WINDOWS IN FINANCIAL SERVICES
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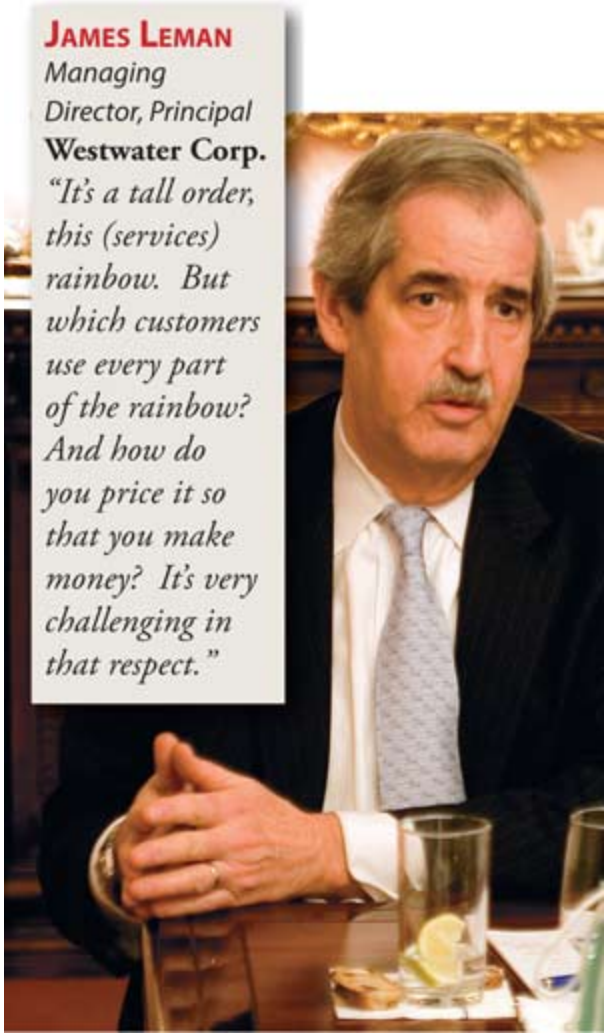
Industry Roundtable: Technology Challenges Facing Prime Brokers in Dealing with the Buy-Side, Not for the Faint of Heart

Industry experts discuss big changes afoot in the prime brokerage world affecting the shape, size and scope of the buy- and sell-side's front- to back-office relationship.

The adoption of technology has brought (and continues to bring) dramatic changes to the shape, size and scope of the buy- and sell-side relationship from the front office to the back office. In the front office, keeping up, interpreting and making faster and better trading decisions is unlikely to get any easier. The influx of trading technology has led many to question the role of the trader. Will they be replaced by quick, super-efficient machines, or will the market always demand the human touch and if so, what degree of touch will it be?



This calls for a huge tooling up exercise to complete the end-to-end trading process.

Incurring endless processing costs without profiting from trading is like using lots of bullets but missing the target. Still, current infrastructures and operating systems need to adapt to the changes and focus on the fundamentals of data management, client data, reference data, real-time data, and the overall architecture of the enterprise's infrastructures.

Given the highly fragmented complexity of today's marketplace, regulatory pressures, proliferation of investment products and the pressure for operational efficiency and risk management, this is no place for the faint of heart.

We recently conducted a WFS Advisory Council roundtable sponsored by Microsoft and Avanade. An abridged transcript of the discussion follows with a full-length version online at www.windowsfs.com.

Tabb: The prime brokerage business is in for a real transition period over the next couple of years. It's had a good run but market dynamics will radically change the way we think about funds and the prime brokerage business overall. Nearly 60% of the large long-only's are starting up alternative products and they don't want to deal necessarily with primes. They've got custodial relationships and they don't want to pay the same kind of fees the funds pay. So, yes, dynamics are going to switch the way that the prime business works over the next five years, how it's allocated, who's going to support them and how and what they're going to support them with. The other main change is around commodity products that are so commoditized they're pushing the envelope so far that the questions will be, how will they serve these guys and what are the cost and technology structures to support all these complex derivatives and structured products?

Leman: The problem is primes are asked to handle millisecond response time into the equity markets with the diversity of dark pools, providing tools to customers that are multi-broker-capable in some dimension, all at a competitive rate and do the lending and the compliance. On the other end of the curve, they have to deal with exotic products that either your competition is putting out or your clients demand you're trading in.

But how do you put them all under one roof and package them? Then, if there's financing offsets you can do to lower the costs and the margin and the capital commitment, you have to squeeze in all of that. It's a tall order, this rainbow. But which of your customers use every part of the rainbow? And how do you price it so that you make money? It's very challenging in that respect.

WFS: Then, how do you get that all under one roof?

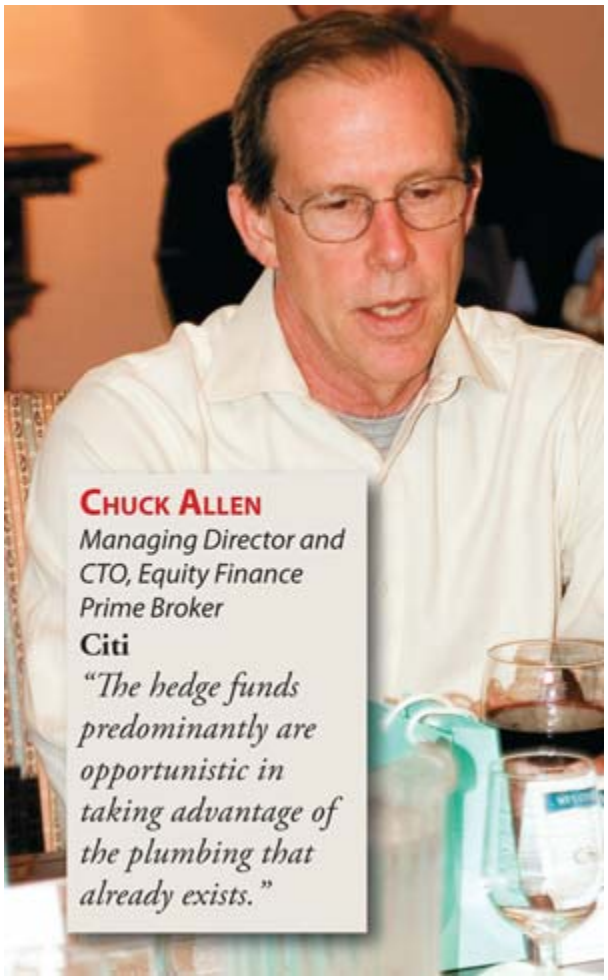
Leman: If you're a prime, you've got it all under one roof whether you like it or not but how pretty is it? The issue really is, are you expected to deploy an application where your hedge fund customer can see the range of positions and transactions they choose to do with you in some effective and credible way, either as a trading platform

or as just a position management platform. This is challenging the technology organization's budgets. How do you do market definition to know how many customers want a particular kind of product? How frequently do those products trade? You're going from billion-share days to maybe this thing has a trade cycle of a month and it has a life cycle that's different. You need different people to manage those kinds of things. Plus, you have all kinds of OTC products. I think it's a real challenge. Either you pick your spaces or you very much live by your customers, being very reactive as opposed to asking, how proactive can you be. And you have to do it around the globe. You just can't do it in the United States.

WFS: Chuck, do you build, buy or outsource?

Allen: We're doing what everyone else is doing, building the things that are practical to build, buying best-of-breed where we find it and outsourcing, but not to a great degree.

Saint-Amour: If in fact hedge funds have become more sophisticated out there, and primes have more legacy-type apps and best-of-breed apps have come down in price, what's to prevent hedge funds from making the investment directly, reducing the services they buy from primes?



Tandon: It's an economic game for the hedge fund. Is it cheaper for them to do it themselves or ask their prime broker to do it? They're already giving some revenues to the prime broker if they're able to benefit from the infrastructure that the bank or the broker-dealer has instead of purchasing or building it on their own, which is not to say some don't. Some of the large funds have invested heavily into an infrastructure for proprietary intelligence or to be more nimble than the big bank.

Saint-Amour: Doesn't buying it directly afford them the competitive differentiation that they seek versus buying a standardized ASP from a prime?

Tabb: They need to invest in places that differentiate them and some of what's provided by the fund admin and the primes aren't the differentiating things they're looking for to drive their strategy.

Leman: They're opportunistic, using one broker against another one to get as much juice as they can out of the

process. They'll favor the guy that can do the particular product the way they like it, using different primes and services based upon what products those guys are really good at. But only the bigger ones will make the big investments.

Tandon: In fact, even the bigger ones are outsourcing it to India or China where they can actually put the operations in the middle office out there.

Lipsker: I see it as a two-edged sword in that prime brokers want to lower the cost and complexity of on-boarding new clients but by reducing complexity, they're facilitating the funds' ability to move and switch, creating essentially a commodity service office. That may be part of the reticence to make further investments.

Lee: This goes beyond large funds. Smaller funds are dead set on developing everything themselves. They don't trust anyone else which is why it's tough to generalize hedge funds in terms of the outsource, buy or build question mark.

Lipsker: Their build mentality's also based on an environment with little regulation. As scrutiny increases, development costs will rise. The amount of infrastructure they have to build in order to insure compliance with these regulatory protocols will increase, making them more receptive to outsourcing.

Allen: I want to go back to something Larry addressed, as I agree that the hedge funds predominantly are opportunistic in taking advantage of the plumbing that already exists. I was once part of a startup. When I joined, we had 11 racks and maybe 30 servers in the World Trade Center. Years later, we had almost 2,000 servers across three data centers in a period of five years. The costs associated with it were not linearly comparable to our revenues. For someone to come along and try to be the next Lava, for example, that's the kind of space you look for, I think, in the prime broker technologist space.

Somebody has to come along with some really best-of-breed software that can leapfrog Goldman, Morgan Stanley, UBS with brand-new technology that somebody has gone out and found investors to let them build with first-class technologists and offer it as a service. Because then you can spread that cost a

lot better than the individual prime brokers can. The prime brokers, actually, can become customers of that type of a service.

Leman: The other point Larry brought up is good, too. Because with the Pension Reform Act of 2006, and our own assumption that the defined-benefit pension plans are going to begin going away, it seldom seems to be more than 20 to 25 percent of the long-only asset managers beat the indexes. The long-asset management game is going to have to shift a lot more to this product dimension that the hedge funds have been embracing for a long period of time. There will be players that see a bigger universe to tap and appetites beyond the hedge fund community that will want, if not with all the leverage, other products.

It sets the stage for somebody to make a bet that they've gotta' do this. It could be the custodial banks, some of which are associated with very large prime brokerage operations.

Tabb: Custodial banks are in such a good position, mostly because they have all the assets and much of it's financing-based. It's Citi, UBS, HSBC, Chase. They have huge pools of securities lying around and once they start going short, they need funding. They have significant financing desks and huge balance sheets.

Leman: And they're racing in with electronic international trading. The sales pitch is, we have the local broker, he clears us. We got the customer, he clears us. Or it's us and it stays in-house. Get the lowest rate and we'll do it for you around the world and wrap the foreign exchange into the whole thing and tie it with a nice bow.

Tabb: It's a huge ability to totally disintermediate the Goldman's and the Morgan Stanley's.

Tandon: Interestingly, though, a number of firms have tried to get into the prime brokerage space in the past, like State Street and The Bank of New York.

Tabb: They haven't been able to do it.

Tandon: The long-only guys, to get a little bit more alpha in their strategy are starting to spawn new strategies that include 20 to 30 percent of shorts.

CRAIG SAINT-AMOUR
Director, Capital Markets Industry Solutions
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"Doesn't buying it directly afford them the competitive differentiation that they seek versus buying a standardized ASP from a prime?"

They're going to the prime brokers to set that up and the primes now have to work closely with their custodian. So, their long assets are sitting with the custodian, the shorts are at the prime and we get into this tri-party agreement.

Leman: I agree with what Neil said, the primes will be primes as they are with Citi and a custody, working much more closely together, gaining some economic opportunity. It'll be advanced beyond where a broker doesn't have that kind of bank relationship but they'll make it happen, forming syndicates where primes go to custodial banks.

Tabb: We're in the early stages of this. The custodians have typically been a volume shop and they generally don't have the personnel or systems to be able to deal with any major complexity. But the question becomes, can somebody like UBS or Citi with the technology advancement they have on the front-end get them leverage on the financing side and the custody side to be able to tie everything up as Jim said, in a bow and charge half the price because everything's under the same umbrella?

WFS: Larry, you said we're in a transition period. What will it look like a year, two years, five years from now?

Tabb: The trends have been clear for the last couple of years. The smaller guys have to be niche-focused, the medium-sized guys are going to be challenged and the bigger guys have huge opportunity across the board. For the primes, there will be bigger cost pressure. Because the bigger funds will have more assets, the long-only guys will move into the short business we talked about. That will create opportunities if the custodians can get their act together and create relationships with the front offices.

I think there's a big opportunity to dynamically change the cost structure. To a certain extent, as these guys get bigger and the Fidelity's of the world step into this business in a big way, 50 million or 100 million, you're starting to talk about shorting billions. But how do you swing that kind of financing without some huge relationships?

Look at Fidelity Magellan. If suddenly they tap on 20 percent short, 20 percent leverage. Who's got that kind of financing to be able to do that? You're not talking about a 100-million dollar hedge fund. You're talking about trillions of dollars. Somebody's gotta step up to the plate.

WFS: How will these recent changes impact the markets over the next few years?

Lee: There's been great change within the

market structure, especially in the equities market with the 30 to 40 potential execution venues if you add up the exchanges, ATSs, ECNs and broker-owned crossing platforms. Can they support that?

But in terms of today's topic, the prime brokers and the broker-dealers are caught in between a confused client base. With all the confusion that's happening in the marketplace, the total list of brokers that a typical buy-side firm may be dealing with may be shrinking. If you look at other asset classes, some of the innovative things that primes are doing in the FX market, like algo trading, is just beginning. The primes themselves are trying to figure out, 'how do we play this marketplace?' It becomes more interesting because credit is everything.

So, yes, the market confusion within the equities market to me is fairly interesting. But I believe it's short term because of inevitable consolidation. But it's the other asset classes where more interesting things will occur in the next three to five years.

WFS: Such as?

Lee: In FX, there's a lot of trading activity related to the inter-bank side, that plus, they're trying to launch a centralized counterparty clearing model, but a lot of the prime brokers are saying that's what they provide now, asking, what do we need a separate entity that's being run by an exchange? Then there's potential friction between the inter-bank market, the client-facing market and what the dealers are trying to accomplish there.

GEORGE LIPSKER
Finance Services Industry Director, NA
Avanade, Inc.
"The amount of infrastructure they have to build in order to insure compliance with these regulatory protocols will increase, making them more receptive to outsourcing."

In the end, will it look like the equities market, where you may have an exchange, perhaps the CME or EBS, provide that service?

WFS: Fixed income?

Lee: You could literally take this concept and apply it to any over-the-counter market that's not regulated. The dealers themselves are trying to figure out how to make money. If you go back to the equities market, obviously the general concept there is as certain instruments become commoditized, the only way you guys can make money off of this market is to automate as much as possible. And, the next thing you'll look for is the next instrument that's going to provide you with a high-profit margin.

Saint-Amour: Sang, here's a question related to OMS versus EMS versus DMA-type systems. The real profit

margins getting squeezed seem to be in an unregulated market with dark pools, an opportunity for the prime brokers. Without rhythmic trading, do you see that as still being an under-regulated environment or is transparency coming to that as well?

Lee: Some people call it ‘gray pool,’ whatever, but I think dark pool is probably not the appropriate name for it.

WFS: Non-displayed liquidity….

Tabb: Dark pools are so much more fun. [laughter]

Lee: In the end, you have to step back and look at the rationale behind Regulation NMS to create market transparency. Question is, as dark pools gain momentum and market share within the US equities market, will regulators sit back and let that happen? I spoke with an FCC official a couple of weeks ago in terms of what they’ll do about dark pools. He said, ‘we’ll just have to wait and see what happens.’

WFS: How long?

Lee: That’s a good question. I asked him if they actually had certain percentage thresholds. On the Regulation ATS, there’s about five percent he said, ‘If you actually follow that, yes, we should do something. But the problem with dark pools is they’re non-displayed. It’s a matter of what we make them display. We’ll have to wait and see what happens.’

WFS: And if they’re displayed?

Lee: The model changes, becoming an ECN.

Tabb: Margins get diminished.

Lee: Then there’s a lot of competition and you either go out of business or you get acquired by an exchange.

Leman: Here’s another question for the table. If hedge funds want to trade multi-product and want an application that trades multi-product, are the brokers supposed to be reorganizing their trading desks to compliment that or are they going to leave it in its traditional, classic sense and watch the hedge funds go to different places on the Street?

Saint-Amour: Are they doing the analysis and asking, ‘Is it worth it for us to be doing this,’ versus, ‘No, let them go the other way because we don’t see the payback on it?’

Tandon: I’m not sure if it will effect a change to the entire bank but certainly the prime broker’s space. At a number of the brokers today, their prime brokerage units are consolidating the futures, FX, fixed income and actuary pieces

under one prime services unit. That's happening in the prime brokerage space because of the hedge funds.

Lee: Then again, it's within e-commerce groups to support multi-asset class trading opportunities.

By Marty Rabkin, Contributing Editor