime Custody have risen steadily over the years and are expected to grow further as 1) hedge fund assets continue to grow at a moderate pace and 2) hedge funds continue to use lower-than-historical levels of leverage. In fact, given the current regulatory environment, it is hard to imagine hedge funds returning to 2007 levels of leverage any time soon.

The Hedge Fund Perspective of Prime Custody

Hedge Funds that use Prime Custody Services appear to fall into two camps: the first have signed up for Prime Custody through prime brokers and allow the brokers to manage most aspects of the relationship. The second have opened custodial accounts on their own and take an active role in transferring assets between prime brokerage and custody accounts. While both groups initiated the move based on investor concerns about counterparty risk, their perspectives for using the Prime Custody services are substantially different and warrant closer investigation.

The first group relies on their prime brokers to manage their custodial relationships. Their initial motivation for setting up a Prime Custody account was to allay the fears of institutional investors and benefit from the safekeeping services of a custodian. These investors were concerned that prime broker counterparties might default and freeze assets in the process. By keeping as many assets as possible in an unencumbered long-only account, this concern was thought to be mitigated. Further, by allowing prime brokers to roll over assets on a nightly basis, custody becomes almost invisible to the hedge fund manager and reduces internal operational burdens.

The second group is much more proactive in their custodial relationships. They see custodians as an important part of their asset holding strategy alongside prime brokers and want the control of managing the daily flows of funds and positions. Some hedge funds also recognize that the legal arrangements of allowing a prime broker to control a custodial account also means that the prime broker could recall those assets in times of need. It is clear that Prime Custody has now become a useful and expected part of these funds' asset holding strategies.

There are some regional differences in hedge fund attitudes as well. In Europe, hedge funds have always had third-party administrators operating in the background alongside prime brokers, and this has reduced the operational burden of funds in adding on a Prime Custody service. At the same time, the Lehman collapse and concerns over a repeat of a Madoff type of scandal have shown the importance of managing commingled and custodian long-only accounts on a proactive basis. Taking this a step further, hedge funds are using excess cash that could be considered commingled assets at either a prime broker or a custodian and buying Treasuries or other high quality assets to hold in a custodial account. This guarantees that the assets will be held in a fund's own name. The most recent evolution to the service is that European hedge funds are now looking at what else custodians can do for them, although this is a slow process given the strong existing relationships between hedge funds and prime brokers.

In Asia, Prime Custody became interesting to hedge funds later than in other parts of the world, driven by the smaller scale of funds and their operational limitations. During Q2 2011, however, three new factors changed market behavior. First, hedge funds appeared to only gain the appropriate scale with some new funds launching with US\$500 million to US\$1 billion. Second, institutional investors began to strongly request from their hedge fund managers that they open Prime Custody accounts. Lastly, funds became concerned yet again about the counterparty risk of their prime brokers. There are still concerns around operational burdens, particularly for smaller funds, and some funds are still conservative about utilizing a new type of service. Even so, Asian hedge funds recognize that industry best practice requires doing business with a custodian. The next step is finding the right balance between engaging with multiple counterparties and managing operations.

According to Finadium conversations with hedge funds, the growth in Prime Custody usage has been significant. It is thought that 50% of hedge funds with over US\$1 billion in AUM now have a Prime Custody agreement in place; this is up from 15% in 2008. Hedge funds that resist signing up for Prime Custody may not have a full understanding of its role. These managers report that they would be perceived as operationally inefficient if they used this kind of service. We expect that further education in the market will increase the number of funds that sign up either directly or through their prime broker.

Hedge funds that have created Prime Custody relationships appear uniformly pleased with the pricing on these accounts. If there is no leverage involved and hedge funds are tapping into the core infrastructure of major custodians, they find that their cost for basic custody and clearing is much lower than what they would pay at a prime broker. They also have no concerns about assets being rehypothecated as all funds are in long-only, no margin accounts. More than ever, hedge funds are establishing tri-party relationships with both their Prime Custodian and prime brokers. While initially this may force some price renegotiation on the use of leverage and trading commissions, overall hedge funds reported financially that maintaining a proportion of assets in Prime Custody is much more beneficial than leaving all the assets with a prime broker.

The Challenge and Opportunity of Servicing a Hedge Fund Client Base

The greatest challenge and opportunity for Prime Custodians today is maintaining advantageous costs for clients while developing their service levels. The core questions for custodians, prime brokers and their clients are, what is the point where custodian service levels rise to the level where they are directly comparable with prime brokers, employing even the same staff? And, is attaining this goal in the interest of custodians themselves?

Recognizing differentiating pricing structures available through a Prime Custody relationship, hedge funds report a “you get what you pay for” attitude toward the service. In the past, hedge funds have been willing to pay custodial charges instead of high leverage balances. In today’s market, any fee increase means less money to go around for perks and specialty product developments.

According to Finadium research, hedge funds must be comfortable with this trade-off. As one example, hedge funds report a difference between the skill sets of people who are hired by Prime Custodians and those hired by prime brokers.

Both groups have skill sets appropriate and acceptable for their roles, but prime broker teams have prior experience in the specific expectations of hedge funds and have established client service models centered around them.

By maintaining the relationship with their prime broker, funds benefit from access to the capital raising and research capabilities available they have always received.

Custodians in turn report that they are working towards enhanced service levels and, while there may never be an exact equivalent to a prime broker, Prime Custody will offer a very reasonable alternative.

For custodians, servicing hedge funds opens up new business opportunities. Like other asset managers, hedge funds need valuation and multicurrency foreign-exchange trading services. Hedge funds also have needs specific to local regulations such as the Alternative Investment Fund Manager Directive (AIFMD) or Securities Exchange Commission (SEC) registration. Changes in collateral management practices brought on by the movement of Over-the-Counter (OTC) derivatives to Central Counterparties will require hedge funds to either upgrade internal systems or seek outsourced service providers like custodians. By building an entrenched client base, custodians generate additional demand for services they already offer and may have incentives to grow in other areas.

Significant differences will continue to remain between custodians and prime brokers. There is no indication that custodians want to simply replicate the prime brokerage business model. Historically, the approach to financing and risk has been the primary differentiator. Hedge funds that require substantial leverage or engage in any bilateral trading strategies are the right fit for prime brokers; these funds are able to meet only a limited amount of their service needs from a custodian. A basic cultural aversion to risk has also been the primary reason why custodians have not offered fully formed prime brokerage services in the past.

Custodians continue to play around the edges of the prime brokerage business model however. Enhanced Custody, also called Self-funding or Self-lending, allows an institutional investor, hedge fund or mutual fund client to custody assets with a custodian, borrow stocks for shorting and generate cash for going long on margin. These activities are all confined to the account holder however; the custodian acts as principal for facilitating transactions but account holders are ultimately financing themselves. This is a significant difference from the prime brokerage model of financing clients from a bank's own balance sheet, and rehypothecating assets in order to make up shortfalls in their funding levels.

Hedge funds with excess long balances may want to evaluate where and how they hold their assets considering several factors:

- **In what form are a hedge funds' excess long assets held at a third party provider, and does this provide segregated access to the funds in the event of the third party's default?**
- **How much operational control does a hedge fund want or is able to manage over its flows of excess long positions and is it seeking a middle office service model?**
- **If the hedge fund trades products that require leverage or collateral movements, is the fund optimizing its fee structure and holdings? Is the hedge fund optimizing their collateral management approach and do they seek a provider to help them accomplish that? Where are their assets held today? Are both their encumbered and unencumbered cash and securities held with one or multiple primes?**
- **Who are their counterparties? If the hedge fund is dealing with multiple primes or fund administrators, are they seeking a full service provider who can offer them both?**
- **Are the hedge fund's assets or portfolios leveraged and does their provider have established relationships and connections to the top prime brokers within the industry to provide a tri-party collateral management service?**
- **Are investors pushing the hedge fund to seek a bankruptcy remote model should their counterparties, such as prime brokers, go insolvent?**

Hedge funds have thus far responded positively to Prime Custody, and largely without disrupting their prime broker relationships. As hedge fund leverage levels continue to fluctuate, and more hedge funds recognize the cost and service level differentials of doing business with custodians, we expect that the Prime Custody service model will continue to evolve toward servicing this group of asset managers.

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