The End of the Single Prime Broker Model

By Sameer Shalaby, CEO, Paladyne Systems
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September's financial crisis calls into question an unaddressed issue in the rapidly changing landscape of independent investment banking and prime brokerage: The reliance by some hedge funds on a single prime broker. In our opinion, the era of prime brokers securing and maintaining exclusive relationships with hedge funds is now over.

Hedge funds with single prime brokers " even firms with less than $1 billion in assets under management " are currently scrambling to balance their assets and manage risk by establishing relationships with new brokers. In the immediate future, many hedge funds will need to take measures to reduce their operational dependence on their primes, actively seeking greater independence and disaster recovery arrangements to protect their assets and operations from third-party shocks.

The Risks of Overdependence

For hedge funds with a single prime broker, the sudden collapse of that relationship is devastating. When a prime goes belly up, a hedge fund can lose access to more than its assets; the fund's very operations can be at risk.

For much of the last decade, prime brokers have offered hedge funds "free" technology as a value-add in their relationship. This means a hedge fund with no technology can gain access to a front-office trading platform, direct market access algorithmic trading tools and even back-office accounting and reporting technologies, all provided and managed by the prime broker as a service to the fund. With prime brokers now on shaky ground, however, hedge funds are finding that this reliance on a single prime broker for fundamental trading and operations is leaving them vulnerable and potentially unable to do business in the event of a crisis.

The collapse of Lehman Brothers earlier this month and uncertainty at Goldman Sachs and Morgan Stanley saw many funds " at least 1,000, with about 20% over 800 million AUM " struggling to unwind assets, many of which were tied to single prime relationships. For these hedge funds, the confusion and disarray drives home just how much a fund's operational integrity is based on the health and good judgment of their prime brokers.

Fund managers that are able to withstand the current market volatility and shorting ban in the coming days and weeks will move quickly to assess these shortfalls in operations and infrastructure.

The Multi-Prime Imperative

The prime broker market, once dominated by Goldman Sachs and Morgan Stanley, has been transformed and is rapidly being dominated by those investment banks attached to a commercial entity " namely: Credit Suisse; Deutsche Bank; Bank of America; JP Morgan; Barclays; and Citigroup. Meanwhile, Goldman Sachs and Morgan Stanley are changing their status to expand into commercial banking in an attempt to expand their balance sheets to retain their hedge fund assets.

Funds that relied on a sole prime broker for infrastructure may choose to turn to their new prime relationships for infrastructure and technology. However, this plan only replicates the risk on relying on a single prime. Secondly, as the prime broker model itself shifts, those counterparties still operating will likely reduce service levels as margins fall and leverage is curtailed. Furthermore, some of those primes still do not offer technology that allows a fund to have multiple prime broker relationships.

Funds will need to grow assets in the future to be viable players in today's markets and to attract investors, which increasingly will be institutional allocations. To attract institutional money, these funds will need to pass rigorous business and operational due diligence investigations.

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Funds will also need to invest in technologies that will guarantee their capability to comply with likely regulation focusing on transparency. This will mean securing independent platforms for the front, middle and back office with multi-prime interface capability. Those funds that relied on a single prime broker for this capability will need to have this up and running in weeks, not months, once they have unwound their assets from their current prime.

Establishing Contingency Plans

For many hedge funds, the September 2008 financial crisis drives home the need for firms to alter their thinking on disaster recovery. With major financial institutions failing or being sold in fire sales, disaster recovery is no longer a "what-if" scenario that simply involves housing servers in an off-site location. Funds need contingency plans for their entire business model " to ensure that their technology, business processes, counterparty and service provider relationships continue uninterrupted in the event of a financial meltdown or catastrophic event.

To protect their assets, firms should consider that establishing relationships with multiple prime brokers can spread the risk that their assets will be in jeopardy if another crisis arises. In these troubled times, the best approach is to establish a balanced, independent infrastructure that is under the fund's control and oversight, with as little dependence on third parties as possible.

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