

## Technology and the Multi-Prime Broker Movement

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### TowerGroup Take-Aways

- Hedge funds of all sizes and strategies are hiring multiple prime brokers; the industry average is 1.9 prime brokers, which is an increase from 2004, when the average was 1.3.
- Smaller hedge funds and even large hedge funds with small IT and operational staff will face major operational challenges when they use more than one prime broker because of the data aggregation requirement that this relationship introduces.
- At least two prime brokers have developed proprietary tools to support their clients' multi-prime business, but two more prime brokers recently launched services built through partnerships with leading independent software vendors.
- Partnering with an independent software vendor provides a robust, hosted application and also helps to overcome fund managers' concerns about data control and ownership and about potential conflicts of interest.
- The convergence of the firms dominating the prime brokerage and hedge fund administration businesses means that ultimately, one firm could become the hedge funds trusted partner for front-, middle-, and back-office services.

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### Report Coverage

It's no secret that hedge funds often use more than one prime broker. But what may be a secret is how they operationally and technologically support multiple prime brokers. When all of a fund's business is with one prime broker, the fund can use the prime broker's tools for profit and loss reporting, collateral management, risk and performance measurement. When a second prime broker is introduced, the picture gets much cloudier. In the past, hiring a second prime broker meant that the fund manager needed to obtain its own third-party technology. But recently, prime brokers have been rolling out applications to facilitate the "multi-prime" business. This TowerGroup ViewPoint looks at whether these applications meet the needs of hedge fund managers, who demand not only functionality but also independence and data ownership.

For more information on the business of prime brokerage, see TowerGroup Research Note V44:27SM, *Prime Brokers: Providing the Choice Cut Services au Jus*.

### Background

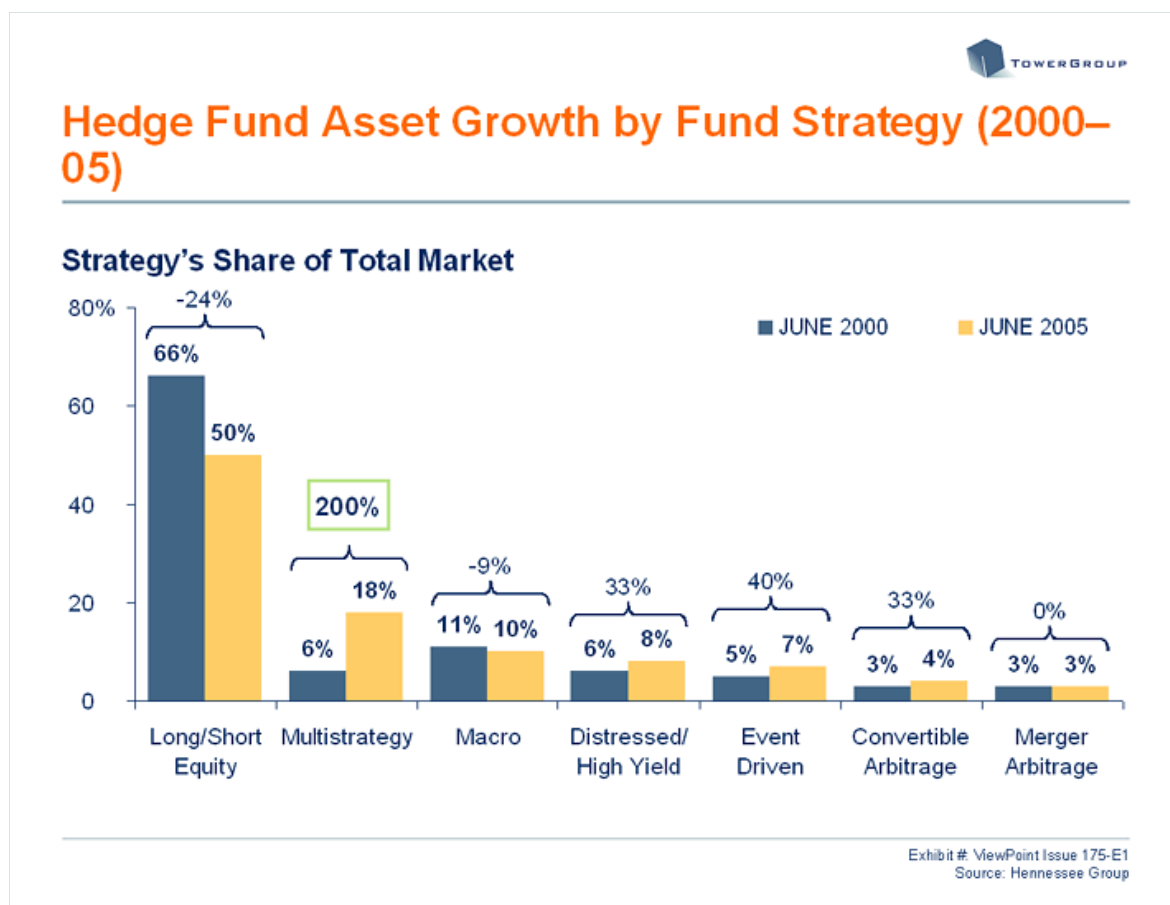
Hedge funds of all sizes and strategies are going multi-prime. According to a 2005 Global Custodian survey, funds with less than \$100 million (USD) in assets use an average of 1.2 prime brokers, while at the other end of the spectrum, large funds with more than \$1 billion in assets use an average of 3. The overall industry average is 1.9 prime brokers, which is an increase from 2004, when the average was 1.3. Why are hedge funds using more than one prime broker when doing so seems to contradict the term *prime* broker?



### Why Hedge Funds Go Multi-Prime

A number of factors might drive a hedge fund manager to hire a second (or third, fourth, etc.) prime broker. Chief among these is the need to access new securities and/or new markets and geographies. Certain prime brokers have developed strength in specific regions or asset classes, and to get the best access to those regions or asset classes at the lowest cost, the hedge fund may have no other choice but to hire an additional prime broker. Another reason for hiring additional prime brokers is the nature of a prime broker's related businesses and the book of securities to which those businesses may give the prime broker access. For example, several prime brokers have large retail businesses (e.g., Merrill Lynch, Fidelity) or clearing businesses (e.g., Bear Stearns, Fidelity) that they can draw on as pools of liquidity for securities lending.

Also at play is hedge funds' desire to develop multistrategy funds, which allow fund managers greater flexibility in deciding where and how to invest their funds' assets. In some cases, a fund manager launching a multistrategy fund will need to hire an additional prime broker to support that strategy. Multistrategy funds were the fastest-growing segment of the hedge fund industry from 2000 to 2005. Exhibit 1 shows the growth in assets across common hedge fund strategies.



**Exhibit 1**  
Hedge Fund Asset Growth by Fund Strategy (2000-05)  
Source: Hennessee Group

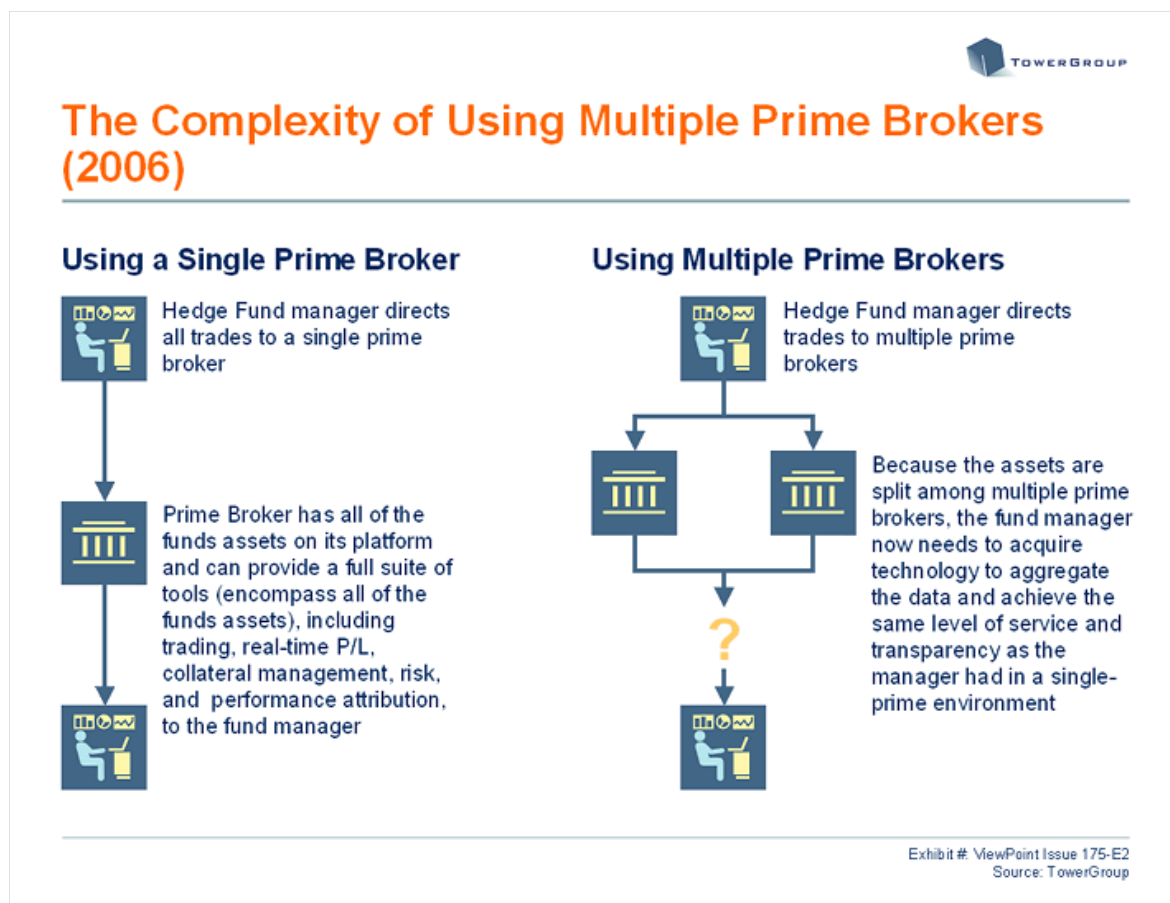
Another factor less talked about is some hedge fund managers' hint of distrust of their prime brokers. They see the huge sums of money that Wall Street is collecting from servicing hedge funds (about 15% of all Wall Street revenues currently come from hedge fund servicing) and are fully aware that hedge funds' primary competition comes from other hedge funds and from Wall



Street's proprietary trading desks. For a growing hedge fund using a single prime broker, hiring a second prime broker offers an opportunity to spread its book of positions around the Street and to restrict any single broker from seeing the entire book. Whether or not this strategy achieves anything or prevents any inappropriate behavior appears to be irrelevant. At the very least, it helps quell managers' concern that their prime broker is trading against them or "front-running" their funds' trade ideas and strategies.

### Going Multi-Prime Is Not a Simple Transition

Smaller hedge funds and even larger hedge funds with small IT and operational staff will face significant operational challenges when making the move to multi-prime. With a single-prime relationship, the hedge fund manager can fully leverage the technology offering of the fund's sole prime broker, which is likely to include a host of front-, middle-, and back-office functions such as trading, real-time profit and loss (P/L) reporting, collateral management, risk, and performance measurement. However, when a second prime broker is introduced into the equation, the process becomes much more complex, particularly when multiple prime brokers are used in the same strategy or fund. Exhibit 2 describes the challenge of going multi-prime.



**Exhibit 2**  
The Complexity of Using Multiple Prime Brokers (2006)  
Source: TowerGroup

### How Hedge Funds Are Overcoming the Multi-Prime Challenge

Hedge fund managers have four options to solve the multi-prime problem:

- Keep their prime brokers separated by fund. Managers won't be able to aggregate their



entire portfolio across all funds, but they'll otherwise have access to much of the information that they may need from each prime broker at the fund level.

- Acquire third-party software applications and load the data in directly or use a data aggregation tool. This can be a costly solution for a lean hedge fund operation with little or no internal IT staff.
- Use a prime broker's tools to aggregate the data. This is a relatively new development in the prime brokerage market and is discussed in depth below.
- Use a fund administrator's end-of-day consolidated data, assuming that the administrator has the ability to reconcile data daily. This solution won't meet the needs of a fund manager looking for intraday or real-time information, and in reality, few administrators can fully reconcile data weekly, let alone daily.

Two prime brokers that TowerGroup is aware of, Morgan Stanley and Bank of America, offer proprietary solutions for their hedge fund clients that aggregate the data and provide higher-value products such as near real-time P/L monitoring. The most recent development, and the one TowerGroup believes will redefine this technology gap, is partnerships of prime brokers with independent software vendors. These partnerships may provide hedge fund managers with the tools that they desire and the independence and data ownership that they demand.

#### **Partnership Redefines the Relationship**

Recently, Credit Suisse and Paladyne Systems announced a partnership, and a similar announcement from Citigroup and Linedata's Beauchamp Financial Technology subsidiary quickly followed. Exhibit 3 details these two recent partnerships that have changed the multi-prime brokerage support model.



## Partnerships Formed to Adapt to the Multi-Prime Environment

June 2006

Credit Suisse and Paladyne Systems



The hosted technology platform provides an integrated, multi-prime broker solution to Credit Suisse clients, including customer relationship management, portfolio management, analytics, security and pricing data, and portfolio accounting.

August 2006

Citigroup and Beauchamp Financial



OpenPrime combines Citigroup's prime brokerage and fund administration units in an integrated offering employing Beauchamp's underlying technology, but hosted by Citigroup.

Exhibit # ViewPoint Issue 175-E3  
Source: TowerGroup

### Exhibit 3

Partnerships Formed to Adapt to the Multi-Prime Environment

Source: TowerGroup

### Credit Suisse and Paladyne Systems

In June 2006, Credit Suisse and Paladyne Systems joined forces to offer a hosted, multi-prime technology platform to their respective hedge fund clients. This partnership is one of the first public initiatives to offer a prime broker's clients technology that enables clients to effectively do business with other prime brokers rather than lock them exclusively to Credit Suisse. The offering was rolled out in November 2006 and initially includes trade auto-routing and security master data functions. The partnership provides Paladyne access to Credit Suisse's 200+ hedge fund clients and provides Credit Suisse with a leading-edge technology platform and middle- and back-office technology.

Paladyne was formed in July 2005 when a group of self-funded individuals agreed to lift out the technology platform of hedge fund manager Alexandra Investment Management. The platform consists of a mix of proprietary applications for customer relationship management (CRM), portfolio management, analytics, and security master and pricing data, and it utilizes Advent's popular Geneva accounting system.

The Credit Suisse/Paladyne platform is fully hosted by Paladyne, overcoming the concerns about independence and data ownership that may exist at some hedge funds. Because Credit Suisse lacks the functionality internally, TowerGroup would not be surprised to see a three-way partnership develop with one of Paladyne's other partners from the hedge fund administration arena (among these names are Dundee Leeds and Caledonian). Credit Suisse is not among the top three dominant prime brokers (Morgan Stanley, Goldman Sachs, and Bear Stearns); however, that is not



its goal. Credit Suisse would rather be a best-of-breed prime broker to a select group of about 400 hedge funds. This business strategy may line up well with some of the midsize and smaller fund administrators that are focused on developing quality relationships through a high-touch customer service model. Common use of Advent's Geneva accounting platform (Paladyne offers a hosted version of the system in the product suite, which is also used by many hedge fund administrators) would also support this type of partnership.

### **Citigroup and Beauchamp Financial Technology**

In December 2003, Citigroup's Global Transaction Services unit acquired niche hedge and mutual fund administration firm Forum Financial Group. This was the first acquisition in the hedge fund administration market that brought a prime broker and a fund administrator together under the same corporate umbrella. Market participants and observers have been waiting to see what synergies and strengths could be found between the two businesses and how Citigroup would approach the market with a more integrated offering. Since the acquisition, Citigroup has steadily increased its assets under administration (AUA) from \$5.8 billion in 2002 to \$19.7 billion as of mid-2006.

In August 2006, Citigroup released its OpenPrime platform, a solution that combines facets of its prime brokerage and fund administration units and utilizes Linedata's Beauchamp Financial Technology's front-to-back-office FundManager application in a hosted environment. The solution offers a variety of functionality focused in four primary areas: order and portfolio management, portfolio analytics and reporting, trade entry and routing, and portfolio accounting.

One challenge for Citigroup in promoting this solution may be that the technology, although hosted, is hosted by Citigroup, not Beauchamp. While it does offer a viable multi-prime solution, the hosting location will do nothing to allay the concerns by some hedge fund managers that arise from giving access to their entire book to one prime broker. However, as a growing fund administrator, Citigroup is in a good position to dispel those concerns. In fact, we believe that the trend among hedge fund service providers to provide a *one-stop-shop* offering including both prime brokerage and fund administration services in a bundled solution will eventually redefine the hedge fund servicing marketplace. We need look no further than the success of Goldman Sachs and, more recently, Morgan Stanley as both a top prime broker and a fund administrator to see that the walls separating the two businesses are eroding.

### **What's Next?**

TowerGroup expects to see more prime brokers rolling out multi-prime servicing solutions in the next 12 months. Firms that have not already done so would be foolish to fall too far behind the firms discussed in this TowerGroup ViewPoint. Although it may seem that offering this type of solution makes clients' assets less "sticky," the reality is that these solutions are strengthening the client relationship at a time when competition among prime brokers is fierce. Pricing pressure on prime brokers' core services of execution, clearing, and custody has squeezed commissions to subpenny levels. This has forced prime brokers to focus on developing their capabilities in the more profitable spread businesses of margin financing and securities lending and also in value-added services such as consulting and outsourced technology platforms. Therefore, the emergence of multi-prime solutions sponsored by prime brokers is not a case of the industry giving in to client demands or giving up on sole ownership of the relationship. It is a means of providing a higher level of service to clients. Challenges for prime brokers will be delivering on the rest of the business and keeping clients happy.

The convergence of the firms dominating the prime brokerage and hedge fund administration businesses means that one firm could potentially become the hedge fund's trusted partner for front-office, middle-office, and back-office services. Although additional brokers may be used for liquidity or to tap into new asset classes or geographies, the success of Goldman Sachs and Citigroup as both prime brokers and fund administrators and the recent entrance of top prime broker Morgan Stanley into the fund administration business are evidence of this convergence. TowerGroup



believes that ultimately, the result will be an increased level of trust between hedge fund managers and brokers and that any trust issues will be dispelled.

### **Summary**

As assets continue to flow into hedge funds and competition becomes tougher, hedge fund managers are aggressively rolling out new and innovative products. These include multistrategy funds as well as complex, more focused funds. Many of these products are beyond the capabilities of managers' current prime broker and compel managers to hire additional prime brokers. Industry data has shown that fund managers of all sizes are currently using nearly 2 prime brokers on average, up from 1.3 just one year earlier.

However, moving from a relationship with a single prime broker to a relationship with multiple prime brokers poses a host of challenges, chief among which are technology and operations. In a single-prime relationship, managers can draw on the technology product offering of their prime broker, which is likely to include trading, collateral management risk, and performance and profit and loss reporting. This meets their needs because all of their data resides with one prime broker. However, introducing a second prime broker means that managers spread their data across multiple brokers and are suddenly thrust into the data aggregation business. Managing this challenge with third-party applications requires software license fees and IT resources, which equates to large overhead for the fund manager.

In what might first appear to be an unwise move, some prime brokers have begun to offer technology solutions for their clients that support the fund managers' use of a second prime broker. However, this does not mean the prime broker is giving in to client demands or giving up on sole ownership of the relationship. Rather, it is a means of strengthening the client relationship at a time when competition among prime brokers is fierce and value-added services (versus core clearing, execution, and custody services) are becoming the most valued products to the manager and to the overall relationship.

In a personal relationship, involving a third party is usually a recipe for disaster, but in the prime brokerage world, it's just another challenge to overcome. Although sufficient tools haven't previously existed to support hedge funds' desire to add a second prime, that's no longer the case. At least two prime brokers have developed proprietary tools for their clients, and another two have partnered with independent software vendors to develop these services. TowerGroup believes these partnerships provide tools that will meet the majority of clients' demands. As a result, we expect to see more partnerships emerge in the coming months.