Prime Brokerage 2016

Regs drive increases competition
Reimagining prime brokerage for the 21st Century
Adapting to support millennial HF managers
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well as up.
Regulations drive increased competition

By James Williams

One of the unintended consequences of market regulation is that it has, to some extent, leveled the playing field. In what was once a fiercely competitive environment dominated by bank-owned prime brokers, in recent years a slew of new entrants has emerged, offering different service models for managers to consider.

Indeed, in early December, ING Capital Markets LLC were the latest to say that they were expanding into PB with the launch of a synthetic prime brokerage platform to provide global, cross-asset portfolio swap products.

"We offer the flexibility of a multi-asset portfolio swap which is operationally efficient, streamlined and provides additional collateral and portfolio margin benefits," said Michael Baudo, Regional Head of Financial Markets Americas and Global Head of Securities Finance. "We are excited to launch a platform that differentiates itself and adds value to clients while drawing upon the more than 20 years of experience our team has been providing securities finance solutions to the market."

Cost of balance sheet is now a forensic exercise for Tier 1 primes. Hedge funds can no longer assume that they will get what they ask for in terms of leverage and financing. This has caused a degree of recalibration, for both managers and primes, as they seek out the best course of action to remain viable and profitable.

Over at Societe Generale Prime Services
If the equities desk doesn’t see this FX flow and jettisons the client, they potentially end up shooting themselves in the foot.

Determining the value of a hedge fund has to be done holistically, not piecemeal.

“We are willing to take on less attractive fixed income PB business (balance sheet heavy) if we are also getting a book of listed derivatives from that client. It’s the overall mix that hedge funds have to offer us. It’s about working with a hedge fund, talking with them and treating the relationship as a partnership where we know what they need and vice-versa. It’s important they know where we can help and where we cannot,” says Crawford.

That lack of an holistic overview of a hedge fund might, in part, explain why certain balance-sheet intensive strategies like fixed income arbitrage have become more expensive to trade.

“At the beginning of the year we were thinking that we didn’t really want to support fixed income because it is pretty heavy on the balance sheet. But actually, we are pleasantly surprised by what we are seeing from the fixed income books. There is a good chance we may actually onboard more fixed income portfolios in 2017 than we envisaged at the start of this year,” confirms Crawford.

At Wedbush Securities, the fact that it self-clears and lends securities on the short side directly out of its own inventory means that it is in much better position than many other prime brokers. As Sean Trager, who heads up the prime brokerage business, states: “We can be more aggressive with our rates because we are not paying an intermediary. That cost saving then flows through to the underlying fund manager.

“We are busy expanding our equity PB business; this remains the prize that everyone wants.”

Duncan Crawford, Societe Generale Prime Services

Many bank-owned primes are not structured in this way and it could be argued that one of the reasons so many smaller hedge funds are being culled is because the banks that operate these prime brokerage businesses simply do not see the hedge fund in its entirety. For example, a manager might be generating moderate trade flow in equities each month, and giving its prime broker the bare minimum in terms of revenue, but might, at the same time, be trading a significant FX book.
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Poor hedge fund performance over the past 18 months means that managers face continued fee pressure from investors. As a result, smaller and emerging hedge funds are becoming increasingly attracted to non-conventional prime brokers that are able to offer automated solutions for risk management, account management, trade execution and pricing.

Leading the pack is Interactive Brokers, which has been built on three pillars: low cost, breadth of product (globally) and best-of-breed technology and trading tools.

"These things are becoming much more important as the hedge fund industry becomes more competitive," says Steve Sanders, EVP, Marketing and Product Development. "What is of particular importance is transparency. A good example of this is our stock lending program.

"Traditionally, if you wanted to find out what the borrow rate was for a stock you would call your broker and they’d give you a rate. At Interactive Brokers, we provide the tools for the client to find out for themselves. Clients can review what the latest borrow rates are in real time and decide whether or not to do a trade."

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.

Another facet of transparency is Interactive Brokers’ IB SmartRouting™ technology, essentially an algorithm that ensures the best price execution is achieved.

"We would like brokers to get more transparent and report their prices," states Sanders. "We use a third party called Transaction Auditing Group (TAG), which goes out and compares us against the best bid and offer for our executions. Our US stock and options price executions continued to be significantly better than the industry during the first half of 2016; a USD0.43 price improvement compared to USD0.34 for the industry."

A third element of transparency is that commission rates can be viewed on the IB platform. Clients know exactly what the rate is. The higher their trade volume the lower the rates.

"I think the future is not to have middlemen but to provide direct access to hedge funds on lending and commission rates. Millennial investors are a lot more comfortable with technology and if possible would rather do it that way; they expect data on demand today.

"Another example of transparency is our Stock Yield Enhancement Program. If a client is fully paid with a stock the broker cannot lend out that stock. With us, the client signs an agreement that gives us permission to lend out the stock, after which we split the fee with the client.

"This is normally only done for the largest clients at other prime brokers but we make the program available to everybody. People are beginning to see that this level of transparency is the way of the future," says Sanders.

He confirms that over the last 12 months Interactive Brokers has been attracting more small and mid-sized hedge fund managers because the larger primes are no longer supporting them.

"We offer great technology, we are a cost-efficient solution and for anyone starting up a hedge fund we are a good option. Even if other primes were to take them, in my mind we still hold an advantage," concludes Sanders.
clearing firm that the IB uses might then mark it up another 10 basis points. With us, there is no mark up. You’re going directly to the source.*

On the cost point, Trager confirms that in addition to Wedbush owning its own clearing firm and technology routing firm, “we are providing direct market access using pipes which we are already using for our own business. This means we can really keep control of cost.”

He confirms that in order to keep close track on the return on asset for each hedge fund client, Wedbush does not offer a standard multiplier per se with respect to leverage. “We do things on a case-by-case basis and we look at the exposure we have with certain portfolios. It’s important for everyone to realise – from the PB to the manager to the investor – that leverage cannot supplement capital.”

Legacy technology infrastructures and silo-based business units have, to some degree, hindered Tier 1 primes. At the end of the day, running a successful prime brokerage business is devilishly hard. The more nimble, and the more integrated the prime broker is with respect to the end client, the better equipped they will be at staying profitable.

One firm that is reaping the rewards is Invast Global, whose prime-of-prime model is becoming a popular choice, at least among emerging managers in Asia Pacific. Whereas bank-owned primes utilise their own balance sheets to provide liquidity, Invast Global’s agency model means that it has built a network of bank and non-bank liquidity providers to bring the best execution and transparency to its clients.

This instantly helps to overcome the cost issues that bank primes have with balance sheet-intensive strategies, as mentioned above.

“Hedge fund managers have very different trading styles; HFT-type trading, momentum and trend following strategies, arbitrage strategies. For an emerging manager, having the ability to say to your PB, “This is my strategy, what do you suggest on the liquidity side?” is very helpful.

“What this means is that by using us, they don’t need to be liquidity experts. They just need to articulate what their strategy is. The feed we provide to any client will in part be unique. There might be similarities with other clients but we don’t just take a feed and stick that with the best possible price on a client’s book. That is not what liquidity management is all about.

“An emerging manager that trades a fundamental LSE strategy infrequently will receive a completely different feed to a HFT strategy. The LPs might be different, and the liquidity within those LPs might be different,” explains James Alexander, Chief Commercial Officer at Invast Global.

This is not only helping fund managers, it is also proving advantageous to the Tier 1 primes who are struggling to justify keeping smaller clients on their balance sheets. They can simply redirect all of that client flow to Invast in a single relationship, in turn helping them to optimise the way they manage their risk capital.

“For an entity like ours that doesn’t internalise any of the flow and passes on a lot of commercial benefits to our LPs and PBs, we are the least worst option for them. They might still want these clients but the regulatory environment doesn’t allow it.

“Having an entity like ours that can pay for these clients but still share the commercial benefit is therefore a favourable situation. A lot of PoPs are missing that part of the equation. They don’t necessarily have the balance sheet or an understanding of the commercial requirements to build strong PB relationships,” adds Nick Briscoe, Director and Head of Prime Services at Invast.

Regulatory tailwinds

The optics of prime brokerage have changed to such an extent that some of the newer entrants like Apex Clearing actually view regulatory change as a huge positive, or as CEO William Capuzzi says, “enormous tailwinds that have allowed us to get into the PB business”.

“It’s important for everyone to realise – from the PB to the manager to the investor – that leverage cannot supplement capital.”

Sean Trager, Wedbush Securities
This is not something that the bulge bracket primes are ever likely to say at a cocktail party. If anything, Dodd-Frank and Basel III has caused them to pare down their hedge fund rosters.

This retrenchment was all Apex Clearing needed as a sign to seize the market opportunity and specifically go out to target hedge funds with AUM under USD200 million. “Until Apex stepped into the space, managers really only had two options. The first was to go to a mini prime like the one I ran at Convergex and work with an intermediary to one (or more) of the large banks. The advantage of this you indirectly get exposure to the likes of Goldman or Pershing; and hedge funds (and their investors) like to hear those names. But the challenge is that a mini prime's pricing for a smaller fund is difficult because there are two pairs of hands that are waiting to be paid; the intermediary and the prime broker.

“The second was to go directly to a big name like Goldman or Pershing. However, this really only works for the biggest funds given the fee basis that they will charge in order to offset the overhead of complying with the new regulatory landscape.

“It therefore made sense for us to take the Fintech backbone of Apex and apply it to the hedge fund space. We provide small and emerging hedge fund managers with the transparency, the reporting, the complete toolset that a billion dollar hedge fund would get, so that they can compete effectively in the market,” explains Capuzzi.

Invast's Alexander also thinks the business will benefit substantially from increased regulatory tailwinds.

“Facilities like ours allow emerging managers to prove their wares at a low-cost basis, with a low hurdle to entry, and that can allow them to build a track record for their investors. You do not get the equivalent low-cost service with a standard prime broker.

“Overall, with regulatory tailwinds, an increased prevalence of quant-based hedge fund strategies that like to source different types of liquidity, and emerging managers looking to prove themselves in a low-cost way, there are reasons for us to be optimistic,” remarks Alexander.

Bank-owned primes like Societe Generale Prime Services show that applying a sensible, 360-degree overview of a hedge fund can go a long towards building a mutually beneficial and profitable relationship. Doubtless many of the bulge bracket names are aware of this and moving away from the old fashioned siloed approach to managing their balance sheet.

They need to because as independent players build their reputation, they will start to provide significant competition. Not immediately. But if the established names on the Street think it will continue to be business as usual over the coming years... well, they need only look at politics in 2016 to appreciate that the status quo is not permanent.

“Thankfully we are not a SIFI (systematically important financial institution) and we do not fall under Basel III and Dodd-Frank. The same risk-weighted asset ratios and LCR ratios that the banks face do not apply to us. We apply our own ratios, however, because we want to remain competitive. We’re not trying to win as many clients as possible. We have the appropriate level of capital for this business,” asserts Capuzzi.

In conclusion, Crawford says: “The fact we bring a portfolio approach to prime brokerage across assets and service the whole book of business rather than just a slice of the book is an enormous benefit in this brave new world.”
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You’re better off without them.

FEEL THE LOVE
Reimagining PB for the 21st Century

Interview with William Capuzzi

Apex is a proven leader in the clearing space and, having built a suite of sophisticated technology solutions over the years, has become the ‘go-to’ clearing firm for fintech firms. Indeed, it is currently the Custodian-of-Choice for tech-savvy firms like Betterment, Stash, Wealthfront and other robo advisors.

This year, to move beyond merely providing custody and clearing to retail clients (online brokerages and RIAs as well as fintech firms), Apex made the jump to provide prime brokerage services to the institutional community. This September, it launched a full-fledged prime brokerage solution and has already onboarded nearly 20 hedge fund clients.

Heading up Apex Clearing is CEO William Capuzzi, who joined from Convergex 12 months ago where he ran a number of different businesses including clearing and prime brokerage. Prior to that, Capuzzi spent nearly a decade at Pershing so he knows the clearing space well.

“The media sometimes talks of custody as being a commoditised service, but it is very difficult to do correctly. That’s why, when you look at those who really do ‘prime’ an asset and provide custody and clearing to the broker-dealers, there are only a handful – less than 10 – the Pershings and Fidelities of the world. We are one of the very few prime brokers who can self-clear.

“Apex has fintech running through its veins. Understanding fintech and getting straight-through processing right is the backbone of Apex,” says Capuzzi.

The aim, for now, says Capuzzi, is to target hedge funds with AUMs of USD200 million or less.

Out of regulation has sprung terms such as Risk-Weighted Assets and Liquidity Coverage Ratios. There is a big focus on return on assets, with prime brokers constantly talking about this as a key measure when evaluating a hedge fund client.

“This has created a great opportunity for non-bank-owned primes. The small- to mid-sized managers are the first ones to get culled, so where do they go? There’s the obvious culling, the “getting dumped by your prime broker” scenario, but there’s also the service level. Large primes are looking to dedicate their resources to their largest clients and so even if smaller hedge funds do survive, the level of service they are getting is starting to significantly suffer. That’s why providing consistently great customer service is a big focus for us and an integral part of the new Apex Prime offering,” says Capuzzi.

Apex is very mindful of how it deploys its own balance sheet and uses Apex RiskCheck™, a five-point risk management system that protects clients’ assets. Embracing key tenets from its parent company, Chicago-based Peak6 Investments LP, which has run several successful hedge funds and operates a successful proprietary trading business, has helped Apex hone in on what are the pain points of providing leverage and what is needed from a stock lending perspective to be successful.

“You’ve got to provide access to markets and have security lending and margin financing capabilities, which we offer. However, we go above and beyond that by providing transparent credit risk management tools and methodologies, as well as reporting solutions. The bigger primes cannot provide those types of tools for smaller managers and that is an area where we are starting to win clients,” confirms Capuzzi.

By embracing innovation, Apex, with its technology prowess, is shaking things up and reimagining what it means to provide prime brokerage for the 21st Century. ■
Adapting PB model to support millennial hedge fund managers

By James Williams

The prime brokerage landscape is changing. The largest names still dominate in terms of market share, with Goldman Sachs and Morgan Stanley at the vanguard. But in a year when the established order has been overturned – think Brexit and the Trump election victory – the large investment bank-owned primes cannot afford to rest on their laurels.

This is because the nature of hedge fund managers is changing. Those spinning out of existing hedge fund groups and setting up their own funds are largely millennials who have grown up with the Internet and who bring a different mindset to the industry. They want quality service, top-rate technology solutions, a prime broker that will be nimble and responsive to their needs.

This is working to the advantage of boutique independent prime brokers who sit below the established order.

“The more that larger primes pare down their smaller clients, the more we’ve taken on new clients as we have strategically positioned ourselves in that space. Regulation plays a role in the sense that its become more difficult to be a client in this space, particularly smaller managers. What we try to do is institutionalise them,” says Sean Trager, who runs the prime brokerage division within Wedbush Securities.

“We’ve seen a lot of consolidation and attrition in the PB space. Mini primes have either folded into larger firms, or partnered up with one another to become a greater force on the Street. What they’ve failed to do is offer a self-clearing model by blending efficiencies. Prime brokerage, by its very nature, is providing DMA, securities lending, financing and providing research. The only way you can do that successfully is by creating product and offering a service out of your own back yard as opposed to soliciting it from a third party.”
“I believe we are well positioned to respond,” suggests Trager. “We acquired a technology firm around five years ago called Lime Brokerage. Lime is a technology provider with low latency solutions, unilateral market access, reporting and risk mitigation tools. This has made us a lot more efficient as we can do a lot of things for our clients that our third party providers were doing previously.

“We feed a lot of fund information straight to the client’s fund administrator(s), which helps keep the costs down. We send direct feeds to all the administrators which removes a whole layer of reporting for them and a layer of underlying costs to the client.”

Wedbush has been offering customisable algorithms to its hedge fund clients for quite some time. It offers everything from a hedge fund in a box – where the client can write their own code – to risk mitigation tools with scenario testing. The manager can plug in their portfolio and see what would happen if the price of gold spiked, for example.

“What we are doing is helping the person running USD30 million in AUM get the same benefit and advantage as the person running a billion dollar fund. Most folks launching funds today are tech savvy and looking for technology resources and services. We are properly positioned to provide our services to them and help them with their launch,” adds Trager.

One of the more recent entrants to the PB space is Apex Clearing. Apex is keen to leverage its technology backbone to make an impact and shake up the natural order. When asked whether the technology capabilities that it can offer its PB clients are potentially even greater than they would get at a Tier 1 prime, William Capuzzi, CEO of Apex Clearing, does not hesitate: “One hundred per cent. We’re reinventing the way a prime broker provides service. We know the next...
The notion of what it means to be a prime broker is changing. Hedge funders are looking for solutions that go beyond the usual services such as trade execution and clearing, capital introduction, securities lending and margin finance. These solutions extend to middle- and back-office support, compliance support and outsourced trading services.

With respect to the latter, this is something that Cowen Prime Services are seeing significant interest in, not just among emerging managers wishing to reduce infrastructure spend but seasoned managers with an eye on improving business efficiency.

“What is becoming more evident to us is that hedge funds who remain with the bigger primes are looking to avail themselves of other services that their primes are not providing them,” remarks Jack Seibald, Global Co-Head of Prime Brokerage, Cowen Prime Services. “Managers are looking to more efficiently deploy their resources and still avail themselves of a high caliber service. On an outsourced basis, we have an experienced team and technologically advanced infrastructure that can serve as a manager’s buy-side trading desk.”

Outsourced trading is a key differentiator within the boutique prime space. “Everyone is focused on being as productive as possible, whilst at the same time maintaining the highest standards of care. By outsourcing trading and financial reporting etc., to a firm like ours, investment managers are able to achieve that,” says fellow Global Co-Head, Mike Rosen.

To bring its prime brokerage service to a wider community of managers, this summer Cowen hired Kevin LoPrimo as Managing Director, Head of International Prime Brokerage in London. The aim, says Rosen, is to replicate the introducing broker model in London, offering European hedge fund managers all the prime brokerage services that are necessary.

Indeed, the platform has just gone live and like in the US, will offer securities lending and margin financing facilities, as well as custody and trade execution services, both cash and synthetic.

“Outsourced trading is being well received not just by managers but also by the bulge bracket primes. They like the notion that they know the counterparty to the trade (i.e. the client) at the time of the order. Plus, it is a full electronic audit trail from the time the trade is initiated to being filled and reported. It’s a solution that is serving two masters - the manager and the executing broker who knows trade-by-trade the revenues being generated by each client,” explains Seibald.

Another ‘value-added’ service that clients do not necessarily get from the bulge bracket primes is outsourced middle- and back-office support, allowing managers to reduce their infrastructure overhead by paying for solutions at a variable cost level.

“With the IB model that we run, the manager still has the counterparty relationship and asset protection with a major bank. Yet at the same time, the manager works with a smaller, nimbler more client-serviced organisation that has the capabilities to provide many of the services that a bulge bracket prime would not offer, on an a la carte basis. You don’t have to use our outsourced trading solution, or our middle- and back-office solution, but they are there if you want to,” explains Seibald.

This notion of providing fund managers with the financial stability of a large bank as the counterparty, coupled with Cowen Prime’s service offering that provides tailored solutions, is an attractive one: especially to smaller and emerging managers who wish to limit their infrastructure spend.
The allure of the boutique prime broker

Interview with Jerry Lees

“There is a clear message coming out of the marketplace that we are responding to. The smaller and medium-sized managers are being squeezed out of the tier one primes and have nowhere to go,” states Jerry Lees, Chairman of Linear Investments. “There is a momentum in the marketplace forcing change. The impact of Basel III on banks’ balance sheets means they cannot afford the infrastructure costs to continue supporting smaller hedge funds and this has created a gap.”

This means small to mid-sized hedge funds are finding it harder to establish a strong prime brokerage relationship. This is good news for specialist or ‘boutique’ prime brokerage providers like Linear Investments. Linear does not have the large overheads of a bank or the associated infrastructure costs that come with running a global bank institution.

“What is unique about Linear is that we’ve put together a comprehensive platform. The issue that a small hedge fund has is this: if they are distracted by the process of having to set up all their IT structures, their operational structures, handle all the regulatory issues, it effectively leads to a performance lull. They become distracted by all the other requirements of running a hedge fund that stop them focusing on their key business: managing the portfolio and generating returns,” says Lees.

A star trader at an existing hedge fund or bank is used to operating in an environment where everything is done for them. Linear is basically offering that same environment, giving new managers the chance to build a successful hedge fund business without myriad pressures.

“We give the manager the whole operational framework. They can walk in to our offices, take desk space, and start managing the strategy. We have all the technology, voice recording, and risk systems that meet regulatory standards. Once we set up the client everything is handled by our operating team. We also use an outsourced compliance firm to provide all the necessary compliance oversight,” explains Lees.

Linear’s clients get an array of services that go far beyond the typical prime brokerage relationship.

This specialist hands-on PB model is being well received among new managers and those rotating out of existing prime relationships where the manager wants a more inclusive, meaningful partnership.

Discussing the Linear model, Lees says that Linear has relationships with executing brokers in every asset class.

“Depending on what the client wants to trade, we have different PB accounts. Each client has a sub account and the global execution broker sees us as one big account. Our omnibus account is fully hedged back to the underlying broker. We never take risk exposure. We’ve also got Linear’s capital base backing that omnibus account structure so it’s a safe environment.”

Linear uses five executing prime brokers including Nomura, R.J. O’Brien, ICBC and also has a custody and clearing arrangement with Societe Generale.

Also, as Linear has a global financing deal with its executing brokers, the fact that overall trade volume in the omnibus account is substantial means that it is able to pass on competitive commission and finance rates; something that emerging managers are only too grateful for.

“We have 105 hedge fund clients trading with us in different ways and we have another 60 clients at private banks doing execution only work. The big banks are not equipped to offer the same specialist model that we provide to the market,” concludes Lees.
generation of millennials really well. They are trying to find alternative ways of investing and I think what’s going to happen is, if you fast forward five years, the lines are going to get blurred between retail passive investment and active hedge fund investment.

“We’re already starting to see this. There’s a company called Hedgeable (a New York-based private wealth manager) that was established by a couple of guys who ran a hedge fund but found it difficult to grow assets. At Hedgeable, they apply hedge fund principals to retail fintech, providing a robo solution that has many of the same attributes of a hedge fund. The premise is to gain assets you can’t just look to your classic institutional investors,” says Capuzzi.

The landscape is changing and prime brokers need to be aware of this. In Capuzzi’s view, “you’ve got to try and create a bridge between the classic old school way of operating a hedge fund and a new school way that fits with the millennial generation that has a mobile device in their hands at all times.”

As the prime brokerage model evolves into something more tech-heavy, this should help bulge bracket primes as they look to optimise their balance sheets. For the time being, however, some are jettisoning strategies and managers because they cannot absorb the risk. This is because Dodd-Frank and Basel III rules are forcing 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.

If a strategy is sucking up too much balance sheet, the banks just won’t support it. This is not necessarily something that affects non-bank primes like Apex but Capuzzi caveats the point by saying:

“The premise is that if you have technology right it shouldn’t matter too much if it is a credit strategy, a stat arb strategy or a long/short fund; we can provide solutions to all of them. Where it gets tricky is around the issue of capital usage. Some strategies are more capital intensive than others. Those hedge funds (i.e. fixed income arb) have had a good ride up until now.

“We are no different than the banks in the sense that if someone wants access to capital we have it, but they’ve got to pay for it. I think those funds are challenged with trying to generate alpha, while at the same time incurring higher costs based upon the amount of capital they need to put to work to deploy the strategy. For some funds their strategy is flawed, largely because they haven’t come to grips with the cost of capital.

“The industry created the problem by providing leverage at a discounted rate. That’s been snapped back now. The guys who play straight down the fairway (long/shorts, global macro) are a lot easier to support in terms of helping them generate alpha and succeed because they are less capital intensive.”

To highlight the pressure that the banks are under, this month Deutsche Bank said it would cease providing some coverage for approximately 3,400 actively trading clients in its global markets division.

A Deutsche Bank spokesperson confirmed the contents of a memo in which it said it would perform a detailed review by the trading division of the German lender’s client list “to identify clients with whom it is not strategically viable for us to continue to do business”.

The action, reported Zerohedge, is aimed at balancing “risk, revenue and profitability”. The cuts affect Institutional Client Group debt and equity sales, sales trading and equity structuring clients, according to the memo.

One aspect of technology that could improve prime brokers’ ability to support millennial hedge funds going forward is the continued electronification of the bond markets. This remains a huge reservoir of untapped potential as fixed income markets gradually adopt more electronic trading protocols.

Steve Sanders is EVP, Marketing and
Offering flexible, tailored liquidity management

Interview with James Alexander & Nick Briscoe

One aspect of the prime brokerage model that is emerging in parallel with technology advancement is greater agility and responsiveness to clients’ needs. At traditional bank-owned prime brokers, regulatory reform is weighing on them and creating a degree of inertia, causing them to overlook their small and mid-sized hedge fund clients.

This is something that is playing straight into the hands of Sydney-based Invast Global, a subsidiary of Japanese listed Invast Securities Co Ltd. Employing a prime-of-prime model, Invast leads the industry in the provision of multi-asset high-quality, non-bank Prime Services. It provides credit intermediation, access to liquidity (both OTC and exchange), sophisticated trading platforms/API connectivity options and complements these services with high quality global equity, FX and commodity research.

“We operate at the top end of the PoP space in terms of how we are structured. We currently use three Tier 1 prime brokers but by the end of Q1 2017 we expect to have four in place. We have made a lot of investment in the back-end so that our clients don’t find themselves capacity constrained,” says James Alexander, Chief Commercial Officer, Invast Global. He adds:

“We are busy refining the Liquidity Provider (LP) mix with banks and non-banks. We have some fantastic LPs and some that don’t price us the way they used to. The landscape is shifting in terms of people’s pricing behaviour. One of the big components of what we do is to manage that change for our clients.”

Invast currently has 20 bank and non-bank FX and Commodity LPs. What makes its model unique is that it allows clients to structure their own liquidity mix in real time, with analysis and advice from Invast’s expert liquidity team. Ordinarily, using a direct prime broker the client gets precious little support in respect to liquidity management and quality of execution.

“More and more managers coming into the industry realise that a conventional bank PB can be an inflexible, constrained environment in which to execute trades; it’s a challenging infrastructure for them to navigate. We have a dedicated 24-hour team whose sole job is to focus on liquidity. This is ideal for emerging fund managers. We can provide a turnkey solution for them that doesn’t have the same credit constraints and is much more flexible. We can typically onboard a client within a week. No bank prime broker can do that,” says Nick Briscoe, Director and Head of Prime Services at Invast Global.

With respect to liquidity, when a client connects with Invast they are unlikely to see all 20 LP names in their stack; they might see 15 they might see eight, depending on their trading strategy.

“It is about knowing how to mix the LPs and use them most effectively for the client to achieve the right outcome. Every client is different,” adds Alexander.

All fund managers need to keep on top of trading costs. Therefore, by knowing that their prime broker counterparty is able to deliver the most appropriate feed to optimise the manager’s investment strategy is a huge fillip. Invast is able to do this across FX, Commodities, equity swaps and futures.
“It’s all about quality of execution at the end of the day,” emphasises Alexander. “Managers who live and die by their trade performance statistics will be watching those executions so closely and we welcome that level of scrutiny. We provide full pre-trade and post-trade transparency.

“Any PoP worth its salt can put together a price feed that gets you EURUSD0.3 or EURUSD0.2 but there is a vast difference in execution quality and consistency of feed and that’s where the PoPs that do that well can really shine; in the execution experience.”

For a lot of managers with less than USD50 million in AUM, if they are trading risk-weighted strategies such as systematic FX, the banks aren’t in a position to cater to them. This is presenting a unique situation for a PoP firm like Invast.

A lot of the banks have had to reduce their risk appetite because of regulation and capital requirements. They face more scrutiny; not just in FX but across all asset classes supported by prime brokerage.

“The banks who have traditionally internalised large amounts of flow are now not willing, or are unable, to do so and some are turning to the agency model (though not necessarily a full agency model). There is definitely a shift in the liquidity landscape.

This requires an understanding of the pricing that the banks are now providing and how it has changed. Similarly, some of the non-banks are pricing in different ways for a lot of flow. The situation is quite nuanced,” explains Briscoe.

Hence why having a liquidity management expert that also has your best price execution objectives at its heart is helping Invast, and others, shake up the established order. Prime brokerage has become a more complex beast, and as banks further retreat from their market making activities, managers will likely need more support from their counterparties.

In many respects, the Tier 1 primes that Invast has relationships with appreciate the fact that they have a trusted partner that they can lean on to direct flow from smaller and mid-sized clients that they simply cannot support.

“In effect what we are doing is aggregating clients that they can’t service,” says Briscoe. “They appreciate the fact that this flow is being aggregated by a significant counterparty. Although they are pulling back, they understand the changing market dynamics and the ability to still see that flow (which Invast directs back to the Tier 1 prime) helps to create a mutually beneficial relationship,” concludes Briscoe.
Product Development, Interactive Brokers. He comments: “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.”

This represents a huge opportunity for Interactive Brokers, in part because the banks are unwilling to hold large volumes of inventory.

“I think the trend is towards further electronic trading of bonds but I cannot predict how fast that trend will develop or how big a move we will see in any given year. Either way, we will continue to bring out new tools and automate regulatory requirements into our system to keep the costs low for our clients,” affirms Sanders.

James Alexander is Chief Commercial Officer at Invast Global, whose PurePrime service, which uses a prime-of-prime model, gives clients unparalleled liquidity and transparency. He views the electronification of fixed income as playing directly to the strengths of Invast, which gives clients access to more than 20 bank and non-bank FX Liquidity Providers (“LPs”) and allow them to structure their own liquidity mix in real time.

Clients are able to see the LPs within their aggregated feed, both pre-trade and post-trade. This is revolutionary transparency for Prime-of-Prime clients and ensures there are no hidden mark-ups.

“Our clients don’t have to go out and establish brokerage relationships, or establish networks to borrow securities; we have all the infrastructure in place for them. We will go out and source stocks to borrow across five or six liquidity pools. In addition, easy to borrow stocks are already in the back-end of our platform for clients to short straight away.

“The model we offer is flexible, easy to use, low cost and there are no monthly minimums in most cases. Our solution is all set up and ready to go. This is what marks us out from traditional PBs,” says Alexander.

Another boutique prime broker offering something similar, using the mini prime model, is London-based Linear Investments.

Technology is a key element of its business according to Linear’s Chairman, Jerry Lees. “We are running state-of-the-art market surveillance with real-time monitoring. Our TCA system can prove best execution to clients on real-time basis.

“We are on our third version of our margin management system optimising margining and control, we have also implemented Advent Geneva for middle and back-office operations. We are live with our EMS system, Xconnect, and we are preparing to launch our own OMS product so that people will be able to see all their positions on any device. The advantage of all of this is it reduces the pressure on our middle and back-office teams, allowing expansion of our client services. The more you automate, the faster you get the information out,” says Lees.

As more banks cull smaller hedge funds from their books to focus on the largest managers it is creating a vacuum which Linear, and others, are working hard to fill.

“I believe we are in the right place at the right time,” continues Lees. “We opened our trading floor with an extra 100 desks only a couple of months ago and it’s now full.”

Jerry Lees, Linear Investments
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Wedbush Securities was founded in 1955 and is one of the largest providers of small and midcap equity research in the US. Three years ago, Sean Trager set up the prime brokerage division within Wedbush Securities to cater specifically to smaller money managers.

“Rather than focus on multi-billion institutions, we choose to focus on the multi-million institutions. We are building a name for ourselves with the emerging manager community,” explains Trager, who continues: “We provide the infrastructure. If someone were to spin out of a multi-billion dollar hedge fund with friends and family money we give them direct market access. They get access to our trading desks, our research; all the things needed to successfully run a hedge fund.”

Wedbush has the largest Equity Research platform on the West Coast comprised of over 20 research analysts covering more than 250 stocks.

“We have a slew of analysts that are covering names that are not typically covered on the Street. These are mainly small-cap and mid-cap names. Our clients are trading off of that information and if there’s an opportunity to short a stock they can reach out to our team,” says Trager.

Tier one primes might also produce research in less well-known areas of the markets, but the point is they are not giving smaller clients access to it without a significant fee attached. Conversely, Wedbush opts to provide this research to emerging managers, which is just one of many value-adds that it offers.

“One client of ours has set up a new fund with USD100 million and uses a bulge bracket prime broker. His rates are triple anything that he pays here and he doesn’t have access to any analysts or research.

“I understand if the manager is raising capital it’s advantageous to have a bulge-bracket name on the marketing documents. But equally, it’s important to implement a strategy and build a track record. That’s where Wedbush is able to lend itself as an infrastructure provider to help institutionalise smaller money managers. We limit their costs and help them grow,” suggests Trager.

Wedbush is one of a small handful of self-clearing brokers currently supporting US emerging managers. This brings a lot of efficiencies to managers as Wedbush acts as their custodian, prime broker and research provider. “We are by far the most well established with the longest track record and the largest capital base,” remarks Trager.

At a time when emerging managers are politely being shown the door by larger primes for economic reasons, the only other option they have is to use mini primes.

Trager notes, “If somebody wants to short a stock the mini prime goes to the bulge bracket prime and then back to the manager who ends up paying a mark-up for that service. They get stuck in this middle layer between the intermediary and the security lender. By contrast, we allow clients direct access to our securities lending group, removing that extra layer of costs.”

Central to the Wedbush prime brokerage solution is the willingness to customise services for the client, acting as an extension of the strategy and trading desk.

“We offer customised algorithms, risk mitigation tools and scenario testing. If a portfolio manager spins out they can become a client of Wedbush and utilise our traders. He doesn’t need to negotiate the best borrowing rates as we’re already offering them,” concludes Trager.
The OMS is electronically linked to our traders. Our traders, who function as an extension of the manager, can see the client’s portfolio and the client can see all live trades; when they enter a trade it populates the system. One of our traders then electronically messages off the order to the respective executing broker. The process is fully transparent to the manager and the executing broker.

“Not only will the client see that the order has been messaged to the specific executing broker, they will see the order being filled tick by tick. The manager therefore has the ability to see everything that happens from the time the order is entered to the time the order is completely filled. They can compare the order to the average price of the stock relative to their order and see the quality of execution,” explains Seibald.

That level of transparency is not necessarily forthcoming at the larger primes where they might cross orders to make a spread.

“I don’t think there is much incentive for larger primes to open up and become more transparent,” suggests Sanders. “They make a lot of money from remaining opaque. I’m not sure it’s really in their interests to develop the technology like ours. For years people have been trying to develop exchanges that you can go to and find out borrow rates. AQS was one of them that openly failed because the participants didn’t want to make it transparent, as it would reduce the money they made.

“We’ve always been a technology company that operates in the trading business. Our programmers and technologists are fundamental to our success and our ability to automate solutions and to provide services at the lowest possible cost.”

Seibald concedes that, from a transparency perspective, it’s still a bit more of the Wild West with respect to providing prices on hard to borrow stocks.

“You might have a security that has materially different borrow rates at three or four different banks depending on whether they have stock available in their system or not.

“Where firms like Cowen have tried to be helpful to clients is on the stock lending side, which allows our clients to lend out stocks they own and generate income for their funds. We have lots of clients who invest in small- and mid-cap securities.

“Often those are deeply researched positions that managers hold for long periods of time, and they are often on hard-to-borrow lists from our various clearing firms. We have a program that identifies such position among our client holdings and when appropriate, offer clients the opportunity to term them out and earn a specifically defined portion – a substantial majority – of the interest earned from such a loan.

“There is a tendency to make sec lending a more transparent process but generally speaking I don’t think some of the larger primes are too aggressive on wanting to share their rates with clients,” comments Seibald.

Prime brokers like Cowen, Interactive Brokers, Wedbush etc., have had to work hard to make a name for themselves by being more cost-efficient and transparent. This augurs will for the future in supporting millennial hedge funds.

“We’re in a world where if you try to do anything that isn’t transparent it just isn’t going to work out well in the long run,” says Seibald.

Apex’s Capuzzi offers a final thought: “As we swim upstream and provide the technology for managers to operate in a multi-custodial world I think we are going to attract bigger and bigger funds.

“We are a prime broker first and foremost, and we also execute. I say that because what’s happened in the industry is that many firms started as execution firms for the buy-side and then said, ‘Oh, and by the way we can clear your trades’. We take the opposite approach. We focus first on custody of the assets, on credit risk management and provide a layer of technology above that to execute a client’s trades.

“We have a great trading desk. But the first thing to get right is to custody the assets before worrying about execution.”