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The silent hero

In terms of industry buzzwords, few can currently match 'transparency' for pertinence and presence. However, while nary a day goes by without, seemingly, another call for an industry-wide increase in the concept, less discussion is given to how, in practical terms, such an increase would come about. Transparency requires data – data provided quickly and provided accurately

If transparency is to increase, therefore, then so should the industry's appreciation of technology. Technology's relationship with transparency is, of course, merely an example of its significance. Technology brings to life the talent, innovation and needs on which the hedge fund industry was built. Without it, the driving forces of the entire sector would grind to halt.

Some will argue that such potential hyperboles are obvious. But, with the hedge fund sector still bruised from recent events and industry evolution – along with the aforementioned calls for transparency – in the air, it could also be argued that rarely has the industry needed the reminder more. If hedge funds are to advance, then technology will lead the way.

In this *HFMWeek Technology Focus*, experts in the field have gathered with progression in mind. And though they provide a reminder of technology's impor-

tance, first and foremost, they offer advice.

The first article, provided by Keith Parker of Koger, looks at the role of technology in the current financial climate and highlights its value in relation to independent administrators. Peter John, of Fidessa LatentZero, follows this with a look at counterparty compliance and analysis, while Brian Rosso and Simon Koziel of ProTrak International conclude with an example of valuable modern technology in the form of ProTrak's Client Relationship Management system.

Issues and developments may hog the headlines, but if hedge funds are to evolve successfully then so too will the systems they employ. Hopefully, this report will help technology, the silent hero of hedge funds, receive the attention it deserves.

Tony Griffiths
Report editor

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“Client Relationships Matter!!”

ProTrak Advantage CRM

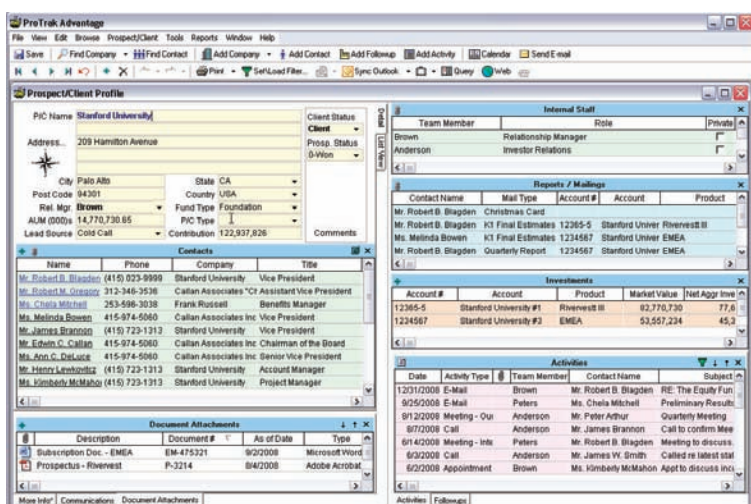
Today – more than ever – Client Relationship Management (CRM) is an essential component in the hedge fund manager's technology toolbox

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Keith Parker of **Koger** discusses the added value and competitive edge that well-applied technology brings to hedge fund administrators competing in the current turbulent climate

Technology's role today



Keith Parker is sales and marketing manager for **Koger**, based in its Dublin office. He has 13 years' experience in the financial services sector, having worked as a pension fund consultant and in business development for both Swiss Re and Canada Life Re.

The parlous state of the global financial markets needs little introduction. In terms of the hedge funds industry, the impact has been devastating. The reduction in the size of the industry in terms of assets under management is arguably the most striking characteristic to have emerged over the past six months. Not only have asset values dropped precipitously but redemptions have sky-rocketed and that trajectory seems likely to continue.

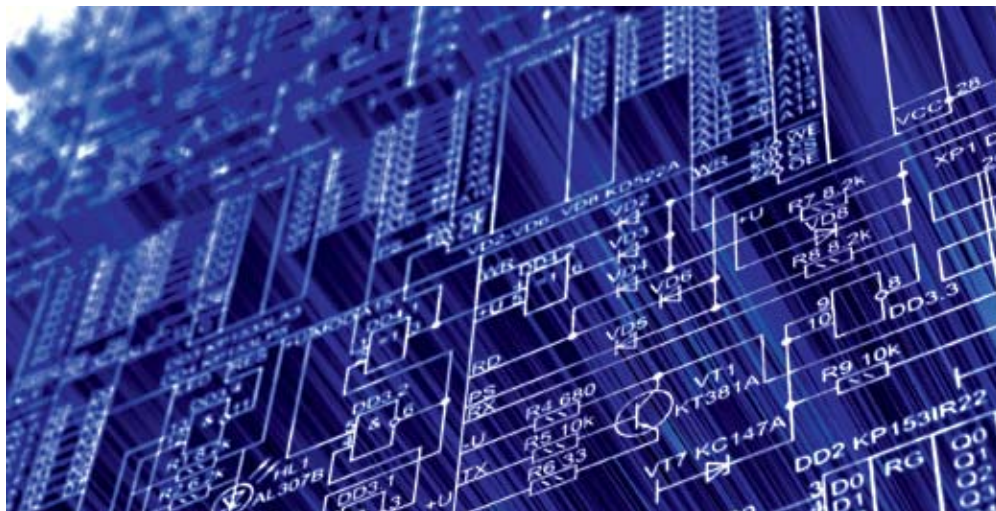
Partly as a function of the enormous upheaval already mentioned, a number of interesting developments have taken place that will impact directly on hedge fund administrators and, by extension, the technology they use. Most of the larger and more established hedge funds use independent administrators. However, there are many that do their own administration and, in many cases, using unsophisticated systems, often just spreadsheets. Hedge funds are, by their very nature, complex. Consequently, sophisticated technology is required to adequately quantify and measure underlying metrics. Good examples are incentive fee cal-

culations and equalisation of shares. Processing these can be notoriously convoluted and significantly prone to errors when, for example, using spreadsheets.

Key to all of this is data integrity. Hedge funds have been called opaque and difficult to understand. A portion of this is justified as that is the nature of the beast, so to speak. However, owing to the impact that hedge fund activity can have on the wider economy, the absence of transparent data is not acceptable. A likely trend to emerge, and there is anecdotal evidence that this is already happening, is that all hedge funds will ultimately use independent administrators. This will be a very positive situation to emerge out of a blighted set of circumstances. Hedge fund managers will be able to focus on what they do best and the administrators will do what they do best.

Using a reputable hedge fund administrator is all very well but that doesn't mean that their job is an easy one or without the challenges that have emerged from the recent financial markets crisis. Let us consider a number of fund administration challenges that can be met by using proper technology. To expand on the

“Investors are no longer likely to give their money to a hedge fund manager and wait for a good return. They increasingly want to know how their money is managed”



theme of data integrity, fund administrators will need a greater understanding of their clients' data than has historically been the case. With the likely increase in regulation in the hedge fund industry and associated reporting requirements, being able to access client data and present it in a meaningful way will be at a premium. Leveraging good technology allows this to happen. For example, Koger's transfer agency platform, NTAS (New Transfer Agency System) contains literally hundreds of reports, with many of them being customisable. This is fundamental as it allows the administrator to scrutinise data and extract information that can be used by fund managers, investors and regulators alike. This ties in closely with the emergence of increased investor participation. Hedge fund investors are no longer likely to merely give their money across to a hedge fund manager and wait for a good return. Investors increasingly want to know how their money is managed, and – equally importantly – on a real-time basis, too. This is again where technology comes into play. Allowing investors to access their investment records on a real-time basis through some form of a web portal has become a necessity. The use of technology empowers the investor and allows them to participate more in the overall process. Koger has designed ETAS (Electronic Transfer Agency System), a web front-end that allows investors and other third parties to access information on NTAS through a secure web portal. Technology bridges that historical divide.

Long-term cost benefits

We cannot talk about technology without considering the cost dimension. Good technology is often thought of as being expensive, but this is without considering the various value-added components and cost savings that technology can bring. The automation capabilities inherent in technology are possibly the key drivers of cost saving, along with associated benefits such as data accuracy and access to data. Fund administrators spend a lot of money on processes that are labour-intensive, whereas these can almost always be totally automated. People could possibly argue that, in today's climate, accessing new technology is an expense that cannot be afforded. This is a reasonable argument but not when one considers the matter further. If technology is considered on a holistic basis, meaning that genuine cost

savings are factored into the costing, then the actual cost is a very different consideration. A good technology provider will also need to be creative in terms of cost structure in today's climate. Using technology should be on the basis of a partnership that should last for an indefinite period of time. With this being the case, the software vendor can take a very different view in terms of costing and possibly minimising the once-off hit to the administrator's P&L. Another important consideration is the 'flight to quality' in terms of investors moving money to the larger and more reputable hedge funds, and in parallel fund managers moving to 'quality' fund administrators. This dynamic will mean that there will be a lot of data migration. Doing this on a manual basis is going to be tedious, error-prone and expensive. Technology can significantly contribute to eliminating these issues. Again, Koger has a product, GRID (Global Reach Interface Daemon), which can access any third-party system and transfer data in a near-automated environment. The common denominator is, again, technology.

Another important consideration relates to multiple-system usage. It is not uncommon to find a fund administrator that uses a number of different systems. This is understandable in many instances, for example where the underlying functionality is highly specialised. However, it is often the case that an administrator uses multiple systems when only one system could be used. Managing the interface between multiple systems is expensive and, again, labour intensive. In today's climate of austerity, using one system can generate significant cost savings. Not only in terms of the absolute cost of one or more systems no longer being necessary but also in terms of ancillary cost savings such as reduced training and support costs.

The current market is unarguably one of extreme flux and uncertainty. Being distracted and losing focus is easy. However, if businesses are going to survive and ultimately thrive again they are going to have to carefully consider how they do business. Leveraging technology is one manner in which latent value can be extracted, productivity can be improved, costs can be reduced and transparency can be ensured. At Koger we see on a day-to-day basis how technology can revolutionise the way fund administrators go about their business. Technology should be at the top of everyone's list of priorities. ■

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Generic interface engine that connects Koger products with third-party software such as accounting systems. Allows for automated loading of data into NTAS thereby removing manual input, improving efficiencies and eliminating manual errors.



Peter John of **Fidessa LatentZero** tells *HFMWeek* how hedge fund managers need to assess counterparty risk and put compliance measures in place to manage it

Counterparty compliance



As derivatives product manager, **Peter John** is responsible for the design and development of **Fidessa LatentZero's** market-leading OTC Derivatives module. Peter has worked at Fidessa LatentZero in Europe and the US for four years.

With the exception of hedge funds working in statistical arbitrage and other volatility strategies, 2008 is certainly a strong contender for the title *annus horribilis*. The brutally swift withdrawal of liquidity, the ban on short-selling in a bear market, and the general underperformance have all taken their toll, and the hedge fund sector is facing a severe contraction, with perhaps a third of all players facing closure in the next 12 months.

If hedge funds have become one of the favoured punching bags for national newspapers, keen to find a culprit for the current crisis, public vilification has been accompanied by a palpable lack of trust among financial institutions across the board. Counterparty risk is now recognised as being paramount: the collapse of Lehman Brothers and the hasty mergers, acquisitions and restructurings that followed it led hedge funds to reassess counterparty exposure. As a result, the financial markets are currently populated by funds and institutions warily circling each other, assessing who is safe to trade with – and who is not.

Unreliable credit ratings

Underpinning this is the recognition that credit ratings are problematic at best, and unreliable at worst. After all, Lehman Brothers was still A-rated just weeks before it went bankrupt. Although prudent asset managers had begun to close their positions against the troubled bank in the months leading to its September collapse – as they had with Bear Stearns earlier in the year – the full extent of its problems was not widely anticipated.

If counterparty risk is now seen as a critical issue for all market participants, it is particularly pressing for hedge funds that trade in OTC derivatives. Unlike exchange-traded derivatives, OTC-derivative trades have no central clearing, and settlement usually takes place via a central body and securities depositories. The bilateral settlement therefore exposes hedge funds to their brokers for all parts of the transaction, not just the trade execution.

Furthermore, OTC derivatives have long maturities, and counterparties remain exposed to each other throughout the lifetime of the contract. Un-

like a straightforward purchase of equities, entering a transaction for interest rate swaps or credit default swaps (CDS) exposes a fund to the counterparty over a period of time. As recent history has shown, there are no guarantees that the chosen counterparty will be in business in 10 years' time. Finally, assessing the risk of each counterparty composing a CDS index – far more common than a single name swap – is time-consuming and far from straightforward.

Yet CDSs in particular show no sign of falling out of favour for obvious reasons: the protection they offer is considered to be worth the high premiums. Hence the volumes in the CDS market have gone up from 62 trillion in September to 64 trillion in the latest figures.

So what are the options for managing counterparty risk in today's markets? It is relatively easy to put a bar on certain institutions, once it is recognised that they present a 'clear and present' danger following close scrutiny of share price movements, CDS spreads and funding structures. Hedge funds could demand more collateral from their brokers to reduce exposure and protect against default. They can also increase the number of prime broker counterparties used to minimise exposure to a single entity. But there are significant downsides to this approach: the operational, administrative and technology costs of working with multiple brokers may prove to be prohibitive. More likely, by sharing volume, none of the brokers will get the business necessary to justify high levels of service.

Minimising counterparty risk

The possibility of central counterparties for OTC trades has also been much discussed in recent years as the best possible course of action to reduce generic counterparty risk by handing over trades to a central clearing house. Naturally, this discussion has been given extra impetus by the collapse of Lehman Brothers. Although we are likely to see more CDSs, for example going on to exchange or through a central clearing house and becoming standardised as a result, a flexible OTC market will remain for non-standard trades.

However, since the rise of counterparty risk, and the greater awareness of the threats posed by other parties' credit problems is an issue for the compliance and risk management departments, it also makes sense to con-



“The reasoning that a hedge fund lives and dies by trading and will only be tied down by systems can no longer be applied”

sider implementing compliance and portfolio analysis systems that can measure and monitor issuer, counterparty and underlying exposure to certain counterparties and assets.

None of the suggestions for minimising counterparty risk outlined above really address the central problem. The interrelated nature of today’s markets means that exposure to a single counterparty can take many forms. It is not so easy to actually measure exposure if a bank is counterparty for cash trading plus OTC derivatives, stock lending and prime brokerage services, for example. If it is also acting as guarantor to another party, then the waters are muddied further. And then it’s entirely possible to be exposed to both the London and New York office of the same institution, or to various trading desks – interest rate swap and CDS desks for example – as well as to mutual market funds.

The real solution is in the deployment of systems that can analyse and calculate primary and underlying exposure, and then run a trade against a set of rules to ensure that certain limits or parameters based on those calculations are not breached. In essence, it’s a combination of a rules-based compliance engine with advanced, interactive analytics.

The move towards a more systems-based approach was already in its infancy when the credit crunch hit. Certain hedge funds were beginning to seriously consider the opportunities presented by implementing the more sophisticated systems developed by independent vendors, rather than individual sell-side institutions. Already facing the possibility of greater regulation, recent events have turned that possibility into an abso-

lute certainty. The District Attorney of New York has started looking at every single hedge fund and every single trade, with an eye firmly on the odds of securing a criminal prosecution. While this level of scrutiny is unlikely to be sustained, and there is as yet no sign of it migrating across the Atlantic, we can be sure that the days of light-touch regulation are all but over.

In other words, this is precisely the time to get off spreadsheets and onto systems that can manage compliance in a transparent and timely fashion. The reasoning that a hedge fund lives and dies by trading and will only be tied down by systems can no longer be applied.

A number of funds have already started to apply a more compliance-tuned mindset to their trading activities. UCITS III is already being used as a best practice benchmark, even where the funds concerned are not or do not need to be UCITS-compliant, to ensure that global, issuer and counterparty exposure is kept under control. Furthermore, these funds are starting to use systems to create complex multi-level, ‘what if’ rules and sensitive, inter-dependent and conditional instructions. And those rules can be applied equally to a strategy as to a fund.

The crunch has caused a huge rethink in the markets. It has brutally highlighted the strengths and weaknesses of all funds. The ones that do survive will be the ones that actually have the systems in place and with them effective risk management. This year will be the year that compliance and portfolio analysis systems for hedge funds come of age and become a key success factor. ■

Simon Koziel and **Brian Rosso** of **ProTrak International** discuss why many hedge fund managers now consider CRM systems one of their core technology systems

Core technology for hedge funds



Simon Koziel is president of **ProTrak International**, which offers CRM technology solution designed exclusively for the investment management industry. Simon's entire career has been in the investment management business.



Brian Rosso is director of business development for **ProTrak International**. Previously, Brian served as a vice-president at Morgan Stanley.

In today's volatile markets and stressful economic environment hedge fund managers should consider a Client Relationship Management (CRM) system as a must-have piece of software. More hedge funds are realising that CRM is a vital part of their core technology, along with their trading, risk management and accounting systems. "CRM no longer means 'contact management' for the sales team," says Simon Koziel, president of ProTrak International. "Our CRM system, ProTrak Advantage, was designed for investor relations, research and compliance groups, in addition to sales and marketing. Don't forget that the 'C' in CRM stands for client!"

Koziel, whose company has been serving the institutional investment management community for over 20 years, is adamant that a CRM system must be tailored to the unique needs of hedge fund, FoHF and private equity managers. "A CRM system designed for the general market won't work as optimal as an industry-specific solution," he says. "Nor will those vendor's support teams have as good an understanding of the hedge fund manager's business needs."

But why are CRM systems now becoming a core technology component for hedge funds? Especially in this challenging economic environment, there are four factors that are critical to a hedge fund managers continuing success:

- Maintaining and growing existing clients
- Acquiring new business
- Meeting regulatory and compliance requirements (due diligence)
- Controlling internal business costs (doing more with less)
- Maintaining existing clients

It goes without saying that there are many unhappy investors out there today. Most hedge funds have had to activate their 'gates' or put at least a temporary hold on cascading redemptions in order to survive. This, along with the performance tsunami and the much publicised Madoff scandal has created a crisis of confidence among disgruntled hedge fund and fund of hedge fund (FoHF) clients. In the past, frequent client communications were not the highest priority in

the average hedge fund shop. Managers cannot undo the events of the past year, but greatly increased client communications and transparency can enhance client trust going forward.

"With the mass e-mail (blast e-mail) features in ProTrak Advantage, managers can easily send out weekly market commentaries or other communications to all clients. Communications can be targeted based on fund holdings or to clients who have called or emailed requests," says Koziel. "And the ability to send out investor K1s and other statements as PDF attachments on personalised e-mails directly from the CRM system is of tremendous value."

For example, when the client calls with a question regarding the statement, the investor relations rep can access the e-mail and the PDF statement with just a few mouse clicks while the client is on the phone. The IR rep can immediately record the client's questions and reactions in the CRM database and create a follow-up task for future action by another staff member. Functionality like this is not a luxury today, it is an essential component in the hedge fund manager's technology repertoire.

Acquiring new business - sales and marketing

Acquiring new clients in the current environment is particularly difficult, but hedge funds that stop trying will struggle to stay in business. "The technology needs of today's hedge fund sales rep go far beyond contact management as we used to know it," adds Brian Rosso, director of business development for ProTrak International. "The sales reps I speak with want to be able to enter and retrieve activities, calendar, contacts and e-mails to and from the CRM through their Blackberries."

All of this is possible with ProTrak's Blackberry licence. In addition, the laptop licence lets users use ProTrak in a 'disconnected' mode, while with the ProTrak OnWeb licence, reps can access the central database anywhere they have an internet connection.

Maintaining a reliable, up-to-date sales database is the lifeblood of any organisation. But if the CRM system is not user-friendly, the sales intelligence information will never make it from the rep's 'brain' to the CRM 'brain'. "Ease-of-use is one of the most critical factors for user adoption by the sales team," says

“The technology needs of today’s hedge fund sales rep go far beyond contact management as we used to know it”



Rosso. “If the system is not easy to use, data will not be entered and information critical to the organisation will be lost, particularly if the sales rep moves on.”

Often sales reps are used to storing their information in Microsoft Outlook and may be resistant to learning a new system. “With this in mind, we have implemented easy-to-use bi-directional synchronisation between ProTrak and MS Outlook,” says Koziel. “This allows those users who wish to continue using Outlook to do so, as the ProTrak database collects information critical for sales reporting and compliance. We designed ProTrak from the ground up to work the way hedge fund managers and their support staff work. Typically, user adoption will always fall short if you expect users to make major changes in their daily workflow to satisfy technology imposed constraints.”

Compliance, due diligence and audit

With the crisis of confidence that exists in the investor community today, compliance and due diligence are more important than ever and a major factor that has made CRM one of the hedge fund manager’s mission critical technologies. As a fully audited system, ProTrak maintains an audit trail of all user interactions. And, the comprehensive security controls provide selective access to sensitive client data. E-mail attachments, both sent and received, are captured and preserved as part of the historical record. “Even if an email originates from ProTrak but is modified in Outlook before it is ‘sent’, the modified email and the Outlook header are stamped back into the ProTrak activity,” says Koziel. “In this way, the compliance officer has an exact record of every transmittal.”

Hedge funds now find it prudent to use multiple prime brokers and multiple administrators. ProTrak’s ability to import investor holdings and transactions from multiple sources (inhouse accounting systems as well as outside administrators) allows it to serve as a single point for client reporting. The IR staff can thus provide better transparency to investors through both ad-hoc reporting and customised reports such as K1 tax letters and client statements. In addition, liquid-

ity analysis reports run from ProTrak let the manager see all possible investor redemption scenarios so they can plan accordingly.

Managing internal cost (doing more with less)

This year has been a most difficult year for most funds, and 2009 may not be much better. Many hedge fund managers find themselves in the uncomfortable position of having to cut costs through staff reductions. Yet pressures for client retention, new business acquisition, and increased regulatory oversight will increase greatly. This means that managers will have to do more with less. ProTrak greatly enhances productivity in the organisation while collecting the critical information that supports investor relations, sales & marketing and compliance/due diligence. “Every department within the hedge fund organisation has numerous time-consuming, repetitive tasks and processes that require gathering information and transmitting it via personalised e-mail attachments,” Koziel points out. “ProTrak’s workflow functionality lets staff automate these tasks. One can send out subscription documents or other fund documents to a prospect or investor with literally just a few mouse clicks. And, the entire transaction is immediately recorded in the historical record.”

The research department at FoHFs will also find that ProTrak is a valuable part of their manager due diligence effort. According to Koziel: “The research analysts can easily document all manager interactions such as tasks, meetings, reports and emails; and control the myriad of e-mail attachments received from invested and prospective managers using ProTrak’s Manager Directory.”

Year 2009 will be a year of new hedge fund regulations and heightened scrutiny. Transparency and substantially increased client communication will be essential to maintaining existing clients and capturing new investors. The ProTrak Advantage CRM solution will allow hedge funds, FoHFs and private firms to do more with less, while addressing their investor relations, compliance and sales and marketing needs. ■