The near collapse of Bear Stearns and the death of Lehman Brothers shook the prime brokerage industry to its core. Investors and hedge fund managers alike suddenly woke up to the unthinkable: a major Wall Street firm could fail, depriving hedge funds of a funding source and potentially tying up cash left on deposit at the firm in bankruptcy proceedings that could take years to resolve. As hedge funds scrambled to diversify their prime broker relationships, they began to look more carefully at the financial health of potential partners—an opportunity the Canadian banks have been quick to seize. By Neil A O'Hara.

CANADIAN BANKS BULK UP

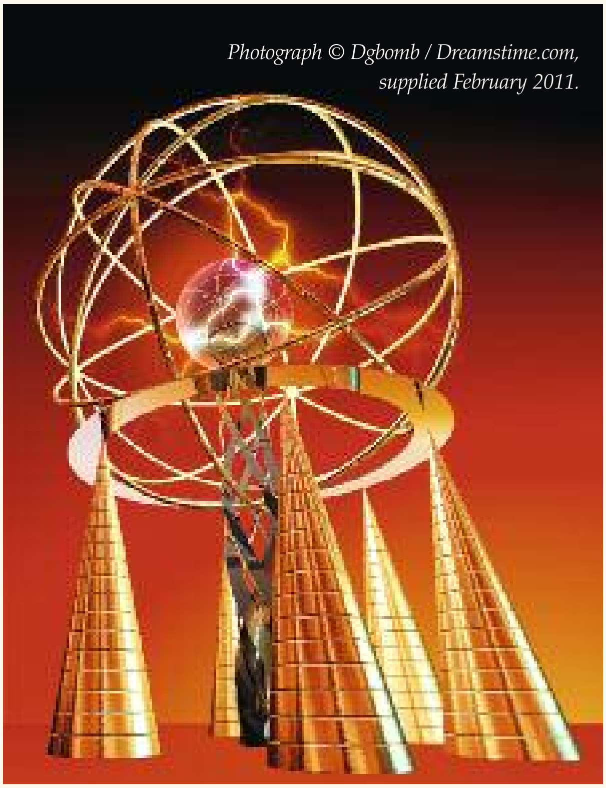
BEFORE 2008, CANADIAN banks were hardly a significant force in prime brokerage. The local hedge fund industry was too small to support the required infrastructure on its own, and most of the banks lacked the global footprint to support funds that wanted to trade outside North America. To the dominant prime brokers in the United States, Canada was just one more country on the map and one easy to service given its proximity, advanced market infrastructure and close ties to the US—so close that 183 Canadian stocks are interlisted on exchanges in both countries.

The five big Canadian banks have always had an edge in servicing local hedge funds, however. Their securities arms account for the majority of share trading in Canada, so they usually have established relationships with managers who set up on their own. The banks also have retail operations that can offer privileged and profitable access to hard-to-borrow securities, a critical revenue source for any prime broker, together with long-standing relationships with custodian securities lenders in Canada.

"Canadian hedge funds have a bias toward investing in Canadian assets," explains Patrick Blessing, global head of prime brokerage at Scotia Capital in Toronto. "It is imperative to have Canadian servicing of their assets. It is a significant advantage for Canadian prime brokers."

The local hedge fund industry has grown rapidly in the past five years and now has an estimated CAD20bn to CAD25bn ($20.3bn to $25.3bn) in assets under management. That has caught the attention of prime brokers based in the US and Europe in addition to the domestic banks. At least ten Canadian hedge funds now have more than CAD1bn in assets, a tempting target for any prime broker with a global footprint. Blessing says: "So far, the global firms have not won a huge amount of business in Canada, but they are more actively marketing to potential clients here." Scotia has extended its own capabilities internationally in the past two years by setting up prime broker operations in New York, Singapore and London.

The other obvious targets for Canadian prime brokers are foreign hedge funds that want to trade in Canada. In addition to the natural advantage of local market knowledge and relationships, the Canadian banks are gaining business based on their stellar credit ratings. All five came through the financial crisis in better shape than banks in either the US or Europe, which makes them attractive counterparties to hedge funds newly alert to the perils of credit risk. The bigger US hedge funds that have added prime broker relationships have not done so indiscriminately, either; risk officers have insisted that they should not all be US based. "We see a real opportunity to face off against the larger funds and use our balance sheet and credit to attract new business," says Blessing.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FTSE
GLOBAL MARKETS

A top-notch rating also appeals to stock lenders, who in the past three years have become much more selective about the entities to which they will lend. Securities lending generates the lion's share of prime broker revenues; up to 75% or 80% in many cases. Hard to borrow securities generate most of the securities lending revenue. Good access to lendable securities is critical to prime brokers in Canada, as it is elsewhere, and the marginal lender is likely to feel more comfortable doing business with Canadian banks than many other counterparties. "To be successful in stock lending you need a large array of counterparties from which to source," says Tom Kalafatis, head of prime brokerage at CIBC World Markets. "We leverage relationships across our whole platform to get clients what they need."

CIBC in 2010 brought together under its prime broker umbrella equity financing, securities lending and electronic trading products. It was the first Canadian bank to embrace co-location services, which attracted new participants to the market including high-frequency trading firms that engage in statistical and index arbitrage as well as electronic market making. The incremental liquidity has largely come from outside Canada, and it has propelled CIBC from a fifth place also-ran to first place in Canadian equity trading: it now commands a 20% market share.

"We are focused on Canadian-related product, both importing liquidity and clients to access Canadian markets and taking Canadian products to the world," says Kalafatis. It is a niche strategy that lets CIBC leverage its strength in Canada rather than trying to go head-to-head with US and European prime brokers that already have a global footprint. In addition to asset servicing, CIBC runs a capital introduction programme that helps foreign hedge funds tap into pension funds and other investors based in Canada.

A strong credit rating may open the door, but Kalafatis says potential clients are also looking for high quality people and a positive attitude toward solving problems. He prefers clients who have strong risk controls, a durable business model and are willing to enter into a long-term relationship that can grow along with their assets under management. "If a client wants the all-singing, all-dancing prime broker then we are not the place for them," he says. "Our experience shows that focusing on what we do well serves our clients better."

Like CIBC, TD Securities pursues a Canada-centric strategy in prime brokerage: its business is focused on domestic hedge funds, European funds and US-managed offshore funds that trade in Canada. TD Securities doesn't trade Asian or South American securities, so it makes no sense to market in those regions. "We would not be able to go head-to-head with the large international players on Asian or European securities," says Lionel deMercado, head of prime brokerage at TD Securities. "We have an edge when it comes to local equities. We know what we are very good at and are comfortable in offering those services."

Through its TD Waterhouse affiliate, TD Securities has access to a large retail box, from which it derives a significant portion of its prime broker revenues. The ideal hedge fund client for TD Securities pursues an equity-related strategy with a heavy emphasis on short selling, particularly of hard-to-borrow securities. "It's a natural fit for clients outside Canada that have an appetite for a large amount of Canadian securities," says deMercado. "We have incredible strength in hard-to-borrow stocks."

Patrick Blessing, global head of prime brokerage at Scotia Capital in Toronto. "Canadian hedge funds have a bias toward investing in Canadian assets," he explains. "It is imperative to have Canadian servicing of their assets. It is a significant advantage for Canadian prime brokers." Photograph kindly supplied by Scotia Capital, February 2011.

The number of new hedge funds launched in Canada plummeted after the financial crisis, but the pace has bounced back a little over the past two years. DeMercado says the funds coming to market today are more attractive to prime brokers: they are fewer in number but have greater assets under management at the outset. As one of the few developed economies that still has sound public finances, Canada has also become a popular destination for international investors, including hedge funds. TD Securities is ramping up its marketing efforts, but deMercado wants to make sure he can service potential clients properly. "We want to grow, but I am hesitant about overpromising and under-delivering," he says. "Senior management is comfortable with the business, and our strong balance sheet is very helpful."

The largest Canadian bank, Royal Bank of Canada, has a broader global presence than its four closest competitors. The RBC Capital Markets division has more than 6,000 employees located at 75 offices in 15 countries, including trading hubs in Toronto, New York, London, Hong Kong and Sydney. "With those trading hubs, we are covered 24/7," says Andrew Thornhill, head of prime broker services at

Daniel Dorenbush, chief executive officer of Merlin Securities. "A dealer may have one hot stock but not another. Merlin has direct relationships with four leading prime brokers and custodians. One of our strengths is in securities lending," says Dorenbush. Photograph kindly supplied by Merlin Securities, February 2011.

RBC Capital Markets. "Our clients that are looking to execute globally really don't have to look any further." RBC's global network not only services Canadian clients trading abroad but also acts as a conduit for foreign clients interested in trading in Canada and the US, for whom its securities lending prowess is an obvious attraction. The bank enjoys close relationships with Canadian custodial lenders and can draw from an extensive and diversified pool of margined securities held by clients as well.

Thornhill says both hedge funds and banks have become more focused on risk management in recent years, a shift that has benefited both RBC and its local competitors. RBC is not afraid to compete for business against the big global prime brokers, either. "Given the size of the bank, our strong credit rating and geographical footprint, it is not a hard story to sell," says Thornhill. "We do have to be competitive in our service offering or we won't win the business."

RBC has a wide range of prime broker clients from large, well-established firms to small start-ups. The decision to take on a client does not depend on asset size so much as the competence of the managers and the potential for leverage across different lines of business within the bank. "We look for strong risk management capabilities and depth of experience," says Thornhill. "We will take on a small fund if they have a solid background, good asset growth potential and are already well known to the bank."

The average size of hedge funds in Canada is smaller than in the US, but to Merlin Securities, the New York-based introducing prime broker, that represents an opportunity. The concept of mini-prime brokers, which provide technology and support but don't take custody of clients' assets themselves, is new to Canada. In the US, Merlin concentrates on servicing hedge funds that have less than $1bn in assets, which means most funds based in Canada fall within its target range.

In 2010, Merlin opened an office in Toronto and hired Daniel Dorenbush to run it. The choice of chief executive officer was deliberate—Dorenbush is Canadian and has spent most of his career in Toronto apart from a stint in New York in the prime brokerage division of RBC Capital Markets. It was intended to demonstrate that Merlin has made a long-term commitment to Canada and is sensitive to the sometimes equivocal relationship between Canadians and their southern neighbours.

The securities owned by Merlin's clients reside at one or more (at each client's choice) of four entities that hold them in custody and handle trade processing: National Bank Correspondent Network in Canada; Goldman Sachs Execution & Clearing, JPMorgan Chase and Northern Trust in the US. Clients have no credit exposure to Merlin, and the prime broker of record in offering memoranda and marketing materials is the underlying custodian.

The ties to the four partners help overcome a natural disadvantage: Merlin does not have a captive retail box it can draw on for securities lending. Indeed, Dorenbush argues that the Canadian banks overstate the importance of an internal box because the inventory is often used for purposes other than lending to hedge fund clients. In any case, a single bank often does not have the ability to borrow stocks its clients want—and Merlin can tap the big custodian lenders as well as anyone. "A dealer may have one hot stock but not another," says Dorenbush. "Merlin has direct relationships with four leading prime brokers and custodians. One of our strengths is in securities lending."

Merlin has also developed a comprehensive multi-asset class, multi-currency technology platform that allows clients to consolidate holdings and see profit and loss statements, performance attribution and risk analytics on an entire portfolio, even if parts of it are not held at Merlin's custodians. In effect, Merlin is leveraging the investment its partners have already made in global trade processing through a software interface of its own design. This powerful tool supersedes the internal spreadsheets many hedge funds use to compile a complete view of their holdings and makes the information available in real time. "No one else is doing this in the Canadian market," says Dorenbush. "The fund doesn't have to have a Merlin partner as its prime broker; we can still aggregate the information and generate these high-octane reports."

It remains to be seen whether other prime brokers in the US follow Merlin's lead and set up in Toronto. Meanwhile, the Canadian banks have all bulked up, and the more internationally oriented—RBC and Scotia—are ready to muscle in on the global players' home turf. ■