Prime brokers have been giving a very labour-intensive service away for free, but unpaid commission to third-party marketers is believed to be prevalent.

Needing no introduction

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As prime brokers scale back on their relationships with hedge funds and regulation clamps down on hedge fund marketing in Europe, what is the future of the cap intro business?

Edward Vickery, owner, Caradon Capital Introductions

As a third-party marketer, this is an interesting question as it is directly connected to my business and therefore livelihood. Third-party marketers charge commission for capital-raising services that have traditionally been offered for free by most prime brokers.

Therefore, we have had to compete with well-resourced cap intro teams, meaning that many larger hedge funds and commodity trading advisers (CTAs) that have carried more weight and influence with the prime brokers have chosen to accept introductions only from cap intro teams and not to do business with third-party marketers. This has left many third-party marketers with capital-raising roles for smaller, less-established managers a much more difficult task.

Third-party marketers consistently struggle when collecting owed commissions and I would like to argue that perhaps part of this is due to the value of the service being undermined, despite it being a crucial way for managers to grow. The fact that much of the work behind third-party marketing goes unseen by the manager combined with the same service being offered elsewhere for free has, I believe, affected managers' desire to pay. With third-party marketers not being able to know when an investor has invested, the situation of unpaid commissions is probably much more apparent than most of them realise.

Cap intro and third-party marketing is more than just a telephone call or email hook-up. It is the value of years of building strong and trusting relationships with investors, along with a lot of work spent researching and selecting the best managers to take to market. It is the value of the third-party marketer putting their reputation on the line for the manager. It is the difference between the manager boasting

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and claiming and the third-party marketer recommending and advising. It is the difference between a lone pick-up artist and one with a wingman. It also involves copious amounts of travel, telephone calls, due diligence, meetings, conferences and becoming an expert in all strategies. This might also give some indication as to why prime brokers might be cutting back on what is a very labour-intensive service that they have previously been giving away for free.

In any country, as soon as one retail bank removes free personal bank accounts, then they all seem to follow and this trend is something that we may find apparent in the world of prime brokerage in regards to their cap intro service. However, maintaining a cap intro team in some format will surely help a prime broker to defend and steal business from its competitors. Therefore, I do not believe that the service will die out completely. Might we even see a situation in which prime brokers form strategic relationships with third-party marketers?

Edouard d'Archimbaud, co-founder, Creative Research

While regulation is increasing pressure on hedge fund marketing and the effectiveness of traditional capital introduction channels shrinks, we see the emergence of new actors as a chance for an industry that may well be on the verge of a new paradigm shift.

Numerous start-ups are already taking advantage of the latest technology stack to embrace this new wave of opportunities. They will eventually aggregate and normalise information in a more comprehensive, independent and open manner, facilitate due diligence through intelligent and social networks-enabled collaborative possibilities like AngelList and HedgePo, and simplify/secure the full investment process such as with 'blockchain'-based clearing and custodial services. User experience will be paramount and competition among hedge funds and capital introducers/advisers, such as syndicates, finally driven by quantifiable metrics rather than marketing.

Let's welcome disruptive forces. As with the digitisation of other financial services – such as Lending Club, Betterment and SigFig – investors stand to reap all the benefits.

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James Lawler, managing partner, VantagePoint Alternative Investments

As the industry landscape changes with growing regulatory requirements, prime brokers continue to evolve. We have already seen prime brokers begin to reduce their exposure to smaller, less profitable hedge funds and focus their efforts on larger, more profitable managers. Their ability to bring in quality funds will still depend on the services they provide. Traditionally, banks have used capital introduction as a selling point, particularly with emerging and mid-sized fund managers. This has been particularly difficult with current alternative investment fund managers directive (AIFMD) regulations hampering banks' ability to market to European investors.

In regards to European coverage, prime brokers have begun to focus their efforts on larger, revenue-generating funds that have the internal resources to meet the burdensome AIFMD marketing requirements. As European-focused capital introduction through traditional channels faces more regulatory hurdles, the model will have to evolve to include additional conferences and ancillary prime brokerage sales-related services, such as bank-assisted sales technology to streamline the sales process.

As to what is the future of the cap intro business, I think what you need to look at is whether capital introduction from a prime broker is the best business model from a marketing standpoint. How many funds have seen significant new investments resulting from capital introduction? Furthermore, what is the breakdown of assets raised for emerging funds versus those for $1 billion fund clients? The fundraising process has changed considerably since the financial crisis. We no longer operate in an environment where investor introductions alone result in new investments. The process has been significantly institutionalised. One must understand the investor, their process, portfolio construction and thinking so you can introduce the fund to investors with the highest probability of allocating. To truly help 'introduce capital', one must assist the investment manager throughout the due diligence process. What does all this mean? We believe that smarter managers will see capital introduction as a smaller piece of their marketing process, and not as a fundraising panacea.

Antoine Haddad, managing partner, Bainbridge Partners

From a cap intro user perspective, I can only say that, regardless of the regulatory framework, their work is always helpful. Their value is not limited to directing capital to one's fund. Their overall market intelligence is quite helpful for any manager looking to promote their strategy. They are always generous with structural advice while funds are being set up, or with marketing advice when a strategic campaign is being planned. I do not think that the new regulation would curb this aspect of their work.

Cap intro teams have adapted to the new restrictions. They are now very adept at planning events where managers and investors meet, without promoting or advising any particular fund or security. They provide the venue, but take a step back during the event, letting managers and

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investors interact directly, without their involvement.

Andrew Saunders, founder and senior managing director, Castle Hill Capital Partners

In a more profitable, clubby pre-2008 world, cap intro desks were once the sole source of investor intelligence and access to capital. But the cap intro function sits within prime brokerage out of evolutionary convenience, rather than business logic. Following the crash, major prime brokers have shed vast numbers of unprofitable clients, leaving managers to navigate on their own.

Fortunately, this is an entrepreneurial space and a range of solutions to raising money have sprung up. There are now numerous conferences, well-established databases and a raft of financial technology platforms emerging that promise to disintermediate the allocation process.

Mass cap intro offerings are simply untenable in a revenue-constrained environment, as prime brokerage firms will either make explicit their focus on their largest clients, or develop domain expertise in a specific strategy or asset class. Managers that do not meet their threshold will be politely ignored or abruptly cut, as happened to one of my clients who received the 'it's not you it's me' notification from their cap intro coverage of 10 years by text message!

As a former head of a cap intro desk, I am intimately familiar with both the opportunities and limitations placed on the business, which is not an outsourced sales force. Cap intro desks, generally, are too few, tend to too many, and in a fee-inhibited world are going to prioritise top revenue producers regardless of their investment attractions.

The future of cap intro no longer sits on the prime brokerage desk. It will be an unbundled approach led by an independent seasoned adviser working for and compensated by hedge fund clients to develop a customised marketing strategy. It should employ all tools available, including traditional and social media, and target investors for whom the client can provide differentiated solutions.

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Managers need help with a whole host of issues, such as filling out requests for proposals, writing letters and engaging their limited partners. Prime brokerage cap intro desks are not only unfit for such work, in many cases they are restricted by compliance for even putting ideas in writing. In the future cap intro desks will be one tile in a mosaic of service providers, rather than the entire picture.

Vince Molinari, chief executive, Gate Global Impact

The passage of the Jobs Act, and the removal of the general solicitation ban, will have a profound impact on the distribution of securities and funds in the US. Under Title II, issuers now have the ability to advertise the fact that a company or fund is seeking investment capital for the first time since the Securities Acts of 1933 and 1934 were ratified. There are minimal restrictions to how they can reach their target audience – speeches, radio, print, TV and social media – but all potential investors must be recognised as an accredited investor to effectuate an investment under the general solicitation guidelines.

We have entered a new era of securities distribution and capital formation, as financial services have begun to integrate and intersect with Web 3.0 and social media. This paradigm shift has the potential to disrupt traditional distribution and create newer, more efficient channels utilising advanced platforms that can be linked to social media networks in order to access end investors. This will allow funds to effectively bypass certain gatekeepers by directly aggregating investment capital from accredited investors and qualified investors, including family offices and self-directed plans.

If we integrate greater investor education, information and data into these systems regarding previously closed/protected investment opportunities, we can achieve greater exposure and access to a new direct investor base. This will also establish new levels of investor protection, as inbound investors will be vetted to comply with suitability requirements.

The last remaining link is the current review of the accredited investor standard. It is estimated that under current standards there are approximately 350,000 accredited investors in the US. It is thought that only 12% of that pool are actively involved in investing. Any increase of the accredited investor pool by either rule-making or educated engagement will offer significant opportunities to access potential investors, and in turn for them to create wealth for themselves through access to a broader spectrum of investment opportunities.

The transparency and efficiency that is being ushered in by combining technology with information and direct access to investment opportunities will serve to dislocate and replace many of the current intermediaries and business models. This may indeed be the new resource for capital introduction, and we as an industry should continue to seek out ways to help facilitate these resources.

Duncan Crawford, global head of alternative investment solutions, Societe Generale Corporate & Investment Banking

Capital introduction is a core pillar of Societe Generale's growing prime services business. We have always taken an educational and advisory approach to capital introductions with the investor at the heart of our focus. Indeed, its role will be even more important in Europe as the new regulation is adopted. ■