Prime brokerage 2018

Revenue options grow as regulation unfolds

Inside the mind of a Prime of Prime Brokers

Transparency can help reinforce fund relationships
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Revenue options grow as regulation unfolds

By James Williams

Prime brokerage divisions are focused on the task at hand of maximising their revenues at a time when the largest bank-owned operators face stiff competition from specialised, boutique primes, keen to offer clients a more inclusive, high-touch service.

The more diverse one’s revenue streams, the better. The days of taking in as many hedge funds as possible, on the assumption that trade revenues and commissions would boost a bank’s coffers, are long gone. This myopic approach, without fully understanding the total book of business a hedge fund might be doing beyond merely the equities desk, feels oddly out of place in 2018, when technological advances offer no excuse to continue looking at clients in isolation.

This is what specialist primes are bringing to the table and it is beholden upon tier one primes to keep pace and overcome legacy infrastructure. Yes, a hedge fund must offer a compelling return on equity. That is inevitable under Basel III. But the more prime brokers understand how and where clients are consuming balance sheet, the better able they will be to tailor their services and remain profitable.

“For us, the stock lending business will become more important, going forward,” says Jack Seibald, Global Co-Head of Cowen Prime Services LLC, the prime services division at Cowen who last year acquired Convergex. “The securities lending team has done a terrific job in putting together the
structure to make it easy for clients to avail themselves of the opportunity.

“As we finalise some of the self-clearing capabilities that we acquired through Convergex, we will be able to make the process even simpler. In an environment where managers are looking to outperform, we can call a manager and say, ‘We notice you are long X security and our securities lending team is noticing that short selling interest is high. Would you like us to lend it out and if so, here’s the rebate rate we can offer you?’”

That enhances a manager’s return in the fund, it adds to performance.

A lot of the large primes custody assets under margin agreements, meaning they can lend out those securities through the process of rehypothecation without having to ask the manager’s permission or offer them any rebate.

“We’re looking at this as an opportunity to help managers make incremental returns, not by doing anything new or radical, but simply by allowing them to participate in the lending of securities. They should have that opportunity to monetise as they are the ones making the investment,” adds Seibald.

Sean Capstick is Head of Prime Brokerage at London-based GPP. He confirms that stock lending revenue has been a decent driver of growth for the business.

“Obviously markets have gone up in a straight line for seven-plus years. There are a lot of people with long-bias directionality in their portfolios so shorting stocks has been less prominent than it has been historically. Managers are necessarily a lot more selective. That said, it continues to be a good revenue earner for us. The GC market is over-catered to, there are more names being offered than there is demand, generally speaking. It is in the specialist areas, where pricing tends to be higher and we have a good source of special names, that we can generate a good source of revenue.”

He confirms that GPP has a more competitive element to pricing at a time when people are questioning stock lending levels: “When a client comes to us requesting a special name, whereas in the past there would have been some opacity in the price quoted, today we are able to get a much more transparent, competitive price.”

“The M&A route is one way for prime brokerages to build out their revenue stream. Convergex had a meaningful presence in global execution. Combining that capability with Cowen Prime’s London office should add meaningfully to Cowen’s repertoire, with Seibald confirming: “There are still some further opportunities to capitalise on in 2018 following the Convergex integration.”

Another institution that has used M&A to its advantage is Societe Generale, who back in 2014 acquired full ownership of Newedge following the purchase of Credit Agricole’s 50 per cent stake in the business.

This has given Societe Generale Prime Services a strong footprint in listed derivatives.

“We’ve invested a lot in the equity prime brokerage business and we’ve benefited from Societe Generale’s inventory and balance sheet,” comments Alexia Weiller, Global Head of Prime Solutions. “We’ve also got a fast growing fixed income PB business and we continue to innovate in this area. We are now offering repo clearing for the buy-side.”

By self-clearing, as opposed to using the inter-bank markets, it is possible to get more of a netting benefit.

“By clearing their repos, the clients will benefit from a broader access to liquidity, no bilateral contractual agreements to manage, and greater capacity as the impact on balance sheet, leverage and liquidity are optimised,” says Weiller.

Setting a clear strategy to grow one’s market share is critical in the cut and thrust world of prime brokerage. Without a singular focus on where that growth should come from (in terms of client base), it is impossible to invest in the right areas of infrastructure. This is something that JP Morgan has committed to in recent years. It has invested
Cowen Prime Services offers a comprehensive suite of brokerage and related services that provide 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 our clients to focus on their core competencies — investing.

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In the current market environment, hedge fund allocators face a bit of a Catch 22. With markets continuing to move north - the S&P 500 was up 19.8% during 2017 (as of 28th December) - there is a strong argument to invest in long-only passive products. Even if investors, worried about a market correction, increase their exposure to hedge funds, how do they determine the extent to which a manager’s performance is alpha-driven as opposed to beta-driven?

“We did some research that looked into this a number of months ago, which at that time suggested that in the aggregate, fund performance in 2017 was being driven by the market. This research did not, however, drill down to individual manager performance,” says Jack Seibald, Global Co-Head of Cowen Prime Services LLC, the prime services division at Cowen.

“We have seen renewed interest in hedge funds among allocators, which is in stark contrast to the first half of 2016 when there was a significant dial back. They are, however, trying to be far more discerning. They are looking at managers' performance and deciphering whether performance has been driven just by being exposed to the market or by specific security selection on both the long and the short sides of the book,” said Seibald.

“As investors are making allocation decisions, the result of that analysis is going to play a significant role in how and where incremental allocations get made during 2018.”

Seibald says that the tendency among clients to maintain a net long bias has helped Cowen grow its revenues and increase the AUM on its books; something which has proven to be a stimulus for its custody business. “To a certain extent, it has benefited revenue streams related to our balance sheet, including margin interest and short rebate revenues. With markets continuing to rise, we’ve seen some uptick in the use of margin in our book of business.”

“With respect to short selling, we’ve seen some uptick in the short book, though it appears more related to the rise in market values and perhaps the rise in interest rates that’s allowing funds to benefit. More and more, managers appear to be using indexes in their short book because they’ve been frustrated by a lack of available names or had concerns about individual issue risk. However, allocators aren’t looking for a manager to short the entire market; they want managers to pick stocks on both sides of the book,” says Seibald.

One only has to refer to a benchmark index, such as the HFRI Short Bias Index, which was down -10.28% for 2017, to appreciate just how hard stock picking has been in the markets.

Seibald says that part of the reason why things have been challenging is that as more indexes and ETFs get created and more money flows to such passive products, the more individual stocks get tied up in these products and the greater potential for them to drive up prices.

“In that sense, it is a tougher environment in which to pick your shorts. But it also means there is greater potential for active managers to make money as passive products may drag the bad up with the good (in rising markets), possibly creating better entry points. When the markets reverse, they’ll be selling the bad companies along with the good ones in a falling market.

“Increasing exposure to good companies as their price gets driven down - and by the same token covering shorts in bad companies - could produce a fertile trading environment when the eventual correction comes,” says Seibald.
This echoes the famous quote by Warren Buffett who said to be fearful when others are greedy and greedy when others are fearful.

“In my opinion, ETFs are vehicles that strive for mediocrity, not outperformance,” adds Seibald.

Cowen Prime Services has seen a steady uptick in the number of both established and start-up funds it has added to its book of business during 2017, thanks in part to the brand recognition of Cowen’s institutional businesses.

“Big firms and portfolio managers know Cowen from the institutional sales and research side of the business, so when they do decide to go off and do something themselves, there’s a touch point with Cowen already. That makes for an easier introduction and potential client acquisition because there’s already history between the two parties.

“Cowen’s Prime Brokerage team can help clients set up their hedge fund, provide outsourced trading, or any combination of things they might need. Based on the activity we’ve seen recently, our pipeline for Q1 2018 looks promising for new launches,” confirms Seibald.

On the business development side, the management team is happy with how things are developing. An important part of this was the successful acquisition of Convergex, whose integration was completed a few months ago. “Convergex’s prime team had been successfully onboarding new clients prior to the Cowen acquisition and since they’ve been fully integrated, we’ve seen that trend continue,” states Seibald.

He says that with the Convergex integration and the additional capabilities that Cowen can offer its clients, “the way we present our offerings to the marketplace is now much more compelling.”

“Cowen has a prime brokerage offering that is so broad and so deep that it puts us in a different category when compared to other introducing brokers or what one might call ‘mini primes’, and positions us as a more credible alternative to some of the bulge bracket firms. We have the ability to use our own balance sheet to facilitate securities financing and clear certain businesses internally.”

Cowen’s prime brokerage clients have the opportunity to participate in industry rebates offered by those willing to pay for the privilege of borrowing hard-to-borrow securities (for short selling purposes).

“Our access to foreign markets, and our securities finance and stock lending business, have materially improved over the last 12 months, through a combination of our own development and the Convergex integration. The offering to our clients to participate in the lending of their long-only stocks has been an attractive value-added proposition,” remarks Seibald.

One of the other benefits to expanding its overall prime brokerage business offering is that Cowen’s clients now benefit from a much larger pool of experienced professionals serving them. It has sales, trading and capital introduction teams spread much more broadly across the US (Texas, Atlanta, San Francisco, Connecticut and New York), and in Europe (London), in order to be closer to existing and prospective clients.

Seibald further illustrates the scope of Cowen’s capabilities by pointing out that it also acquired Westminster Research Associates, a pre-eminent commission management firm.

“Westminster Research Associates has a strong presence in the US and there is an opportunity now, under MiFID II in Europe, with Westminster functioning as a research payment agent, to distance ourselves from some of our peers, giving us the ability to win new client mandates.

“Convergex had a strong presence in Europe so combining the prime businesses through Cowen International Ltd is something we think can add meaningfully to our repertoire,” concludes Seibald.
significantly in infrastructure, such that it now has what it regards as a global product offering. As reported by the Financial Times*, it has overtaken Goldman Sachs to become the #2 ranked prime brokerage in terms of advising hedge funds and hopes the PB business will bring in “halo revenue” by driving more business to its equities desk and e-trading platform.

To underscore its success, the bank’s PB business has enjoyed a 22 per cent growth since 2014, thanks largely to onboarding quantitative funds in Europe, which allowed JP Morgan to grow its revenues by 40 per cent in the region.

Turning pennies into dollars
In a similar trading vein, though not related exclusively to quantitative funds, another brokerage division that has seen good activity with respect to cryptocurrencies, is Wedbush Securities. “Over the last year we have seen a surge of investing in cryptocurrency-related companies and block chain technology,” confirms Sean Trager, who heads up Prime Brokerage Services. “Whereas larger fund managers and bulge bracket firms alike shied away from, and even turned their noses up at this relatively new space and sector, emerging hedge fund managers efficiently deployed capital and strategically invested, in many cases leading to record returns.

“My team and I were fortunate enough to facilitate trading in bit coin service companies, derivative products and block chain firms alike over the last year, contributing to our own record volumes and revenue targets.”

Cryptocurrency developments are happening at breakneck speed. Some are drawing comparisons to the dawn of the dot.com boom at the turn of the century. Trager says that his watch list consists of a multitude of public companies investing in this space, “and I spent much of 2017 watching pennies turn into dollars”.

“While I have never seen asset appreciation of this magnitude, I am equally taken aback by the unprecedented volatility. The wider trend is perhaps that technology and political ideology alike now play as great a role in financial markets, and more specifically in economic trends, as the government and banks do,” remarks Trager.

Asked what other key revenue drivers Wedbush has focused on over the past 12 months, Trager responds: “We spent the better part of 2017 increasing efficiency as it pertains to seamlessly processing and trading securities in a low latency environment, free of internalisation of order flow and parasitic order flow.

“Our agency model allows us to solely and independently represent the interests of our clients deriving revenue from commission and interest income alike. Essentially, we only generate revenue when we add value and work for it.”

Technology is proving highly effective at enabling prime brokers to drive efficiencies and lower the costs of doing business; which, in turn, help them to maximise their profits. One example of this relates to how brokers source data vendors; something that can be an expensive exercise and which Jefferies Prime Brokerage recently sought to address; read the blog here: https://www.ibm.com/blogs/think/2017/08/42477/.

To give its clients the ability to query and check portfolio positions and risk exposures in real time, run stress scenarios, do VaR calculations and so on, Jefferies partnered with IBM's Watson Financial Services team – a moniker that shows just how closely Silicon Valley now operates on Wall Street – to develop cloud-based technologies that would help achieve superior data efficiency. As the blog confirms, since embarking on the project, Jefferies Prime Brokerage has reduced its reliance on higher-fee data vendors by 90 per cent.

Seibald confirms that Cowen Prime constantly looks to reduce the cost of the services that it avails itself of. “That’s an ongoing process,” says Seibald. “In the prime business, we go through a
Increasingly, boutique prime brokers are gaining favour among both emerging and established hedge fund managers as they seek to develop higher-touch, more meaningful relationships. This is understandable against a backdrop of uncertainty in recent years, with bank-owned primes culling non-profitable hedge funds as they deal with the pressure of managing their balance sheets more effectively under Basel III.

At the end of the day, hedge funds want the stability of long-term PB relationships; something that GPP, a London-based boutique prime, has been more than willing to offer.

“The allure of the boutique prime broker is that we provide access to a full range of services that a lot of smaller managers often don’t get with the bigger prime brokers,” remarks Sean Capstick, Head of Prime Brokerage, GPP. “They are increasingly focused on larger, billion dollar hedge fund managers. Ultimately, what that means is that the smaller manager gets ignored with access to limited client service, slower response times and no flexibility.”

Boutique primes work for smaller minimum fees.

Big banks have more demanding minimum fees for the PB services they offer. Moreover, many of them still work in a siloed way, whereby those revenues paid to the prime don’t necessarily buy smaller managers access to some of the bank’s other divisions.

A boutique prime, on the other hand, is one-stop shopping.

“You can trade equities (physical and synthetic), fixed income, futures and options, etc, you get access to margin finance and stock lending, all from one place.

“In a bank PB, this means multiple phone calls and multiple coverage people. This is just not scalable for a smaller manager without a huge operations team. It’s a lot easier for them to work with a boutique prime as they have one legal agreement and the whole relationship is much easier for them to manage,” says Capstick.

Anywhere hedge funds can achieve greater operational efficiency, and potentially greater cost efficiency, they will sit up and take notice. The days of staying loyal to a star PB, and using its name for kudos in the marketplace, are largely over. Today, regardless of the name of the PB, what managers want, and expect, is a high quality client experience. They want to feel valued, and appreciate that they need to generate sufficient revenues in order for that happen.

This is helping the PB model become more transparent because the more PBs know a manager’s entire trading strategy, the better placed they will be to support them the right way.

“We use an omnibus account where we aggregate all of our clients’ portfolios into one trading account. That gives us more buying power with our end providers. Each one of our clients gets the buying power equivalent to 70 hedge fund clients, which translates as a GBP4 billion entity. Most people’s pricing when they come to us doesn’t go up, it goes down,” explains Capstick.

On the trading side, GPP has a dedicated trading desk that trades everything from

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Interview with Sean Capstick

GPP

Revenues are at all-time highs and growing rapidly

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In the largest bank-owned primes, they will typically have large incumbent cap intro teams dotted across the world’s leading cities. There is no actual revenue associated with them, however. Rather, the revenue comes from the bundled payment that is the prime brokerage revenue stream.

“How do you best allocate that cap intro resource? The answer is, to your largest hedge fund clients, who by definition are not the ones who need that service because they will often have their own internal sales and marketing teams.

“The very people who need it are the smaller and emerging managers, who aren’t paying the banks enough in revenue. There’s a clear conflict with this,” suggests Capstick.

There is no right or wrong way to offer PB services. Ultimately, it will come down to personal chemistry, whether portfolio managers have pre-existing relationships, and other soft factors, beyond merely cost considerations.

But it is fair to say that the level of interaction and support one gets from their prime is becoming an increasingly important consideration, especially among millennial managers.

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It seems to be working to GPP’s advantage.

“We’ve gone from GBP1.5 billion of assets to GBP4 billion of assets over the last 18 months. Our revenues are at all-time highs and growing rapidly. We’ve added three hedge funds a month, on average, this year and we now have 70 hedge fund clients in total,” concludes Capstick.
We've added three hedge funds a month, on average, this year and we now have over 70 hedge fund clients in total. Favorable markets will always go a long way to helping fuel the revenues generated by prime brokers. In that sense, the macro picture continues to look good as global economic indicators appear promising. Trump’s decision to cut US corporate tax to 21 per cent could have huge implications for US equity markets, and as hedge funds increase their conviction levels, prime brokers have reason to feel upbeat.

Not that primes can rest on their laurels, however. New managers, from the millennial generation, expect far more transparency and quality of service from their primes and they aren’t afraid to say so. This is something that bank primes have to adjust if they are to remain competitive. There is still kudos attached to saying one’s prime broker is Goldman Sachs or Morgan Stanley, but it is not a given that every manager will be seduced by a name.

“We have an ongoing dialogue with our clients, we keep them updated whenever we add any new providers and the additional capabilities that might give them. We talk to clients about all parts of our service offering – whether it's margin financing, stock lending costs, whatever it may be. We provide comprehensive pricing schedules. Everything is very transparent and our legal process is highly robust in terms of implementing those pricing schedules,” comments Capstick.

Jerry Lees is Chairman of Linear Investments. He confirms that Linear’s ability to generate complementary sources of revenue “helps us to cope with market swings”.

“On the one hand we have a flat fee structure coming out of the compliance and appointed representative business where we provide a regulatory hosting solution for new managers. Those monthly fees underpin regular basic operating and facility costs. Then we have prime brokerage and agency clients trading through us into global markets. The agency execution business is a bit more volatile but it’s still lucrative. We have a number of agency clients who pay us every month and as we gradually build out the PB business we are increasing those fees as well.

regular review of all the expenses related to market data, to IT systems and so on. We want to deliver better services in a less expensive way to our clients. On the research side, the team is using innovative ways to come up with better, more complete ways of providing analysis on companies, sectors, markets, and we are doing the same thing with respect to electronic trading.

“We've spent a great deal of effort looking at changes taking place in market structure and developing new trading venues based on the results of that work. We need to keep finding ways to do business more effectively and find ways to distinguish what we do; not for the sake of being different, but to help clients outperform.”

2017 was a very good year for GPP, and a pretty good year for hedge funds, in terms of performance. Assets going into the industry are at all-time highs, well over USD3 trillion in total AUM. Start-up numbers were strong and as Capstick suggests: “I would say it's been one of the best years for us in terms of number of new launches in quite some time.

“Leverage levels have remained robust throughout the year and looking at our current leverage levels, they continue to be at a pretty decent level. Confidence continues to be high among fund managers given where the markets are. We’ve gone from GBP1.5 billion of assets to GBP4 billion of assets over the last 18 months. Our revenues are at all-time highs and growing rapidly. We’ve added three hedge funds a month, on average, this year and we now have over 70 hedge fund clients in total.”
Linear Investments
Boutique Prime Brokerage

Linear is your 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.

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 our small to medium-sized fund groups and brokerage clients with a cost effective way to run their business, and grow their AUM.

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A comprehensive MiFID II solution for new managers

Interview with Jerry Lees

Starting up a hedge fund is a challenging endeavour. Hiring staff, implementing all the necessary risk controls and regulations as well as running the organisation profitably, is far from easy. Many new hedge funds fail every year. However, starting a successful new hedge fund is still possible if one takes a pragmatic approach by outsourcing as many of the operational parameters as possible, including trading and execution.

“We have the infrastructure in place, which is a big benefit to any new hedge fund manager and effectively offer a hedge fund hotel-type model,” comments Jerry Lees, Chairman of Linear Investments.

In today’s regulatory environment, it can be hard to make a GBP20 to GBP30 million fund operate over the long term. A start-up manager is unlikely to be charging 2/20, at least not at the outset. If their Year One performance is 10 per cent and they are charging 1.5/20 this would equate to 3.5 per cent. If the fund’s AUM is GBP20 million, GBP700,000 of total revenue would be coming in to the business.

As Lees points out, with that a manager has got to factor in the costs of operating the fund, including annual regulatory costs, office space, salaries, and IT infrastructure costs, all of which can quickly burn a hole in the operating revenue.

“What we do, using our MiFID compliant and FCA registered platform is package everything together. Generally, our recommendation to managers at the smaller end of the scale is to start off with a managed account. They’re not going to be making enough profit to justify setting up a standalone fund structure.

“By doing this they only pay brokerage fees. Then, at the end of two years (for example), if the manager is ready to set up a standalone fund structure we give them an independently audited track record,” says Lees.

This option of outsourcing the compliance aspect is proving highly popular with new managers, where they join a regulatory hosted platform and act as an appointed representative.

“By outsourcing processes such as regulatory set-up and reporting to a platform solution, you will be able to show that your fund has operational technology in place, complies with all regulations and has the necessary risk controls.

“Managers can use desk space in our office and use our IT infrastructure, all of which is now fully compliant with MiFID II. This includes transaction reporting, best execution, voice recording mobile phones, market abuse oversight, as well as complying with General Data Protection Regulation (GDPR) which comes into effect in May 2018,” explains Lees.

All of this means that start-up managers don’t have to look at the whole process of setting up their own IT infrastructure to get operationally ‘mission ready’. Rather, they can focus on the task of running their investment strategy and building a track record while they wait to receive FCA approval.

Linear has a significant compliance team able to offer expertise in helping managers put all of their fund documentation together to apply for their FCA license, as well as advising them on the best jurisdiction to set up their fund. It has independent relationships with all of the big law firms and fund administrators so there are no conflicts of interest.
By using Linear’s office space in the City of London and also in the West End, it gives start-ups the opportunity to talk to and share ideas with other fund managers.

“We have 130 trading desks and at present we have six or seven fund managers, which vary in size; One of them has a staff of 18 people. It’s a diverse mix of trading strategies. We have FX funds, global macro, a cryptocurrency fund to name a few,” confirms Lees, who further adds that by using outsourcing trading, managers immediately remove the fixed costs of hiring two of three internal traders, Bloomberg terminals, paying end-of-year bonuses, etc. It all adds up and makes a real dent in a manager’s fledgling P&L.

“A number of large funds have moved across to us recently from existing prime brokers because they only had GBP40-60 million in AUM. They were given 30 days' notice at the end of last year and needed to set up quickly, which we facilitated. They appreciate the fact that our trading and execution team gives them far more support than they ever received with their former PB.

“To illustrate the point, this particular manager needed to execute a large block trade without moving the market and we managed to do the whole trade in the dark. There was no market impact and we managed to keep the costs down to a minimum. That sort of thing is really important to fund managers,” remarks Lees.

Linear’s business model performs two major functions: execution, clearing and settlement on the one side and prime brokerage and financing on the other side. Without doing both, says Lees, “it becomes problematic”.

“Say you are a GBP150 million long-only fund. Long-only funds hardly trade at all; they don’t generate a lot of commissions and revenue. Under Basel III, a bank-owned prime broker has to allocate up to 1 per cent of their balance sheet against those positions. That’s not economically viable if the fund is only generating a couple of hundred thousand in commissions each year.

“Alternatively, that manager can come to us where we have huge trading lines due to the fact that we pool all of our clients together into an omnibus account. When we go to one of our prime brokers they like the fact that we give them a mixture of trades. We push through a high trading volume, on aggregate, so it works well,” says Lees.

Linear has an experienced trading team that includes David Michael, head of multi product trading who has more than 25 years’ experience and who joined Linear in May 2017 from Convergex. The aim, at all times, is to seek out best of breed trade execution prices.

This is especially beneficial to managers as they start to adjust to life under MiFID II.

Linear spends a substantial amount of capital each year on technology, including the latest transaction cost analysis software, which it runs on a real-time basis.

“We look at trade flow going to a particular broker to determine if they are offering the best price and have the tools in place to properly analyse trades. We have access to multiple market makers, MTFs and dark pools so we can fish around and get a client’s order to multiple brokers to execute best price,” confirms Lees.

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

The omnibus account is fully hedged back to the underlying broker meaning Linear never has risk exposure. Linear currently uses a number of executing prime brokers including many global international players.

Moreover, as Linear has a global financing deal with its executing brokers, Lees says 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 in today’s challenging market environment.

To find out more about Linear go to www.linearinvestment.com

“We have the infrastructure in place, which is a big benefit to any new hedge fund manager and effectively offer a hedge fund hotel-type model.”

Jerry Lees, Linear Investments
“We are growing our balance sheet and custody assets substantially quarter by quarter. The significant assets will potentially enable expanded repo and stock lending services subject to client approvals and we see this as becoming an increasingly important part of Linear’s business.

“We are onboarding substantial assets during 2018 as we continue to grow our PB client base and expect to be in excess of USD2 billion,” explains Lees.

One area that could prove useful, if done strategically and smartly, is the whole approach to research unbundling under MiFID II. This has just gone live in Europe and it will require sell-side institutions to think far more carefully about how they produce and price their research, as it will need to be sold to their hedge fund clients on a separate basis, wholly independent of trading commissions.

This could lead to a revenue reduction if the right steps aren’t taken and as such, research has the potential to be an even more important value-add than at any time previously.

Of course, quite how this will impact the PB model globally is yet to be determined. Could MiFID II usher in a global standard and lead to research unbundling in the US and Asia markets? That is hard to say. What is certain is that some organisations like Cowen are well placed to support their clients in this regulatory environment.

Cowen has its own institutional research capability but it has also developed, in part internally and in part through acquisition, the capability to perform un-conflicted trade execution for clients.

The acquisition in this instance is Westminster Research Associates, whose unbundled aggregation model allows clients to keep sensitive research spend data private from sell-side executing brokers. Moreover, it has a Research Payment Account (RPA) administration service. Its integrated research portal supports the acquisition of research from over 4,000 providers with a fully audited payment process.

“Managers are going to become much more discerning over the research they consume. There will be a cutback on how much research they consume from their brokers. They'll only want to pay for the research that has proven to be most effective for them. They’re no longer going to pay for mediocre research,” concludes Seibald.

Sources:
1. https://www.ft.com/content/0761ead6-0f10-11e7-a88c-50ba212dce4d
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Price transparency can deepen hedge fund relationships

Interview with Alexia Weiller

One of the clearest manifestations of technology innovation is the way in which it is enhancing transparency in all aspects of the investment funds industry, from front-office portfolio analytics and trading cost analysis, middle-office investor reporting, to back-office compliance and accounting.

This is also benefiting prime brokers as they look to better service their clients and develop more trusted partnerships. One bank that is working hard to drive the transparency agenda is Societe Generale Prime Services.

“What we have discovered is the more transparent you are, the more things you put on the table at the outset, the better the relationship will be,” says Alexia Weiller, Global Head of Prime Solutions. “We want to build a mutually beneficial relationship by having investment managers understand our constraints but also by putting ourselves in their shoes.”

Over the last few years, hedge fund managers have sought to diversify their PB relationships due to counterparty risk, and also due to Brexit, diversifying between the US, Europe and the UK. As such, looking for the right long-term partner has become a carefully considered exercise, especially for smaller managers who have been jettisoned by larger tier one primes in recent years, simply for not being profitable enough.

This too has proven to be fruitful for Societe Generale Prime Services.

Admittedly, there is somewhat of a dichotomy between older established hedge fund managers and younger millennial managers, with respect to transparency expectations, but irrespective of this, Weiller says the long-term strategy is to deliver superior client service where managers know exactly what costs they are paying.

“Even though there might be tough conversations on the level of service, the expected level of profitability, etc, when you are grounded and transparent I think clients appreciate it and are receptive to it.

“The more sophisticated millennial managers are trying to automate things as much as possible with all of their service providers. To do that, you have to be more transparent. They are pushing us to improve and giving us new ideas. We continue to find new ways to interact with them,” comments Weiller.

It is fair to say that pricing among different prime brokers remains somewhat of a black box. Trying to compare the cost of shorting emerging market stocks across four or five different primes remains a challenging exercise.

But as Weiller is quick to state: “We’ve actually been trying to sell the pricing and analysis of profitability as a differentiating factor at Societe Generale Prime Services. What I mean here is being able to explain to the client what their capital and equity footprint is, how their business is impacting our balance sheet, and how we look at their business holistically across all different activities (depending on trading strategy) and products.

“If, at the end of that discussion, a manager wants us to be more competitive, we might suggest they change the duration of their rates portfolio, for example.

“We analyse the trading pattern of the portfolio manager to try to gain a deep
understanding of how they trade and how it has an impact on capital and liquidity. Then we explain to the manager how we compute the numbers so that they can do it themselves. It is the opposite of a black box, in that sense.”

This ability to calculate the costs is advantageous to the buy-side as they prepare for MiFID II (which has just gone live at the time of publication). Managers will need to demonstrate to investors that best execution is being achieved for the fund and that trading costs are being properly managed. “We see a lot of managers wanting to disclose to their clients how prices are formed, what the logic is behind it, and the model we’ve had in place for the last two years enables them to do just that. We are happy to provide the price calculations, as opposed to just providing a number.

“We see ourselves as a trusted partner and as such, we feel it’s important to provide an end-to-end service. We provide balance sheet and liquidity, which come at a price, and we need to be able to explain it,” says Weiller.

In many respects this is re-shaping the PB service model. Knowing the economic value of a client is vital, given the expense involved for banks to use their balance sheets under Basel III, but that can only be truly achieved by understanding what the manager’s trading behaviour is in totality. This may sound obvious but one of the reasons some bank primes are showing clients the door is because they still operate legacy infrastructure where different divisions exist in silos.

This means a hedge fund with a modest equities book, a modest rates book, but a high volume FX book, might be shown the door, even though the aggregate level of business might be profitable.

Societe Generale Prime Services does not have that silo-based issue to overcome.

“We have given careful consideration over the last two years as to how we want to position ourselves and how we were going to differentiate our PB offering from the competition. What became a key selling point for us was the fact that the way the PB is set up at SG is very different to most other banks.

“It has not emerged out of a number of merger and acquisitions, which can lead to a natural split between the businesses where you have listed derivatives on one side of the bank, equity finance sitting within the equities division, the fixed income PB sitting within fixed income, etc. If you have a client who has interest across all those different activities, it will often not be evenly distributed.

“This has made it difficult for silo-based PBs to determine the client’s overall profitability.

“If you don’t combine repo with rates, or FX, or any other activities, and instead look at things on a standalone basis, it can lead to a difficult conversation with the fund manager.

“We come at this from a different angle, and look at what the manager is doing across all their trading activities. By doing this, it might be possible for one business to subsidise the other, as long as the overall relationship is balanced,” explains Weiller.

One of the obvious advantages to treating the client this way is that allows for cross-margining across different asset classes. If a manager has interest rate swaps and futures cleared under the same roof, they can achieve greater capital efficiencies by netting their margin and avoiding the complexity of handling margin calls for each different set of instruments being traded.

“We have a clear view of a client’s profitability across all the relationships it has. Other large PBs are trying to do this but it is not a natural way for them to look at their hedge fund clients.

“Prime brokerage is a bit like marriage. The more products one has with their PB, the stickier they are. Our message to the marketplace is, ‘Come and speak to us, test us on something and see what you think of our transparency,’ concludes Weiller.

“What we have discovered is the more transparent you are, the more things you put on the table at the outset, the better the relationship will be.”

Alexia Weiller, Societe Generale Prime Services
Hedge fund managers are putting their prime brokers under continued pressure to be more transparent and open with respect to how they set their revenue targets and how they determine their costs for stock lending, commission rates, and margin finance.

For the last two decades, the PB operating model has been rather opaque, with very little consistency over how one bank prices its services versus another. It worked perfectly well but as new regulation such as MiFID II in Europe requires fund managers to demonstrate they are delivering best execution for their investors, PBs are having to respond accordingly. This is helping improve the PB/manager relationship simply for the fact that both parties need to have a clear understanding of what they are trying to achieve, and how that plays out in terms of profitability on the one hand, and cost on the other.

“You should work out how much of a purse you have to spend with the PB at different points of your development,” says Phillip Chapple, COO at Monterone Partners, a European equity long/short hedge fund.

“Also, you need to make sure the PB gets paid what it needs to give you the service that you require.

“For example, if your revenue is going to be X but you know that the PB is going to want 2X, it’s not going to work. It won’t have a chance to become a meaningful long-term relationship so you have to look at revenue carefully. This is where the expertise comes in because some PBs will make money out of fixed income, some second that out (and won’t consider it as part of their revenue stream) so you’ve got to look at your investment strategy, your purse, and think about how that would fit in to the PB’s business model.”

This calls for an open and honest conversation. The more a prime broker
understands a manager’s investment strategy, and how it can potentially touch other areas of the bank (from a revenue perspective), the less chance there will be of getting offloaded at a later date. That is far from ideal but it has been happening in earnest over the last couple of years as banks deem smaller clients no longer economically viable.

“I think there is more transparency coming from PBs, especially now that MiFID II has gone live,” says Chapple. “Previously, PB was this large packaged product, some of which you needed, some of which you didn’t. Pricing was opaque, as was the profitability to the PB. Now, I think it is a healthier situation to go through each of the revenue lines and work out what the PB is making. Then the manager has transparency to understand what drives revenue for the PB and it facilitates an easier relationship.”

The COO of a global macro fund who asks to remain anonymous tells Hedgeweek: “We’ve always got transparency on costs. Now we have to pay something for research – which is not ideal. MiFID II has increased our costs, not reduced them.”

He says that they rely on their PBs more for settlement and custody as opposed to funding and that they prefer to avoid multi-netting arrangements, which some in the industry regard as improving cost (margining) efficiency.

“I’m not a big fan of multi-netting agreements. I like to know what the margin costs are for specific asset classes like FX. When we trade swaps, everything is given up to the CCP, which makes things easier. I would estimate that 95 per cent of what we do with swaps is given up to the clearing house, with a single clearing margin.

“There has to be very clear transparency on how margin is being calculated and whether it is reasonable or not,” he says.

Simon Hampshire heads up Investor Relations at Cognition Investment Partners, a London-based macro strategy. For their strategy (and many other macro and CTA strategies), things such as financing and stock lending were not important considerations when selecting their prime brokers at inception as the strategy trades futures. Of much greater importance were commission rates. This is critical for controlling trade costs.

“You should work out how much of a purse you have to spend with the PB at different points of your development.”

Phillip Chapple, Monterone Partners

“The costs were quite high early on the relationship as we got to know one another. However, after the first month we re-negotiated our rates substantially. We have to know the full breakdown of all the pricing involved from electronic execution through to clearing costs and exchange fees. Quite a few providers are reluctant to break down the combined figures into the three elements because they see it as part of their competitive edge. For us, we have to tightly manage our budget. It is important we know the figures in order to trade efficiently on exchanges and manage our margin costs in the most optimal way,” explains Hampshire.

He agrees that primes are being pushed more by their clients, especially the younger generation of millennial managers, to be more transparent.

“There are strategies such as ourselves that only need a vanilla product. We don’t need to have a specialist PB relationship in that sense. And that is the case for a lot of managed futures funds. There are very few add-ons that PBs need to offer us – it’s all about execution and STP capabilities,” adds Hampshire.

Where macro strategies like Cognition will hold their PB to account is when the strategy suffers trade breaks. Prime brokers have invested huge sums in technology to support STP and e-trading, such that trade breaks are increasingly rare. “Most primes can offer a process that is 99.9 per cent accurate. Because everything is automated there is no reason for human error.

“As a result, there is very low tolerance among macro managers for trade breaks,” says Hampshire.

Testing the manager relationship and establishing clear terms and expectations at the get-go is something that Societe Generale Prime Services is fully focused on, as it looks to build its market share.
Inside the mind of a Prime of Prime

Interview with James Alexander

How is bank regulation helping Invast Global win market share from traditional prime brokerages?

There is no doubt that the suite of bank focused regulations has been a tailwind for Invast. Of the regulations currently curtailing banking activities in Prime Broking, Basel II has been the greatest catalyst for the shift in appetite to onboard various client types, especially smaller or emerging managers and brokerages looking to distribute products to a broad retail audience.

MiFID / MiFIR are also having an impact, generally favouring the boutique organisations who can respond rapidly and are able to focus on market niches.

Importantly though, our successes have not been to the detriment of the tier 1 banks. As we utilise the services of three bank prime brokers, we are essentially acting as an aggregator of clients for our PB’s who often refer clients to Invast, so the relationship is symbiotic.

What are the benefits to emerging hedge funds using a non-bank prime broker and why do you feel Invast Global is well positioned to meet their needs?

The single most important benefit is access. One significant challenge facing many emerging managers is the ability to access global markets on commercial and risk terms that allow them to focus on generating alpha and growing their funds. By utilising Invast Global, fund managers have access to over 30 equity and futures exchanges as well as liquidity in FX, metals and commodities globally. Our clients are able to consolidate their trading capital into a single cross-collateralised account for improved capital efficiency.

The second benefit is costs. Unlike most traditional prime brokers, Invast Global does not charge a minimum monthly fee. We understand that these charges can hinder the growth of an emerging fund manager. Furthermore, our prime services team works closely with our clients to ensure that their commercial agreements facilitate long-lasting relationships. We want our clients to develop and thrive.

Service is another area that sets Invast Global apart. The professionalism across the entire team gives customers a consistently positive experience. Our service levels befit the ‘high-touch’ style manager, who requires far more than execution and a trading statement. We are nimble and innovative, which ensures that our client’s needs are swiftly met with a bespoke solution.

Invast Global has quite a diverse client base, including managers that are just establishing their fund after leaving a much
larger one, funds that have a bank prime facility as well as one with us and funds that have simply not been able to justify the commercial requirements of a PB facility.

**What enhancements/changes have you made to your bank and non-bank Liquidity Provider (LP) mix over the last 12 months?**

2017 saw two key themes come into sharp focus for our liquidity management team. The first of these was the continued rise in prominence (and volume capture) of the non-bank liquidity providers, a trend we saw emerging over 2015 and 2016. The ability of the non-bank LPs to make material impacts on pricing and liquidity, especially in the crosses and exotic currency pairs has been clear. Metals and other commodities are another area where the non-banks have begun to capture significant market share through aggressive pricing and high quality, low market impact execution. It is important to note that in the G7 currencies, the major bank LPs still form the liquidity bedrock, with aggressive skewing from the non-bank LPs providing additional spread compression.

The second driver of change in the liquidity space has been the FX Global Code of Conduct (FXGCC), of which Invast has been a strong supporter and advocate. There is within Invast, a preference towards using LPs that have clearly stated their adherence to the FXGCC and we believe that there are distinct and practical benefits for our clients from this position. This has already proven to be true as many of those clients are now in a position where they are required to demonstrate best execution capabilities to their own customers.

**Keeping on top of trading costs is important for any manager, and under MiFID II they will have to demonstrate that best execution is being delivered on behalf of their investors. How is Invast Global able to optimise the way that its clients execute their strategies using the best liquidity, at the best price?**

As a non-bank prime broker, Invast provides clients credit intermediation and liquidity provision to a degree of transparency and level of control unprecedented in the market.

Invast Global clients are given transparent access to our many liquidity providers across a range of asset classes and can – in conjunction with our expert liquidity team – customise their liquidity mix to best suit their trading and execution style. Our clients also have access to a suite of execution algorithms covering a variety of orders types to allow them to achieve the best price with minimal value leakage. With the right liquidity and execution methodology backed up with pre and post trade transparency, managers are clearly able to demonstrate best execution for their clients.

**In what ways is the firm leveraging new technologies to improve transparency, both pre- and post-trade, to strengthen client relationships?**

Invast is already leveraging numerous technical resources to not only deliver greater transparency, but to optimise the execution strategies of our clients. Various forms of Transaction Cost Analysis (TCA) programs are at the heart of this conversation. Being able to clearly demonstrate the dollar cost value of market impact is hugely beneficial for our clients in maximising value capture.

**How would you sum up 2017, from a business growth perspective? Any key milestones achieved?**

2017 has been a year of exceptional growth for Invast Global. We have continued to expand our client base in scope and scale and are looking forward to executing our growth and expansion plans in 2018. There were a quite a few key internal milestones reached in terms of turnover, client numbers and overall profitability, but the truth is, given the scope of the opportunity and the regulatory tailwinds we foresee, our greatest successes still lie ahead.

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**What will you be focusing on in 2018 to continue to grow Invast Global’s revenue stream?**

The continued growth trajectory of the business will encompass significant geographic expansion. London and Hong Kong offices are planned for launch in 2018, with further expansion in Europe and Asia likely in 2019. ■
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The power of execution

Interview with Steve Sanders

Being a fully automated online electronic brokerage firm, Interactive Brokers has found itself in an enviable position of adapting to new regulations such as MiFID II relatively seamlessly. As it already had a lot of the IT technology in place to demonstrate best execution, IB has not needed to go through a significant overhaul nor, importantly, has it needed to hire a lot of extra staff, thereby increasing its fixed costs.

One example of the technology IB uses which will help clients under MiFID II is IB SmartRouting™ technology; essentially an algorithm that scour the markets to ensure that best price execution is achieved.

“It is very important within a MiFID II context,” comments Steve Sanders, EVP, Marketing and Product Development. “There was not much work for MiFID II in terms of our Smart Routing. However, in terms of reporting there was a lot of work to get it in place in an automated way.”

Costs can make or break a hedge fund’s performance, especially in the recent environment where they haven’t generated the type of returns seen in previous years.

“If your prime broker hasn’t automated everything and doesn’t have the technology to automate, they aren’t going to be able to give managers the best price. Or, they’ll make some money on trade volume and limit the managers they work with to the biggest and best hedge funds. They have to because a lot of what they do is still manual,” states Sanders.

In terms of developing new tools and IT capabilities, it has been a prolific year for Interactive Brokers.

As Sanders explains: “We have a programming API which people can use to write code in C++, JavaScript and so on. This has now been enhanced to support Python for those engaged in programmatic trading.

“We introduced a Forex auto swap program, which allows clients to carry live Forex positions with better carry costs when holding positions that aren’t being closed out intraday. They can essentially participate in the interbank Forex swap markets. For institutional traders, this has been an important introduction.”

In terms of product classes, the platform has added KOSDAQ 150 index futures, new FX options on USD and RMB on the Hong Kong Futures Exchange; it has added the South African rand as a deposit currency, and it has also added 222 China A large-cap stocks.

“Moreover, we added a FTSE 250 future on the ICE (EU) and LME metal futures last year. We have also introduced a split spread order type, which builds upon the IB Smart Router. Rather than paying up to the ask quote for a market buy order, investors using the split spread algorithm may improve the fill by allowing their market or limit orders more latitude to fill,” confirms Sanders.

Eris Exchange is a US-based futures exchange group that offers swap futures as the leading alternative to traditional over-the-counter (OTC) swaps. Interactive Brokers now offers Eris Swap Futures, meaning users are now able to gain access to interest rate swap risk; a market previously beyond their reach.

One other important development has been the introduction of an Investors’ Marketplace, which provides a search tool for hedge fund allocators.

“We currently have 2,911 hedge funds on our system, up from 2,494 last year. We can now show them to the marketplace, which is beneficial to hedge fund allocators,” concludes Sanders.
According to Alexia Weiller, Global Head of Prime Solutions, when selling prime brokerage services “you aren't just selling access to the bank, you are selling access across the whole chain – including operations and IT infrastructure”.

In other words, PB is not just a front-end solution.

“It’s important for us to work with our clients to develop a transparent, long-lasting relationship. Fund Managers are also assessing us on the way we manage incidents; we can’t treat them as any client buying a product.

“When a manager is selecting a PB I think it’s important to try to understand front through back how they work, how integrated their operations are, what IT capabilities they have: all of these should be part of the service offering,” says Weiller.

As with any healthy relationship, communication is key. Fund managers today understand why Basel III is making banks’ balance sheets a more expensive commodity and that margin costs will be higher, depending on how much leverage they are looking to employ.

“We work with our clients from the start to define the capacity they need. We analyse the composition of their portfolio and define the most appropriate business mix for both them and us. Each client will have different needs, depending on their strategy, size and appetite.

“That way, at least at the discovery phase the manager knows what he’s going to get. He will know what impact he is having on our balance sheet,” explains Weiller.

Other primes are adopting a similar mindset to Societe Generale. In that respect, the paradigm has changed.

As one source tells Hedgeweek: “We live in a world where regulations continually change and evolve, putting pressure on the banks. We need to understand the constraints and communicate them clearly to our clients. You can’t expect your clients to give you the right book of business if you don’t explain to them what you need.”

Hedge funds want the ability to reach around the world to access different assets – futures, Forex, options and stocks – from one single platform. “We’ve always had this capability but it is not easy for bank-owned primes to develop such a capability,” remarks Steve Sanders, EVP, Marketing and Product Development, Interactive Brokers.

“We make all of our pricing available to the world. Prime brokers tout transparency but one of the areas they make the most profit is in stock lending and borrowing; and the fact is, there is no transparency on this. They tell you over the phone what rate you can get. We, on the other hand, make those spreads available to any of our clients so that they know, in real time, the cost of borrowing.”

With so much digital technology disruption happening in the market, as the years go by Sanders does not believe that the legacy issues of non-transparency in the bank-owned primes will be as much of an impediment as perhaps they were in the past.

“Everybody has a different way of showing how they give price improvement and depending on the definitions you put into your analysis, you can make them look really good. You could say you only want to include market orders, limit orders, you only want to look at the market over the last 10 days, so it’s not as cut and dried as commissions.

“With commissions, you can easily compare one broker who charges USD1 versus another broker who charges 50 cents. We think our definitions are pretty good.

“We announce our earnings every month, in which we show the total commissions per trade that we charge along with the execution cost of that trade. Very often, it’s negative and we get rebates from the exchanges. We think this is a good measure of how we perform versus everybody else. We know what the intrinsic value is of all our hedge fund clients,” explains Sanders.

Going forward, Weiller says that the strategy at Societe Generale will be to become a prime broker where managers go for quality of service and breadth of product offerings.

“Our clients are constantly looking for innovation and new ways of doing business. You need to be proactive, to respond to your clients very quickly. Prime services is one of the key growth areas over the coming years so it is important to have the full backing of the bank,” concludes Weiller.