

Woodfield Wire

AN E-NEWSLETTER FOR HEDGE FUND MANAGERS
AND OTHER INDUSTRY PROFESSIONALS

Welcome! Woodfield's e-newsletter brings you articles about hedge fund-related topics and best practices. We welcome your thoughts--just hit "reply" and send us your comments.

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How to Choose a Prime Broker

If you are a fund manager, your choice of prime broker can be critical to your fund's long-term viability. How do you choose the one that's right for you? In our continuing series on best practices for choosing service providers, we turn our attention to the prime broker relationship.

Why Is the Choice Important?

Prime brokers offer services ranging from securities clearing and lending and global custody to financing and portfolio reporting, and provide access to options, futures and commodities. Some prime brokers also provide capital introduction, risk reporting, real-time P&L, electronic trading and a wide variety of other services.

Your choice of prime broker affects the way investors perceive you. Working with a known, respected prime broker can help communicate competence and, if your fund is a startup, can help establish your credibility.

More importantly, your choice of prime broker has a big impact on your operational efficiency. The prime broker makes sure that your trades are flowing properly, your assets are in the proper account types, and margin calls are addressed properly. Although these components may not be obvious when things are running smoothly, they are critical.

The prime broker's work dovetails with that of your administrator. The prime broker can help your administrator do their job more efficiently through providing such data as accurate realized and unrealized P&L, accurate tax lot and trade activity, and cost basis.

Finally, selecting a prime broker that can provide you the right level of service for your needs can help you manage your variable and fixed expenses--a key component in being able to prosper in the up times and survive in difficult times.

Step 1. Determine what arena you're playing in.

The largest prime brokers are investment banks such as JP Morgan, Morgan Stanley, Goldman Sachs and Deutsche Bank. They provide access to investment banking, securities and lending, and get most of their revenues from financing. They offer an extensive range of personalized services to their clients. In general, they do not cater to startups or smaller funds. Very large hedge funds need the balance sheet of one of these larger prime brokers to leverage financing for their trades.

If your fund is \$1 billion plus, you will likely need the services of one of these large firms. Even if your firm is less than \$1 billion but you're going to participate in new issues, secondary offerings, credit

defaults and derivatives, you should at least contact a few of these large prime brokers to see what they can offer your fund, while also considering other prime brokers.

The next group consists of prime brokers targeting their services to funds in the \$25 million and up range. These brokers get their revenue through trading and financing. In general, they are poised to provide a great deal more attention and service to this target audience than the large prime brokers are.

Finally, there are registered broker-dealers that target smaller funds. They handle front-end trading services but clear through the largest firms and are clients of those firms. Their clients' assets are housed at the larger brokerage firm. They get their revenues primarily from trading and some financing. If you have a fund with less than \$25 million, one of these brokers is likely to be a good match for you.

Step 2. Understand what's commoditized and what's unique.

All prime brokers offer custody and finance. Features that are more differentiated include technology, such as proprietary trading algorithms, order management systems, the ability to provide real-time P&L, the ability to shadow reports on assets not custodied with them; and services, such as capital introduction and deep analytics for investors. Some prime brokers can't do futures; others are limited as to international operations. Some focus on automation and low cost; others use a more traditional approach.

Prime brokers that specialize in startups will take a more consultative approach than those that don't. Some of them offer dedicated consulting teams that will work with startups to identify trading technologies and other service partners, provide capital introduction, and more.

Step 3. Identify what's important to you and to your investors.

Every fund will have different needs, based on trading technology and the expertise of the fund management. If you're dealing in municipal bonds or preferred stocks, for example, you may need a more sophisticated OMS (order management system) than if you are a long-short equity fund. If you are a relatively new fund manager, consultation services may be key.

As for your investors, consider what questions they will ask you. Investors want to know about such things as attribution, stock selection, exposure and risk, and will want to be able to get these analytics from the fund. One thing investors are likely to want is a proven prime broker--a name they've heard of.

Step 4. Do your research.

Contact a few of the better-known prime brokers of the size that best suits your fund and get them to show you what they can do. Say to each of them: "I need these solutions to attract and retain capital." Get the prime brokers to show you--not just tell you--the solutions that will help you articulate your edge and answer your investors' questions. You want to make sure that all the systems work properly for your fund and that the client service representatives you speak to do their jobs properly. Take note of the way they treat you and consider if that's the way you would like to be treated on an ongoing basis.

Read about the prime broker and look at the firm's balance sheet. It's important to know who will be clearing your trades and holding your money.

How many people at your fund should be involved in this choice? That depends on the size of the fund; if three people are managing \$45 million, everyone needs to understand what the prime broker is doing. If the fund has a 15-person staff managing over \$1 billion, only the trading office and back office need to participate.

Step 5. Make the decision.

Pick someone your fund can grow with. Think, "I may not need this now but I might need it two years from now." You don't want to make a change midstream if you can help it. Not only is switching prime

brokers a headache operationally, it's also a poor move in terms of market perception. Any investor is going to wonder why you're switching.

Evaluate the risks as well as the benefits. A dramatic example of risk in a prime broker relationship is the fallout from Lehman Brothers' bankruptcy filing in 2008. Although some clients' assets were saved due to the sale of the North American portion of the business to Barclay's, some other funds, whose assets were housed with Lehman Brothers' Europe operation, lost everything. Be sure you understand where your assets will be held and what would happen to them in the event of a bankruptcy.

As with any professional service relationship, part of the choice comes down to chemistry. Now that you've talked with people from several firms, studied their materials, done your due diligence and discussed it with your colleagues, what does your gut tell you?

When is it time to split prime broker affiliations?

Three or four years ago, it was usual for firms to add a second prime broker when the fund got to, say, \$500 million. These days, sooner than later, people are adding a second prime to reduce exposure and counterparty risk. Investors want the security of two accounts open rather than just one. So funds are adding a second prime broker sooner--maybe at \$175 million or \$250 million. This can also depend on your strategy. If you are a \$50 or \$60 million short-only fund, you may need more access to borrow so that you have a better "borrow" than your competitor.

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