

# Tips for Choosing a Prime Broker

By

Richard R. Lindsey\*

President

Bear, Stearns Securities Corp.

Lately it seems as though everyone with a balance sheet and the ability to clear a trade is offering prime broker services. Given this, how should you separate the wheat from the chaff? What are the important things to pay attention to when choosing a prime broker? Here are thirteen tips which, if followed, will ensure that you end up with the best prime broker possible.

**Tip 1: Choose a prime broker who understands both the business of prime brokerage and what *you* do.** Prime brokerage is a business that looks much simpler than it is. And, admittedly, at least in concept, the core business *is* simple. A prime broker clears and settles trades; keeps custody of and lends against assets; and maintains books and records. The trick is that all of this has to work consistently day-in and day-out across a broad product range. You need a prime broker who can provide these services without blinking. I can't stress this enough—glitz and glitter make nice additions, but make sure that the underpinnings are solid. Next, make sure that the prime broker understands what you do—your strategy, how you implement your strategy and any nuances that may exist. If you use foreign exchange, you want to make sure that your prime broker can handle FX, not just the securities transactions. Make sure that your prime broker understands all of the parameters of what you do and is capable of servicing your *entire* business well. Don't be the "test case"—choose a prime broker with relevant experience.

**Tip 2: Choose a prime broker who is separate from its firm's trading division.** Some prime brokers are sub-units of trading divisions, which, no matter what anyone says, changes the dynamics—for the worse. If prime brokerage is not run as a separate and distinct business, you should not count on the confidentiality of your trading activity or positions. The temptation of using your proprietary information to the "benefit" of the trading division is simply too great and "Chinese walls" are notoriously porous. If you doubt this, re-read Roger Lowenstein's book about Long Term Capital, *When Genius Failed*, which offers many lessons in how prime brokers incorporated into trading

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\* Richard Lindsey is president of Bear, Stearns Securities Corporation (BSSC). With over \$2 billion in capital and \$165 billion in assets, BSSC is a global leader in providing comprehensive Prime Broker and Broker-Dealer clearing services, processing trades for more than 2,800 accounts in 73 countries. Prior to joining Bear Stearns, Dr. Lindsey was the director of market regulation for the U.S. Securities and Exchange Commission from 1994 to 1999. In that position, he was the primary regulator of U.S. capital markets. Before joining the SEC, he was a finance professor at Yale University in the School of Management.

divisions operate. Protect yourself—choose a prime broker whose sole function is prime brokerage.

**Tip 3: Choose a prime broker who understands the risk of your strategy and knows how to effectively manage *its* own exposure.** It is important for your prime broker to have a global risk management organization that understands your style and trading strategy. First, this ensures that at the onset of your relationship leverage is set appropriately. Second, as you trade, your prime broker will understand and, one hopes, be comfortable with what you are doing. Both of these are most important when linked with the last point—that the prime broker knows how to manage its exposure. The last thing that you want is for your prime broker to “suddenly” discover that you are a risk arbitrage manager who uses leverage, and that it therefore needs to increase your margin requirement to protect itself. You want your prime broker to understand your style and trading strategy completely, and for your prime broker to have experience in working with hedge funds similar to yours. There have, unfortunately, been several times when some prime brokers have acted precipitously, and forced entire strategies into liquidation. You are dependent not only on your risk controls, but also the risk controls of your prime broker. Don’t depend on the reputation of the parent—make sure that the prime brokerage business has a great risk team and that *you* understand how *they* operate.

**Tip 4: Choose a prime broker who is honest about the capital introduction process.** If a prime broker promises to “raise” capital for you, it is either lying or violating the law. Let me explain. Hedge funds are sold as private placements and are technically continuously in distribution. This means that they require *continuous* due diligence by any third party that is raising capital from investors. If a prime broker were to raise capital for a hedge fund, it would be taking on underwriting risk and no major firm would do that without sufficient compensation (remember that equity IPOs are done for something on the order of 7% of the assets raised and the typical hedge fund marketing firm charges “20 and 20”, that is, 20 percent of the management fee and 20 percent of the performance fee so long as the capital raised remains in the fund). What a prime broker *will* do is introduce you to potential investors—investors with the capacity and interest to invest in hedge funds. It is your job to raise capital and the investor’s job to perform due diligence. Also remember that a prime broker who *raises* capital for you can violate your regulatorily mandated marketing restrictions because you don’t know what the prime broker is saying about you. Raise capital yourself—let your prime broker play a role only by introducing you to qualified investors.

**Tip 5: Choose a prime broker who offers a variety of solutions to leverage.** Whether or not you intend today to use leverage, make sure that your prime broker has the capability to extend leverage. Further, it is important that your prime broker have a variety of leverage products available, both for ordinary leverage and enhanced leverage. We live in a volatile world of rapidly changing regulation. As much as possible, you want to be able to isolate your business from changes in the regulatory framework. A prime broker who understands the current regulatory framework and provides a number of different avenues to achieving your leverage objectives will serve you better in the long run in case regulatory changes affect your current leverage strategy. Give yourself

flexibility for the future—make sure your prime broker knows more than one way to extend leverage to both your on-shore and offshore funds.

**Tip 6: Choose a prime broker with a strong global securities lending presence.** One of the most important services a prime broker can provide is securities lending. Make sure that your prime broker can lend both stocks and bonds, has access to hard-to-borrow securities, and has a strong global presence. You need to work closely with the securities lending desk at your prime broker to build a strong relationship. The desk should be able to provide you with “color” on the market, give you “early warning” about potential buy-ins, and understand your preferences and style in trading. Your prime broker should also be able to provide you with electronic access to securities lending (at least for easy-to-borrow securities). Your success depends on the strength and consistency of securities lending—know your prime broker’s team and rely on their expertise.

**Tip 7: Choose a prime broker who offers a range of mechanisms for trading.** Make sure your prime broker can provide you with multiple ways to trade. Your prime broker should be able to offer you a variety of electronic platforms for trading—not just one. Different trading styles need different platforms. If you already use a third-party trading platform or have developed your own, your prime broker should be connected or be able to connect to your preferred platform. In addition, your prime broker should offer both wholesale execution services and institutional coverage. If you don’t want to trade yourself, your prime broker should provide a desk that will trade for you. You want a prime broker that has flexibility, not one with only one approach.

**Tip 8: Choose a prime broker with broad product capability.** Your prime broker should be able to handle equity, fixed income, and derivative products including new issues, contracts-for-difference and swaps. In addition, your prime broker should be able to assist you with soft dollars and repos. Your prime broker should be able to provide reports that incorporate all of these products and be able to provide margin across products. More flexibility and capability across product lines signal a prime broker who is sophisticated and serious about the business of prime brokerage. Even if you don’t use all of the capabilities of your prime broker today, you want a prime broker with depth and breadth to meet your future needs.

**Tip 9: Choose a prime broker with strong technological capabilities.** Your prime broker should be able to offer you a variety of proprietary applications, including portfolio reporting (for you), transparency reporting (for your investors) and shadow reporting (for any positions held away). For these reports and applications, your prime broker should also be able to offer you a variety of connectivity options—FIX, internet or dedicated circuits. Your prime broker should also be connected to leading third party vendors—order and portfolio management systems (*e.g.* Advent and Eze Castle); risk systems (*e.g.* Imagine and Riskmetrics); accountants; offshore administrators; and middle office service providers. You will, no matter what, be dependent on your prime broker’s technology—make sure that you choose a prime broker with demonstrated capabilities.

**Tip 10: Choose a prime broker who offers cash management capabilities.** You will always have some amount of cash in your account, but today most hedge funds have more cash on hand than at any other time. Your prime broker should be able to offer you dedicated cash management and fixed rate financing capabilities. You want to be able to minimize the cash drag on your fund—your prime broker should be able to provide expertise and bargaining power to obtain better returns for any cash holdings.

**Tip 11: Choose a prime broker with a strong back office.** At the core of everything in prime brokerage is the back office. Make sure that your prime broker has a strong, experienced operations department. The prime broker's reorg, cage and margin departments must work seamlessly, and the working should appear effortless to you. The measure of a back office isn't whether it can handle plain vanilla situations—which should be taken for granted—the real measure is how the back office handles difficult situations or problems. The broader the range of activities, the more businesses and the more hedge funds that a prime broker's back office supports, the more you should be able to trust that it knows how to resolve problems. The only way that a back office becomes really good is through experience. Experience will save you money—choose a prime broker with an experienced back office.

**Tip 12: Choose a prime broker with a mature, knowledgeable customer service organization.** Key to your relationship with your prime broker is the customer service organization. When you first sign up with a prime broker, there should be a dedicated team of people to ease you into the relationship—to train you or your personnel on technology, to introduce you to your primary contacts and to explain policies and procedures that the prime broker may follow. The prime broker should also provide a team of relationship managers or customer service agents who work with you on day-to-day issues. There should be a dedicated training staff to assist your organization with the nuances of any proprietary systems and new systems as they are developed. And, finally, you should have a relationship with the highest levels of your prime broker's organization. Knowledge, access, experience and responsiveness should be the cornerstones of your prime broker's commitment to you.

**Tip 13: Choose a prime broker who is deeply committed to the business of prime brokerage.** Some firms are in and out of prime brokerage every few years. Some prime brokers have been sold a number of times. And some prime brokers are brand new to the business. Prime brokerage is a business of consistency, reliability, integrity, service, experience and, most importantly, relationships. Look for a prime broker that has been around for a while—choose a prime broker who has chosen to be in the business of prime brokerage—not someone who thinks that it might be a good sideline or something to try for a while.