

September 2018

# Prime brokerage perspectives 2018

**PBs reap the  
benefits of investor  
relationships**

**Bank-owned  
primes set for  
major changes**

**Managers'  
perspectives on  
their prime brokers**



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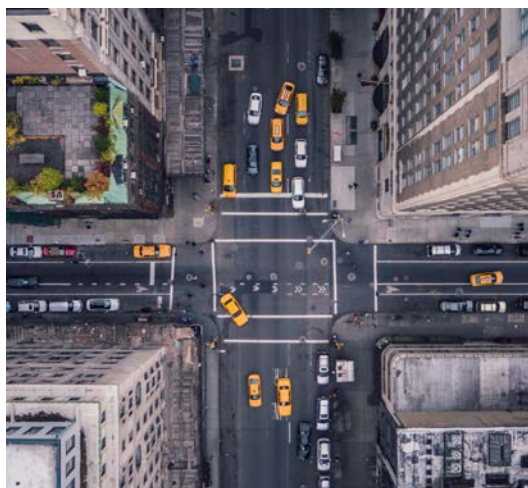
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# Prime brokers get closer to investors and enjoy Q1 growth

By James Williams

The first quarter of 2018 saw prime brokerage revenues jump 20 per cent to USD4.9 billion for the largest investment banks according to a report from Coalition, which monitors the industry.

As the *Financial Times* wrote on 23rd May 2018, this revenue boost was the highest in almost three years among the world's 12 largest investment banks but signs of a sustained period of growth appear short lived. Volatility earlier in the year has not continued.

This is the fuel that hedge funds use to increase their trading activity – in so doing, increasing the revenues earned by prime brokers for giving up balance sheet. On the one hand, investment banks might be

forgiven for thinking that prime brokerage is a fickle business, dependent on the whims of how much leverage and securities lending activity they wish to engage with.

On the other hand, during the longest equity bull market in history, US investment banks have strengthened their balance sheets and built a strong capital buffer. This has enabled them to reinvigorate their own trading desk activities and generate revenues independent from prime brokerage activities.

As *Forbes* revealed in June this year, the five largest US investment banks had a combined securities trading portfolio of USD1.53 trillion as of Q1 2018, up 15 per cent from USD1.34 trillion at the end of 2015.

This shows that proprietary trading is

on the rise. But while prime brokerage will likely always remain a key part of investment banking, it remains to be seen whether US banks will choose to use more balance sheet, or resources, to support hedge funds.

One prominent global prime broker, who asks to remain anonymous, tells *Hedgework* that there is a limit to how much science can be applied to assessing the economics of hedge fund clients and the relative merits of their wallet size. "Relative to the size of our book, it's not a material balance sheet investment, rather it is a resource in which we invest," they say.

Technology is, nevertheless, being used by primes both large and small to help better understand their hedge fund clients and to try to better recognise where the value and the returns are coming from.

At the same time, technology is allowing the buy-side to compare the rates they are getting with their PBs versus the market and potentially discover new PB relationships that might better fit their business.

Some solutions look specifically at how PBs are 'axed' and whether they can find complimentary trades in the market. ENSO (acquired by ICAP in April 2016), for example, has become a matching engine and is used as another sales channel for primes, as well as a way for hedge funds to discover which primes might add value to their portfolios.

ENSO provides powerful portfolio analytics to the hedge fund and asset management industry. ENSO's team of prime brokerage, asset management, technology and data specialists deliver identifiable and measurable operational insight on counterparty credit risk, collateral management, and portfolio financing and treasury functions.

The tier one broker quoted above believes that the single largest change to the PB model, which is still yet to be completed, is the focus on the use of balance sheet.

"There is an inward and an outward dynamic; to know what the returns are and to make sure clients understand those returns. That is strengthening the relationship and it is very important that they understand how you offer the balance sheet.

"The vast majority of clients make fine returns. A relatively small number run complex business models and returns are an



*"If I asked someone to send me a sample portfolio and I told them we could source all of their shorts without issue, they are probably going to be more confident about developing a relationship with us."*

**Sean Trager, Wedbush Prime Brokerage**

issue, with dedicated finance teams focusing on that issue. Most clients would like to know their returns are fine," he says.

Small independent primes like Wedbush play a vital role in the overall PB ecosystem where their capabilities tend to be more closely aligned to supporting emerging managers, and those running smaller, niche fund strategies.

"If I asked someone to send me a sample portfolio and I told them we could source all of their shorts without issue, they are probably going to be more confident about developing a relationship with us," suggests Sean Trager, head of Wedbush Prime Brokerage. "Oftentimes, when a prospect sends you a potential portfolio he is very much reaching for the stars i.e. it is an ideal portfolio where he would like to be short X number of obscure names. And typically we are able to source that liquidity whereas a lot of our competitors would struggle to do so."

Proficient market access, wedded to good market research, can lead to fruitful relationships with emerging managers who are more likely to trade obscure names to generate alpha because their size allows them to, without fear of the market moving against them. Over the long term, this gives prime brokers like Wedbush the chance to develop relationships with managers who might not be hugely profitable at the outset but could be at a future point in time, when their AUM has grown.

In that regard, prime brokerage requires patience and resource commitment.

To ease the burden of this, it is not uncommon for larger hedge funds to enter in multi-prime arrangements. This is important, from a diversification perspective.

Stuart Bloomfield is Managing Director, Head of Prime Services Sales, Scotiabank. In his view, hedge fund managers need to think about the geography of different prime brokers, and to try to select relationships that are less likely to be at the mercy of a changing strategy or commitment to the prime brokerage business-line.

As balance sheet is much more important a commodity for banks, it is necessary for managers to strike the right balance and ensure that each PB in a multi-prime relationship gets a sufficient slice of their wallet.

"The challenge managers have to solve is how diversification amongst their Prime Brokers might look – that is, how each of the Prime Brokers complements rather than competes against each other. Managers used to think in two dimensions, price and margin when allocating business but increasingly they have to consider a third dimension, whether the allocation fits with a Prime Broker and is therefore a sustainable arrangement. The addition of the third dimension means managers may need to compromise on price or margin efficiency to address a sustainability issue with a particular bank.

"Managers should get into the details with each Prime Broker to understand what business is a best fit and what their thresholds and metrics are around assessing clients," adds Bloomfield.

Since the financial crisis, the old model of 'divide and conquer', where PBs onboarded all and sundry without necessarily worrying about how much value hedge funds added, has ended. US banks have worked well to bolster their liquidity ratios in response to regulation but European banks have lagged behind and are still working through issues.

Overall, the last decade has been a period of consolidation, causing smaller hedge funds to be jettisoned. Mini primes and small independent self-clearing primes have stepped in to fill the vacuum, taking on clients who would otherwise have nowhere to go.

This concerns some people who feel it should be hard to win any new business.

"The fact is, for many of our clients, if they didn't work with us they wouldn't have anywhere else to go," states Trager. "That's



*"The challenge managers have to solve is how diversification amongst their Prime Brokers might look – that is, how each of the Prime Brokers complements rather than competes against each other."*

**Stuart Bloomfield, Scotiabank**

not ideal. Some online retail brokers have segued into the institutional community and do a good job but they aren't a traditional PB; they moved into this space because they had the capital and the technology to do so.

"We are a full service prime broker: we do research, securities lending, we offer clients the chance to participate in syndicated deals and so on. Regulation has made it more difficult to be an independent prime and in my view, we can't afford to have much more consolidation if we want to retain a free market."

Some prime brokers pride themselves on offering stronger value-added services than others as a way to appeal to hedge fund managers availing of a multi-prime relationship. Winning new business is hard but retaining that business, and growing, is harder. When it comes to hedge funds, prime brokers don't only look at monthly trade revenue activity and financing levels, they look at AUM growth. How is the manager doing? Are they attracting new investors? And if not, could this be a short-term relationship that offers little real value to the bank?

Capital introduction teams play a key role in this respect. It is in their interests to get their clients in front of the right investors. This requires understanding what investors are looking for in the first place.

Brett Yarkon is Head of Capital Introduction at Cowen Inc. Yarkon and his team spend a great deal of time speaking to allocators and getting a sense of investor sentiment, at a minimum on a quarterly basis, to support Cowen's prime brokerage and outsourced trading clients. It is a highly tailored approach that one





would expect at Tier One firms such as Morgan Stanley.

Looking at the last quarter, Yarkon says that continued allocator interest in private markets is making it harder for hedge funds to raise new assets. There is, he says, no urgency investing in hedge funds, unlike private equity funds, which might have a hard close.

"Everything is cyclical but with the inundation of hedge fund products, it has become a lot more difficult to raise capital," says Yarkon. "From a pure seeding perspective, it seems the traditional sources of that capital have dried up to a certain extent. Speaking to an allocator recently, he said it is almost the luck of the draw; you need to have the right product put in front of the right investor at the right time. Also, there have been a few unusually large new launches this year, which took capital away from others who have been trying to launch a new hedge fund firm.

"If you're speaking with an institutional allocator, like a FoHF, and they have a fully invested portfolio, even if they love a hedge fund manager's product, that manager is not going to get money from them until they redeem from someone else."

It often can be one in, one out, and that frustrates many firms trying to raise capital to get up to scale.

This reinforces the earlier point that prime brokers need patience when committing resources to hedge fund clients, especially newer and emerging managers. Not all primes will see the value in this and decide to focus on more established managers. It depends on the internal strategy and the level of support across the investment bank.

At Scotiabank, part of its growth strategy is to roll out Direct Electronic Access (DEA) in Europe to unlock partnerships with systematic equity managers trading Europe, whether they're located locally or from other regions. This is a Prime Broker taking an organic approach to grow its market share, with a clear plan around the size of manager and type of trading strategies it is willing to take on.

"Historically our equity execution capability in Europe has been limited to care orders and this has somewhat restricted the hedge fund strategies we can service for our clients. By offering DEA, our clients will be able to send us a much higher volume of trades and choose from a suite of algorithms, depending on how they wish those trades to be executed.

"The off balance sheet revenue this rollout will generate will complement the traditional Prime Brokerage revenue and generate more compelling returns – an important trend for every Prime Broker," explains Bloomfield.

Trager believes that new managers are likely to be more open to partnering with smaller primes who have a longer-term outlook and are willing to support them early on in their AUM growth cycle.

"Twenty years ago when I started in the business you couldn't go to market without having a brand name prime broker on your offering document. Your marketing deck needed one to give it credibility, whereas now people are looking for a competitive edge."

The larger primes must therefore remain aware of the changing mindset and priority set among millennial start-up managers who aren't necessarily swayed by the kudos of a name as in times past. Bulge bracket primes will always remain focused on their top 10 or 15 per cent highest revenue clients, but continuing to tweak the business offering and commit resources to new talent should still remain part of their business strategy.



On the capital introduction side, teams like the one headed up by Yarkon understand that investors want to stay up to speed on the next best manager, as they look to adjust their portfolio holdings. In many ways, finding these new managers/ideas is of far greater importance than a cap intro team bringing them a roster of high profile managers they've already heard of and are familiar with.

"Our aim is to continually have conversations with investors on a quarterly basis in order to stay on top of investor trends," says Yarkon.

"We always make sure to ask them if they've allocated in the prior 12 months, and if they have, we follow up with what strategies and types of firms they invested with. We also inquire about what strategies they've redeemed from, and what are they looking for now? Getting answers to these

questions allows us to quickly draw a summary of what the allocator's views are on managers, and if we start to see patterns of responses across different investors, we can start drawing conclusions about what's driving investment decisions.

"We listen to what allocators are saying, figure out why they are saying it, and then take that back to our client base as a source of new guidance."

As technology improves and the PB/manager relationship model evolves, it is not too much of a quantum leap to suggest that greater transparency – and a clearer understanding by both parties as to the economic value of the relationship – could help prime brokerage to become more profitable than ever before. Specialist primes could well trump the generalists, focusing on a lower number of key clients (regardless of AUM size) with a good Return on Capital, than using up balance sheet to support a wide number of clients; and potentially reducing the quality of returns.

"Our story is one of transparency, it's what clients expect," says Bloomfield. "We're honest in our views with prospective and existing clients. Ten years ago, the Prime Brokerage financing markets were almost entirely opaque but increased competition and technology has enabled managers to become more attuned and ensure they are not overspending.

"It's an important part of doing business today. The more you can be transparent the more it should lead to better, more sustainable business relationships based on trust."

Yarkon offers the following advice to those managers evaluating their current PB relationship(s): "When you're speaking to your prime broker and capital introduction team, you really need to be sure they understand what you do, and as importantly, have the ability to articulate that back to the right allocator audience. Also, get a good sense of who that allocator audience is.

"Many times, I see managers who have allocator idea lists from other cap intro teams that we know have no interest in their strategy or firm profile. Pick a prime broker whose cap intro team can put you on the path to getting in front of the right allocators at the right time." ■

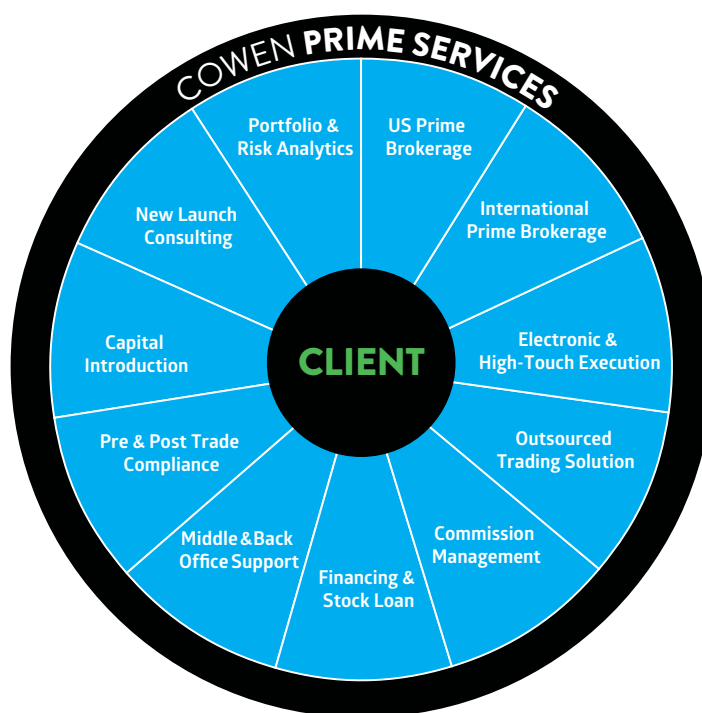


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# The investor's view of capital introduction

Interview with Brett Yarkon

In many, if not most, cases, capital introduction teams at prime brokers have tended to function as 'quasi marketers' for their hedge fund clients. The name of the game appears to be getting their clients in front of as many investors as possible, and quite often this means doing so without truly taking the time to understand what investors are looking for.

Cowen Prime Services LLC capital introduction and business consulting team takes a much more measured approach and is taking the opposite side of the trade.

"We're not acting as distributors of information or products, we are looking to be a source of validation for the allocators," says Brett Yarkon, Head of Capital Introduction. "We believe that if we focus on the allocators and take the time to understand their underlying mandates, their risk/return tolerances, and the hedge fund manager profiles they tend to gravitate to, we're much better positioned to show them ideas that are appropriate for them."

With the proliferation of hedge funds in the marketplace, it has become difficult for allocators to source the right managers who are relevant for their mandates. Yarkon and his team believe that engaging in a tailored cap intro solution that focuses on both the fundamental characteristics of the hedge fund clients and the needs of the allocators, has allowed Cowen to build its strong relationship base "and achieve success in getting our clients in front of the potential right money at the right time." The main goal of the team's effort is to assist the firm's clients in maintaining a very targeted outreach to allocators.

The background that Jack Seibald and Mike Rosen, Global Co-Heads of Prime Brokerage and Outsourced Trading, share as former portfolio managers, coupled with



**Brett Yarkon, Head of Capital Introduction at Cowen Prime Services**

Brett Yarkon's former affiliation with a large institutional investor, and the investment backgrounds of others on the Cowen team, shapes much of the cap intro strategy at the firm. "The investor approach to manager research and selection helps us to differentiate Cowen's capital introduction process from others in the marketplace," comments Seibald.

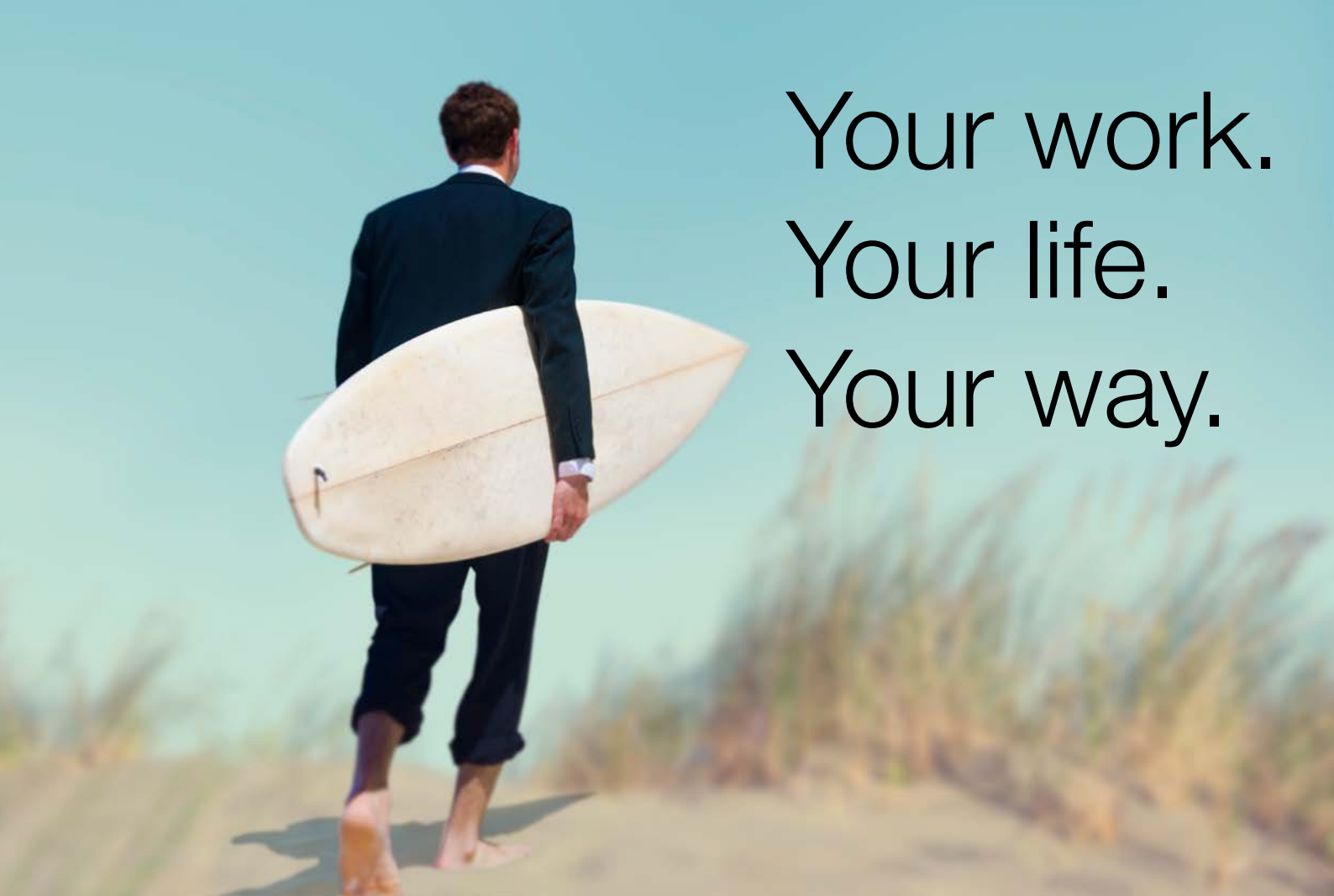
Capital Introduction is anchored on building relationships. "Because we are able to speak the same language as the investors we interface with, we ask the right questions in an effort to understand what drives their investment activity, and therefore are better able to tailor the list of managers we show them. Allocators have come to appreciate us as a valued partner in their manager selection process," states Yarkon.

To illustrate the efficacy of Cowen's tailored capital introduction model, Yarkon refers to one recent event-driven manager who had posted strong returns, boasted a strong manager pedigree, and had decided to start outwardly marketing.

Coincidentally, Yarkon had just had a conversation with a corporate pension fund.

"We followed up, discussed the strategy and our impression based on the research we had done, passed along the relevant information and they agreed that an introduction would make sense. This particular allocator was looking for high alpha generative strategies in areas of the market that require particular expertise, and event-driven was one of those.

"We made the introduction, gave the manager feedback on what the pension fund thought of the meeting, ensured that all data requested was delivered, and ultimately a sizeable allocation was made. The whole process was completed within six months," concludes Yarkon. ■



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# A model to support market efficiency

## Interview with Sean Trager

The art of a good stock picker is identifying companies in obscure parts of the market that have yet to reach their full value potential, or, when it comes to shorting, have artificially high valuations. But aside from this, another skill is being able to construct trades that move anonymously through the market without signaling to others what the portfolio manager is doing.

This is something that Wedbush Prime Brokerage excels in, supporting emerging managers who have the nimbleness and dexterity to trade smaller positions.

"A long/short equity manager might focus on an obscure pharmaceutical stock, for example – many of which Wedbush covers from a US equities research perspective – and utilise our research capabilities," explains Sean Trager, who heads up Wedbush Prime Brokerage. "If they were going to engage that company directly for certain deal flow, we would be able to help the manager achieve minimal market impact to execute their orders.

"Part of what we offer, therefore, is anonymity. You're not shopping orders to the entire Street. With Wedbush, managers use a small, independent trading desk to move quietly and efficiently through the marketplace."

From a securities lending perspective, Wedbush acts as an independent intermediary to many of the larger lenders on the Street and has in excess of 100 relationships – ranging from global banks to retail brokers. In addition to this, Wedbush uses its own core inventory from its corresponding clearing business. "In many ways," says Trager, "we've replicated the Bear Stearns model. We run correspondent clearing in tandem with PB and unlike the bulge bracket firms we have no proprietary trading."

"Independence is key. We're not competing with our clients. We simply act as a vehicle for them to access liquidity to



Sean Trager, CEO of Wedbush Prime Brokerage

execute their strategies in the open market, both on the long and short side."

Trager speaks passionately about the important role he believes Wedbush and a handful of other small independent primes play in the PB arena. In his view, competition should be welcomed.

While bulge bracket firms are largely focused on larger money managers, they still have a foothold in the smaller manager space by working with introducing brokers (ie; BTIG, Weedhan, etc). Without self-clearing independent Prime Brokers like Wedbush, the industry would end up with only a handful of counterparties. This is a risk not only for money managers but also the markets. For example, in the wake of MF Global, managers street-wide were dislocated and markets fragmented.

"If you believe in free markets then you believe in competition. We believe that smaller hedge funds who seek alpha and find opportunities should be able to deploy capital seamlessly. If Wedbush and other small independent PBs left the space I think we'd be looking at a very different market. We'd see fewer small-cap and micro-cap companies being traded and large-cap companies would dominate the market (even more so than they do today)," suggests Trager.

Every morning, many large custodian banks send Trager numerous of names from within their stock inventory, which Wedbush then disseminates it to its clients, allowing everyone to make a spread and hedge funds to access liquidity. This is the essence of free markets.

Think of it as large institutions outsourcing their securities lending function to Wedbush.

"For us, it's a case of prioritising relationships but also making sure there is an equal opportunity lending programme," concludes Trager. ■



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# Creative opportunities to support mini primes

Interview with Roger Woolman

Mini primes and those looking to establish new prime brokerage businesses are currently a big focus for SS&C Advent, according to Roger Woolman, Business Development Director, Asset Management & Alternatives.

Over the years the firm has built long-running relationships with some of the world's largest prime brokerages and are, without doubt, highly valued clients. But as Woolman says: "The more interesting area for us, from a new business development perspective, is firms who are looking to break into the PB arena, such as mini primes.

"We have a number of mini prime clients in the UK already and we are having ongoing discussions with a number of firms who are looking to move into the PB space here in the UK."

The Geneva platform is well known in the industry and can actually trace its origins to the prime brokerage space thanks to a joint venture with Goldman Sachs, years before it incorporated the comprehensive fund accounting capabilities for which it is famous for today. The majority of Tier 1 primes use the platform where it operates within often quite complex IT environments that are required to support global bank activities.

By contrast, mini primes and spin-off operations are in a position where they can look at the current state of technology, as well as options such as hosting and managed services that the bulge bracket primes don't necessarily need or offer to their clients.

"It is not just about the software but the deployment of that software. We have the Syncova product, as well as Geneva, which also plays a key part in the PB/hedge fund relationship," says Woolman.

Introducing primes like Cowen Prime Services understand the benefits of



**Roger Woolman, Business Development Director, Asset Management & Alternatives at SS&C Advent**

technology agility. As well as trading services, they provide additional operational support, including account opening with brokers, deployment of trading systems, trade-break resolution, as well as a complete set of shadow books and records using portfolio accounting and reporting technologies. What this means is that small and emerging managers receive Geneva reports that would ordinarily be beyond their reach. "We receive very robust reporting through Geneva using the web portal, which allows my COO to do analysis on the profitability of trades," says one hedge fund manager.

Woolman says that the benefit to fund managers is high quality, robust reporting, which they can demonstrate to their end investors, while the benefit to prime brokers is the ability to attract new clients because of that reporting prowess. Not to mention the benefit it brings to SS&C Advent.

"The fact that emerging managers who partner with mini primes are indirectly getting familiar with our system could mean that in the future they consider using Geneva themselves, when they reach a certain size of AUM.

"An emerging manager can now access Geneva a lot easier today than they could five years ago. We have much more agile and affordable ways of deploying the software.

"Through their PBs, they achieve familiarity with the product before necessarily buying it, and it helps us reinforce our position in the marketplace. It is an easier transition for managers to make if they decide to deploy Geneva some time in the future," explains Woolman.

He adds that over the last couple of years, a lot of new enquiries have come from mini primes or people looking to set up mini

prime operations: "In terms of mini primes, there are probably only a dozen or so that are here in the UK. We have onboarded a couple of those as new clients over the last two or three years."

SS&C Advent Syncova helps strengthen transparency in the prime brokerage relationship by allowing hedge funds to accurately monitor and manage its margin obligations and stock lending costs. Specifically, Syncova Margin gives hedge fund managers clear insight into how profitable their trading strategies are with regards to margin and financing costs across multiple counterparties.

"From a prime broker's perspective, it's all about profitability and that's primarily why they use Syncova," says Woolman. "Any types of margin calculations or finance calculations are particularly onerous and risky without using that sort of system and actually we have seen instances where profitability has increased significantly following its implementation. Like Geneva, there are also different ways to deploy Syncova available to PBs and fund managers. On the manager side, like Geneva there is some reassurance in terms of what they are being called for, from a margining perspective, and what exactly they are being charged."

Technology advances have undoubtedly helped primes, big and small, in respect to assessing the economic value of hedge fund managers. When regulation such as the Dodd-Frank Act was introduced following the '08 financial crisis, the initial reaction by US banks with PB divisions was to cull unprofitable clients that they could not justify supporting with their balance sheets. Over recent years, that culling process has eased off as US banks have settled in to life under the DFA. Indeed, this June, the Federal Reserve confirmed that all 35 bank holding companies subject to annual stress tests had passed.

Profitability calculations will depend on the suite of services being offered by the individual prime broker, when assessing hedge funds against available balance sheet.

"The Geneva system provides a foundation, a true source of data, from which prime brokers can spin off a variety of calculations," says Woolman. "Some are only offering trade execution services and they need robust, core

systems to support various asset classes. Geneva not only provides a true record of positions, it also records spreads on those positions. It's about ensuring that the prime broker is charging clients and making a profit over and above what they are being charged on those positions, when interacting with other prime brokers.

"Data integrity and accuracy is key from a position perspective but also important is understanding the margin on each position; and that's when Advent Syncova becomes an important tool."

SS&C Advent remains as focused as ever on ensuring that its systems deliver the best capabilities to all its clients, not just prime brokers. Each year, approximately 20 per cent of its revenues go into R&D, with Woolman confirming that they are currently working on something called "Next Generation Geneva".

"We are making improvements in the background with respect to how the system performs calculations, as well as improving user interface flexibility. We are bringing it up to speed with the mobile age. From a future proofing perspective with respect to data capabilities, the beauty of Geneva is that it was always there and I think that's been borne out by the types of clients who use it. It is a fully extensible database without requiring programming changes. The way we improve it is the way people interact with the system in terms of surfacing and interacting with that data, etc," says Woolman.

Looking ahead, Woolman is excited by the opportunity of supporting start-up primes and mini primes "because it gives us the possibility of being a bit more creative in terms of deployment and outsourcing".

There is, he says, much more of a partnership consideration with these smaller firms, not only in terms of getting the business up and running, but also in terms of knowledge sharing to support their operations.

"These firms tend to be more specialist than generalist, where they look to focus on specific hedge fund strategies. That might mean there are certain nuances in terms of how they process things and charge their clients.

"We're definitely focusing on those types of firms, not least because they act as a gateway to emerging managers," concludes Woolman. ■





# Manager perspectives on the prime broker relationship

By James Williams

With the rise of social media platforms over the last decade, led by Facebook, the way we think about connecting and interacting with people has drastically changed.

LinkedIn provides a similar experience for our professional lives, while Amazon and Netflix seemingly know what we want to buy or watch before we've even thought about it.

This has created a unique experience where the customer feels as if they have a close relationship with the platform provider, despite being one of millions of people all benefiting in the same way.

Within the hedge fund space, one of the most important client experiences for any manager is the prime broker(s) they appoint

to the fund. All primes are different and excel in some areas – electronic trade execution, cap intro, research, hard to access stock inventory, competitive finance costs, etc – better than others. But with today's new and emerging managers, who have grown up with the Internet, they now expect superior client support and transparency more so than they did a decade ago.

Prime brokers are very mindful of this. Alexia Weiller is Global Head of Prime Solutions, Societe Generale Prime Services. She says the bank's 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."

One global market neutral multi-strategy shop that *Hedgeweek* spoke to runs a fund portfolio that comprises multiple different sub-strategies with different accounts and is well aware that some PBs treat asset classes better for margin relief than others.

"We therefore look to see how we can leverage one PB who might be better in fixed income compared to another PB who might be better in international equities, or one that can provide better intraday leverage for day trading. There are different leverage levels



*"Post the financial crisis, hedge funds started diversifying and using multiple prime brokers and I think the playing field has levelled out today, in terms of quality."*

**Alexander Kalis, Milltrust International**

depending on the nature of the instruments being traded so leverage and pricing is an important consideration.

"Another big driver for us is knowing what the cap intro resources are. As we allocate to underlying sub-strategies, we find it useful for cap intro teams to send us suggestions for traders we should look into as well as make investor introductions," they say.

Alexander Kalis is Managing Partner and Head of Investments at Milltrust International LLP, an institutional allocator based in London and Singapore, which currently manages a range of specialist emerging market-focused fund products. Speaking with *Hedgeweek* on how he thinks about prime brokerage relationships when allocating to managers, he says that prior to the financial crisis, he would take into account the calibre of the PB a lot more than today because managers typically used a sole prime.

"Post the financial crisis, hedge funds started diversifying and using multiple prime brokers and I think the playing field has levelled out today, in terms of quality. Most primes are on par now in terms of their offering to managers and investors," says Kalis.

Expanding on the comment regarding the importance of cap intro teams, from Kalis's perspective as an investor in hedge funds, he thinks there is less enthusiasm and corporate support because a lot of these teams simply do not have the budgets or resources they once had. "It's become more commoditised and there's been a lot of turnover in cap intro teams over the years," he says.

"A lot tends to fall through the cracks, possibly because they assume investors won't be interested, which might not be the case. I now find myself having to do a lot





more of my own research. It helps that there are technology fund platforms available that help bridge the gap.”

Milltrust invests mainly in emerging markets and Asia Pacific-based fund managers which tend to be smaller in AUM, on average, compared to their US and European counterparts. Kalis understands that they might be too small for tier one prime brokers to justify using up their balance sheets and believes that managers are now more open-minded to working with specialist primes. Ultimately, there has to be a right fit, not just from an economic perspective but a cultural perspective.

“Emerging market strategies tend to be more long-biased for structural reasons and it means that primes get less revenue because they aren’t shorting as much as US or European hedge funds.

“Banks don’t have the budget or the bandwidth anymore. Their PB teams are getting smaller and they are trying to do more with less. The PB business has always been something of a cost centre. Now, with the multi-prime model being used by

managers, it’s harder for PBs to get the same bang for their buck,” argues Kalis. “The timing is right for something to disrupt and improve the existing PB model.”

Speaking off record, another hedge fund manager tells *Hedgeweek* that although they trade frequently with their PB, and therefore generate a lot of commission dollars, they do not receive capital introduction support because of their size:

“We understand that they can’t really do anything about it – it is a resource constraint for the bank. Given our size, however, the fact that we have a relationship with a tier one prime is very helpful. As an emerging manager, we regard ourselves as being lucky that we are able to work with one of the industry’s top brokers but we understand the fit with cap intro might not be there.

“What we value most is the pedigree of the prime.”

This suggests that in the early years of growing their fund AUM, some managers still highly value the kudos of a tier one prime, even if the overall quality of the client experience is less than optimal.



Smaller funds place a lot of emphasis on wanting to partner with bulge bracket primes because they think it has marketing value but in reality, investors don't care too much.

"The risk to these managers is that they might get squeezed out. I've seen that happen," says the multi-strategy manager.

Multi-strategy hedge funds are in many respects, ideal clients. They might be market neutral, use leverage, do a lot of shorting, and perhaps have quantitative strategies in the portfolio that do a lot of trading.

"Therefore, making sure we are giving enough wallet to each of our primes is not too much of a concern for us. At the moment we have counterparty relationships with six PBs. One or two have less exposure to us at the moment but they are happy to grow with us. That's why getting the right relationship in place is so important," says the multi-strategy manager.

Over in Palo Alto, George Sokoloff is the Founder and CIO of Carmot Capital LLC, a sophisticated statistical arbitrage hedge fund that uses cutting edge deep learning algorithms to trade US equity markets. Over the last five years, he says that the ability to partner with a global PB has been hugely



*"One of the things that the big primes bring to the table is a variety of algorithms and good electronic trade execution options."*

**George Sokoloff, Carmot Capital**

important because Carmot's investment strategy relies on extremely high quality trade execution; something that a smaller PB might not necessarily be able to offer.

"Although we are a sub-USD100 million fund, we are trading a lot. In terms of gross trades, it is around USD2 billion a year so commission levels are extremely important, as is the quality of execution. We look closely at how well the PB handles our trades, how much slippage there is, etc.

"There are many aspects to the relationship so I wouldn't want to overemphasise one over the rest," says Sokoloff.

He says that the fund does not rely on the prime broker to provide any research services and believes that one of the reasons the relationship works well is because the strategy is quite unique and uncorrelated with most things on Wall Street.

"That appeals to them from a fundamental growth perspective.

"One of the things that the big primes bring to the table is a variety of algorithms and good electronic trade execution options. We've been very happy with the variety of algorithms our prime broker has been able to offer," concludes Sokoloff.

There are many different aspects that constitute what makes a good PB relationship. Ask 100 different hedge funds and you'll get 100 different responses.

What remains clear, however, is that while PBs scale back resources in some areas like capital introduction, new technology platforms will continue to step into the breach to improve the way fund managers connect with investors.

It wouldn't be surprising if some of the banks acquire technology groups to bolt on to their prime businesses over the coming years. ■





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# Bank-owned primes set to contract

Interview with Gavin White

Regulation continues to bite and influence the way investment banks structure their business activities. Most notably for the hedge fund industry, the banks are being forced to reassess their activities pertaining to prime brokerage. Five years ago, banks remained in denial about the impact regulatory reforms would have. But then a black swan event occurred.

On 15th January 2015, the Swiss National Bank decided to de-peg the Swiss franc from the euro, sending the markets into turmoil and leaving a trail of casualties. Within a twenty-minute period, between 9.30am and 9.50am UK time, the CHF went into hyper drive, appreciating almost 30 per cent as it pulled away from its three-year peg at 1.20 francs per euro to reach 0.85 before falling back close to parity.

"Suddenly, overnight, FX became a much more volatile asset class," says Gavin White, CEO of Invest Global, a subsidiary of Japanese listed Invest Securities Co Ltd. Employing a prime-of-prime model, Invest leads the industry in the provision of multi-asset high-quality, non-bank Prime Services. "Since the Basel capital requirements are weighted according to the "risk" or "volatility" of the asset class, the banks were forced overnight to take the Basel requirements seriously with regard to their FX-related activities, particularly FXPB."

Basel III aims to strengthen banks' balance sheets (by increasing liquidity) and decrease the amount of leverage. Leverage constraints are forcing bank-owned primes to focus on finding efficiencies in terms of how they use balance sheet for securities financing, both long and short. While new metrics, such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are requiring banks to think carefully about how they deploy assets to fund their PB clients.



Gavin White, CEO of Invest Global

It is White's contention that while FX PB was the first to reel from the effects of regulation, leading to the offboarding of thousands of smaller clients (including hedge funds) as banks focused on those who offered clear economic value – benefiting Invest Global and other non-bank primes – the industry is about to go through a second wave of contraction. One which will see bank PBs reduce their activities in *all* asset classes now that the Basel reforms are more clearly understood.

"Our business has tripled this year alone. This shift is happening but it still has a long way to go. It is our view that the banks are going to be significantly constrained in their activities for, potentially, many decades to come," comments White.

He says that Invest Global has been winning clients thanks to its ability to



commercialise small and medium-sized clients that the banks cannot.

"We are nimble and focused. Specialists in our field. We utilise technology to ensure our service is cost-effective and bespoke for each client. We don't have the overheads of the global banks, nor the organisational complexities. Importantly, we don't attract the regulatory burdens of the banks. We are filling a vacuum in the industry, which we take very seriously. It is the small/medium managers that form the foundation of a healthy hedge fund industry. If this segment is left out in the cold, they won't have the access and facilities to grow into the industry leaders of tomorrow."

Assuming White is correct and that more contraction takes place in the banking PB arena, this will create a lacuna in the marketplace for non-bank institutions to capitalise on, who are not constrained by the likes of Basel III.

To that end, Invest Global is aggressively growing its PB business beyond purely FX, to support clients in a multi-asset capacity, including Metals, Commodities, global Equities and Futures.

"We intend to move into many other activities the banks are being forced to withdraw from," says White. "There are numerous business lines within the global investment banks which are being disrupted. Clearing, Execution, Facilitation, Research, Reporting, Cap Intro ... the list goes on. It will be interesting to see how things shake loose. We have built a specialist brokerage model that aims to benefit from these changes."

To quantify the effects of regulation, a recent [white paper written by Quinlan & Associates](#) estimates that over USD13 billion in revenues has been off-boarded by the top 15 global banks alone since 2014, as a result of culling what they refer to as 'tail clients'; these include corporate clients as well as hedge funds, asset managers and family offices.

The paper argues that "we believe many banks have also become rather short-sighted in their strategic objectives by ignoring a sizeable and fast-growing fee pool of tail accounts", as they look to focus more of their resources on a small percentage of high value, high revenue clients.

This is good news for non-bank primes who are very happy to win new client

business, providing them with market liquidity and ancillary services many simply do not get with Tier 1 primes.

White views the current situation as history repeating itself.

Almost one hundred years ago, following the Great War, banks invested heavily in the stock markets as Europe sought to rebuild. As more money flowed in, and the banks made increased profits, confidence grew and they developed and distributed complex structured products. Then, in 1929, the stock markets collapsed, there were runs on the banks and subsequent liquidations. Mums and Dads lost life savings as banks closed their doors across the US. And then the Great Depression set in.

Public outcry resulted in the implementation of the Glass-Steagall Act, where the US sought to separate the activities of commercial banks from those of investment banks. Most investment banks chose to operate as commercial banks, and in their place, non-bank behemoths emerged: Goldman Sachs, Merrill and so on.

But over the decades, the GSA was steadily chipped away, culminating in a repeal by the US Congress in November 1999. The door was thrown open for commercial banks to ride the coat tails of investment banks and before long, they were engaging in financial engineering, trading CDOs and other complex derivatives for short-term gains. The same confidence as that seen in the '20s led to greater risks being taken - including by investment banks like Lehman Bros, which ended up leveraged to the hilt - and culminated in the '08 Global Financial Crisis.

Now, banks are facing the same fate as the GSA in 1933, as they adjust to life under Dodd-Frank, Basel III, MiFID II. The screw is turning, and prime brokerage activities have become more restricted as a result.

Asked how he sees the next few years playing out as the prime brokerage model continues to evolve, White responds: "There will be some big winners in the non-bank prime services space. The Investment Banks of the future are being spawned right now. But they will be a new type of business. Lean, focused, utilising latest technologies to provide better, cheaper services. It is an exciting space." ■



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# Growing prime services with an eye on sustainability

Interview with Stuart Bloomfield

The last thing any hedge fund manager wants is to be off-boarded by a Prime Broker. It can be a destabilising and unsettling experience, potentially leading to a loss of confidence among investors. It is vital, therefore, to find the right Prime Broker that can partner with a manager based on a clear understanding of business wants and needs.

This is especially true in today's regulatory environment where Basel III has caused banks to carefully consider their short-term and long-term liquidity positions and transform their businesses. In many ways, this has reshaped the Prime Brokerage relationship, making efficiencies and returns more important than simple revenue measures.

Stuart Bloomfield, European Head of Prime Services Sales, Scotiabank, recalls a time when revenue was the only industry metric, but adds that product expertise and funding efficiencies are now prioritised. Finding a bank focused on a particular piece of business is now more important when adding a Prime Broker.

"Prior to the financial crisis, most institutions had fewer constraints on the financial resources they deployed. Since then, regulation has helped to create a more level playing field. Financial institutions have become more attuned to maximising their returns on financial resources," says Bloomfield.

New regulations have prompted Prime Brokers to reevaluate their hedge fund relationships and quantitatively understand exactly how much balance sheet and capital they consume. Those not meeting thresholds



Stuart Bloomfield, European Head of Prime Services Sales at Scotiabank

have been culled by some bulge-bracket Prime Brokers, as they chose to focus their efforts on the biggest clients or those with broadest product reach. A recent report by **Quinlan & Associates** attempted to quantify the impact of regulation. It estimated that the off-boarding of what it terms 'tail clients' has reduced revenue by USD13 billion among the top 15 global banks.

"Thinking about the survey results, the revenue among the historic bulge-bracket Prime Brokers has probably dropped, but so have the financial resources they allocate to the business line," suggests Bloomfield.

"If you look at the returns on financial resources across those Prime Brokers, they've likely risen. Regulation has forced banks to be much more focused on return on capital."

Some clients, and therefore revenues, might have been exited but the industry has seen the emergence of a number of mini primes that have taken up those tail clients.

Of course, one of the risks for traditional bank-owned Prime Brokers who cull hedge fund clients is that they do so without holistically understanding their economic footprint. Legacy technology and siloed businesses, where equities, rates and FX teams work independently, can make it hard for a Prime Broker to know the true value of a client. They might, in other words, be taking revenue off the table for no good reason.

This is providing an ideal platform for banks like Scotiabank, with its strong heritage of supporting clients in North America and Latin America. Bloomfield says that one of the key ingredients for building



a strong relationship is for managers not to make assumptions about the competencies of an incumbent or potential Prime Broker. While Scotiabank is well known in North America, it is impressing existing and new clients with a strong product offering in Europe and Asia.

"More and more, people are focusing on specialist Prime Brokers and our strengths in Canada, Latin America and financial resources, whether it be our credit rating, or our Tier 1 capital ratio, which are very strong on a global comparison, have allowed us to disrupt incumbent Prime Brokers.

"Our global Prime Brokerage business continues to evolve and Europe, Asia, Latin America and the US continue to grow, complementing our Canadian business. We have a healthy pipeline of managers who have either joined us in the last couple of years or are in the process of doing so. While our primary purpose is to help North American managers in Europe and Asia, we are also focused on finding opportunities with local managers that fit well," says London-based Bloomfield.

To that end, Scotiabank's mission is a simple one: to target the world's 300 largest hedge funds. Not to act as the sole Prime Broker, but to play a key role in a multi-prime relationship. The reason for focusing on the largest asset managers in the industry, says Bloomfield, is because "we want the relationship to provide various touch points to the bank and develop partnerships that can endure for a very long time".

Just as fund managers need to think long and hard about whom they should appoint as their Prime Broker, likewise Scotiabank thinks very carefully about whether a client will be a good fit for the bank.

As Bloomfield intimates, most decent sized hedge funds will have more than one Prime Broker "so you need to find a mix of complimentary strengths. Managers don't need three or four Prime Brokers, all of whom offer the same strengths. Rather there is a need to create a diverse pool of Prime Brokers who are strong in different areas; maybe one has expertise in capital introduction, one in fixed income, one is better at global equities and one has a strong sustainable story, with a strong credit rating and capital ratio.

*"As a business, we've been able to demonstrate that our efficiencies and returns have improved as we've grown over the last few years. We will continue to remain thoughtful as to how we grow in future. Sustainability is key to what we do."*

**Stuart Bloomfield, Scotiabank**

"You need to understand your client's strategy and be able to plan for the long term. Rarely do you finish where you start out. If we identify a global manager that has great potential to stretch across regions and other products in the bank, it would not be uncommon to start with a single piece of business and prove our worth before broadening the relationship."

Scotiabank's principal strength is to partner with equity-linked hedge fund strategies. One important development for its European business is the imminent launch of Direct Electronic Access, which Bloomfield says should go live in Q4: "Direct Electronic Access will unlock our capabilities to partner with systematic equity managers trading Europe, whether they're located locally or from other regions."

Today's Prime Brokers have to pay more attention to each hedge fund client and enter into open and honest dialogue. As such, banks are looking to improve their technology stance to get a global and cross-markets view of attribution on a client-by-client basis. In Europe, some banks have taken a very inconsistent approach, making knee-jerk decisions to dial down their Prime Brokerage activities because of balance sheet constraints, only to then dial their activities back up, as more balance sheet becomes available.

This isn't helpful to hedge funds that need to know they have a stable relationship where the rug isn't going to be pulled from under their feet. This is something that Scotiabank is very mindful of.

"As a business, we've been able to demonstrate that our efficiencies and returns have improved as we've grown over the last few years. We will continue to remain thoughtful as to how we grow in future. Sustainability is key to what we do," concludes Bloomfield. ■