Special Feature
Advanced Trading

Rethinking Bulge-Bracket Relationships -- The Bear Stearns meltdown raises questions for the buy side about whom to trust as a counterparty.

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The rapid demise of Bear Stearns could be a wake-up call for buy-side traders who are consolidating their trading and research relationships with bulge-bracket firms.

"There's been the assumption in the past that if you trade with a large Wall Street firm that there's no risk - that you're achieving best execution and getting your research covered," says Kristi Wetherington, president and CEO of Capital Institutional Services (CAPIS), an agency broker based in Dallas. "The Bear Stearns meltdown has called into question the practice of consolidating brokers with only the largest Wall Street firms. It's a wake-up call for the buy side," asserts Wetherington, who, as CEO of a smaller agency brokerage, has something to gain from buy-side firms diversifying their brokerage relationships.

Over the past year the buy-side trend toward consolidating business with the bulge-bracket firms increasingly has been fueled by the use of client commission arrangements, or CCAs. The soft-dollar programs allow the buy side to seek best execution with bulge-bracket brokers via electronic trading, while setting aside commissions to pay for independent, third-party research. Meanwhile, many buy-side firms also tap the top brokers for electronic trading tools, execution management systems, algorithms and even dark pools.

"Some buy-side managers have been consolidating their trading commissions through the [bulge-bracket] Wall Street firms," says Wetherington. With so much uncertainty over counterparty risk and the value of mortgage-related securities still on brokers' books, however, Wetherington and others are questioning whether it is wise to consolidate trading relationships with bulge-bracket firms and rely on them for electronic access to the equity markets. "[It's] like putting all of their eggs in one basket," contends Wetherington.

With rumors flying a few months ago that Lehman Brothers, another large player in the mortgage-backed securities market, didn't have the liquidity to weather the credit storm, concerns mounted that other bulge-bracket firms could fail. Even when the Federal Reserve stepped in to guarantee Bear Stearns' trades and arranged a fire sale to JPMorgan Chase, fears that other banks and brokers might experience liquidity problems intensified.

Adding to the concerns, at press time Merrill Lynch reported a nearly $2 billion first-quarter '08 loss and an additional $6.6 billion in new write-downs. The firm also began the process of cutting 4,000 jobs.

In addition, Citi posted a $5.11 billion first-quarter loss, reported nearly $15 billion in write-downs and bad loan reserves, and said it would lay off 10 percent of its workforce. And UBS announced a $19 billion write-down resulting from toxic assets, bringing its total write-downs to $38 billion - among the largest losses resulting from the collapse of U.S. subprime mortgage investments among Wall Street brokers. "You never know what you're going to read the next day," notes Wetherington.

On the other hand, the sale of Bear Stearns to JPMorgan Chase for $10 a share actually could end up encouraging buy-side firms to trade through the bulge bracket with no fear, according to at least one buy-side trader with an asset manager. The intervention by the Fed showed that "There's no way Bear Stearns

or anybody else is going to fail - the Fed would not let them fail," says the trader, who requested anonymity. "Not only that, the bigger they are, the harder it is for them to fail."

The collapse of Bear Stearns "was a one-time anomaly," the buy-side trader adds. Since the government stepped in, he says, the risk of potential failures doesn't warrant distancing oneself from the bulge bracket. "Although the bulge bracket would take on more risk, smaller firms would have the propensity to fail more than the bulge-bracket firms," he explains. In fact, the Fed is more likely to let a tertiary or regional broker-dealer fail, because it would have less of an impact on the whole market, the trader suggests.

For now, the buy-side trend toward consolidating broker relationships shows no sign of abating. In fact, the emergence of CCAs has accelerated the trend.

CCAs are becoming popular because they allow the buy side to seek best execution through the bulge bracket while still using **soft dollars** to pay for independent research. A buy-side firm sets up a CCA with a bulge-bracket firm, which in turn cuts checks to pay the smaller research firms that the buy side chooses to engage.

"If I feel that I can get best execution from a bulge-bracket firm, given their order flow and their levels of capital, I would set up a CCA," relates the buy-side trader. This way, the buy-side shop would not have to trade through a less experienced firm, he says. For example, the buy-side shop could trade though JPMorgan and ask JPMorgan to pay a smaller research firm with the commissions that are set aside for research.

Roughly 50 percent of buy-side firms have implemented CCAs, according to Larry Tabb, founder and CEO of TABB Group. "Another 63 percent of that group have started cutting back on their brokers," he says. Still, Tabb notes, the average fund uses 25 to 50 brokers. "It's not like they are consolidating down to three," he says. Nonetheless, counterparty risk is a significant issue, especially with the growing popularity of CCAs in the U.S. and client-sharing arrangements (CSAs) in the U.K., Tabb cautions.

If a buy-side firm accrues commissions to pay a research bill via a bulge-bracket firm's CCA program, there is some financial risk, Tabb continues. "In effect, you're banking your commissions to pay out later," he says, explaining that it may be difficult or even impossible to recover unallocated commissions from a failed broker. For example, "It would be difficult to go back to Bear Stearns now and say, 'I had X millions of dollars of commission sitting in your research platform that I never allocated. I want to allocate it now,'" Tabb offers. "I'm not sure how Bear is going to respond to that."

Honor Among Brokers

Tim Olsen, SVP and head trader at ICM Asset Management, thinks JPMorgan, as the firm that took over Bear's business, should honor the research credits that the buy side has built up with the failed firm. "I can't imagine a [broker] relationship that wouldn't," he says. The buy side has "enough due diligence statements going back and forth and there's a paper trail that would let [JPMorgan] pay those bills."

Despite these unresolved issues, it isn't time for the buy side to panic and pull the plug on bulge-bracket relationships, according to Tabb. "It's going to be very hard to justify to anyone if all of a sudden you cut out all the bulge-bracket brokers and only execute with the small research brokers," he says.

Tabb notes that even though the bulge bracket may be experiencing financial difficulties, the problems are more on fixed-income desks than in equities. In addition, Tabb says, buy-side firms still can find value in the bulge bracket's extensive infrastructure.

However, Tabb adds, all buy-side firms and hedge funds should periodically examine with whom they do business and see if that mix is right. "Every [buy-side] firm has to look at whom they trade with and what they trade, and take a look at how much risk they want to take," he says.

Who's Worried?

But not every buy-side firm trades heavily with the bulge bracket. As a small- and mid-cap equity investment shop, ICM executes through smaller broker-dealers that follow those stocks, notes the firm's Olsen. "They are the ones we will trade with and pay," he says. "We do rely on the bulge bracket for information, but not enough business is done with bulge-bracket [firms] for me to worry about consolidating those relationships."

In general, Olsen says, he hasn't heard any news in the past six months that would lead him to consolidate those relationships further. On the other hand, "We're cautious when you are hearing big news on a Friday afternoon before the close that someone [such as Bear] might go out of business," Olsen concedes. "That would get my attention."

Another issue that got Olsen's attention was his exposure to Bear's clearing business. At some point, Olsen says, Liquidnet cleared through Bear Stearns. But the buy-side electronic marketplace did set up a new clearing relationship in the event Bear were to go bankrupt, he adds. Some of the smaller brokerage firms through which ICM executes, however, also had clearing relationships with Bear Stearns.

"I did look across my list and see if they had a clearing relationship with Bear," Olsen says. "That doesn't mean that I won't trade with them. We need to get the trade done for the client - I go where the liquidity is to get the trade done."

CAPIS' Wetherington, however, insists that the buy side should diversify its trading partners by considering regional and middle-market firms. "My firm is polar opposite of what is happening because we're agency-only and because we don't invest in proprietary trading or speculate," the CEO asserts.

"We have no debt, and everything is paid out of operating capital and we're hiring people," Wetherington continues, noting that her firm will benefit from the layoffs at Wall Street firms. "As far as best execution is concerned, we've proven that over and over again in equities, fixed income, options and international securities."

But Tabb says it's more likely that a small brokerage firm with a boutique trading desk would go out of business than a multibillion-dollar, capitalized Top 10 broker. "If you take out of consideration the Bear issue, it's more likely that the small firm will go out of business than the big one. That said, hopefully we won't see another bulge-bracket firm melting down," Tabb comments. "But every firm needs to take a look at those credit issues and counterparty issues."

"Two months ago," Wetherington adds, "you never would have thought the mighty could fall. ... Apparently, we're entering a different phase. It may cause the buy side to rethink their broker diversification and their broker-selection model."

SIDEBAR: Is the Buy-Side Exposed to Bulge-Bracket Technology Risk?

The subprime mortgage crisis has led to fears about the solvency of top brokers, and, as a result, has raised concerns about the buy side's exposure to bulge-bracket technology risk. As the markets have become more electronic and low-touch, sell-side firms have become major developers of algorithmic trading strategies, acquired execution management systems (EMSs) and launched dark liquidity pools.

"In an indirect way, the EMSs either have been purchased by the bulge-bracket firms or have been gobbled up by the OMS [order management system] providers," says a buy-side trader who requested anonymity. "There are no independent EMSs out there."

Although all broker-dealers and some independent firms have created algorithms, the buy side still seems to rely mostly on bulge-bracket algorithms. "I guess you could say that's true," the buy-side trader comments. However, he contends, there are enough brokers providing technology that the buy side is not relying on any one particular firm. "You're not tied to three, four or five - there are 10 varieties out there," he says. "Even though it's all supplied by the sell side, it's pretty well diversified."

This is even more true with alternative trading systems (ATSs) and dark pools. The fact that the more than 40 sell-side ATSs all are piped into one another, the buy-side trader argues, creates diversification. "Because they're all interconnected, you don't have to worry about going into one pool," he explains. For instance, if a buy-side trader puts an order into NYFIX, the Credit Suisse (AES) algorithm could enter NYFIX Millennium and cross with the order in NYFIX where it resides.

"There are enough providers of technology out there that if you have a concern with one firm, you can find a replacement," observes Tim Olsen, SVP and head trader at ICM Asset Management in Spokane, Wash., who notes that he doesn't use a lot of the bulge-bracket alternative trading platforms. He says he prefers the agency-only, independent platforms (i.e., Liquidnet and ITG Posit Now). -I.S.

SIDEBAR: Monitoring Counterparty Risk

With the collapse of Bear Stearns and more than $200 billion in write-downs accumulating on Wall Street, fears that the credit crisis could take down other firms are intensifying, and buy-side traders are carefully considering counterparty risk when evaluating their relationships with bulge-bracket brokers.

"I'm always nervous with my counterparty when I get out of a trade," says Stephen Davenport, SVP, risk management and investment management, at Wilmington Trust in Atlanta, who executes a lot of options, swaps and structured products. "I've always felt like your hand is in the lion's mouth when you want to get out [of a trade.]"

The Bear Stearns debacle, Davenport continues, "has made me rethink even more whenever I have a position with a counterparty - how much do I have with a certain counterparty?" He notes that Bear Stearns approached him about starting a relationship for trading structured products shortly before its collapse and says Merrill Lynch has been asking about entering a relationship as well.

"People are going to think about [which] counterparties [they enter relationships with] and about who is strong and who is not," Davenport says, adding that Wilmington Trust uses five dealers for structured products. "The idea is that you want to get a selection of quotes, and you want to get good access to firms that you want to be your counterparty," he explains. "This whole credit thing isn't over, and we're going to be diligent about trying to get the right firms to add as a counterparty." -I.S.