

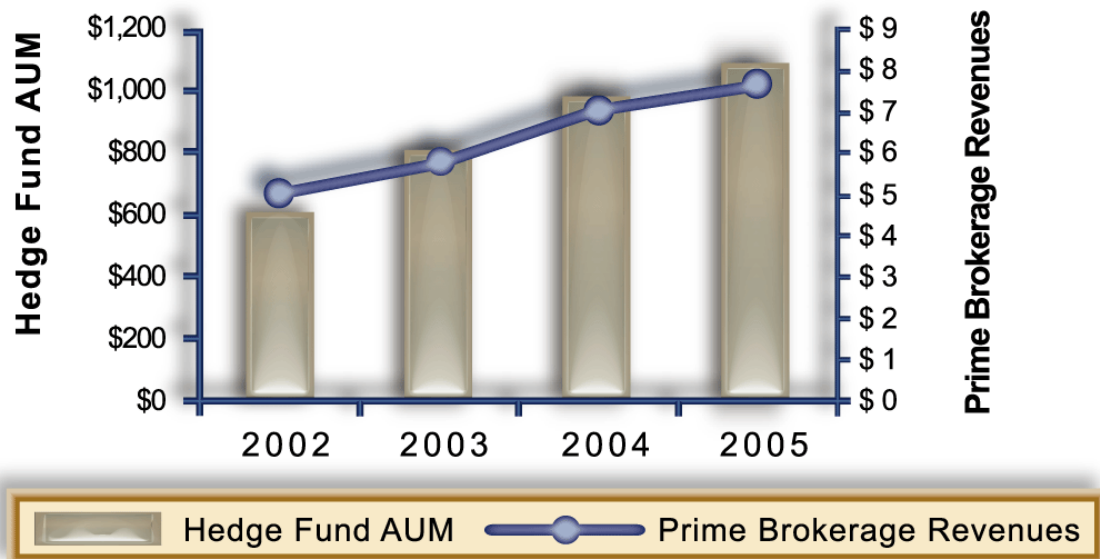
THE NEED FOR MULTI-PRIME BROKERS

In the fast changing and demanding world of hedge funds, managers continue to chase opportunities by expanding into strategies that promise higher returns, while managing their operating costs. At the heart of any hedge fund's operations is its dependency on the prime broker – or as is the case in most leading funds, *dependency on multiple prime brokers*. For smaller managers the structural challenges of adding a second or third prime can be prohibitive and many prefer the ease of staying in an existing relationship. Still, the requirement of multi-prime brokers is no longer going to be only a luxury for the larger fund managers but rather, with the increased industry and investor demands, will mean *all* hedge funds managers will, and are, moving aggressively towards having at least two or three or more prime brokers to service their needs.

Background

As the hedge fund market has matured, it has attracted institutional investors and an increased need for regulation. Over the last five years, the total assets under management (AUM) have grown dramatically. With over \$1 trillion of assets under management -- a sum that is expected to double by 2008, according to the Tower Group¹ – managers now invest in more robust infrastructure, with increased risk analysis and performance measurement and reporting to streamline their operations and provide greater transparency.

Hedge Fund AUM and Prime Brokers Revenues (\$ bil)

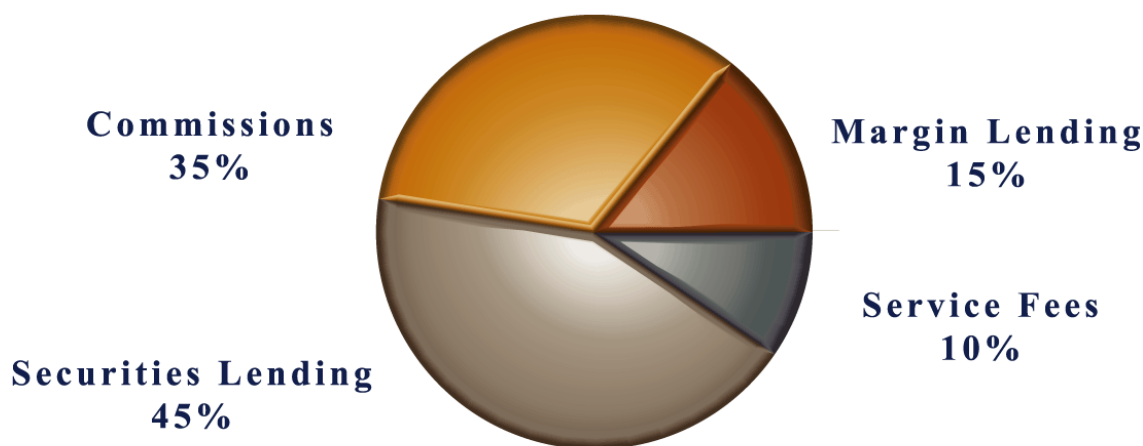


Source: Hedge Fund Research and Bernstein Analysis

¹ The Impact of New Competitors in Prime Brokerage, Bernstein Research, April 2006.

As hedge funds have grown to attract more institutional investors, managers are requiring more transparency into prime brokerage fees to better respond to sophisticated investors demands. In many cases, this has increased the need for second and third prime brokers to better manage such fees. By having multiple primes, managers have greater leverage to pressure for better rates from their brokers. (The table below shows the types of fees and associated revenue breakdown.)

Hedge Fund AUM and Prime Brokers Revenues (\$ bil) (2003)



Source: BCG, in CSFB's "Hedge Funds and Investment Banks, March 9, 2005

Until some time ago, prime brokers were merely clearing houses and custodians of publicly traded securities. Today, hedge fund managers expect more from their primes: from a wide array of products to large balance sheet and credit ratings and comprehensive technology offerings. As fund managers face more pressure from investors, they must increasingly evaluate the scope and quality of the products and services they receive from their primes -- in part to justify those large fees.

Leading prime brokers are backed up by hefty balance sheets and credit ratings to support fund manager's trading activities. Increasingly, though, a large balance sheet alone is not enough to attract quality managers as clients. As the market evolves, leading prime brokers are expanding their services to integrate their institution's offerings, with the aim of establishing themselves as a "one-stop-shop" service.

In addition to the integrated products, prime brokers typically provide fund managers technology to maintain their operations. This is very compelling to hedge funds that do not want the challenges or the expense (which are especially onerous for start ups) of developing internal technology infrastructure.

Although larger prime brokers offer diverse products and services, typically they have particular areas of specialization that make them ideal for certain fund managers. As such, for many small hedge funds (sub \$250M AUM), having a single prime broker to service their needs is acceptable.

However, managers who are looking to effectively compete, and grow to institutionalize their business, quickly expand their interest into diverse strategies, markets and instruments.

Requiring the most competitive prime brokerage services (such as, rates, stock availability for shorting, technology, etc), they typically add second and third prime brokers to address their needs. In addition to getting the best services, fund managers feel they must diversify the exposure of their portfolio by spreading it across multiple primes.

What Fund Managers Expect From Their Prime Broker

For fund managers, the prime broker function means a lot! Fund managers rely on prime brokers for their core operating and financing services.

As a result of increased demands on their services, fund managers are expanding their uses of multiple primes and considering splitting assets along specific class lines. As for the primes, they are aggressively expanding the breadth of their services to retain and attract clients.

Managers compare the quality of services, with the level of pricing and place more demands each day on their prime broker, including:

- **Multi-asset coverage** – As fund managers expand trading strategies, they expect prime brokers to handle a wide range of assets ranging from equities, futures, options, repos, FX, OTC, commodities, interest rate swaps and other fixed income instruments to exotic and illiquid assets.
- **Global coverage** – In search of opportunities, fund managers are expanding their trading to include many global markets. As such, globalization is an increasingly prominent issue among all managers.
- **Integrated offerings** – Fund managers expect prime brokers to provide a consolidation of the clearing and financing of all instruments that could form part of a trading strategy, in addition to connecting prime brokerage to the worlds of research, trading and execution, and advisory.
- **Extended services** – Fund managers expect prime brokers to incorporate synthetic funding, structuring capabilities, bank loans, and leases along with the traditional offerings, stock loans, cross-margining and cross-netting of products.
- **Protecting their positions** – Fund managers expect prime brokers to not compete in the same trades with them and thus do not like seeing large proprietary trading desks involved in their strategies.
- **Comprehensive technology** – Fund managers expect prime brokers to provide a fully integrated suite that covers order management, electronic trading and execution platform, real-time P&L, portfolio accounting, risk reporting, performance measurement and attribution, portfolio reporting with flexible slicing and dicing, and portfolio pricing.

Challenges and Issues

While a price point can't be attached to adding a second or third prime broker there are added expenses in the form of people, processes, and systems. Typically, adding a second prime broker leads to:

- More points of contact and interface (multiple accounts) with the second prime.
- Additional documents/counterparty monitoring.
- Portfolio aggregation and reporting challenges.
- Reconciliation with multiple primes puts pressure on systems and staff.
- Trade booking and allocation becomes more complicated.
- Increased error rate in the back office.

Prime brokers typically do not help managers with any of these challenges. Additionally, fund administrators do not usually have appropriate tools to facilitate these issues. As a result, fund managers often postpone adding a second prime as long as is feasible for their business operations. But in a fast moving industry, successful managers need to be ready to react, even if it means facing the challenges of adding additional prime brokers.

On the other side, prime brokers have long talked about an open architecture platform to support hedge funds' needs for having multiple primes. Most have done nothing (clearly it is not in their best interest to make it easy for their fund managers to add second and third primes). For example, Goldman Sachs and Morgan Stanley (who command the first two spots and more than 60% market share), provide no technology to their hedge fund clients to support electronically executing trades with other prime brokers. Fund managers often feel "locked up" in their single-prime technology platform.

Where the Industry is Headed

Most of the larger prime brokers are focused on servicing large clients – the \$1 billion+ hedge funds (which, according to TASS and Bernstein constitute approximately 2% of hedge funds, with 23% of the total AUM²). For the smaller hedge funds, specialized boutique prime brokers are scrambling to take their business.

Larger hedge funds (those with more \$1 billion in AUM) reported using more than four prime brokers³, according to Global Custodian. This is, on average, twice as many prime brokers as used by those under \$1 billion (just under two prime brokers) and three times more than those under \$100 million (on average 1.3 prime brokers).

² The Impact of New Competitors in Prime Brokerage, Bernstein Research, April 2006.

³ 2004 Spring Prime Brokerage Survey," Global Custodian.

Typically, mid-size fund managers running between \$100 million and \$1 billion in capital (which, according to TASS and Bernstein constitutes approximately 35% of all hedge funds, with 65% of the total AUM) are most likely to go through significant operational changes as they continue to grow their business.

Accordingly, one would expect the phenomenon of moving from a single prime brokerage relationship to a multiple one to be particularly evident in this last group. One can expect to see the increase in prime brokerage relationships from one to two or sometimes three as the manager's capital approaches \$1 billion. We believe this is an inevitable, and positive, development which will lead to more diversification and competitively priced services.

The Need for Technology

Small fund managers can often rely on a single prime broker to satisfy their technology needs. They typically complement their prime's service with a series of spreadsheets that track and manage operations and daily needs.

However, as successfully expanding managers add a second and third prime they can no longer rely on a single prime broker to provide an integrated view of their portfolio. At this point, what is necessary is a "leapfrog" of technology to match that growing demand.

Typically, a multi-prime hedge fund also requires avenues to execute trades with the different brokers they deal with, along with an aggregated real-time P&L view of their portfolio.

In addition, they need a way to consolidate all trades into a centralized accounting system -- and the ability to create daily performance and attribution reports. For such fund managers, spreadsheets simply do not work. They must invest in technology infrastructure to support their business needs.

Moving forward, in a more institutional-based world, featuring fully integrated technology is ever more crucial to a fund manager's ability to run his business, attract more investor capital, and provide higher and consistent returns.

The challenge with developing streamlined technology to address a manager's demands is the potential high costs it could incur. A mid-size hedge fund (say \$500 million AUM) wishing to add a second prime broker needs to transition its operations from relying on a single prime addressing all their technology demands, to building their own infrastructure (technology products, necessary support staff and appropriate management processes), or outsource their technology management.

A reasonably priced integrated technology platform would be an ideal solution to this dilemma. Currently, most of the technology offerings are segmented and address a specific part of the business process. Paladyne's solution offers hedge funds the *only* fully integrated technology platform which eliminates reliance on a single prime broker's technology and enables management of a multi-prime platform, at a manageable cost.

About Paladyne Systems

Paladyne Systems LLC, (<http://www.paladynesys.com/>) a leading solutions provider for the hedge fund industry, develops and distributes technology designed to streamline hedge fund operations while providing business efficiency and cost savings throughout the organization. Paladyne offers an integrated technology platform known as the PALADYNE™ suite which is capable of supporting the front- to back-office requirements of today's most comprehensive hedge funds. The PALADYNE suite is an integrated set of applications including: order management, portfolio management, portfolio accounting, global security master, analytics toolset, comprehensive portfolio pricing, custom reporting, and customer relationship management. Paladyne was formed through an acquisition of its technology platform from a large US-based multi-strategy hedge fund.

Additional Resources

1. Prime Brokerage: Of Prime Importance to the Securities Industry, SIA Research Reports, Vol. VI, No.4 (April 28, 2005).
2. "Prime Time for Primes" by Paul Allen, Wall Street & Technology, February 14, 2006.