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We deliver everything you expect from a bulge-bracket prime broker, with one exception, we never forget who we work for. Numerous established hedge funds consider M.S. Howells & Co. indispensable to their day-to-day operations. Your needs not your fund size drive the prime brokerage relationship.

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US prime brokers are stealing a march on their European peers as European banks grapple with the demands of shoring up their balance sheets to comply with Basel III rules. As Reuters reported 7th October 2015, Goldman Sachs and Morgan Stanley have a 37 per cent market share, up 6 per cent from the end of 2014 (according to data from Preqin). Goldman was servicing 2,240 hedge funds through May 2015, followed by Morgan Stanley with 1,693. JP Morgan rounds out the top three with 1,462 hedge funds.

Credit Suisse Prime Fund Services is the highest ranked European PB, with 1,214 hedge funds but as recent newspaper reports have suggested, the Swiss bank’s new chief executive, Tidjane Thiam, is planning to split the bank into three businesses – an investment banking business, a Swiss business and an international business – and scale back its prime brokerage activities to free up capital.

With Deutsche Bank having also lost ground, the situation has enabled US primes to ramp up their activities, leading to higher revenues. According to data compiled by
The likes of Jefferies, Global Prime Partners, and many others, are actively looking to compete with the bigger primes in the US and Europe. Even though the US is in a stronger position, Goldmans, Morgan Stanley and others have, for quite some time, been culling hedge funds that are simply not profitable enough as they take a more forensic approach to understanding the return of assets (ROA) when committing precious balance sheet.

"If a manager is looking for competitive rates and supply on securities lending, whether they are USD100million or USD10billion, Jefferies is a good choice. Our approach is, 'How can we help you make money, raise money and build an institutional business?' Today’s regulatory landscape gives us the opportunity to compete more readily with the big primes," comments Laub.

"When I look at the differences (between US and European primes), there were some firms that grew very quickly. Then the rules changed. All of sudden, ROA is a factor that previously hadn't been. We paid a lot of attention to these changes. We have always focused on our ROA thanks to the slow and steady approach we’ve taken to growing the business. We didn’t have to take a huge sidestep in our business post-crisis and scramble to ensure our business model fits the new regulatory environment. Trading and financing has always been integrated holistically for Jefferies and this has helped maintain a good ROA."

If European primes continue downsizing it will likely present opportunities for US primes to win lucrative client business and not have to rely on more capital intensive hedge funds. If you can remove USD1billion of AUM that uses USD300million of balance sheet,
Cowen Prime Services offers a comprehensive suite of brokerage and related services that provide traditional and alternative investment managers with solutions that are customizable and scalable. The firm was built by former investment managers to serve hedge fund managers, managed account platforms, institutional investors, family offices, and registered investment advisors with turn-key solutions designed to free its clients to focus on their core competencies. Our offering features world-class custody and clearing options, multi asset class capabilities, leading execution and order management systems, a seasoned execution desk, a range of financing options, a highly professional operations and customer support team, comprehensive portfolio reporting capabilities, and capital introduction.
Poised to expand rapidly into Europe

Interview with Mike Rosen & Jack Seibald

Earlier this year, Concept Capital Markets LLC was acquired by Cowen Group, Inc. ("Cowen"), a US investment bank and alternative investment manager with a heritage dating back to 1918. The transaction was completed 1st September and thanks to the significant financial resources that Cowen has at its disposal, the newly named ‘Cowen Prime Services’ division is now in a strong position to move quickly and build out its market share; with Europe a key focus of attention.

“We believe that there is a real opportunity for Cowen Prime Services to enter the European market and be successful,” comments Mike Rosen, Cowen’s Global Co-Head of Prime Brokerage. “There are a number of European bank-owned primes that are changing their approach and being required to downsize. That is creating an opportunity for an upper mid-tier firm like ours to provide prime brokerage services to European hedge fund managers.”

In addition to financial resources, Cowen also brings significant intellectual resources to the table.

As Jack Seibald, who works alongside Rosen as Global Co-Head of Prime Brokerage, explains: “With respect to technology, we’re developing enhanced portfolio reporting capabilities. We now have personnel in Belfast, Northern Ireland working with our team here in the US in both client service and technology solutions.”

Seibald continues: “Cowen has an existing infrastructure in place for their traditional institutional business in a number of US markets as well as in London, neither of which we had at Concept Capital Markets. We are now in a position to build a more meaningful sales presence in certain US markets and in London; both as it relates to our prime services offering, as well as our outsourced trading solution.

“We aim to cover the entire trading day for major markets by having outsourced trading services in London, New York and San Francisco.”

Currently, Cowen Prime Services has clearing relationships in place with Pershing, Merrill Lynch, Goldman Sachs, Merrill Lynch Professional and Chinese bank, ICBC. Seibald says that when analysing Europe it will look to establish “local clearing relationships” which will be an “important element of our business.”

Cowen Prime Services intends to leverage Cowen’s established FCA-registered London broker dealer to expedite its service offering. Looking ahead, Cowen Prime Services will aim to replicate as much of its US fully disclosed introducing brokerage model as will work within the European regulatory framework and provide outsourced trading solutions for European investment managers.

“We want to be able to offer European clients many of the same services we provide our US clients,” says Rosen. "We believe we have a clear path to launching a portion of the services we will ultimately offer in the first quarter of 2016."

Rosen says that the goal, where appropriate, is to replicate the service offering of its US business in London. "Outsourcing trading services enables managers that can’t afford an institutional-quality trading infrastructure to get precisely that. They get the benefit of an experienced buy-side trading desk that has relationships across a large number of brokerage firms, and is able to offer broader insights into stocks, sectors, and market colour than an individual trading solely within a fund management company."

The goal, concludes Seibald, is to bring “a high-touch consultative service to fund managers in Europe. We want to partner with our clients to help them achieve the best long-term results.”
for example, and replace it with USD1billion of AUM that only uses USD100million of balance sheet, the chances are that is something US banks will look at.

“I think that’s the process that is going on right now, generally speaking, in US banks,” says Jack Seibald, Global Co-Head of Prime Brokerage at Cowen Prime Services. He is in no doubt that European banks were slower to recapitalise and as a consequence have found themselves at a competitive disadvantage. “They are having to address the issue. One way is to shrink the balance sheet. The second is to rebuild capital. They are at a stage where it appears that the easiest thing to do is to shrink the balance sheet; i.e. show clients the door. It’s hard in that environment to win new client mandates when you’re going through this period of restructuring.”

One of the negative developments in recent years, before Basel III took meaningful effect, was the perverse desire among prime brokers to engage in a race to zero with respect to spreads on financing rates, execution costs, securities lending etc. Some US primes have been quick to act on this and have raised their rates necessarily. It needed to happen and it is something that hedge funds have to accept when operating in today’s regulatory environment.

“I’m surprised by a lack of a more meaningful increase in the costs imposed on hedge funds by prime brokers. When we look at the pricing coming out of some of the European banks when speaking to prospective clients we scratch our heads. I don’t understand why banks are more comfortable saying they are going to restructure and can’t offer a home for hedge funds, rather than tell clients, ‘We value your business but in order for you to stay here your rates need to increase from X to Y,’” opines Seibald.

US banks raised a lot of capital from 2009 onwards. Granted, some have been hit with significant fines by the regulators but despite that they’ve been able to continue to build their capital structure. That accounts for the significant spread between the leverage ratios in place in the US banks like Goldman’s and those in Europe.

At the same time, there’s a need to generate a return on capital because US banks are being continuously assessed based on the capital requirements they have in place for assets held on their balance sheet.

“I tend to think that the firms who are growing market share are the ones that have the best integrated equities platforms,” suggests Laub. “We’re starting to field more enquiries from European hedge funds as they start to get culled, just as we did a year ago when US managers noticed that their rates were going up, and were beginning to feel less important. I think in 2016 you’ll increasingly hear that European banks are raising their rates and culling managers.”

Not that it is all doom and gloom in Europe. One bank that is preparing to build out its prime brokerage offering is Societe Generale Prime Services. In May 2014, the bank chose to buy out Credit Agricole’s 50 per cent stake in Newedge, a leading Prime Broker in Equities, Fixed Income, Listed and OTC products. Newedge is now able to leverage the strengths of Societe Generale and operate as a full-scale prime services business.

“Many of our competitors have had large PB franchises for year. Some of them were perhaps oversized versus the rest of their business, leading them to reduce their clients’ portfolio. On our side, we have taken the time to grow our PB franchise steadily and we are committed to keep expanding”, says Fred Colette, Deputy Head of Prime Brokerage & Clearing Sales, Societe Generale Prime Services.

“The combination of Newedge’s existing PB franchise and infrastructure with Societe Generale Equity footprint (large inventories, execution, derivatives expertise, research...) enabled Societe Generale Prime Services to...
Pre-2008, Prime Brokerage was a land grabbing exercise. Balance sheet was put to work, free of the shackles of regulation, and hedge funds of all shapes and sizes were welcome. That model has now changed under Basel III. And whilst US banks were quick to recapitalise following the financial crash, European banks have taken longer to assess their balance sheets. Many are now taking steps to restructure as a result.

“In the post-2010 era, it has become a much clearer regulatory environment and a much tougher capital situation, particularly for European banks. I think US banks, with liquidity stress testing etc., have been a bit ahead of the curve and have got their balance sheets in better shape,” says John Laub, Co-Head of Global Prime Services at Jefferies LLC, one of the few pure-play global investment banks still in existence.

Laub is uniquely positioned to bring his perspective to the changing prime brokerage landscape. He joined Jefferies last year from Red Alder LLC, a US equity long/short hedge fund. Prior to this he was head of Prime Brokerage in the Americas at UBS AG.

That bank-owned prime brokers are going through a period of rightsizing is proving advantageous to Jefferies. Its business is all about serving institutional customers through equities, fixed income and banking. Crucially, Jefferies didn’t overinflate its balance sheet in 2008. It has, says Laub, grown its business “slow and steady”. This has helped avoid the need to react to regulatory rules and re-think its business model and become more of a partner to its hedge fund clients.

“Being an institutional investment bank, what we are selling to our clients is not really our balance sheet, it’s the franchise overall,” explains Laub. “We’ve got an excellent equities platform encompassing research, corporate access and trading expertise. What we like to say to clients is, “We’ve got a tremendous equities platform, we cover 2,000 stocks, so partner with us to get the resources you need to make money and grow your business.”

Jefferies currently has approximately 400 managers on its equities platform. “We’ve invested resources both in our Capital Introduction team and our Business Consulting team to help expand that capability over the last 18 months,” says Laub, adding: “We help our clients to make money not only on the research and trading side, but also in areas such as securities lending. We have tremendous color and content to help clients understand the short selling landscape, pricing trends etc., and ensure they are being as efficient as possible at executing their strategy.”

“Overall, we can provide many resources to help managers in the early stages of running their hedge fund business and as they continue to grow and institutionalise,” comments Laub.

Regardless of regulations, a USD5billion hedge fund will likely always get resources from any prime broker. The issue for a lot of emerging and mid-sized managers, however, is they’re not getting the attention of tier one primes. It’s only when they start to grow their AUM that these larger primes pay attention.

“What we are saying is, ‘We’ll help you to grow your business from day one. We’ll help you with your marketing strategy, your infrastructure and and everything else you need to be successful and we believe we will be very complimentary to those managers that already have a large bank as a prime broker.”

“If you factor in our business consulting efforts and our capital introduction efforts, along with our securities lending expertise, overlain with the entire Jefferies franchise: that is what is helping us to win market share and grow our business,” concludes Laub.
build a competitive Equity PB offering for all clients. The integration is now successfully complete and we are continuously winning more mandates as Societe Generale Prime Services.”

What gives Societe Generale Prime Services a competitive advantage over its European peers is that its prime brokerage business has been constructed as a single integrated offering that has neither the legacy technology issues nor the silo-based arrangement that is now proving challenging for some banks to gain a full understanding of the revenue capabilities of hedge fund clients.

“Our strength is to offer a truly cross-asset approach. By combining execution services, cross-asset financing and prime brokerage under one umbrella our clients benefit from a global, non-siloed service. We can address all our clients’ needs, regardless of the products and services, as one single partner.

“In the current context, hedge funds looking to diversify their source of balance sheet capacity cannot solely rely on US-based prime brokers. Clients are looking to diversify their exposure to regulatory uncertainty and counterparty risk, which is a strong selling point for European Prime Brokers. It goes without saying that the year ahead is critical for the reshuffling of the industry mix,” states Colette.

From a regulatory standpoint, a new disclosure requirement is set to come into effect in 2016 that could, potentially, add an unwelcome operational cost to European primes. Known as Securities Financing Transaction Regulation (‘SFTR’), it relates to repos, securities lending, margin loans etc. However, SFTR contains a provision that has a broader effect than repos, securities lending and margin loans. It governs any collateral arrangement that carries a right of reuse; i.e. rehypothecation.

“In the early stages of developing the regulation there was talk that rehypothecation might be banned altogether, which would have had a massive impact on European prime brokers,” comments Allan Yip, Partner at international law firm Simmons & Simmons LLP.

“Luckily, it didn’t happen. Instead, what we’ve ended up with are some rules and parameters for any collateral arrangement to carry a right of reuse. One of which is that when a prime broker takes collateral, it has to disclose explicitly to its clients what the arrangements are, what the risks are associated with right of reuse, and some operational requirements such as getting the clients’ express consent.”

This disclosure requirement is a European rule. It mirrors what the FCA had put in place in 2011 for prime brokers – this is when the FCA first formally recognised prime brokers and inserted into their rulebook a PB Annex, which included disclosing the risks of rehypothecation of clients’ assets.

Broadly, the SFTR disclosure is similar but it now applies at a European level. Moreover, it’s not just geared towards European prime brokers but any counterparties that have a collateral right of reuse arrangement. If a hedge fund has an OTC derivative relationship, and uses separate margining to the prime, to the extent that the fund receives any variation margining from the prime then the fund, too, will have to provide the same disclosure to the prime. All of which seems rather counterproductive.

“I would best describe the disclosure and transparency requirements of SFTR as a pain to prime brokers in relation to collateral reuse.”

Allan Yip, Simmons & Simmon
Linear is a specialist prime broker and Hedge Fund incubator. Linear’s integrated platform is made up of seven core services, bringing together all the skills and expertise hedge funds require for a full solution – significantly reducing your operational costs – and helping bring you to market faster and more efficiently.

Increasingly, Linear is establishing Seeder capital for Funds focused on incubation and acceleration capital. If you’re looking to raise capital and interested in Linear Seeder structure, please contact our Capital Introduction department on 020 3603 9448.

In today’s highly-regulated financial environment, where the major prime brokerage providers limit their customer-base to the very largest of funds, it is becoming increasingly difficult for new, small and medium-sized buy-side firms to get off the ground and grow their business.

Linear Investments offers the complete suite of front-to-back office services, from execution, Prime Brokerage, custody and settlement, regulatory umbrella through to capital introduction. This unique service provides the small to medium-sized fund groups with a cost effective way to run their business, and grow their AUM.
The growing appeal of specialist PBs

By Jerry Lees

A quasi-revolution is happening in prime brokerage. Post-2008, bulge bracket banks were non-discriminatory in the type of hedge fund business they onboarded as managers and their end investors sought to minimise counterparty risks post-Lehman Brothers by opening up accounts with multiple prime brokers. Today, the landscape is vastly different.

Basel III is having a profound impact on bulge bracket banks and their prime brokerage operations. The rules force banks to adhere to Liquidity Coverage Ratios (LCRs) which require them to hold onto sufficient High Quality Liquid Assets (HQLA) to manage down a 30-day market stress event. Meanwhile, Net Stable Funding Ratios (NSFR) seek to reduce the risk of liquidity mismatches and over-reliance on short-term funding.

As hedge fund cash held with prime brokers is viewed as short-term, it subjects banks to higher capital requirements. Smaller hedge fund managers or those that have struggled to grow their Assets under Management (AuM) have seen their prime brokers unilaterally terminate their relationships, often with limited notice.

Other prime brokers have resorted to increasing fees to unsustainable levels. Again, this gives cash-constrained hedge funds little alternative but to find a new prime broker, a process that is not always straightforward.

Financing is also under threat because of Basel III, a point that has been made in papers published by bulge bracket banks including Citi, Barclays and JP Morgan. Leveraged or illiquid hedge fund strategies could see financing drying up in what will ultimately lead to a precipitous decline in returns for investors.

A report by the prime services business at Barclays estimated the average hedge fund could see a fall in returns of between 10 basis points to 20 basis points. Leveraged strategies such as fixed income arbitrage could see an alarming fall of between 40 basis points and 80 basis points because of reduced prime brokerage financing. These numbers make for alarming reading, and will force a number of managers to rethink how they obtain their financing.

Other traditional prime brokerage services such as consultancy and capital introductions have been scaled back substantially at bulge bracket firms.

This means small to mid-sized hedge funds are going to struggle to find a viable prime brokerage relationship. It does, however, spell an opportunity for specialist prime brokerage providers such as Linear Investments. Linear Investments provides traditional prime brokerage services to small to mid-sized hedge funds, and puts client relationships at the forefront of what it does.

The specialist prime broker market in London has seen significant growth, partly driven by its ability to offer smaller hedge funds better financing terms, but also client service in the way of meaningful consultancy, best-in-breed technology and capital introductions that are tailored to the needs of smaller managers.

Specialist prime brokers will often have access and relationships with investors, such as funds of hedge funds, consultancies, family offices or high-net-worth-individuals, which are more supportive backers of smaller hedge funds than institutions. This hands-on approach enables managers to grow their businesses and build up a track record.

The prime brokerage landscape is changing, and specialist prime brokers will be very well-placed to cater for the changing requirements of small to mid-sized managers going forward.
The opportunity in defined contributions

Interview with Mark Aldoroty & Rob Cirrotti

As the industry watches the growth of liquid alternatives among institutional and individual investors, fund managers are also looking ahead. The retirement market may be the next frontier. It represents a large and growing pool of assets driven by the importance of retirement savings across multiple investment segments.

How is growth in the retirement space opening the door to liquid alternative strategies? This Q&A with Pershing’s subject matter experts Mark Aldoroty and Rob Cirrotti will help fund managers understand what to consider when looking to the defined contribution (DC) plan space as a growth opportunity. There continues to be a structural shift in the marketplace from defined benefit (DB) to defined contribution (DC) plans. In fact, DC plans have become the central structure for retirement savings in the US.

If you look at an IRA as a traditional wealth management solution with access to all kinds of investments, you can understand why people often move money to an IRA. They want and need to access those advisers and more flexible investment options. Alternatives have become an important part of those strategies as investors look for new ways to hedge risk. Exposure to these strategies outside of DC plans has led us to question why we cannot have those kinds of vehicles in DC plans.

How can liquid alternatives fit into a DC plan?

One way for alternative investments to permeate the DC space is through the independent advisers and RIAs that act in a fiduciary capacity. These advisers often create their own advisory models. So when alternatives are included in these turnkey investment portfolios or packaged investment advice, you inherently give plan participants the right structure to utilise alternatives. As we figure out how to embed these advice solutions we usher in the opportunity to access liquid alternatives.

Increasingly, plan advisers are focused on new strategies to improve plan participant outcomes. They understand how liquid alternatives can carry through to the plan participants and help mitigate risk while still capturing upside. But before plan advisers can feel comfortable recommending liquid alternatives to their clients, they need to feel that alternative managers are launching funds built on strategies that are transferable and will translate well into liquid form. Those funds with transferable strategies can now find a place in the growing segment.

What is an attractive DC plan-focused alternative offering?

There are two elements that should be considered to make an alternative offering attractive to a DC plan. First, plan advisers need to examine what reasonably converts from the hedge fund space to the DC plan space. The strategy needs to feel like a daily liquid product, and not everything will prove to be transferable. Second, the DC plan space itself wants to know how to get greater access to hedge funds. DC platforms are evolving to accommodate less frequent liquidity events, so as hedge funds begin to understand what products work within the space, alignment will increase, driving more liquid alternatives into DC plans.

The challenge is to position liquid alternatives within these embedded advice solutions. One avenue to consider is packaged target date funds. By gaining access to the fund’s decision-makers, whether they are the portfolio managers or CIOs, alternatives managers can position themselves well within the larger DC plan strategy.
What are the common reservations when first considering including alternative strategies? How can they be addressed?

Ultimately, the performance of a DC plan is dependent upon the fiduciary. As the fiduciary becomes more comfortable with alternatives, the trend to include these vehicles in a plan’s investment options will continue to grow. From a DC plan adviser’s standpoint, engendering that level of comfort is the biggest challenge. The DC plan advisor understands the value of these investments, but the fiduciary, the one who is truly responsible for the plan, has the biggest hurdle. The fiduciary must make decisions for the plan that are prudent. First they need to understand and educate themselves on the investment. Then balance the benefits of these new alternative investment vehicles with the liability and risk of incorporating them in the plan participants’ investment options.

Two facts that should not be ignored: DC plans offer ingredients for a successful outcome and plan participants can use all the help they can get. So, if an alternative strategy can help plan participants see greater returns with no significant additional risk, then from an investment policy perspective it becomes a strategy worth considering.

The bottom line should be whether liquid alternative funds can help produce greater returns without increasing an individual’s risk. If liquid alternative funds can get plan participants on a path to a more secure retirement, then they have a role in the DC plan.

What message do DC plan advisers need to communicate to DC plan fiduciaries?

Liquid alternatives can play an important role in a retirement plan. Fiduciaries need to understand the benefits to their plan participants and their portfolios. Increased returns or hedges that reduce risk can increase returns which can have a significant impact over time. But experience and comfort go hand in hand. These liquid alternative strategies might be completely new and unfamiliar to fiduciaries. We have seen the evolution of new products before. Mutual funds are household names now; eventually the same thing will happen with alternatives and hedging strategies. As these strategies become more pervasive, fiduciaries will understand them better. When fiduciaries are more familiar with them, they will welcome alternatives into their plan lineups.

What are the most critical evaluations for DC plans to make when they are considering including alternative investments?

One could argue that fiduciaries have an obligation not only to avoid risk but to actively seek increasing returns. A fiduciary should not focus solely on how to demonstrate a prudent selection process. He or she needs to think about how to carry plan participants to an adequate retirement. A more progressive fiduciary wants to know where to look for investments that will deliver the best returns, while being mindful of the investment risk involved, and help participants grow their investments to the levels they need for a secure retirement. That shift in the marketplace is an opportunity that plan advisers can seize.

More plans are bringing in specific, professional investment fiduciaries. These fiduciaries do look to alternative vehicles, and they want to be innovative around the way they are being evaluated. These fiduciaries are still judged on the process and thoughtfulness of the investments they recommend, but are increasingly being judged on plan participant outcomes. If a plan adviser cannot show value with greater outcomes, the questions about the success of the DC system will continue to be raised.

What are the next steps for advisers, liquid alternative managers and DC plan fiduciaries?

Education around liquid alternatives must continue for RIAs and the investment professionals within the industry who are holding themselves out to be 401k or DC plan specialists. Liquid alternative managers should also provide education and resources for DC plan fiduciaries so the fiduciary is best equipped to make decisions about the prudence of the alternative fund in the DC plan. A plan fiduciary may even look to the alternative fund manager to help share investment liability.

While the role of a DC plan fiduciary remains the same, in providing prudent investment decisions, the investments to consider are ever changing. With the growth of alternative investments, DC plan fiduciaries need to educate themselves on new products and how they will, or will not, fit into their DC plan investment menu. By consistently evaluating new investment vehicles and asset allocations for suitability within a DC plan, plan participants will be well positioned to have adequate retirement savings through a combination of investment options fit to their needs and retirement savings goals.

About the experts:
Mark Aldoroty has had a prime brokerage career spanning more than 25 years. Currently, Mark is a managing director for Pershing, a BNY Mellon company. He is a member of Pershing Prime Services Management Committee and leads the Prime Services Sales and Relationship Management teams.

Rob Cirrotti is a managing director for Pershing, a BNY Mellon company, where he leads Retirement Solutions. Rob oversees the strategy and development of retirement and insured solutions to help clients grow retirement assets. Rob is a board member of the SPARK Institute, and a member of the SIFMA Retirement Committee, American Society of Pension Professionals & Actuaries, Insured Retirement Institute and the Money Management Institute Retirement Committees.
There’s no question that regulation is causing prime brokers to reassess, and, where necessary, evolve their business model. Much is made of the fact that prime brokers are ruthlessly culling hedge funds, banishing them to hinterland. Hedge funds that aren’t generating revenues for their primes have become the vampires of high finance, sucking the lifeblood out of banks’ balance sheets.

Speak to any prime broker and the stock response is: ‘We need to improve our return on assets’.

This is completely understandable; necessary even. But it is equally incumbent upon hedge funds to assess, and, if necessary, cull their prime brokers if they are not delivering better efficiencies and transparency that can support their long-term business objectives.

“I completely agree,” says Gildas Le Treut, Global Head of Prime Services, ABN AMRO Clearing. “There is still a tendency to gravitate towards the same big names and whilst it’s important for primes to do deeper analysis on their clients, it’s also important that the fund manager fully understands the revenue items from the prime broker.

“They need to understand what the prime broker’s strategy is. It’s not a pure service provider relationship anymore, it really is moving more towards a partnership arrangement. Both sides need to decide whether it’s a good fit to enter into a
business relationship - managers are becoming more selective, just as much as the primes are.”

Steve Sanders, EVP, Marketing and Product Development, Interactive Brokers, who this year joined the list of top 10 largest prime brokers - the only specialist prime broker to do so - says that the industry has changed. Everybody is looking for greater cost efficiencies: “Traders don’t call their brokers over the phone, everything is shifting towards electronic platforms. That is making everything more transparent, particularly costs.”

A recent EY survey - The evolving dynamics of the hedge fund industry - found that 30 per cent of managers have experienced price increases. Some 41 per cent of managers running distressed strategies, and 32 per cent of fixed income/credit managers had experienced increased fees, compared to 13 per cent for relative value strategies and just 4 per cent of those running quantitative long/short strategies.

John Laub, Co-Head of Global Prime Services at Jefferies Group LLC, believes that the industry is still in the “early innings” of price change.

“I think a manager’s AUM is much less of a focus now,” says Laub. “It’s more a case of primes determining whether the manager has a balanced book. Are they running a large tail on shorts? Are they running a large debit with no short book? Do they trade infrequently and hold cash in their margin account? Clients have been educated over the last 12 months on ROA and how their ROA is thought through. On the margins, I think there are going to be some fund types that are going to be much less attractive but the market will recalibrate.”

“We all watched what happened through the financial crisis to convertible arbitrage,” recalls Sean Capstick, Head of Prime Brokerage at European boutique prime broker, Global Prime Partners. “A lot of these strategies are not what they once were, the amount of leverage just isn’t available today. People are definitely shying away from more difficult to finance strategies.”

One prime that is cognisant of the need for greater transparency is Barclays. Its Quantitative Prime Services division analyses trends in PB financing models. “We then share that information with our clients to assist them in identifying what they should be thinking about when engaging with different primes,” explains Rahul Jaising, Director, Quantitative Prime Services.

Jaising notes that the prime brokerage business has become more returns-focused (as opposed to revenues-focused) as balance sheet becomes more precious under Basel III.

“Our quant business is accretive to the prime business because a lot of our clients who trade in the quant space run market neutral statistical arbitrage strategies. We are trying to bring in more of these clients as these strategies have a higher efficiency, in the mix of the prime brokerage business; and that is a key driver of returns. Also, because we intimately understand the clients we deal with, we can help them optimise their allocations to PBs to generate the right return profile,” says Jaising.

Bank-owned primes are creating new value propositions for their top clients, ensuring that they get access to different parts of a bank’s product suite to address their business needs. Within Barclays’ Quantitative Prime Services division, for example, it offers two flavours of products for clients who require direct market access: a global low latency product called SubM and another ultra-low latency product called Native, which works in select markets.

“We try to use these products as a point of differentiation for clients who want low latency direct access to the market.”

Joe Mecane, Barclays

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“We try to use these products as a point of differentiation for clients who want low latency direct access to the market,” says Joe Mecane, Managing Director, Electronic Equities and Credit Products at Barclays.

Some bank-owned primes continue to struggle to understand precisely what revenues a hedge fund client generates in isolation. Often, they need to look across different revenue buckets: comparing revenues in the prime brokerage division (financing, stock lending) to what the client

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**INDUSTRY**
PRIME CLEARING SERVICES

Making our clients globally competitive.

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ABN-AMRO Clearing
Opportunities for Specialised PBs with custody expertise

Interview with Gildas Le Treut & Delphine Amzallag

Regulation, in the form of AIFMD and Basel III, has had a profound effect on the way that prime brokers and fund managers view their relationship. Ten years ago, things were simple. Hedge funds and prime brokers alike operated with fewer regulatory constraints, leverage financing was more freely offered to funds of all shapes and sizes. But the environment has become a lot more complex. Banks’ balance sheets come under increased pressure and managers face direct regulation under AIFMD, requiring those running EU-based AIFs to appoint a depositary.

“Last year, one of the biggest impacts of AIFMD was that it directly changed how hedge funds ran their strategies and indirectly the relationship with their prime brokers regarding the operational set-up with depositary banks. This year, it is exactly the opposite. Basel III is directly affecting the way prime brokers do business with hedge funds and indirectly, how some fund managers have to run their strategies,” says Gildas Le Treut, Global Head of Prime Services, ABN AMRO Clearing, Amsterdam.

Consequently, depending on their capital ratio constraints, prime brokers are becoming more selective with clients and prospects, sometimes even parting ways with funds that do not meet certain thresholds. Under Basel III capital requirements, banks have to closely look at how they allocate their financing capacities, how the funds’ strategies affect the Bank’s balance sheet and what is the overall return on equity of the clients. Certain hedge funds are being favoured when it comes to allocating balance sheet and extending a credit line.

Delphine Amzallag is European Head of Relationship Management, ABN AMRO Clearing Bank in London. She says that during the immediate post-crisis period, a number of larger prime brokers intensified their focus on top hedge funds as these moved to a multi prime relationship model.

“Not many could foresee the extent of regulatory pressures and financial burdens that would dominate. Now, however, these big market players are having to seriously rethink their strategy as balance...
Amzallag’s view, there are “big opportunities” to capitalise on the relationship between the two.

“In this regulatory environment, hedge funds and asset managers are very much focused on financing trading strategies and an asset protection mechanism. When you can combine the two, that offers efficiency and a unique selling point to managers,” says Amzallag.

In this new regulatory landscape, the “one-size fits all” is not sustainable for Prime Brokers. Prime Brokers are becoming specialised in hedge funds strategies where they can demonstrate expertise in risk management, financing and deliver cost efficient services to allow funds to deliver performance. This is putting specialised prime brokers like ABN AMRO Clearing, who can offer cost-efficiency by providing execution and clearing and custody services, on a strong footing.

“I strongly believe that hedge funds not only look for specialised Prime Brokers that fully understand their strategies and can support their growth with the right level of financing. The same is valid for their depositary banks, that take on liability for restitution, to seek out financially sound and committed Prime Brokers,” concludes Le Treut.

sheet becomes more and more precious,” comments Amzallag.

One problem, that some large universal banks are facing, is that they grew via client acquisition without structuring their organisation as a unique fully-fledged prime broker. They may combine a Prime Brokerage offering by using the services of different departments and even legal entities of the same group.

Services are managed out of various silos of the bank, even in different legal entities, making it difficult to have a holistic view of the profitability of the client and of the services. In such situations, it is often hard to speak as one voice to clients.

“Because of the new capital constraints, banks now have looked at the profitability of different product lines and made drastic changes such as stopping part of their offering. To run a trading strategy fund managers need cohesion of the service they receive from their Prime Broker,” observes Le Treut, who continues:

“Our cross-asset / cross-product clearing model allows us to have a holistic view of a client’s strategy and portfolio, and precisely understand their risk and financing needs.”

Of real importance, given the sensitivity of assessing the ‘worthiness’ of a client, is the ability for prime brokers to get a complete overview of the fund strategy which might be profitable in one aspect, but not in another. Client retention is a key factor so the greater the insight a prime broker has, the better.

Due to its history in post trading, ABN AMRO Clearing can offer both Prime Brokerage and custody services, and in
is generating in the cash channel (trading revenues, research and so forth) and also in the derivatives channel.

As a result, it’s getting increasingly difficult for hedge funds to pay the big banks in one channel. This is not a problem for large billion dollar hedge funds, but it is a problem for smaller and mid-sized managers if they are falling below the banks’ desired thresholds; and that’s where the boutique prime broker has a role to play.

“A lot of the larger banking primes can’t always provide their smaller clients the client service attention, the trading desk attention, the technology attention that we can to our clients,” says Capstick. “We give a high touch service to smaller hedge funds. We have an 18-person client service team. We have a trading desk, and our own proprietary technology supported by a 30-person team in Cape Town. There are a lot of managers looking for a suitable home beyond the tier one primes and that’s where we are concentrating our efforts.”

Whether it is boutique primes like Global Prime Partners utilising an omnibus account structure to provide a valuable lifeline for smaller hedge funds, or bank-owned primes that are focusing on quantitative solutions to improve revenues, there are many ways to adapt and evolve in today’s environment. By leveraging electronic trading expertise in equities, credit, and other asset classes, bank-owned primes have the potential to generate revenues in different pockets that are accretive to the creation of a higher overall ROA.

“Electronic trading, whether it relates to the prime brokerage business or pure cash trading business, allows us to collect commission dollars without consuming significant financial resources. We are able to generate returns across a menu of services, whether it’s to support systematic managers requiring low latency direct market access or traditional money managers, long/short managers and so on,” says Jaising.

ABN Amro Clearing is a prime broker with a custody DNA. With AIFMD now up and running, this is putting them at a distinct advantage as depositary banks, appointed to safeguard the assets of EU-domiciled Alternative Investment Funds, look far more closely now at which prime brokers hedge funds want to appoint: their financial structure, credit worthiness and operational capacities, etc.

“With our DNA in post-trading, and as a custodian, we understand what is needed in respect to segregation of assets. We definitely have gained momentum under AIFMD, mostly with the depositary banks who understand the importance of operational efficiency and transparency.

“Pre-AIFMD, hedge funds were deciding which prime brokers to use. Post-AIFMD, it has become a combined decision between the fund manager and their appointed depositary. In our business proposition, we offer a true partnership. We are not a depositary bank but we speak the same language, and that is working to our advantage,” confirms Le Treut.

Key to this is that a full depositary arrangement under AIFMD means that they are legally responsible for the restitution of an AIF’s assets, should anything go awry.

“In the clearing world, providing complete transparency around what and how you charge, is a necessity. In the new regulatory landscape, depositary banks wants to achieve greater transparency in the counterparties they work with, and we are well positioned to offer that,” comments Delphine Amzallag, European Head of Relationship Management, ABN AMRO Clearing.

“We’ve built our franchise over the last 35 years and now the prime brokerage space needs new players with strong balance sheets and a sound financial structure. Nevertheless, you need to be focused on certain strategies, not all strategies, and I think this is where the evolution is heading: a set of prime brokers that specialise in core strategies as opposed to being generalists.”
Economics 101

Why does IBKR do more trades than any other broker?
Because it is the least expensive.†

Why is IBKR the least expensive broker?
Because it does more trades.*

How did we get here?
In a free economy the best technology wins!*
Interview with Steve Sanders

Automation lies at the heart of Interactive Brokers’ prime brokerage model. Be it for risk management, account management, trade execution and pricing, everything is streamlined so as to provide fund managers with a cost-efficient solution.

Interactive Brokers can be viewed as a technology company that operates in the PB marketplace. At a time when bank-owned primes are overhauling their legacy IT systems to bring them into the 21st Century, the ability to remain nimble and technologically lean is working in the favour of non-banking primes like Interactive Brokers.

“We are constantly updating our systems for the future. I would say that is the biggest difference between us and the bigger bank-owned primes,” says Steve Sanders, EVP, Marketing and Product Development, Interactive Brokers.

“We are a leader in pushing the trade lifecycle electronically. We are connected to a number of global electronic trading venues. I believe some 20 per cent of all bond trading today is now electronic and it’s moving higher. One of the causes of that is regulation and the capital requirements that banks face; pushing the bond markets into the electronic realm reduces costs.

“We therefore think we are well placed to cope as the markets evolve. The days of calling brokers and trying to negotiate trade prices over the phone are over. We have a great bond offering, a great FX offering, futures and options, stocks; we cover all the major asset classes.”

Historically, prime brokers went out of their way to support hedge funds of all shapes and sizes. They threw money and human resources at the business to stay in the game and consolidate market share; problem being, that was an expensive business model and one that no longer works.

“We have a low-cost model and in recent times this has worked in our favour. As the capital costs have increased to support this business, it no longer makes sense for the tier one primes to support smaller hedge funds,” suggests Sanders.

To optimise trade execution, Interactive Brokers uses IB SmartRoutingSM, to seek out the best company stock, option and combination prices available at the time of initiating the order. By continuously tracking and evaluating market conditions, IB SmartRouting will re-route a client’s order to ensure that the best price execution is achieved. For those wishing to protect block trade orders from signaling and information leakage to the lit market, SmartRouting is able to route institutional orders to eight different dark pools.

As market structure moves to full electronification under Mifid II, prime brokers will be required to offer this level of trade order sophistication for bonds and OTC derivatives as well as stocks.

“Costs come in three flavours: financing, commissions and price execution,” says Sanders. “With respect to financing rates, they are fully transparent and listed by currency on our website. Once hedge funds get used to looking for alternative prime brokers like Interactive Brokers, and see that our costs are actually very competitive, they will wonder why they didn’t consider us sooner.”

Interactive Brokers has grown its prime brokerage business, such that roughly 50 per cent of trade flow now comes from institutional traders. The firm has over 2,000 funds on its books and as Sanders concludes: “We’ve automated everything and are, bluntly speaking, more cost-efficient. The last thing we’re going to do is show clients the door!”
We specialise in supporting quantitative strategies, high-frequency trading and arbitrage strategies.

One firm that is pushing the envelope and growing its market share by offering a fully automated low-cost prime brokerage model is Interactive Brokers. The way that market structure is evolving, Interactive Brokers suddenly find themselves in a favourable position. Not that it has been an altogether smooth process.

“When we first got into this business we would get two objections: a) your name is not well-known and b) people would say, ‘I want capital introduction services so I’d prefer to go to Goldman or JP Morgan who can introduce me to investors and help me raise capital,’” recalls Sanders.

People have found out, however, that actually getting those introductions hasn’t been as easy as perhaps they expected.

“We take a different spin on this. Our Investors’ Marketplace allows hedge funds to list their services electronically, their performance track record, and we have a very sophisticated client base of individuals who come in and view this through our firm. That has certainly helped overcome the challenges we faced in the early days.

“We do it all, from trade execution to securities lending and financing, but with an automated twist. Indeed, if someone wants to lend out their shares we will borrow them. We post our rates electronically so there’s no need to call someone up. We have something called our Stock Yield Enhancement Programme. Provided you’re not taking out any financing, we will lend out your shares and whatever revenues we make we share with the beneficial owner on a 50:50 basis,” explains Sanders.

There is no doubt that technology is vastly improving the way that both primes and hedge funds can evaluate the ‘economic value’ of their business partnership. Indeed, for specialist prime brokers like Interactive Brokers, the very fact that they have incorporated technology into the heart of the business model is symptomatic of where the industry is headed, and one of the reasons why some bank-owned primes are struggling to improve the ROA that Jaising refers to above.

“A lot of the systems that they’ve built are still mainframe systems, and over time they’ve added a new interface. What’s really required, however, to bring their systems up-to-date is to apply a whole re-write. They put together these multi-year projects involving lots of personnel, they often then get hit with cost constraints, and it becomes a bureaucratic mess. I tend to view Interactive Brokers as a technology company that operates in the prime brokerage business, and as such we are constantly updating our systems for the future,” comments Sanders.

“The thresholds that we look at among clients are much lower because we don’t have such entrenched costs,” adds Capstick.

Capstick thinks there may well be more entrants into the boutique prime space, moving forward. Global Prime Partners have a competitive advantage, if this were to happen, given that they’ve been around for eight years, over which time they’ve put the technology in place, the client service team in place, a stock lending programme in place and so on; this is not, in other words, an easy business to establish overnight.

“It requires a fair amount of capital and technology investment. But I think others will look at this business, given the pressures that the banks are under,” says Capstick.

“The nature of the next layer down from tier one primes is changing. Not all banks are now able to provide the same amount of leverage and access to client service that they once could because they don’t have the balance sheet and depth of departments any more. That is allowing other entrants to enter the PB space. We want to double the asset base and double the revenue base within the next three years.”