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As Hedge Funds Mature, They Look to Upgrade Operations

The rapidly growing alternative investments sector faces a host of new demands that are placing an emphasis on operating efficiency.

Joseph Radigan

A federal appeals court gave hedge funds a reprieve of sorts when it overturned the Securities and Exchange Commission's registration rule in June. Whether hedge funds can kick back and relax is another matter.

The alternative investments sector is growing so rapidly and undergoing such a radical transformation that a host of new demands may ultimately dwarf the requirements that these firms faced under registration. They now increasingly cater to institutions such as public pension funds that have boards of directors, legal charters and fiduciary responsibilities to their beneficiaries.

"Almost everything I've seen in the hedge fund industry, in terms of changing business practices, is being driven by the institutionalization of the industry," says Brett Lane, SVP and manager of Mercantile Alternative Investments, a fund of funds manager owned by Baltimore-based Mercantile Bankshares Corp. "The investors who are determining where the growth is coming from are dictating the terms under which the industry will operate. You've seen firms build out staffs. They've assigned specific tasks to chief compliance officers and chief operating officers."

Not long ago, a manager of a start-up fund could assert legitimacy by pointing to his background as a trader with a bulge-bracket Wall Street firm or as a portfolio manager for a high-profile mutual fund. Pedigree is still critical, says Geoffrey Tudisco, CEO of New York-based VanthedgePoint, a registered broker-dealer that provides services to new hedge funds, "but it's becoming much more important that someone has the infrastructure to manage the post-trade process. That's where institutional investors are putting a lot of pressure."

According to Tudisco, hedge funds are being formed in such large numbers that prime brokerages can't meet the demand. His firm aims to fill this void.

Customers of VanthedgePoint--there are now 24--can choose among Merrill Lynch, Penson Worldwide or Calyon Securities for custody and clearing; and Citigroup, JP Morgan Chase & Co.'s Neovest subsidiary and Susquehanna International Group for trade execution.

Other factors behind the emphasis on operating efficiency include the uneven returns on U.S. equities since the tech bubble burst in 2000 and a lack of volatility in global equity and debt markets up to the past few months. Both trends squeezed investment returns and turned a tighter focus on cost-cutting.

"In the mid-1990s there wasn't as much sweating the details on whether or not you were paying a couple of extra basis points for executing a trade," says Lee Cutrone, manager of industry relations for post-trade communications hub Omgeo, a joint venture of New York's Depository Trust & Clearing Corp. and Thomson Financial.

The focus on operational efficiency is particularly noticeable in post-trade functions, and specifically allocations. "As hedge funds get more into the institutional investment area, they have more requirements," notes Adam Sussman, a New York-based senior analyst with research firm Tabb Group. "When they were small, with just two or three strategies, this didn't come into play." But now hedge funds serve multiple clients with numerous reporting and compliance obligations of their own, making an effective post-trade allocation system crucial.

Alexander Kouperman, president and director of consulting services for InfoHedge Technologies, a New York-based consultant, says that manual processes still predominate, but as more funds automate the allocation function, it becomes a type of "glue" that aids the integration of front-, middle- and back-office systems. For example, some 70 percent of new sales of Omgeo's Central Trade Manager allocation interface are to hedge funds. That indicates "the maturing of the customer base to make sure that their operational capabilities match their investment performance," Cutrone says.

Challenges for Primes

At the same time, the ties that traditionally bound hedge funds to their prime brokerages are unraveling. For years, prime brokers typically helped start-up funds get established with everything from office space to computers and investment research to clearing and settlement and credit. Hedge funds were happy to have the help, and prime brokers were usually so eager to win the business that they would support any system the fund requested, says Martin Campbell, managing director of prime brokerage services for SunGard Data Systems in Cambridge, U.K. But prime brokers now want their clients to standardize on a few platforms, in the interest of their own efficiency.

"The hedge funds find that the prime brokers actually serve their clients better if they don't bend over backwards for them," Campbell says.

Funds may also be more willing to go along with technology requests from prime brokers because they're no longer dependent on a single relationship. Most funds execute trades through several brokers, and while they may use one prime broker for custody and clearing and trade reporting, funds have the

flexibility to shop around based on brokers' expertise in particular instruments.

The search for technology that can manage relationships with multiple parties was one of the reasons behind Credit Suisse's decision in June to sign a licensing agreement with Paladyne Systems of New York and to private-label Paladyne's hedge fund processing platform. Salvatore Ventura, a managing director at Credit Suisse and global head of the prime services business development group, says that in one respect, as the hedge fund industry matures, it's no different from any other business: "They typically outgrow one provider." As funds mature and reevaluate their operations, they often look to outsource their technology to lower costs, and that was part of Credit Suisse's decision to offer access to Paladyne.

Robert Agne, a director in product development for Boston-based trade order management systems (OMS) developer Eze Castle Software, says the desire for multiple prime-broker relationships often stems from a hedge fund's wish to seek out expertise in an asset class. Funds will now designate specific primes to clear their trades for particular asset classes. They may execute the trades through other brokers, but they want the lead prime for that type of security to aggregate all the positions. This, too, is dictating systems changes.

"Five or six years ago, prime brokers weren't ready to deal with this," notes Nilesh Nanavati, president of Advanced Financial Applications, a New York developer of trading software for hedge funds. "What's helped them overcome the inertia is that if they don't do it, someone else will. It's a giant snowball that can't be stopped." His firm's Impact Pro OMS is distributed through prime brokers; one of the features that has helped it gain acceptance is its ability to manage multiple relationships.

Even as hedge funds gain flexibility, an active debate is under way about the optimal number of prime brokers, says Daniel Leyden, managing director and CFO of Highland Financial Holdings Group, a New York hedge fund with \$850 million under management. The issue of post-trade reconciliation is a determining factor.

"At the size we are, we have one prime broker and one very strong credit, which we are very comfortable with," Leyden says. "There are advantages to having more than one, but when you get to eight or nine, you won't be able to standardize your reconciliation at the end of the day. I want to be in control of all of my processes."

Often the choice of a prime broker for a particular asset class is determined by the skills that broker brings to the table. "Different prime brokers specialize in different products, and as in any third-party relationship, it's the people who are doing the service and not just the firm," Leyden adds.

With multiple relationships common, standardization of reporting has become a priority, says SunGard's Campbell. Investment banks still tend to run separate prime brokerage desks for each asset class, with separate client reporting for each. But with risk management and capital allocation becoming more of an enterprisewide concern, more banks are looking to unify their operations and reporting to cover the entire client relationship. The result is that prime brokerages are being run as distinct franchises with consolidated reporting.

"The challenge is that the hedge funds, fund administrators and prime service providers are all operating on legacy platforms," explains Reinhardt Olsen, managing director and global head of fixed-income prime brokerage with UBS in New York. He says that resolving back-office issues in fixed-income trading presents a host of challenges that may exceed those in equity operations, simply because of the vast number of debt instruments.

Standardized and comprehensive reporting will also provide the primes with a better grip on their capital allocation and margin lending. That will free up more funds to lend to clients to invest, "but bringing all of that together is a real operational challenge," Campbell says. Adds Leyden, "If the infrastructure fails, it doesn't matter what the returns are, you won't have the investors there to realize those returns."

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