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The reshaping of the prime brokerage industry

In last month's newsletter, we discussed about the impact of the financial crisis on the credit rating of the major equity prime brokers to hedge funds. Last summer, Global Custodian published its annual survey of the prime brokerage industry which provides interesting insight on the impact of the crisis on their business and the perspective of the industry going forward. Global Custodian estimates that the revenue generated by the prime brokerage has ranged from \$25 billion a year to more than twice that figure.

Following last year events, one fund in three had experienced the termination of a relationship with a prime broker during the 12 month preceding the publication of the survey. This number rose to more than one in two among the larger hedge funds. As explained by respondents of the survey, the main reasons why prime broker relationships were terminated were as follows: counterparty credit risk concern, reduced need for service and those contractual terms were modified by prime brokers. Another reason is directly linked to the run to the gate in the last two quarters of last year by investors in hedge funds was induced, in part, by the fall of Lehman Brother, one of the six leading providers of prime brokerage services. Hedge Funds had learned in August 2007 and again during the Bear Stearns rescue that even contractually guaranteed margin terms were not sacred to prime brokers. However, in fall 2008, the leading prime brokers abandoned any pretense that anything mattered but the survival of their firm. Prime brokers effectively assumed powers of life and death over hedge funds, determining which they would support and which they would not.

According to the survey, the prime brokers that suffered the most from the reduction of balances on the last 12 months were Morgan Stanley (-70.2%), Goldman Sachs (-43.6%) and UBS (-38.5%). The ones that showed the largest inflow of new assets were Credit Suisse (+55.6%), Deutsche Bank (+51.6%) and J.P. Morgan (+47.5%). There was a rapid and decisive shift of balances, particularly among the larger funds that were most exposed to institutional investors, from broker-dealers to banks. In fact, it seems that the only thing that was making it hard to do business with banks, such as Credit Suisse and J.P. Morgan, was the number of staff members available to document and open accounts as fast as hedge funds wanted.

Last year events also unraveled the fact that hedge funds were not all clear with the level of safety that prime brokerage structures were providing to their investors assets. Following the fall of the U.K. regulated Lehman Brothers, a lot of hedge funds moved their balances to U.S. counterparties or to the U.S. subsidiaries of their U.K. relationships to benefit from the perceived extra protection provided by U.S. laws. Twelve months after the events, hedge funds are still trying to figure out what is the best way to secure the assets. In this connection, funds have implemented various solutions, namely: invest the cash in T-Bills or in money market funds, move the cash and/or the long positions to a custody account, open specific accounts to benefit from different asset protection programs developed by Regulators (for example, client money protection in the UK, liquidity guarantee program in the U.S., etc.). The prime brokers are trying hard to provide their clients with proprietary solutions; for example, Morgan Stanley is proposing a trust structure to custody long assets and cash; Citi has developed what it calls Prime Custody; UBS now offers clients separate custody accounts; and BNY is offering custody partnerships to established prime brokers. These solutions are not without disadvantages; for example, the fact that for operational ease, the automated "sweeping" of assets from the PB to the Custodian and back would require the Prime Broker to hold a power of attorney over the assets in the segregated Custody account.

In order to diversify their counterparty risk, Hedge Funds have opened new prime brokerage relationships. According to the Global Custodian survey, 49% of the respondents have done so in the past 12 months. This trend towards multi-prime brokerage is also not without its problems. From an operational standpoint, it is adding some complexity and hedge funds have to invest in technologies and extra resources to manage the different relationships. Also, from the investors' point of view, the multi-prime brokerage is adding some complexity to the due diligence as it becomes very complicated to perform proper assets reconciliation between the fund's administrator and its counterparties.

The prime brokerage has to adapt to the current environment and propose new solutions to retain and attract hedge funds clients. The solutions will have to be forward looking to ensure that the industry is not solving a short term problem; nor replacing it by another remote problem which could be worse than the cure.