HEDGEWEEK

INSIGHT REPORT

Charting New Territory:

THE FUTURE OF HEDGE FUND PRIME BROKERAGE

FEBRUARY 2022

SUPPORTED BY:

COWEN

KEY FINDINGS

PBs' activities face closer scrutiny following Archegos losses
The GameStop 'meme stock' short squeeze and the rapid implosion of Archegos Capital Management has upended the hedge fund prime brokerage space over the past year, with a number of PBs exiting the market, putting leverage models, transparency and risk limits firmly on the agenda among managers, primes and regulators

The new landscape is ripe with opportunities – and challenges
As hedge fund performance rebounds, and assets under management soar to record highs, prime brokers are well-placed to capitalise on the industry's recent positive momentum. But amid the dominance of the so-called 'Big Three', the increasingly quantitative, complex, multi-asset nature of the industry poses scalability challenges for some smaller PBs

Virtual networking is now an established part of cap intro services
The Covid-19 pandemic saw capital introduction services pivot to the virtual landscape. Digital events are now here to stay, offering time and cost efficiencies to managers – but in-person events remain vital when it comes to building lucrative relationships

Evolving market dynamics are reshaping primes' product offering and hiring process
New trends spanning technology, data, digital assets and ESG are transforming the way hedge fund firms invest and operate, and prime brokers are increasingly alive to how the business is evolving. Smaller and more boutique outfits can carve out specialist niches in burgeoning sectors, asset classes and geographies

PB selection is now more important than ever for new and start-up funds
Prime broker selection is more important than ever for start-up hedge funds and emerging managers in the process of launching, with services such as cap intro and consulting making the difference between success and failure

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A TRANSFORMATIONAL YEAR: ASSESSING THE CHANGING PRIME BROKERAGE LANDSCAPE

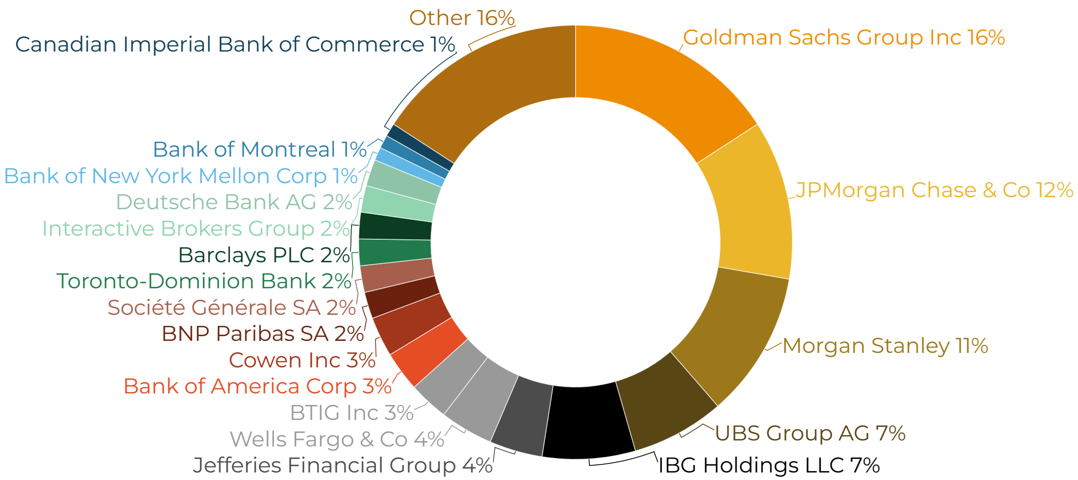
The collapse of Archegos and the GameStop short squeeze has radically upended the hedge fund prime brokerage space over the past year, raising fundamental questions over PBs' lending activities and business models

The implosion of Archegos Capital Management in early 2021, coupled with the "meme stock" short-selling squeeze which saw amateur investors drive up the price of selected shorted stocks – handing hefty losses to certain hedge fund managers in the process – has brought renewed upheaval to a prime brokerage sector that had only recently adapted to the challenges of Covid-19 and a landscape of lower revenues and falling trading volumes post-2008.

The sudden meltdown of Archegos – the New York-based family office led by Bill Hwang, a former 'Tiger Cub' who previously managed money at Julian Robertson's Tiger Management – led to USD10 billion in losses for its brokers. Amid the USD30 billion fire sale, triggered by a series of defaults on highly-levered margin calls by several investment banks, Credit Suisse suffered a USD5.5 billion hit, leading the Switzerland-headquartered banking group to shut down most of its Prime Services operations. Japanese lender Nomura also dramatically scaled back its cash prime brokerage business in the US and Europe following a USD2.9 billion loss.

The withdrawal of Credit Suisse from much of the prime services sphere saw the Zurich-based lender recommend hedge funds and other clients of its prime services business to BNP

Top 20 Prime Brokers by % Usage



Source: Bloomberg, February 2022; sample of 850 hedge funds

> The industry is growing, the assets are growing, the wallet is growing – but the actual number of providers has shrunk

Paribas as part of a referral agreement between the banks – a shake-up which brought "significant incoming business" for the Paris-based investment bank, explains Ashley Wilson, global head of prime services at BNP Paribas in London.

Before joining BNP in June 2021, Wilson had previously run prime services at Deutsche Bank, co-heading all trading risk across the equity division. He later oversaw the transfer of the electronic equity executing, prime financing and the Delta 1 units across to BNP Paribas in 2019 when Deutsche Bank exited the sector after the German firm overhauled its investment bank business.

"Archegos had been a very large client of ours – we unwound three large block trades to get out of the positions that we had. To come away unscathed from Archegos sent quite a powerful message to the hedge fund community that we knew what we were doing," Wilson says of the episode.

Beyond the immediate shake-up of competing banks' prime services businesses, the rapid Archegos collapse also flagged up more fundamental questions surrounding the oversight and supervision of excessive leverage and risk limits within prime brokerage lending activities.

Joel Press, founding member of hedge fund consultancy firm Press Management in New York, and former senior partner and head of the global hedge fund practice at Ernst & Young, notes that prior to the Archegos implosion, it was relatively rare for a prime broker to lose money.

Aftermath

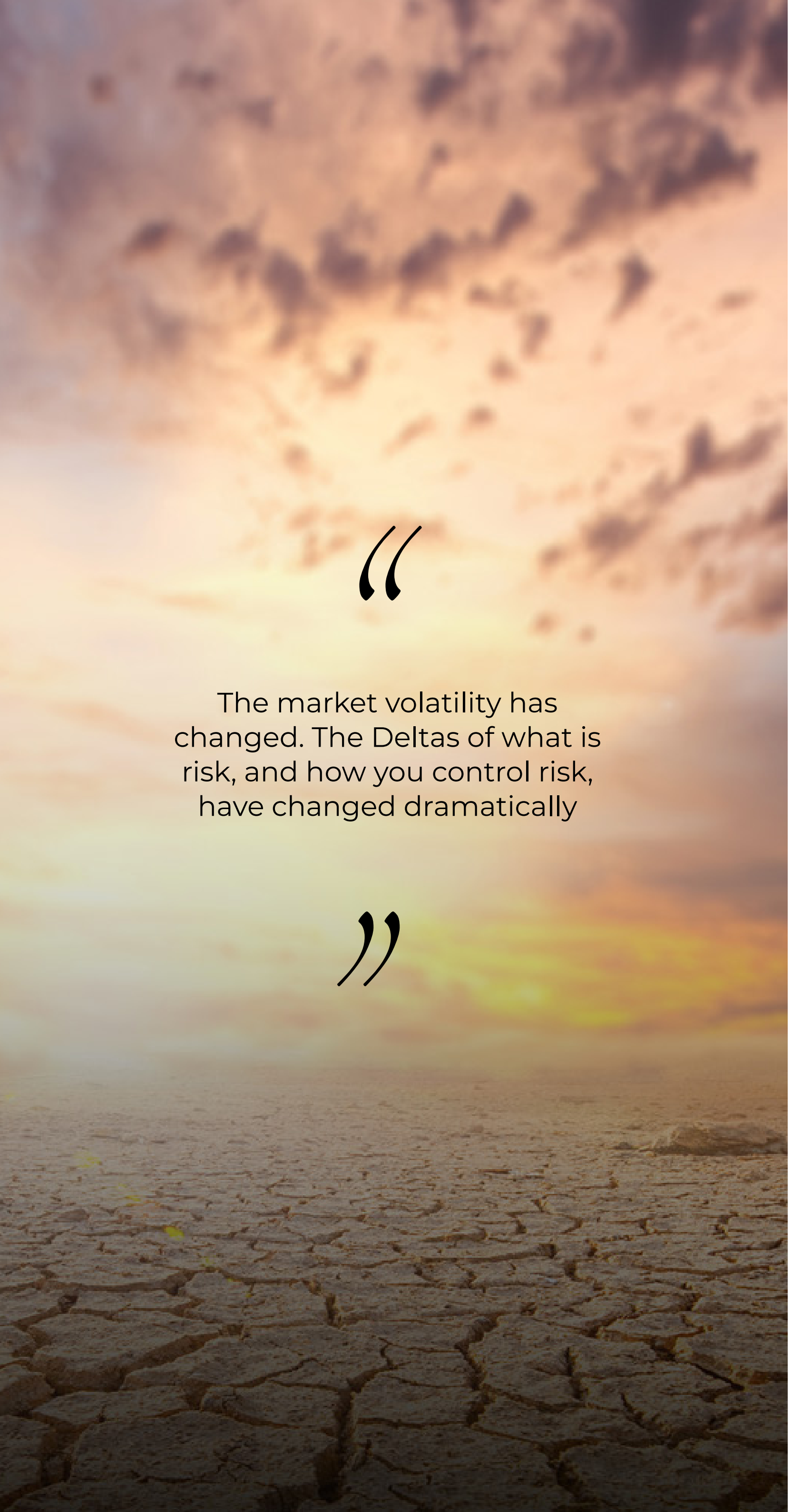
"What's changed? The market volatility has changed. The Deltas of what is risk, and how you control risk, have changed dramatically, and I don't think anyone has a full handle on it," Press says. "That's where prime brokerage has changed. What is leverage? How do they look at loan-to-value when derivatives are part of the structure? How do they determine risk with the current levels of volatility?"

In the aftermath, the US Securities and Exchange Commission has set out a raft of new measures covering certain instruments, particularly around equity derivatives swaps which were at the centre of the Archegos debacle. Plans include new disclosure thresholds on swaps and securities for hedge funds and other investors, and extra reporting requirements for sizable trades involving bonds and credit default swaps, among other things.

The fall-out came on the heels of the coordinated billion-dollar raid on hedge funds' short positions in US video game store chain GameStop by amateur traders – many from Reddit's WallStreetBets discussion forum – in January last year. By deliberately driving up the price of certain "meme stocks" through online trading platforms, they handed steep losses to several hedge funds, including Gabe Plotkin's Melvin Capital and Light Street Capital, led by another former Tiger cub Glen Kacher.

The so-called GameStop/Reddit saga had a substantial impact on the way that hedge funds were transacting shorts and shorting securities.

In the attendant chaos, many prime brokers discovered they could not rely on historical volatility models to assess the risk that clients were assuming, whether long or short, and instead tweaked their models to use 30-day volatility patterns rather six-month windows. The so-called "meme stock" frenzy – which also drew in other retail



> "The market volatility has changed. The Deltas of what is risk, and how you control risk, have changed dramatically"

stocks including AMC, BlackBerry, and Bed Bath & Beyond – saw several PB lenders reportedly tightening up risk controls and collateral requirements for certain short positions.

In a key step-change for their PB businesses, lenders adapted their models accordingly and are now seen as better-placed to address periodic bouts of volatility which risk the potential loss of capital resulting from an Archegos-style blow-up.

"Being a relatively nimble organisation allows you to address crises quickly when they arrive. During the 'meme stock' saga, for example, we were quick to act in a manner that protected our clients as well as our balance sheet," says Jack Seibald, managing director and global co-head of prime brokerage and outsourced trading at Cowen in New York.

Meanwhile, in another shift, there was a pull-back from certain harder-to-borrow shorts which had traditionally been a good source of income for securities lending desks and prime brokers.

"Retail investors put pressure on some highly shorted positions that hedge funds held, and as a result, you saw a pull-back from that market segment of the securities lending universe – the small-cap names that had been heavily shorted," says Eamon McCooey, head of prime services at Wells Fargo. "That revenue went away in the first part of the year – you started seeing managers hedge more with indices or pull completely away from certain stocks, so they weren't exposed to specific names. "That was prevalent throughout most of 2021, though you started to see more shorting come back into some of those names in the latter part of last year. That has continued into the first part of this year."

Stress tests

"I think larger funds continued, if they had a short view, to maintain their positions because they had the capital to afford to wait out the volatility. But the smaller hedge funds that typically trade in those small-to-mid cap names were potentially really impacted in terms of their investment strategy."

Daniel Childs, managing director at Jefferies in London, believes the relationship element of the prime brokerage business has become critical in the aftermath of last year's upheaval surrounding Archegos and GameStop.

"As a prime broker, what that means is you need to be close to the funds themselves to really understand their business and strategy," Childs, a former international chief operating officer at Citadel, tells Hedgeweek, adding that relationships are a core part of Jefferies' DNA.

"The industry is growing, the assets are growing, the wallet is growing – but the number of providers has shrunk. So there will be opportunities as a consequence; we've certainly seen growth there."

As the dust continues to settle on a remarkable couple of years for the industry, recent events have underlined the need for closer scrutiny and better understanding of the collateral that clients are posting, and spotlighted the importance of risk management systems and relationships within prime brokerage businesses.

"The last two years have provided prime brokers with a series of consecutive stress tests, including Covid, the meme-stock short squeeze phenomenon, the huge losses resulting from excessive margin extension, and the swoon in many Chinese stocks. Most firms navigated these volatile times and are the stronger for it, but some well-known ones elected to retrench or leave the prime brokerage business entirely," Seibald says. "As an industry, we have a responsibility to help our clients navigate through such volatile periods, but also an obligation to our employees and shareholders to manage our exposures during such periods to ensure business continuity."

TAPPING INTO THE HEDGE FUND RENAISSANCE

As hedge fund assets rise and performance rebounds, prime brokers can be a critical part of the industry's growth

The hedge fund industry is on the up. Following several years of patchy manager performances, a number of high-profile closures, and sustained investor reluctance to continue coughing up hefty fees in exchange for often-lukewarm returns, the sector is enjoying something of a renaissance. In 2021 hedge funds generated their third biggest annual gain since the Global Financial Crisis, while global industry assets under management swelled to record volumes last year – in the neighbourhood of more than USD4 trillion in total.

At the same time, investors are said to be once again looking at how hedge funds can provide diversifying returns in portfolios. A study of more than 2000 hedge funds by Barclays last year suggested hedge funds now offer a "compelling alternative" to fixed income allocations within a traditional 60/40 portfolio, and could be key to strengthening returns amid a shifting market paradigm.

"From the end of the financial crisis to the end of 2018, as market averages marched upward, it was very hard for alternative investment managers to stand out. The overriding theme was that they were underperforming while charging outsized fees. Then December 2018 happened, and they realised that hedge fund managers could still serve their purpose," explains Jack Seibald, managing director and global co-head of prime brokerage and outsourced trading at Cowen.

"This was an 'ah-ha' moment for allocators. And while it was short-lived, the onset of the pandemic brought back that 'ah-ha' moment, where you saw many hedge fund managers do very well in what they're supposed to be doing, which is navigating very volatile markets and making idiosyncratic investment decisions in those environments."

Seibald adds: "The current environment lends itself to that expertise and I think the interest level in alternatives will remain elevated relative to the mid-2010s."

Momentum

Against that backdrop, prime brokers appear well-placed to ride the current upward momentum in the hedge fund space. The past decade may have seen PBs' top-line revenues squeezed thanks to lower market volatility, falling trading volumes across securities and sustained central bank intervention in global markets, while the Archegos and GameStop sagas have thrown up new challenges. But stronger performance, increased assets and newer markets nonetheless proffer a range of lucrative business opportunities for prime brokerage units further down the line.

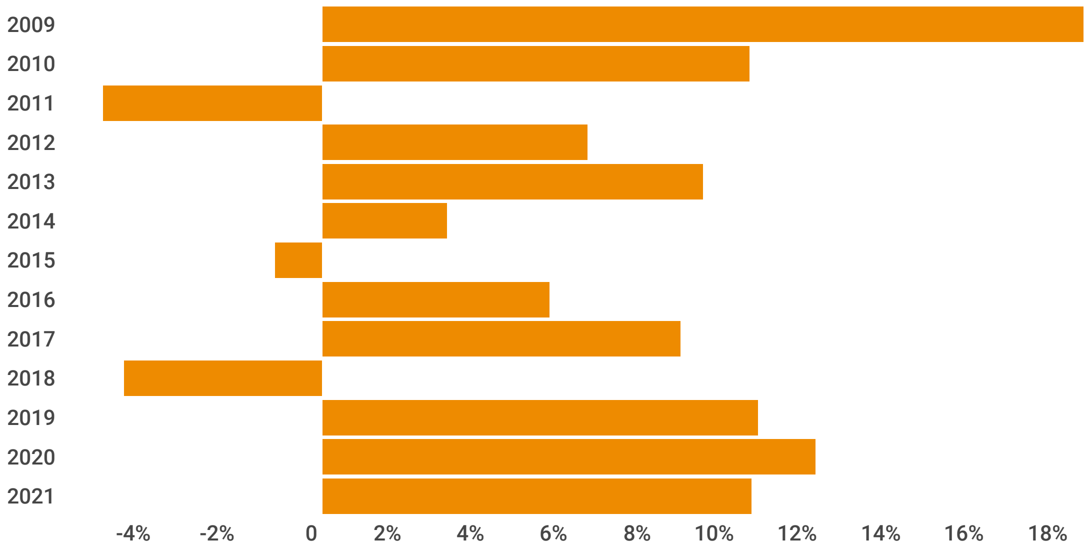
"The prime brokerage business is more important today than it's ever been," says Joel Press, founding member of hedge fund consultancy firm Press Management in New York, and former senior partner and head of the global hedge fund practice at Ernst & Young.

"Prime brokerage is going to be a critical part of the growth of the industry – look at trading volumes, look at the number of new instruments that are coming to play. It's also larger than it's ever been, because hedge fund assets are somewhere in the neighbourhood of over USD4 trillion."

Observing the broader market landscape, Michael Webb, global head of prime equities at Barclays in New York, believes that consolidation will define much of the future growth trends in both hedge fund managers and the prime brokers that serve them in the coming years.

"One of the big overriding themes is that this is an industry that's more at maturity than it is an industry that's seeing explosive growth as it did in the '90s and into the 2000s," Webb tells Hedgeweek, noting that much of the growth in hedge fund AUM in recent years has been fueled predominantly by performance rather than additional capital inflows from investors.

Hedge Fund Performance 2009-2021



Source: HFR Fund Weighted Composite Index, Hedge Fund Research, January 2022

"When you look at this industry, growth comes from scale and efficiency. So with the big getting bigger, which we're seeing in the hedge fund industry, there's going to be a corollary to the prime industry."

Stephane Marchand, head of international prime finance and clearing sales at JPMorgan in London, says: "The large global hedge funds are becoming more complex, more multi-product, more quantitative, more sophisticated. So prime brokers need to have almost a supermarket-like offering of all products. As soon as you take one product out, or are weaker in a certain area, it's going to be difficult for a prime to move into the top tier."

Turning to the opportunities and challenges confronting prime brokers specifically, Webb says PBs must be able to service a client base that is "big, sophisticated, technologically-driven, active in every product, in every market, and continuing to grow and expand their footprint."

As a result, Webb believes the USD10 billion of losses resulting from the Archegos collapse demonstrated the difficulty that sub-scale, third-tier prime brokers face today. "Some will pack it in, but you're also going to see others who are committed who will double and triple down in the business," Webb says.

With consolidation proving an enduring trend within the hedge fund industry over the last few years, prime brokerage participants concede that larger funds will continue to dictate terms in the coming years, with most PBs acknowledging that pricing power is still tipped in favour of the larger managers, with most brokerage shops remaining price-takers.

Robust

"In order to service these big hedge funds, you cannot be a niche player who's only in one market, or in one product. You have to be full service because the client you're dealing with needs full service and they're looking at their wallet holistically. So that means that within the PB space, the big will get bigger," Webb adds.

"The client of the future is large and sophisticated, much more global. It's cross-asset, it's highly quantitative – they look more like sophisticated asset managers than hedge funds of the past.

"Our business model at Barclays is to continue to be the only truly integrated prime on the Street. That integration is between fixed income financing, equity financing, US, Europe and Asia execution, financing and clearing. So all of the services that a hedge fund would need – the client base is going to demand that you are integrated across all products and services because that's where they're going.

"If you're integrated across execution and financing, the quants like you. If you're integrated across fixed income and equities, the multi-strategies like you. If you're integrated across your equity and cash business and your prime business, the long/short managers like you.

"The biggest clients in the world want to call up their prime broker and have a conversation because they need to finance, say, US government securities because they have got an RV strategy, they also need to finance JGBs, and their credit, and finance their long/short equity as well as their converts. They may also have a little bit of crypto.

"They want to think about you, as a financing provider, as one holistic provider of all that.

They don't want to have 27 independent conversations on every asset class in every region."

Underlining the importance of controlled growth, Ashley Wilson, global head of prime services at BNP Paribas in London, believes there is "huge upside" potential for prime brokerage businesses such as his, as the hedge fund sector continues to evolve.

"My focus is to make sure that each time we keep growing, we are very analytical about how the platform is performing and that it can handle this significant growth and the new business that we're seeing coming in every day.

"BNP has got the technology, it's got the balance sheet, we tick that non-US box that many clients look for, and it's got the management commitment to growing this business with serious investment," he says, pointing to the firm's acquisitions of French equity and research unit Exane and the Deutsche Bank platform. "But I need to be sure that the platform is working well, that it's stable and scalable such that we don't onboard too much too quickly."

Alexandra Krystal, managing director, head of prime services sales and capital introductions, CIBC Capital Markets, meanwhile points to the burgeoning opportunity set in asset-raising in Canada.

"We create situational awareness among the Canadian investors and global hedge fund managers are reaching out to us to amplify their message in this market," she explains. "If hedge funds want to grow assets in Canada across the family office, endowment, foundation, and pension fund space, CIBC Prime Brokerage has the unparalleled depth and breadth across this investor community."

Observing the evolving market dynamics of rising inflation, soaring commodity price rises and central banks retreating from asset purchasing programmes, Eamon McCooey, head of prime services at Wells Fargo, believes rising volatility and market uncertainty offers a "great opportunity" for hedge funds to differentiate themselves from long-only products within investment portfolios going forward.

"I think '22 will be a good opportunity to see significant inflows, separate from performance, into hedge funds, given market dynamics.

"Obviously if the hedge fund industry is performing well and raising assets, that's more assets that prime brokers are financing. It's very highly-correlated – a robust hedge fund industry bodes well for the prime brokerage industry."

INDUSTRIAL EVOLUTION: HOW NEW TRENDS ARE RESHAPING THE PRIME BROKERAGE OFFERING

New trends – from technology and data to digital assets and ESG – are transforming the way hedge fund firms invest and operate. What new innovations, products and services are prime brokers offering to keep pace with this evolution?

With markets in a continuous state of flux, new products coming into play, and new regulations being implemented, the need for prime brokerage businesses of all shapes and sizes to constantly evolve is key to maintaining an edge.

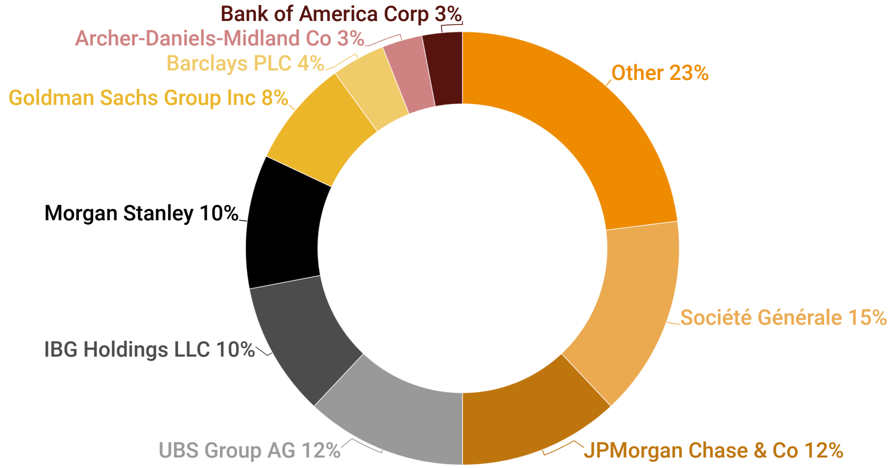
For prime brokers servicing systematic hedge funds, for instance, whose businesses centre around fast-moving computer-based investment strategies, this means building out new or enhancing existing technology or making other changes to the platform or processes to service such clients. For newer asset classes – such as cryptocurrencies – it may entail a more far-reaching and challenging expansion. Elsewhere, as responsible investing and environmental, social and governance (ESG) metrics have garnered interest among allocators and managers in recent years, prime brokers are also taking active steps to tap into the momentum for sustainability-focused products.

The ways in which prime brokers can best capitalise on these assorted trends amid the relentless drive for innovation that underpins much of the hedge fund industry will help define the sector in the coming years, industry participants say.

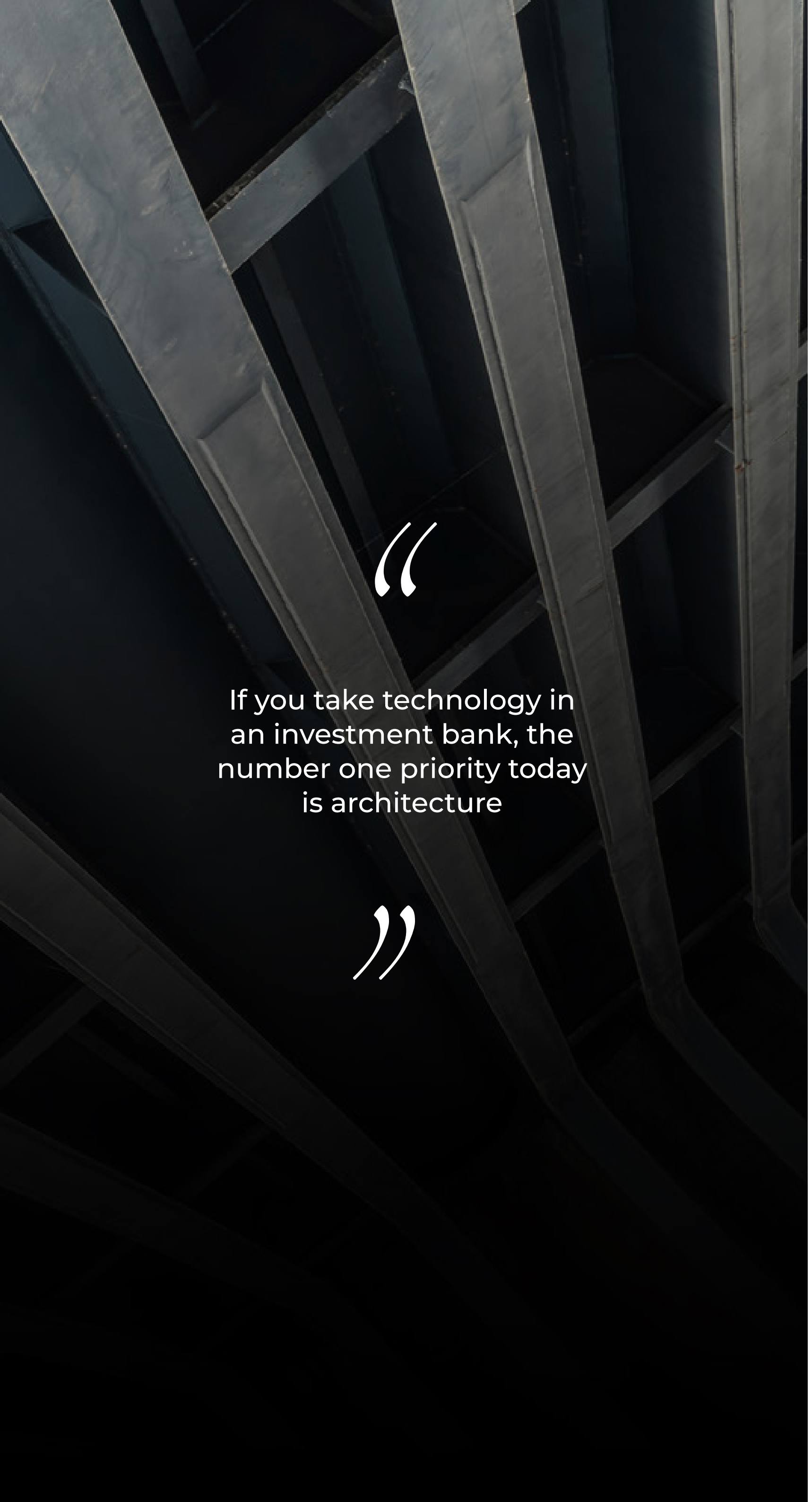
With technology becoming more important for hedge fund strategies of all stripes, and quantitative managers in particular trading ever-larger amounts of activity, a prime broker's ability to handle such demands from an electronic trading perspective is critical.

"If you take technology in an investment bank, the number one priority today is architecture - pure tech spending to reduce the unit cost

Top 10 Prime Brokers for Macro Funds



Source: Bloomberg, February 2022



and to be able to innovate on the functionality faster. It's the same in asset management," says Stephane Marchand, head of international prime finance and clearing sales at JPMorgan in London.

Most quantitative hedge funds have their own in-house technology and quant teams developing their trading models, and these firms are looking for their prime brokers to have the infrastructure to service the fund's trading activity.

"That infrastructure comprises three key areas for a prime broker: operational, technology and financial resources," says Eamon McCooey, head of prime services at Wells Fargo.

"A prime broker needs to have reliable and efficient operational and technology capabilities to provide capacity and scalability to meet our client needs across all market scenarios. It is critical that processing occurs in an automated and straight through environment to provide scalability and reduce operational risk. Coupled with a strong balance sheet and appropriate financial resources allows these funds to execute their strategies in a seamless manner."

He continues: "Given that Wells Fargo is relatively new in the prime brokerage space – we launched our business in 2014 – we were able to take advantage of a lot of the new technology that was available during our build-out period. We made significant investments across the business including in our low latency trading. We were able to partner with a market leader to provide scalability and throughput capacity with regards to the processing of those transactions. In addition, we invested in our post-trade processing capabilities including operation settlements, corporate actions tools, enhanced reporting, client portal with self-service tools for reporting, payments, corporate actions, security lending locates and other services which are important in servicing our customer accounts."

Bespoke

Mike Ginelli, managing director and global product head of prime brokerage at CIBC Capital Markets, pinpoints cryptocurrency and quantitative strategies as two key trends currently underpinning PBs' business evolution.

"From a cryptocurrency perspective, we are actively financing both US and CAD exchange traded products that reference digital assets. From a quantitative perspective, we continue to leverage our dominant market share by volume on the TSX, where we can provide unparalleled Canadian execution for these managers," Ginelli says.

"In addition, we are well positioned to provide bespoke margining specifically designed for quants. Both of these areas are very important for the future of CIBC Prime Brokerage and building out these capabilities from a personnel and tech perspective remains a high priority. As such, we continue to make significant investments in the areas of locates processing and axe lists."

The increasingly quant-focused nature of the business has also come into sharp focus during the staffing process, notes Ashley Wilson, global head of prime services at BNP Paribas in London.

"In the front office, I like to hire people with a quantitative skillset, specifically in the execution side," he says. "That flows over into wanting quants in my client analytics, and quants in risk."

He adds: "We now have a global business with an execution capability that can handle the most complicated of quant funds, which are obviously continuing to grow. With the bolt-on Exane acquisition, which gave us the European algorithms that Exane had, plus Exane's research, which is highly-ranked in Europe, that is an attractor

> "A prime broker needs to have reliable and efficient operational and technology capabilities to provide capacity and scalability to meet our client needs across all market scenarios"

that funds like to have access to."

This increased emphasis on quantitative capability within primes is, in turn, shaping their approach to hiring.

"We have a programme to hire quants, which runs parallel to the grad recruitment process. I want to hire quants from specific universities that we've identified, and have this deep math skill right across the board – that's where we are expanding," Wilson says.

Elsewhere, as cryptocurrencies, digital assets and blockchain technology become increasingly visible and viable components of the financial services universe, investment managers such as hedge funds – never shy of seizing on emerging trends and sectors and pioneering new strategies – require trading, clearing, settlement and custody of digital assets.

As such, prime brokers now need to offer a technology-driven dedicated solution, according to George Zarya, founder and CEO at Bequant, a Malta-based regulated virtual financial assets prime broker which services institutional and professional traders. This includes lending and borrowing services, access to trading venues, cross-margining capabilities, and post-trade services, among other things.

"An agile, holistic, cross-integrated platform should allow the client to automate the whole cycle without being reliant on an army of operations people. This is all about technology," Zarya told Hedgeweek recently.

Noting how Cowen has been among the early movers in the SPACs space, as well as in cannabis stocks and cryptocurrencies, Chris Elliott, head of European prime brokerage at Cowen, says: "We continue to evolve and innovate in keeping with the entrepreneurial spirit that you would expect from a boutique quick-moving investment bank."

Jack Seibald, managing director and global co-head of prime brokerage and outsourced trading at Cowen adds: "One area in the US where we do have the ability to touch much larger entities is in specialty asset classes – cannabis stocks being a major example.

"We are the only US-based prime broker offering a full cannabis solution that ranges from execution to custody and clearance. That's a major differentiating capability relative to the big bulge bracket firms.

"It means that we've served as the prime broker to most cannabis-dedicated hedge funds over the past few years, and more recently we have become the prime broker to some very large hedge fund platforms that have carved out a portion of their book to allocate to the cannabis space."

Seibald says the ramp-up in Cowen's outsourced trading business, which has seen it add fixed income and FX products in recent years, has also taken it towards "a different tier or calibre" of client, such as those typical of larger, bulge bracket outfits.

He explains: "We're doing the outsourced trading for those larger funds, and when they move towards an incremental prime solution - whether it's for a specific need or whether it's just to diversify – we are increasingly there in the mix because we do have the capabilities to service them in much the same way as the bulge brackets do."

Transition

In a number of instances in recent years, Cowen has transitioned some of its outsourced trading relationships into at least partial prime brokerage relationships, Seibald adds.

"Outsourced trading for us as a firm has been a game-changer over the last decade," he observes. "It's a value-added service that has become increasingly appealing to a much broader audience within the investment management community. It used to be very centered on hedge funds - smaller to mid-sized hedge funds – but it's now taken on a life of its own to the point where very large hedge funds and, more importantly, the traditional investment management organisations – like family offices, endowments and foundations, and even large investment advisory firms - are either looking at or have taken on that service, for a variety of reasons. One is cost, the other is expertise. That's relatively difficult to replicate unless you dedicate an enormous amount of resources to it."

Pointing to the substantial drive towards ESG within the industry, Will Davies, managing director and head of UK sales, prime services at Société Générale in London says: "We have an enormous initiative and push towards ESG across every single facet of the bank, with the prime services being very much part of that drive."

The challenge with ESG, however, remains in determining industry standards and taxonomy, and the metrics that go with that, in terms of how ESG is measured, and how success is measured.

"We are working with exchanges on the futures side to push ESG and be at the very forefront of the ESG phenomenon. If you look at it from our perspective as a PB, what we can do is that we have added an ESG future algo to our algo suite; we have held surveys and various webinars with ESG-focused clients. At every juncture we try to be as relevant as possible for clients and investors alike."

ONLINE AND IN-PERSON BALANCE KEY TO EXCELLING IN CAP INTRO

After two years of virtual introductions, are capital introduction services still a cornerstone of the prime services industry in the way they were pre-pandemic?

While the face of capital introduction services may have drastically changed across the course of the pandemic, these services remain essential to the hedge fund industry and have adapted to a (post) pandemic world.

The million-dollar question: is the future of capital introductions virtual or in-person?

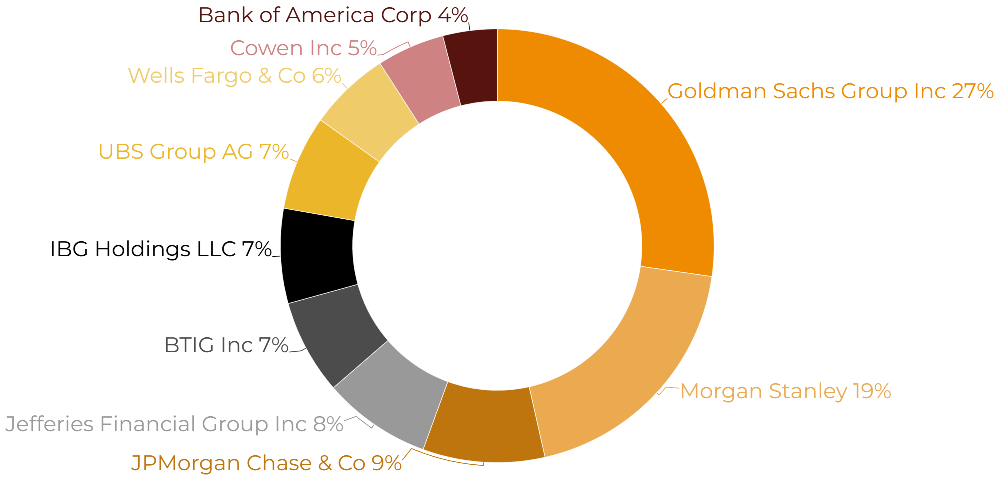
The capital introduction world has evolved over the course of the past ten years. With the crash of '08 and the pandemic throwing turmoil into set ways, cap intro services have moved with the times and adapted to varying circumstances.

"Before the global financial crisis, very few hedge fund managers had marketing teams, and those that did had limited personnel. Then, when hedge funds started to become more institutionalised, the client base changed and suddenly most hedge funds needed an in-house sales team team," observes Marlin Naidoo, global head of capital introduction, BNP Paribas.

For many prime brokers, the pandemic has proven that moving prime brokerage services, such as capital introductions, online has its benefits and can often be extremely efficient.

Eamon McCooey, head of prime services, Wells Fargo says: "Prior to Covid, most capital introductions meetings were held in person, often this was prohibitive in both costs as well as limiting the audience. With the onset of the pandemic, cap intro teams had to adjust their engagement

Top 10 Prime Brokers for Equity Hedge Strategies



Source: Bloomberg, February 2022

> There will be more managers of all sizes looking to gain exposure and broaden their investor base through cap intro

model from in-person to virtual meeting settings."

However, despite this Naidoo states that investors are now "chomping at the bit for in-person events" and maintains that events will not be left redundant after the pandemic.

"I would go so far as to say that people have virtual fatigue; virtual events have their benefits in terms of cost-efficiency and time efficiency, but managers and investors want to meet each other in person. In-person events provide an opportunity to network with one another less formally, which is an important factor in building relationships."

The future of these services lies in striking the correct balance between virtual and in-person contact. The pandemic changed the face of what capital introductions stood for (in-person events and introductions) and opened new opportunities for the service.

Naidoo believes that BNP Paribas have found a good balance for this through their newly launched digital cap intro service called 'Bridge': "bridging the gap between investors and managers, both in-person and virtually".

The service looks to store essential content, providing information and analysis around asset raising. It's about efficiency and scalability, knowing the investors and managers in the space, and seeing what they're doing.

Access

Speaking about the launch of Bridge, Naidoo says: "the pandemic forced this to come to fruition; it was something that we had already been working on before 2020, but the lack of available travel and in-person meetings created a real need for it."

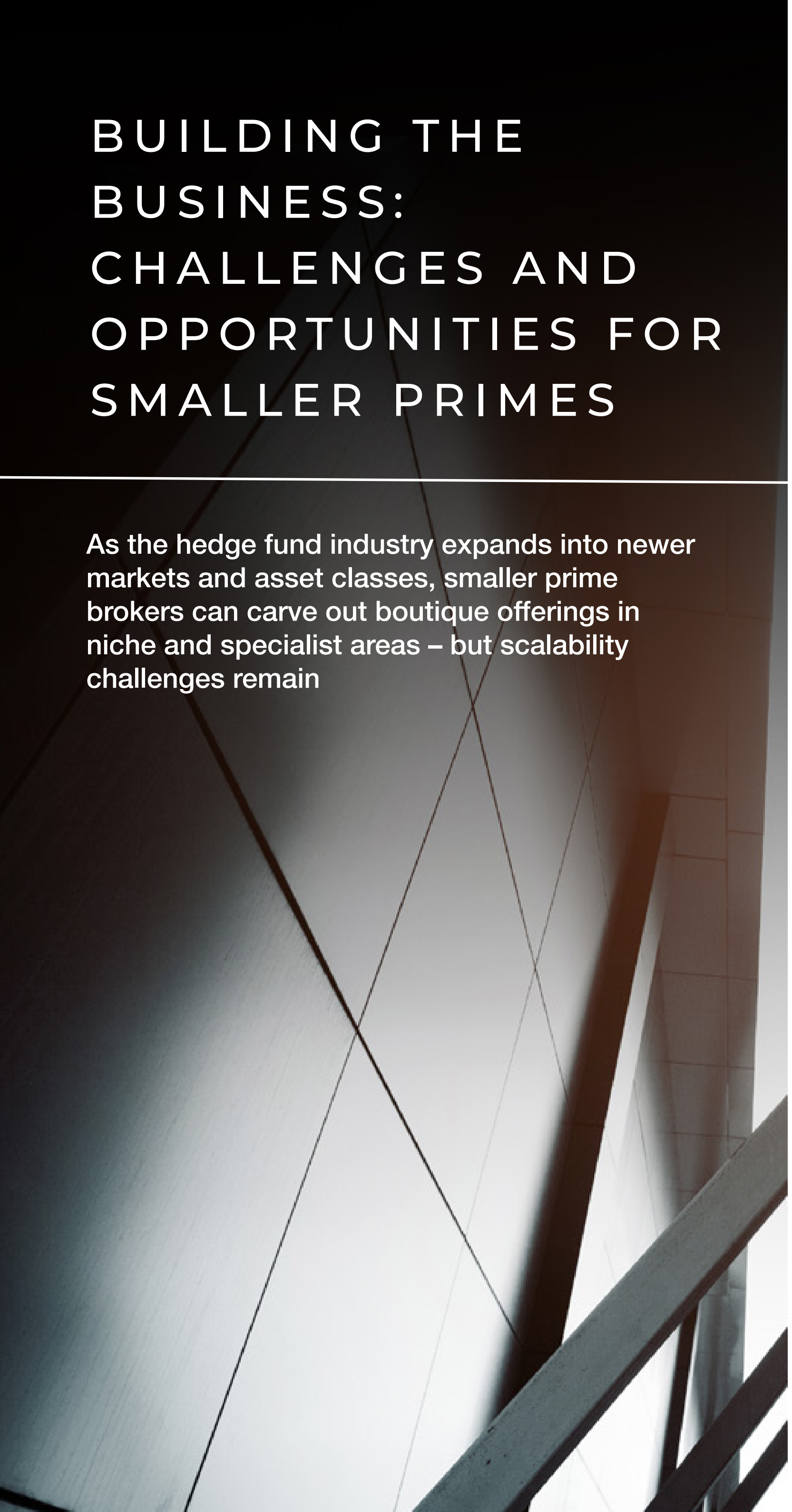
Aaron Steinberg, head of capital introductions, BNY Mellon | Pershing also notes how the pandemic "opened-up people's calendars, and managers' ability to meet with allocators increased."

The change in capital introduction services across the last ten years proves how quickly the industry needs to adapt to keep up. It's almost certain that things will once again evolve over the next few years.

Commenting on the future of the industry and service, Steinberg says: "We've been talking about access for a number of years, given the broader demographic of investors in the marketplace beyond just institutions who want to gain access to hedge funds and other alternative strategies. I think there will be more managers of all sizes looking to gain exposure and broaden their investor base through cap intro."

Regarding the future of events, Naidoo predicts that virtual events will continue to play a big role and thinks that the balance will sit at 25 per cent in-person events and 75 per cent virtual.

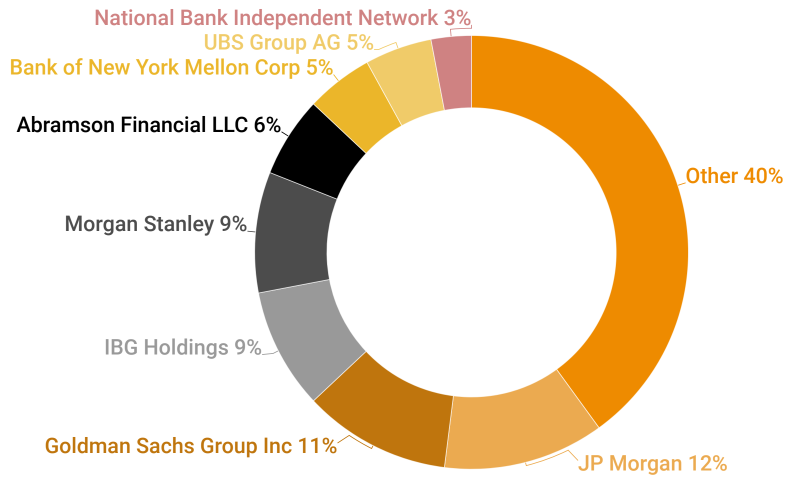
McCooey says: "This virtual environment has opened up meetings to larger audiences as well as making it more efficient for the fund managers in both time as well as enhancing the potential investor participants. I still believe you will see the return of the large marquee capital introduction events, but I think more of the day-to-day engagements will be done via video technologies."



BUILDING THE BUSINESS: CHALLENGES AND OPPORTUNITIES FOR SMALLER PRIMES

As the hedge fund industry expands into newer markets and asset classes, smaller prime brokers can carve out boutique offerings in niche and specialist areas – but scalability challenges remain

Top Prime Brokers for Multi-Strategy Funds



Source: Bloomberg, February 2022

While investment banking behemoths like Goldman Sachs, JPMorgan and Morgan Stanley continue to dominate the prime brokerage landscape in terms of mandate numbers and sheer asset volumes, many market participants see the expansion of hedge funds into new markets and asset classes, coupled with continued innovation in investment strategies and trading instruments along with tighter risk limits, as fueling demand for a wider spread of prime brokers to service a broader base of managers of all shapes and sizes.

Industry experts note how the smaller and more boutique primes have been on the leading edge of certain new asset classes, establishing specialist footholds and market share in sectors such as digital currencies and cannabis stocks, areas where larger investment banks have been seen to tread more cautiously given the potential regulatory and reputational pitfalls.

Thriving

For other mid-tier PBs, opportunities lie in capitalising on demand for regional coverage, such as offering Asian or European capital markets expertise where they may generate capital flows beyond core US markets.

Eamon McCooey, head of prime services at Wells Fargo says: “When you deal with these multi-billion-dollar hedge funds that have global financing businesses, there are niches for other institutions to come in and service and capture a meaningful wallet share. The large funds want that diversification – they don’t want all of their assets at a single prime broker. A lot of the large funds have internal risk limits on their exposure to a single counterpart that requires diversification.”

“In a crowded and commoditised field where primes are ever expanding, we are constantly looking for new ways to differentiate,” says Alexandra Krystal, managing director, head of prime services sales and capital

introductions at CIBC Capital Markets.

"Hedge funds are coming to CIBC for the geographic diversification along with the strong balance sheet and strong credit rating," Krystal adds. "CIBC Prime Brokerage looks like a boutique Canadian prime brokerage covering most of what the global bulge bracket prime brokers do, along with a geographic diversification, a strong balance sheet, commitment from senior management, and an upward trajectory.

She continues: "We want to help managers understand that we have built this business to access a true credit and multi-strategy house, which in our view are products that are underserved relative to the equity space. The result is hedge funds are getting the opportunity to trade with a service provider that has a platform tailored for a more active credit trading strategy."

At the same time, boutique prime brokers have also looked to carve out a more efficient and personalised prime brokerage and custody experience for clients, tapping into outsourced trading solutions free from the administrative bureaucracy and legacy technology often found in large investment banks and certain discount brokers.

Dale Klynhout, managing director at Lazarus Capital Partners, and founder of its prime brokerage business, told Hedgeweek recently how Lazarus is operationally leaner compared to larger prime brokers, which allows for faster resolution times to manager requests and queries.

"Emerging managers require cost efficient processes, outsourced trading desks and operational agility with minimal risk, along with time to ensure consistent growth within the early cycle of their growth," Klynhout said.

Pointing to her firm's "thoughtful and strategic" approach to price and margining for investment grade and non-investment grade corporates, SPACs, converts, and equities, among other offerings, Krystal says: "In terms of where we fit within the prime brokerage space, we believe we are a complementary addition or alternative to the largest and most successful prime brokerages."

Elsewhere, the increased trading volumes and renewed volatility characterising prevailing market conditions may also bode well for smaller PBs looking to grab a piece of the action.

"The likes of Cowen, Jefferies, BTIG, Mitsubishi, Scotia, I could go on – they're all thriving," says Joel Press.

Credible

"They're not just simply surviving – they're all doing amazingly well because the dynamics of the markets, such as trading volumes, are so large. I see the prime brokerage business over the next five years exploding with trading volumes and credit risk allocation, so you need to have other primes to help spread the risk and provide a broader range of execution."

On the flipside, however, some see smaller prime brokers potentially bumping up against operational hurdles further down the line, stemming from the scalability challenges inherent in the prime brokerage sector.

Outlining the challenges faced by many mid-tier prime brokerage shops, Stephane Marchand, head of international prime finance and clearing sales at JPMorgan, says: "You can either be fully in and try to challenge the top three, or you are a smaller niche player. The asset management industry is going through the same cycle – the cost is so high from a technology point of view, and from an innovation point of view, that you need to be extremely big to maintain a top three position, or you can choose to remain a niche player. From asset management to markets and investment banking, it's all about scale today."

"The problem in the business running sub-scale is that all of the money to be made in prime is sitting with the biggest clients. Prime is the ultimate scale business," observes Michael Webb, global head of prime equities at Barclays.

"For the smaller primes, the problem is that it's a very negatively convex trade – if the hedge fund that you deal with stays small, you're not going to get a greater share of the wallet. But if that hedge fund becomes big, then they go into the big bucket – they need the larger primes' big infrastructure – to clear, to execute, to settle, to asset service, often in lots of regions.

"With some of those mini-primes, they are hoping that their clients become bigger than when they first got them, but don't become big enough so that they leave for the big league. So it's hard to have sustainable returns in that space. You're fighting for a small piece of the wallet."

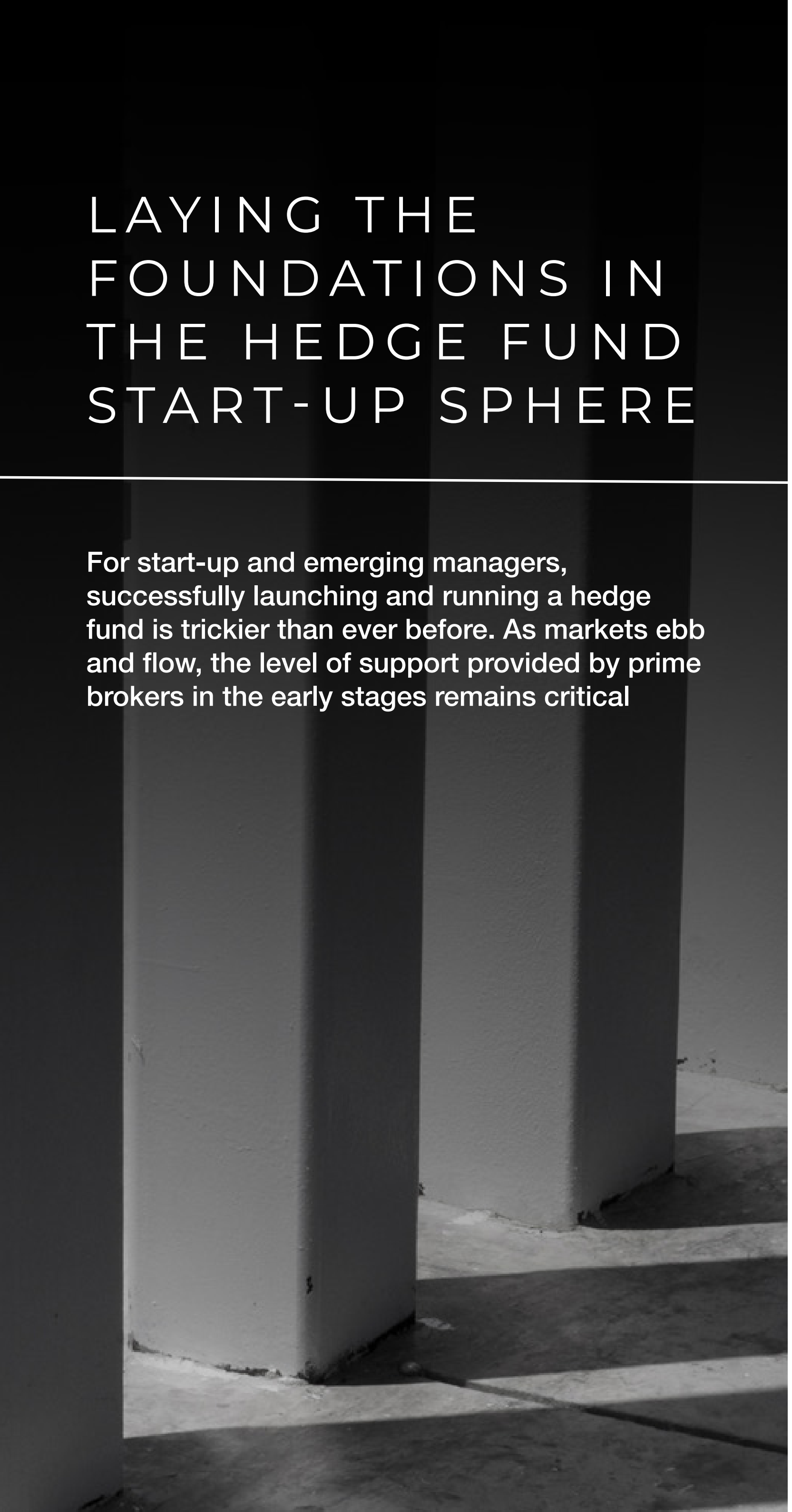
Underlining this point, he adds: "It's going to get more and more expensive to run a prime broker, just as it's going to get more and more expensive to run a hedge fund."

Still, a number of the prime brokers in the second or mid-tier space have the capabilities to become a credible alternative or complement to the bulge bracket prime brokers, according to Jack Seibald, managing director and global co-head of prime brokerage and outsourced trading at Cowen.

"While they certainly don't have the balance sheets that the bulge bracket firms do, in terms of capabilities such as global access, servicing clients, trading in foreign markets, and custody in foreign securities, they can certainly be considered reasonably credible alternatives or a complement, particularly when considering some of the additional services they can offer," Seibald says.

"In more and more instances, we're being looked at as an incremental prime solution, where funds are growing beyond certain levels of assets and they need to diversify their counterparty risk. And so rather than going to yet another bulge bracket firm because they already have a couple of them, they are adding a firm like Cowen to their stable."

LAYING THE FOUNDATIONS IN THE HEDGE FUND START-UP SPHERE



For start-up and emerging managers, successfully launching and running a hedge fund is trickier than ever before. As markets ebb and flow, the level of support provided by prime brokers in the early stages remains critical

Following the global economic upheaval and market shocks brought about by the Covid-19 pandemic, hedge funds' selection of service providers has come under ever-closer scrutiny.

The changing picture of the prime brokerage business has seen many PBs reduce the types of services they are willing to offer to managers, while the process of outsourcing across the service provider community has accelerated. As start-up hedge funds and emerging managers face bigger barriers to entry, the choice of options on offer – whether brand-name PBs or smaller, more boutique outfits – is often influenced by critical cost concerns. Now, more than ever, the process of picking the right prime broker – arguably the most important service provider – could make all the difference between success or failure.

ASHLEY WILSON, GLOBAL HEAD OF PRIME SERVICES AT BNP PARIBAS

"We have an emerging managers policy for funds that are under USD100 million in assets under management that are just starting out. We go through a detailed selection process in terms of the history of the firm and the portfolio manager, and whether we think we can get them from USD100 million to USD500 million with our capital introduction services.

"The thought process I have around emerging managers is that if you are in at the beginning, it's not the first or second year's P&L you are looking towards – it's the future where you think that if you are a day one prime and you have helped them grow to be a large fund, then you have a very deep relationship with that account and you can grow across global markets.

"Capital raising remains key. The number one conversation which has not changed is: 'How much capital do you think you can help us raise?'"

> The consulting side of prime brokerage is critical

EAMON MCCOOEY, HEAD OF PRIME SERVICES AT WELLS FARGO

"The emerging manager segment can be challenging in that it may require significant resources in terms of consulting and capital introduction resources from a prime broker that may not pay off given the large turnover in the emerging manager segment. However, if a fund can continue to grow there tends to be a strong relationship and wallet share with the counterparty that helped to launch them.

"One of the key services that emerging managers seek to leverage from their prime broker is capital introduction. Given that many emerging managers launch with capital primarily sourced from friends and family they are looking to expand their potential sources of capital by utilising the investor networks established by prime bokerage capital introduction teams. Often introductions focus on family offices and fund of funds given that large institutional investors can't invest in emerging managers due to investment guideline restrictions such as minimum investment size or maximum percentage ownership of a fund.

The second key service that emerging managers look to their prime brokers to provide is consulting services. Over the past decade prime brokers have built out their consulting business to provide myriad services to managers of all sizes but with a particular focus to emerging managers. These services include providing overview of service provider capabilities across the outsourced CCO, technology, admin and legal firm offerings. In addition, we see these teams providing managers with budget forecasting tools, marketing strategies, peer group analysis and human capital introductions, all of which are important to a new launch."

WILL DAVIES, MANAGING DIRECTOR AND HEAD OF UK SALES, PRIME SERVICES AT SOCIÉTÉ GÉNÉRALE

"Coming out of Covid, investors may be becoming more interested in meeting new managers, especially as there is more volatility in the market. There are smaller niche managers who have delivered alpha to investors and provide diversification and non-correlation from an investor portfolio perspective.

"We have a strong track record of providing cap intro services for emerging managers, particularly in managed futures where we have helped certain smaller managers and seen them grow to multi-billion dollar levels. It's been hard for many managers, especially commodity funds, but commodity volatility right now has created more demand for many of the more commodity-focused funds, which are coming back into vogue."

MICHAEL FITZGERALD, MANAGING DIRECTOR AT COWEN

"Aside from a small handful of very large launches, it is always difficult for new hedge funds to raise money. Yet the number of start-ups last year is roughly on par with the year prior, and so it's a trend we see continuing - Cowen can be an ideal partner as we can more than handle the core competencies of what they need in a prime broker.

"Newer managers often go from being at a large firm to starting a smaller firm and consequently need to consider all costs related to running their business. They want to make sure they mean something to their partners, and that the hurdle isn't so insurmountable. They need corporate access, capital markets access, and capital introductions – we're in the business of making bets smartly on emerging managers, and putting our resources behind them much as our larger competitors do for larger funds.

"We would not suggest that a start-up manager would skimp on building that institutional-style infrastructure, but if they're going to be launching below a number that requires them to register with the SEC, we often counsel clients to still build an environment, particularly in the compliance area, that enables them to pass an operational due diligence exercise from an institution and Cowen can offer assistance on many operational levels that a manager would otherwise foot the bill for.

"Oftentimes start-up managers look to us as an alternative voice to help them determine what's pragmatic to launch a business with, so that they can right-size yet also scale, based on what their projected assets are going to be out of the gate."

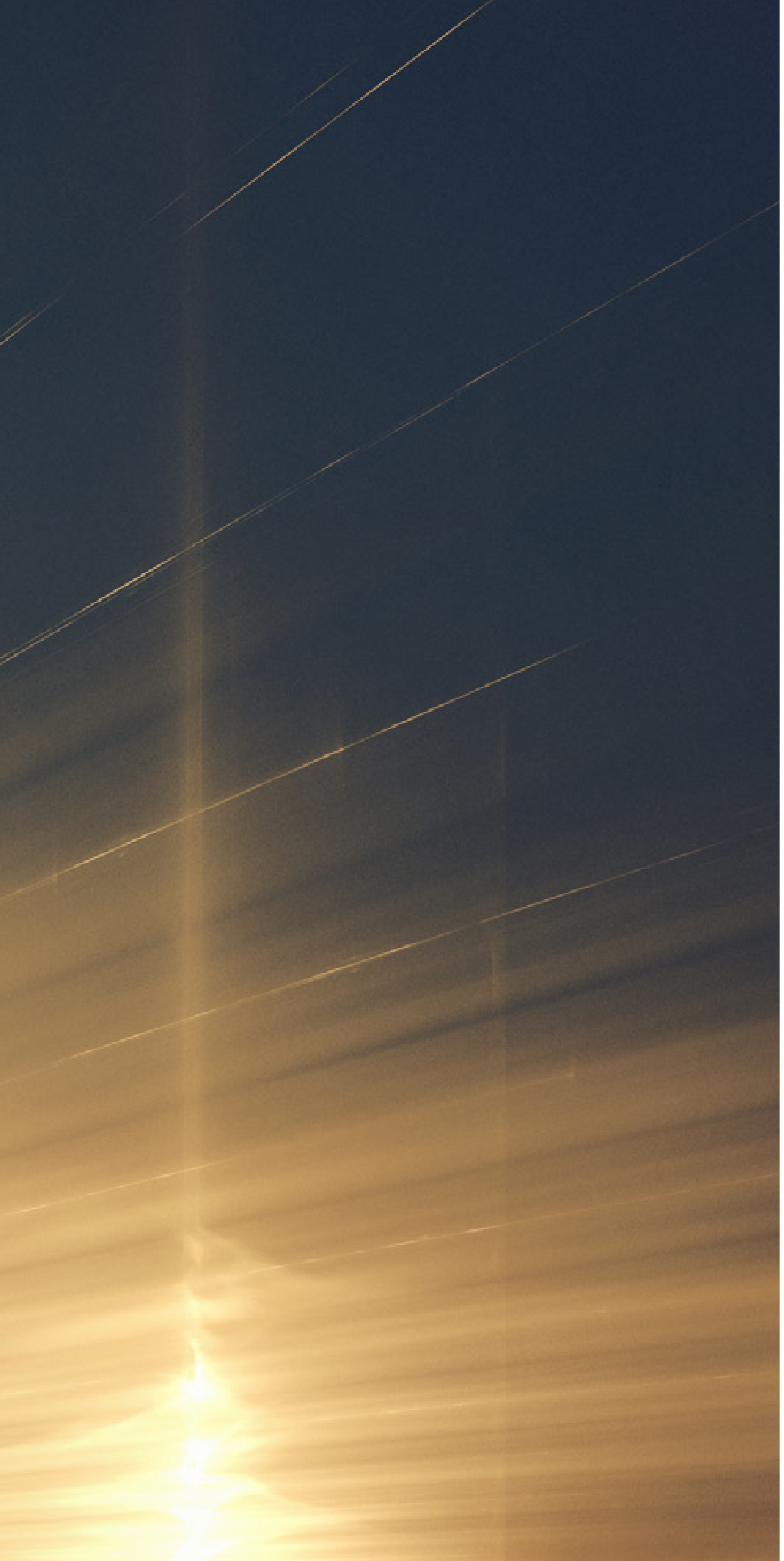
DANIEL CHILDS, MANAGING DIRECTOR AT JEFFERIES IN LONDON

"The hedge fund industry – the business of hedge funds – is very much about the relationship that funds have with their investors. Providing hedge funds with intelligence and advice around investors and how to grow assets continues to be an incredibly important part of prime brokers' offering."

"The consulting side of prime brokerage is critical. As hedge funds grow, they need to be focusing on different areas. In the early days, it's going to be about setting up their business; so building a team, helping them trade through, identifying appropriate service providers and raising capital. As a fund matures, interest may pivot to different strategic areas – for example the use of alternative data, ESG impact, identifying partnership opportunities, as well as investor trends. Bottom line is prime brokers should be able to provide valuable advice at every stage of a fund's life.

"What's maybe less well understood is the many ancillary pieces which are tremendously important if you are trying to grow and build a hedge fund business.

"Prime brokers like Jefferies have the ability to provide a more bespoke offering. Hedge funds care deeply about service and ability to scale. A fund that's running a few hundred million dollars with 20 staff will have a very different experience working in partnership with a firm like Jefferies that is in growth mode vs a prime broker not looking for growth."



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HEDGEWEEK

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