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Prime Brokerage

Primed for Change: Pershing's Messinger on An Industry in Flux

Pershing started its prime brokerage division in July 2007 at the tail end of the hedge fund heyday, when Wall Street's bulge-bracket firms typically had their pick of clients. But as a subsidiary of a custodian bank—Bank of New York Mellon Corp.—that avoided proprietary trading and derivatives, among other hazards, Pershing has seen the tide turn.

For hedge fund managers, the collapse of Bear Stearns in February made diversification a top priority. When Lehman Brothers declared bankruptcy in September, funds that held assets there, but also diversified, were rewarded for taking such precautions.

Prime brokerage leaders Goldman Sachs and Morgan Stanley may have faced the same fate as Lehman had the government not intervened. With their adoption of commercial bank charters, and Bear Stearns' acquisition by JP Morgan Chase & Co., all the biggest primes are now affiliated with banks.

Craig Messinger joined Pershing in 2005 as head of the clearing firm's global agency trading and principal trading activities. Two years later he was put in charge of the firm's nascent prime brokerage, Pershing Prime Services, which had signed on 20 clients as of February 2008—well before the market turbulence climaxed. More recently, says Messinger, the firm has gained eight to ten new customers a month.

In an interview with *Securities Industry News* correspondent John Hintze, Messinger, who previously spent nine years at Fidelity Capital Markets, where he led trading, execution, prime brokerage and stock loans, explained why Pershing's offering has become more attractive in the current market and how it fits with the prime brokerage industry's future.

How has Pershing Prime Services fared since the market turmoil began in September?

Craig MESSINGER

Over the last four to five months, we've added nearly 40 customers. Some have not fully come on board, but they've committed or are in the process of funding.

How big are they?

They cover the spectrum from very large firms with $1 billion in assets or more to midsize funds. Most are in long-short equity strategies, typically domestic, with a smattering of fixed-income and quantitative-strategy funds.

Why are they opting for Pershing?

One reason is the broader theme of diversification to more than one prime broker. Secondly, our combination of services and access to sources of liquidity, whether in the form of lending and borrowing securities, custody, reporting, etc. Thirdly, some firms are looking to put their long securities in a bank custody arrangement.

What are your criteria for new customers?

We look to work with hedge funds where we see a good match in terms of services and the alignment around appropriate leverage, strategies and product scope—where we can be a complementary partner.

Is size a factor?

It's more the segment of the markets funds participate in: U.S. versus international—and certain international [geographies] would be more complementary than others. We look for funds where our strengths complement their needs, and where we can grow our businesses together.

What are some of those strengths?

In the event the hedge fund is looking for a long custody at a bank, we've built a fully integrated service [with Bank of New York Mellon] that includes bank custody, tri-party reporting, operational support and efficiency, and all the relevant financing and execution services. In addition, Pershing and the bank have long histories of being strong custody partners in various market segments. We each have built very good tools and [processes] around those activities, both domestically and internationally.

How do Bank of New York and Pershing interact in terms of custody?

It's really the customer's choice. If a customer prefers custody at the bank, our operating model allows Pershing and the bank to work together in a seamless manner. If the hedge fund is long-custody at Pershing, we have tools and capabilities for the adviser and broker-dealer communities that

we can extend to the hedge fund community—from check disbursements to money movements to hundreds of different reports.

The bank may have built tools a bit more relevant to long-only funds—pensions and the other customers they typically custody for. As PPS has grown, we've been able to deploy tools that are of significant help to hedge funds' operational areas, centering around operational efficiencies, reporting and things like workflow.

Is Pershing seeing increased interest from fund managers in separately managed accounts (SMAs)?

We've come across numerous hedge funds or funds of funds that have a desire to increase their involvement in SMAs. The Pershing Managed Account Solutions (PMAS) group has a great deal of experience and has developed technologies we believe have some portability to the hedge fund segment.

Some smaller primes' clients are reportedly using SMAs to gather assets alongside their hedge funds. Has Pershing seen that?

Probably a little bit, but we tend to deal with bigger funds. We believe we may have interesting synergies with our PMAS group, in light of the products and technology they make available to the SMA manager.

How do you see prime brokerage changing over the next year?

As the biggest primes de-leverage, the rest of the prime brokerage community that wasn't as leveraged will probably move up a bit, within tight tolerances based on their strategies and relationships. At the same time, the whole business has shrunk in terms of revenue available to the prime brokerage industry.

Are there other factors driving change?

Counterparty risk may be number one. Since the hedge funds themselves are de-leveraging, they want sound counterparties. Another thing is diversification within the prime brokerage business model. For those of us who don't have proprietary trading and a different business model, we bring a different approach that you wouldn't get priming at Goldman, Morgan Stanley and Credit Suisse.

Is technology a draw for hedge funds?

There's a combination of proprietary and third-party technologies that one needs to make available to be successful. We're going to partner with established third-party solution providers, and we also hope to leverage the broad platform opportunities that Pershing has developed in-house. PMAS will likely fit into that equation. Another would be our Web portal, which extends the work we've done in our Net-Exchange Pro environment [for correspondent broker-dealers].

How would the Web portal apply to a hedge fund manager?

Web portals become a center where the hedge fund can grab reports, or access information-intensive tools or dialogue boxes, which allow people to send messages to each other, confirm information or receive the status of things like ACAT [automated customer account transfer] movements. We also make our stock-loan locate and availability tools available through that portal, and we integrate third-party solutions, which appear seamless to the user but allow customers to access myriad other tools through a single sign-in.

EVEN IF REVENUES DROP BY 50 PERCENT, I THINK FINANCING WILL STILL MAKE UP 75 PERCENT TO 80 PERCENT OF THE TOTAL.

What kind of third-party tools are available?

We're about four months away from rolling out Advent Geneva, the portfolio accounting system, and right now Netik is available as a reporting package. We provide access to numerous third-party direct-market-access applications like [JP Morgan's] Neovest and Mixit [an independent execution management system].

Those services are included in the prime-brokerage commission fee?

Most of the tools we offer are part of the prime brokerage services. But the ones providing direct-market access or algorithms would likely have an additional fee.

Does Pershing still provide leverage to clients?

Depending on the customer's strategy, we are approved to offer portfolio margin and we'll do traditional Reg T margin accounts. Depending on the situation and product, we'll provide margin financing and leverage.

Has portfolio margin drawn customers?

It was going to have the effect the regulators wanted it to have, but the market—hedge funds and other investors—have really de-leveraged. Although it is certainly a required capability for prime brokers, in today's environment it's not asked for as much.

Given that leverage and securities lending were the main revenue drivers, will primes seek other sources of revenue?

Even if revenues drop by 50 percent, as some project, I think financing will still make up 75 percent to 80 percent of total revenues. You may see a swing, but I don't think services like executions are going to jump much as a percentage of revenue. If something changes dramatically, prime brokers may be put in a position where fees have to be invoked for services that today are included in a bundled price.

What might prompt such a change?

An unexpected regulatory change could make financing more onerous for prime brokers or hedge funds. There are a couple of things that could evolve over the next year or two to change the revenue dynamic, but I wouldn't expect them to be significant enough to change the core model.

How have the SEC's hard-close and disclosure rules for short-selling affected Pershing?

The new rules have made our jobs much more complicated. We've had to do an enormous amount of additional work every evening to confirm the status of our own box and [those of] customers who executed the transactions we were financing. Everybody's stock-loan area is working an extra three or four hours in the evening to comply with the changes.

Have you been automating that extra work?

We're doing what we can to provide whatever automation is appropriate relative to the fluid nature of what's going on. We've built "sub-programs" to do some of the work, but we're not going to build a fully integrated solution that may have to be changed a few months from now if the rules change again. ■

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