Promising outlook for European start-ups

Challenges and opportunities in prime finance

Allocators favour equity-focused emerging managers
Contents

In this issue...

04 Evolution is the key to staying competitive
By James Williams

07 Prime brokers battle the perfect storm
By Duncan Crawford, Newedge Alternative Investment Solutions

08 Strong opportunities for Europe’s start-ups
Interview with Kevin LoPrimo, Global Prime Partners

11 The attraction of emerging managers
Interview with Jack Seibald, Concept Capital

12 New regulations set to raise costs and erode margins
By James Williams

14 The challenges in prime finance
By EJ Liotta, PrimeOne Solutions

Publisher

Editor: James Williams, james.williams@globalfundmedia.com
Sales Managers: Simon Broch, simon.broch@globalfundmedia.com;
Malcolm Dunn, malcolm.dunn@globalfundmedia.com
Marketing Director: Oliver Bradley, oliver.bradley@globalfundmedia.com
Publisher & Editorial Director: Sunil Gopalan, sunil.gopalan@globalfundmedia.com
Graphic Design: Siobhan Brownlow, siobhan.brownlow@globalfundmedia.com
Photographs: iStock Photo; various
Published by: GFM Ltd, 1st Floor, Liberation Station, St Helier, Jersey JE2 3AS,
Channel Islands Tel: +44 (0)1534 719780
Website: www.globalfundmedia.com

©Copyright 2012 GFM Ltd. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the publisher.
Now with a New Model for Prime Custody.

Manage collateral online with groundbreaking new technologies from Pershing Prime Services—PrimeConnect™ and PrimeConnect40™. Customized for both hedge funds and ‘40 Act funds, these systems automate the process of moving collateral between the custodian and Pershing Prime Services to help mitigate risk and boost operational efficiency by providing:

- Control of collateral selection
- Automated credit and risk approval process
- Online real-time margin calculator
- Consolidated portfolio view

PrimeConnect and PrimeConnect40 represent more market-leading innovations from Pershing Prime Services—the New Model Prime Broker.

If you manage a hedge fund, ‘40 Act fund or alternative assets, contact us at:

(866) 538-5046 • primeservices@pershing.com • pershingprimeservices.com
Evolution is the key to staying competitive

By James Williams

What is evident among the top-tier prime brokers is the emphasis they place on helping clients and their end investors do their best work.

That starts with the quality of the prime brokerage offering, the safety of their assets, the safety of the counterparty handling those assets and the alignment between the fund, its investors and its financier according to Philip Vasan, head of prime services at Credit Suisse, New York. Pricing is a secondary function of this.

“We’re aiming to get those right, after which pricing becomes an outcome. Are clients actually getting what they need to solve their problems?”

“That’s an important distinction we’ve tried to draw with our clients over the last few years,” says Vasan.

Firms like Credit Suisse take a highly tailored, focused approach to prime brokerage. Quality of operation is, in essence, the ultimate value-add. Whereas some in the industry have been keen to over-expand their client base, top-tier primes have taken a more considered approach, allowing them to spend more time with each client. Vasan says that the firm has
already digested the capital impact of Basel III and operating in that new framework for its clients.

Stu Hendel heads up the prime brokerage business at Bank of America Merrill Lynch. One of the big strategic focuses for the business has been in building out a dedicated team to focus solely on the start-up space.

“In today’s resource-constrained environment it comes down to picking your sweet spot, and dedicating the proper resourcing. We’re trying to do that in a measured way. When we make a decision to partner with a start-up manager we over-resource them,” says Hendel.

Hendel’s start-up team sits within the prime brokerage business but is effectively ring-fenced. It covers consulting, start-up services, start-up sales and capital introduction on a global basis. Adds Hendel: “To be a viable, long-term prime broker you have to be in the start-up space because it allows you to build relationships from the ground up.”

Newedge’s prime brokerage business is widely regarded as the market leader for CTA/managed futures strategies, having won a combined 61 European futures and fixed income mandates last year.

But as Duncan Crawford, co-Global Head, Alternative Investment Solutions (AIS) group emphasises, the firm is not resting on its laurels. Constant evolution is the name of the game.

“Firstly, we’re opening new distribution channels for our listed derivatives business. Our new solutions will provide a broader range of buyers access to managed futures which – in general - is a different process for UCITS and mutual funds compared to offshore funds. We’ve also been a major provider of managed account solutions since day one: half of our business is in the managed account space, which continues to grow.”

A further sign of evolution is the fact that this year Newedge rolled out its FX prime brokerage offering to enhance its multi-asset platform offering. Newedge has been doing FX clearing and settlement for the last 15 years for a select number of clients but now a more enhanced “industrialised” FX solution is available to a wider audience.

“Are clients actually getting what they need to solve their problems?”

Philip Vasan, Credit Suisse

The benefits of this platform to traders are greater operational efficiency and optimisation of post-trade allocation and reconciliation.

Says Crawford: “A manager can trade with multiple liquidity providers on our credit lines. Some of those trades will go to other FX clearers and some we will clear ourselves as their FX prime broker. Managers will have all their FX trades give-up to us to then split the allocations according to the account and “reverse give-up” the trades to their various managed account FX clearers. It’s very efficient for processing, netting and margining.”

The ability to provide a fully consolidated suite of financing, settlement and clearing, and value-add services across all major asset classes is something that all serious prime brokers now have to offer.

Credit Suisse integrated everything a fund could trade or finance into a single asset class neutral offering some 10 years ago, providing its clients with a complete toolbox to address their trading needs. In what proved to be a prescient move, this led them to develop the multi-prime solution well ahead of the financial crisis.

“We were willing to cannibalise our business to prepare our hedge fund clients and their investor clients for the reality that a multi-prime solution was both safer for the hedge fund, and would enable them to wield their buying power more effectively,” says Vasan.

Ajay Nagpal is head of prime services at Barclays Capital. Operationally, the firm has developed a comprehensive solution where all equity-related financing – cash or synthetics – clearing and settlement falls within prime. Likewise for fixed income, be it the repo business or the prime brokerage business.

“I don’t believe there’s any other organisation where equity financing, cash and synthetics, fixed income financing – repo or prime brokerage – futures clearing
“It is by being a partner, that we become a leader.”

Chris Topple
(Head of Prime Clearing Services, Newedge)
Prime brokers battle the perfect storm

By Duncan Crawford

Revenue pressures coupled with increased costs are forcing many in the industry to overhaul their business models in an attempt to capture new revenue streams. The alternatives industry has radically changed and the turmoil created by this has been particularly damaging to prime brokers, many of whom operate revenue models focused on stable client securities balances and securities trading volumes.

While the bulk of a traditional hedge fund manager’s investment thesis is implemented through equity and/or fixed income transactions, cost pressures are forcing prime brokers to diversify towards servicing strategies that utilise instruments other than cash equities and bonds, such as listed derivatives clearing, synthetic and FX prime brokerage. Top-line revenue for prime brokers has been compressed due to increased central bank intervention in global markets, as well as low market volatility. This has resulted in a decrease in their clients’ leverage, a fall in trading volumes across all instruments and the emergence of the inconsistent ‘risk-on/risk-off’ approach.

From a bottom-line perspective, the challenges are the same for prime brokers and their clients. With so much legislation impacting the industry, the cost of doing business is increasing for all participants but the smallest fund managers are being hit the hardest.

From an investor’s perspective the last five years have been characterised by poor returns and asset erosion, but the quest for alpha remains. Herd mentality may have resulted in assets flowing predominately to the largest hedge fund managers, but this will likely result in a homogenisation of returns as deployment of capital becomes more onerous and managers chase the same trades.

Consequently, we are observing a return to prominence of emerging managers, many of which are prop desk spin-outs. Investors are being persuaded by the increased agility of these funds with more attractive risk/return characteristics and employing fee structures more closely aligned with investor interests.

Furthermore, the investor community is ascribing more importance to liquidity and transparency on the back of several prominent fraud cases. One direct trend resulting from this is the emergence of separately managed accounts. This represents a significant opportunity for those prime brokers that are able to deliver an increased understanding of the asset owner, the trading counterparty and the credit risks involved.

Additionally, servicing managed accounts can be a counterintuitive concept for a prime broker to amalgamate into their strategy, as it typically requires an operational acceptance of multiple smaller accounts being traded by the same manager, each for a different investor and with lower trading levels.

At Newedge we believe that successfully implementing a workable managed accounts strategy for all clients will be a key differentiator in the future.

I have worked in the industry for more than 20 years and prime brokers have shown a unique ability to transform and prosper in the face of upheaval. I believe the changes we are observing will bring out the best in many of us: certainly, a return to stability and growth is within the industry’s grasp.

The continued emergence of Alternative Mutual Funds, for example, promises to offer a more diversified, and hopefully, more stable investor base for the industry.

For us all to emerge bigger and better than ever, prime brokers must evolve alongside fund managers and investors, and capitalise on the opportunities that have been borne out of change.
“We provide an institutional service to a market segment that doesn’t typically receive such a service from the bigger, top tier prime brokers,” states Kevin LoPrimo, head of hedge fund services at London-based Global Prime Partners, an award-winning boutique prime broker.

That market segment, predominantly, is hedge fund start-ups and small managers. Despite global macro headwinds, from what LoPrimo has been seeing this year Europe’s start-up market is as strong as ever. Global Prime’s position is to provide the go-to platform for these managers, who maybe don’t have sufficient working capital to be able to work with larger, more established prime brokers.

“The start-up space is growing quite rapidly. It’s an exciting time. I’ve been working in this industry for 30 years and I’d say this is as good a time for start-up numbers as ever, it’s just that they’re launching with smaller AUM,” says LoPrimo. There’s no denying that capital raising is tough today for new managers. Getting one’s voice heard is hard unless the manager has come from a leading prop desk and has a stellar resume. LoPrimo observes that whereas, around five years, the average manager was launching with between USD50-100million, today that figure is more like USD10 to USD20million or less.

Partly, this is because there are so many hedge funds out there. As the market gets more crowded, the ability to launch a unique strategy, and potentially attract numerous investors, diminishes. The whole point to Global Prime Partners’ platform, however, is to ensure that as the managers they work with – no matter how small – grow and succeed, a long-term symbiotic relationship is established, even if the manager then decides to move on.

“As some of our clients grow to the point where they’re running USD100-200million in assets they might want to work with a bigger firm. We understand that. The idea of our platform is that we will continue to provide them their outsourced operational support in the same way we are now, in addition to them getting the direct access to a big firm.”

When asked whether higher costs of doing business might put off potential new hedge fund managers coming to market, LoPrimo agrees that they are getting squeezed but doesn’t believe that service providers are necessarily over-pricing themselves:

“Firstly, consider the bigger prime brokers. Usually they will set a monthly minimum revenue target of between USD20-50K for each client: we don’t. Our minimum revenue target is much lower. A lot of the other service providers have also come downstream on cost: law firms, compliance firms, fund administrators. For instance, five years ago the average start-up was probably paying USD350K or more to get up and running, whereas we have many funds that have set up for a cost of USD75k or less.”

Given that Global Prime Partners has become widely regarded as one of the best networked firms for start-ups and small managers, LoPrimo says that more institutions are starting to approach them: “We have a few family offices interested in tracking some of our managers now.”

Around 85 per cent of our managers are equity-focused, and with institutions now starting to raise their interest, coupled with more managers coming to market, this is a propitious time for the firm:

“Our pipeline is growing quite rapidly. At the moment we are onboarding between two and five new clients a month, and based on what we’re seeing with the pipeline I believe that number will continue to grow.”
Overview

and execution, FX prime brokerage and OTC derivatives clearing all rest under one umbrella.

“Our strategy is to deliver the sum of those parts to our clients in whatever combination they require,” says Nagpal. Also key to the firm’s prime brokerage offering is its expertise and insight of the financing markets which derives from the fact that, as Nagpal states, “we are responsible for funding our clients’ positions and also the bank’s balance sheet across all asset classes”.

This has allowed BarCap to evolve its prime services business to the point where, today, a hedge fund client can have a single conversation encompassing all of their financing needs, all of their clearing and settlement needs, and leverage non-commoditised services including capital introduction, research and portfolio reporting across each major asset class.

Hendel confirms that BoAML rolled out its fixed income prime brokerage platform last year in response to the move towards centralised clearing of OTC derivatives.

This represents a huge growth area for primes and those that have the operational structure in place will lead the way. Those that fail to evolve – perhaps because the costs are too onerous – will disappear.

“We want to ensure that we have not just the capability to clear and settle those products but to cross-margin those products and offer collateral efficiency with respect to those products as well.

“At the end of this you’ll have a client who can have his collateral most efficiently managed by having all his products cross-margined, having all his collateral optimised for purposes of clearing and posting margin. We’re not there yet but our goal is to be a one-stop shop for clients across asset classes,” states Hendel.

“Being a Listed Derivatives house offers us great opportunities in the developing OTC clearing space,” confirms Crawford.

Credit Suisse has also moved purposefully to support OTC clearing and has gone live with its client offering but it’s still early days. “We are still in the foothills of client adoption but moving purposefully upwards,” states Vasan.

Nagpal believes that asset segregation is another important differentiator for prime brokers today; specifically, the ability to offer clients a menu approach. Some want unencumbered assets swept out to a third party custodian. Some might ask for their initial margin to be segregated. Still others might explore voluntary segregation provided by the prime broker, albeit at a cost.

“My point here is that there’s a menu of techniques clients can use, and most clients have determined what combination on that menu best fits with their own risk management objectives,” says Nagpal.

Hendel adds that Bank of America Merrill Lynch has partnered with third parties to develop its own internal custody solution to provide seamless customer support.

Although not always championed, the quality of a prime broker’s research and consulting expertise remains a key value-added service.

Managers now work in a new era of higher standards and much greater complexity. This has prompted leading primes like Credit Suisse to engage in active dialogue with clients on issues that simply weren’t top-of-mind a few years ago: e.g. safety of assets, best practices, managing costs in a more informed way.

“A hedge fund’s clients no longer include just investors and their consultants but the regulatory authorities as well. The insight and content that we are creating respects that we are speaking now as much to the CRO and the CIO of a fund as we are the CEO and CFO,” says Vasan, confirming...
that the firm’s Prime Consulting team is the busiest ever.

“Top-of-mind for the CRO today is regulatory risk management. The evolving regulatory framework will require the hedge funds of this decade are going to have to operate with a more thoughtful approach and meaningful scale in order to be viable. Our consulting team is devoting considerable focus to the rapid evolution in the job description of our hedge fund COOs, CFOs and CROs.”

Likewise, Hendel emphasises the value of consultation. In his opinion you cannot be a full-service prime brokerage without it: “Any new avenue of value-add we can think of we’re trying to impart to our clients. It could be providing colour around the stock lending market, the capital raising environment, the regulatory environment.

“Chris Throop is our head of Prime Brokerage Business Consulting and he spends all his time thinking about those different areas of content.”

Crawford cannot emphasise enough just how important research is and the benefit it brings to doing capital introduction work. Newedge has been at the vanguard of research on futures markets since the 1990s. Today, with investors looking to diversify away from equities and into more managed futures and global macro strategies, the firm is well placed to leverage its expertise and help educate investors who wish to increase allocations into such strategies.

“We’ve got data on individual futures markets which we’ve stored on a tick basis since 2000. We’ve been doing some groundbreaking research using that data, which distinguishes us in the market and adds value to our client proposition,” says Crawford. “The most recent piece of research we put out was on autocorrelation of managers’ returns, which was well received within the investment community.”

Published last month, the paper is called It’s the autocorrelation, stupid <http://trendfollowing.com/whitepaper/newedge.pdf>

Commenting on where he thinks future growth opportunities lie, Nagpal says: “I think in fixed income we’ll maintain our dominant position, in equities we’re growing aggressively, and for OTC derivatives clearing, futures and FX clearing, and we’ve established a multi-asset class clearing model.”

Going forward, prime brokers will need to become increasingly flexible as hedge funds move into new regulatory waters.

“We are working toward a model that helps managers tap other sources of financing away from prime brokerage. In a way we’d like to be the prime broker that helps hedge funds become less dependent on prime brokers.

“We plan to continue targeting our clients on a handpicked basis and will focus our attention on two fronts: to help them do their best work today, but also to think ahead to help adapt their businesses,” says Vasan.

“Ultimately it’s about helping our clients manage change in the interest of their investors.”

“I don’t believe there’s any other organisation where equity financing, cash and synthetics, fixed income financing – repo or prime brokerage – futures clearing and execution, FX prime brokerage and OTC derivatives clearing all rest under one umbrella.”

Ajay Nagpal, Barclays Capital
The attraction of emerging managers

Interview with Jack Seibald, Concept Capital

Last year, the majority of the USD70 billion in net new inflows went to the biggest well-established managers. And despite industry assets this year climbing USD183 billion to USD2.19 trillion, through Q3 only USD31 billion represent net inflows, suggesting that capital raising, particularly for smaller and emerging managers, remains as hard as ever.

To try and improve the efficacy of fund raising for such managers, Concept Capital have this year pushed on in their capital introduction efforts, expanding the team and hosting more regular investment meetings. As the firm’s managing member, Jack Seibald, explains: “Mid-way through the year we started hosting investment meetings. That effort has been well received both on the part of allocators to whom we’ve introduced a select number of managers, and of course the managers as it has given them the opportunity to meet with a several dozen allocators at a time.”

Since the summer Concept Capital has hosted three such events, with plans to schedule them on a more frequent basis in 2013. One of the spin-offs of this approach has been the production of an asset allocator survey, which is due to be published in the coming weeks. The survey reached out to a diverse range of investors more inclined to allocate to small and emerging managers - who represent the majority of Concept Capital’s prime brokerage clients - and included family offices, FoHFs, wealth managers and HNW individuals with a combined investment of USD150 billion in hedge funds.

“This survey was designed to provide some value-add to our clients and provide them with market research that may be helpful to them in the capital raising arena in the New Year. The survey dovetails with the strategy of having more regular communications with hedge fund allocators, so as to provide a better, more coherent way to guide our capital introduction process,” explains Seibald.

“The first meaningful statistic in this report is that well over three quarters of respondents expect to increase their allocations to hedge funds in 2013. Moreover, more than three-quarters of respondents said they were significantly interested in emerging managers, specifically those with an equity bent. That included global equities, US equities, emerging market equities. As a category, long/short equities seemed to elicit a strong response,” confirms Seibald.

With yields at artificially suppressed levels and interests rates having remained low, fixed income strategies have excelled this year. It is possible, from this survey that allocators think that the fixed income markets have peaked, and are gearing up to rotate back into riskier assets next year.

“We broke the survey down into a variety of categories but the ones that shot to the type, in terms of favoured strategies, were global and US long/short equity strategies. There appears to be an opportunity for emerging managers to gain assets in 2013 assuming they have a good story to tell and a solid track record of performance and volatility to demonstrate. If you’re a long/short equity fund manager you should be particularly encouraged by the results of our survey as there seems to be a ready audience willing to look at your strategy.”

Among the reasons for this increased interest in emerging managers demonstrated by the survey may be that many allocators already have representation with larger managers and are now looking for some “incremental alpha generation from emerging managers”, speculates Seibald.
Prime brokers are bracing themselves for a swathe of new regulations that will place them under fresh operational and cost pressure. “The operational expense and sheer implementation cost under all this new regulation is not something prime brokers will be able to pass on easily to their clients, so I expect their profit margins will be impacted by implementing the regulatory changes over the next two years,” comments Claude Brown, prime brokerage expert at law firm Clifford Chance.

These are challenging times for prime brokers. On the one hand their hedge fund clients are becoming more demanding by wanting better solutions at lower cost, at a time when trading volumes are down significantly and leverage levels remain modest at around the 2.5 to 2.5x mark. On the other hand, they’re facing increased costs of doing business because of the raft of regulation coming down stream.

As anyone will tell you, to be a major player in the prime brokerage arena means having enough “skin in the game”. Firms either have to be fully committed to building out their platform offering, or go home.

How, then, might things play out as global regulation kicks in? Before touching on the key regulatory points, it’s worth saying that in the next couple of years there is likely to be further consolidation in the market. Already this year Wells Fargo has acquired Merlin Securities: more will follow.
This will be in response to Basel III increasing the Tier 1 capital ratio requirements on banks. Currently banks only need to hold a capital ratio of 2 per cent of common equity in Tier 1 assets, but that is set to rise to 4.5 per cent. Factor in the 2.5 per cent “liquidity buffer” for risk-weighted assets and the funding of a prime brokerage business – which has never been a high margin business for banks – is likely to get harder and more expensive.

“My feeling is that Basel III will result in some more consolidation. Reduced trading volumes plus the other bits of regulation coming down the line might prompt some people to say this is no longer a business they want to carry on with, or to expand. I also think any expansion by prime brokers into emerging markets will be substantially curtailed,” says Brown.

Ironically, the fact that primes use netting for “quasi-secure” lending and implement leverage based on security over a client’s assets actually means that they are already well positioned as the future of the new regulatory environment moves toward secured lending.

Of perhaps greater concern is the AIFM Directive in Europe, which is likely to require prime brokers to undertake a substantial re-structuring exercise. Under the Directive any hedge fund will need to have a depositary who will be liable for any loss of securities held in custody, even due to the actions of unaffiliated third party sub-custodians.

Put simply, prime brokers are going to need to firewall themselves from the bank’s depositary function (if it has one). As one prime broker stated, this will involve creating new contractual relationships between depositaries and primes, adding that they themselves were now currently “working with all the top custodians, who will become depositaries, to jointly address the issues our clients will face”.

“Basically, this is going to create a lot more noise around the way a prime broker operates,” says Brown. “In essence, the rule is that the prime broker cannot be both a counterparty and a depositary unless it can show what is called “functional and hierarchical separation” for its custodial business. Generally speaking, most financial institutions that have custodial services have them embedded within that financial institution and not as a separate legal entity.”

This means that those who stay in the game are going to have to restructure themselves so as to ensure the depositary function is completely separate from the prime brokerage business. Clearly, there’s a cost, both material and operational, to doing this. The whole point of having a depositary function alongside the prime brokerage is for banks to create synergies. Under the Directive, banks will have to run an autonomous organisation within an autonomous organisation – rather like the Russian doll – and in one fell swoop remove the very operational efficiency it was designed to achieve through this forced separation.

Adds Brown: “For those that get the separation in place, even if the depositary is within the same group it’s unlikely to be in the same jurisdiction. Some might have custody services in London within the universal bank but actually they’ve got separate legal entities that can do third party custody services in, say, Luxembourg. Even though they are part of the same group there will be inefficiencies in the movement of securities and operational infrastructure.

“If you went through a hypothetical default scenario with a fund, if everything is in the same organisation you want to move quickly to shut it down, net off your positions, close out your OTC derivatives etc. In multiple entities within one organisation it may not be the smoothest operation but it’s 100 times smoother than it would be by having to use third party custodians and trying to unwind positions in different jurisdictions.”

The degree to which prime brokers are affected by the AIFMD will depend on whether they are “pure” prime brokers.
The challenges in prime finance

By EJ Liotta

The past several years have brought about rapid changes to the global banking industry. The post-credit crisis world has been defined by uncertainty and put pressure on revenues and operating margins. Combined with acute regulatory demands, this has created an unprecedented set of challenges for many firms. Organisations are facing significant obstacles to generating proprietary trading revenue and are now focusing as intensely as ever on their client franchises.

With its focus on hedge fund financing and service, prime finance is a major pillar of any client-centred banking organisation. Prime finance is capable of driving many facets of global investment banking including rates, order-flow and structured finance. Because of the long-term nature of prime finance relationships, it can help set a strategic tone across a banking organisation. Recently, much of the hedge fund servicing world has been dominated by a handful of firms. This has impaired competitiveness and adversely impacted the industry.

The post-crisis world has presented opportunities for new entrants to generate new revenue streams and introduce competitive forces, ultimately benefiting the global hedge fund community. Hedge funds’ continuing requirement for diversification and the long-term nature of the hedge fund/bank relationship make entrance into prime finance particularly compelling.

Larger, existing prime finance organisations also have an opportunity to gain market share. The challenges they face, however, are different from new entrants and are focused on simultaneously reducing cost and providing additional product depth. Many have spent massively in an attempt to crack the upper tiers of the industry, often meeting with mixed results and then ending up with expensive, bifurcated and hard to manage technology platforms.

While firms understand the benefits of expanding or entering into prime finance, the one major challenge faced by all participants is technology. New participants who wish to enter the space must build industrial-grade systems.

PrimeOne Solutions provides three core products that cover swap, cash prime brokerage and securities lending. The most basic features (i.e. trade capture, margin and reporting) are required just to enter the business, while advanced features (i.e. re-hypothecation, arranged finance, book optimisation) are needed for larger participants seeking to expand their product offering and/or drive P&L.

PrimeOne Solutions is the only technology firm in the world to provide a comprehensive package for facilitating the prime financing business. Although organisations face new challenges and opportunities, they must also comply with an increasingly complex, evolving global regulatory apparatus. Many regulations have now been entered into law and been interpreted by regulatory bodies, yet for many others the interpretation process has just begun.

The key is to ensure that a solid regulatory foundation has been put in place. For example, business-wide swap consolidation is essential to ensure compliance with Dodd-Frank. Equally, prime services-specific issues, such as limited use of client positions for funding purposes and finding asset-liability mismatches must be covered.

PrimeOne Solutions technology forms the foundation of these services, providing many off-the-shelf tools to ensure proper compliance, whilst removing barriers to entry. Using a cloud-based technology model, PrimeOne Solutions’ clients are able to improve time-to-market, take advantage of feature modularisation, and the naturally superior economics of hosting.
As EJ Liotta, global head of PrimeOne Solutions, explains: “The prime brokerage industry is facing a high degree of pressure around funding. Many firms operate on the basis of using short-term funding sources and finance clients for much longer periods creating a fundamental mismatch between asset and liability durations. We have capabilities that clearly show funding mismatches, thus providing an opportunity to reduce risk.”

Our re-hypothecation engine will also help prime brokers monitor their ability to use clients’ assets more efficiently.

This issue of prime brokers using the repo markets and re-hypothecation to finance a lot of the services they provide is also important in light of the fact that the Financial Stability Board (FSB) last month released a white paper on the potential regulation of the shadow banking market, entitled Global Shadow Banking Monitoring Report 2012. The objective here is to ascertain the degree of potential systemic risk created by such activity.

Says Frase: “Is there a mismatch between the assets raised by prime brokers on the back of clients’ securities and their obligations on the other side? The answer might be no but it’s likely to be re-examined again.”

It’s too early to tell what impact potential shadow banking regulation will have on primes but Brown thinks it could actually be a positive development because it would, in effect, level the playing field: i.e. bring hedge funds and other non-banking institutions who are increasingly starting to lend into a regulatory framework.

On the systemic risk issue, Brown observes: “If your hedge fund clients are getting into lending activities, how do you know whether or not they are lending to one of your big corporate clients? That creates a systemic risk that you can’t even see.”

“...that is institutions like Goldman Sachs and Morgan Stanley - or whether they are universal banks that have decided to do prime brokerage. These institutions, provided they effectively re-structure themselves based on the above, will find it easier to provide the depositary function. For the independent prime brokers, it might prove tougher.

Says Richard Frase, partner at Dechert LLP: “The track record for an independent prime broker and an independent depositary, if you look at what’s happened in Ireland, is quite a bouncy ride in terms of getting agreement at the launch of a fund. Any prime broker who can manage to work through that sort of arrangement should be in a good position under the new regime.”

Another key concern for primes is the liability issue under the Directive. Up until this year a lot of trust was placed in ESMA’s recommendations that securities being held as collateral would not have to be treated within the strict liability requirements under the Directive. That’s no longer the case.

But there are options. “One is to do what FoFs do, which is to place a charge over assets held with the depositary. Legally, this ought to work but operationally it creates problems,” comments Frase.

“Another option is to pass liability on to the sub-custodians, who then agree to assume liability directly to the investors. That’s something which we’ve tried to achieve in the past and been told it’s impossible. If they did manage to achieve this something good would come out of the Directive.

“A further option could be to persuade the manager to waive the requirement that they accept full liability, though this puts the responsibility back on to the manager. You might possibly be able to rationalise this if you were looking at an emerging market-type fund.”

Clearly, then, prime brokers face a structural and liability issue under the Directive, which will make it more expensive to do business. They will also need to pay closer attention to their funding models under Basel III. Technology vendors are aware of these regulatory pressures and are working hard to help prime brokers, and the wider investment fund industry, keep on top of things.