MULTIPLE PRIME BROKERS VEX HEDGE FUNDS

THE ADVENT OF MULTIPLE PRIME BROKER RELATIONSHIPS IS PUSHing hedge funds to seek out new providers of middle- and back-office services that in the past had been performed by their prime broker.

"It's impossible for hedge funds to obtain a comprehensive risk perspective if their positions are spread across multiple prime brokers and custodians," George Michaels, CEO of G2 Systems, told Markets Media.

In the wake of the Lehman Brothers collapse, hedge funds have utilized multiple prime brokers as a fallback for facilitating rapid transfer of assets should one broker show signs of imminent failure.

However, when a hedge fund utilizes more than one prime broker, functions such as intraday P&L reporting, and position and risk reporting, can no longer be provided by a single prime broker.

In some cases, the prime broker with the bulk of hedge fund assets will gather trade and position data from the other primes, then aggregate them into their reports and statements, a process known as "hearsay reporting."

But prime brokers are scaling back or even cancelling hearsay reporting because it's viewed as a noncore service. "Banks don't want to be in the business of reconciliation and back office services," Michaels said. "Consequently, they are cutting back on providing hearsay reporting."

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As a result, hedge funds are increasingly using fund administrators to perform the work that had been done by their prime brokers. "We are seeing a migration of risk and related functions out of prime brokers to fund administrators," Michaels said.

However, in contrast to prime brokers, who get paid in soft dollars, fund administrators need to be paid in cash, which places an added cost on hedge fund managers. Also, most fund administrators aren't equipped technologically to provide real-time risk management.

"While fund administrators have access to all the data on a fund's positions, they're accustomed to doing monthly or quarterly reporting, not daily reporting, let alone real-time intra-day reporting," Michaels said.

G2, which provides customized programming for hedge funds, is seeing growing demand from fund administrators. "They need a technology to transform themselves into aggressive, risk-focused operations," said Michaels.

One of the more successful fund administrators at making this transition is Stone Coast Fund Services, Michaels said. "They've been very aggressively stepping into the void left by prime brokers."

In contrast to high-turnover "NAV Factories" that dot the administration landscape, Stone Coast, based in Portland, ME, utilizes a professional services model through which it specializes in credit-and-derivatives heavy portfolios, whose needs are served poorly by institutional administrators.