

CAPCO

OUTSOURCED TRADING: WHO, WHAT & WHY NOW?



Outsourced trading demand is increasing as investment firms look to reduce costs, satisfy regulatory demands & expand into different markets. For those offering, it is an opportunity to gain extra revenue leveraging their existing platforms.

In this paper, we share why a growing number of firms are looking to use and provide outsourced trading as a service, the key trends emerging, market offerings and providers, and ten takeaways from Capco's experts.

WHAT IS OUTSOURCED TRADING?

Outsourced trading (OT) is when a firm provides trading services e.g. trade execution, research, middle office activities, access to international markets to other firms, such as investment managers and hedge funds.

There are typically three main reasons why firms buy this service:

1. **Cost saving:** due to higher trading costs and lower revenues, firms are using OT to reduce the typically high costs of trading (such as IT, personnel, etc.) as well as moving to a variable or on- demand cost model.

2. **Satisfy regulatory demands:** OT providers can manage regularity requirements such as MiFID II.
3. **Access to trade support:** the access to 24-hour markets, a wide broker network and larger liquidity pool & access to international markets are all compelling reasons to use OT.

On the other side of the coin, selling outsourced trading as a service **provides scalable revenue**, allowing providers to leverage existing infrastructure and connectivity, and **creates more opportunities for cross-selling**, giving OTs the ability to sell other products parts of the firm to fund managers.

Key components of outsourced trading

- Global market reach
- Defined corporate structure
- Research capabilities
- Execution capabilities and trading tools
- Conflict of interest capability
- Anonymity vs. attribution capability
- Extensive broker networks
- Commission sharing agreements.

Three emerging trends

1. Increased demand for outsourced trading as investment firms look to reduce costs
2. From research, additional items are attracting firms to outsource, such as enhanced trade support, access to international markets and wider liquidity pool
3. Larger established firms are now offering the service to further monetize their existing platforms and cross sell different products or services.

KEY COMPONENTS FOR AN OUTSOURCE TRADING OFFERING:

Solutions can range from completely outsourcing all trading and analysis, to on-demand items, such as research and risk analysis, to handling overflow or providing coverage when in-

house traders are not available. The key benefit is that optimal outsourced trading is customizable to the needs of the client.

Key Components for an Outsource Trading offering:



Global market reach

- Traders placed across the world providing access to different markets
- Extensive broker network for varying expertise of local markets
- Access to Foreign Exchange, Commodities, Futures & other security/asset classes
- 24-hour staffed trading desks for specific markets and products.



Corporate structure

- Ideal offering prioritized by the provider, rather than secondary to Research, Investment banking or prime brokerage.



Research

- Extensive product and market research to support clients' trading strategies
- Reporting/tracking capabilities attributed for research credit with other brokers.



Execution Capabilities and trading tools

- Advanced trading tools (i.e. execution management systems, transaction cost analyses), to cater to varying clients, from small funds to institutional investors
- Additional tool offerings such as daily reconciliation, managing/calculating trade data, realized and unrealized P/L, real-time orders, investment book of records, and portfolio performance.



Eliminate conflict of interest

- Establish outsource trading desks separately from the provider's other trading functions to reduce potential conflicts of interest within the firm, especially for providers involved in proprietary Trading.



Anonymity vs. attribution

- Allow the client to decide whether the OT desk is trading on an attributed basis or anonymously.



Extensive broker networks

- Extensive broker network that are able to generate the most liquidity for trade execution/order prices.



Commission sharing agreements

- Provider should offer extensive commission management, including attribution, aggregation, technology, and reporting.

Customization examples

Exclusive high-touch trading

- Original (and most simplistic) form of outsourced trading. One trader provided for executing all trades. Additionally provides general portfolio monitoring, market color, and limited research

Full-Service outsourced trading

- Client is assigned an outsourced trading desk responsible for trade, commissions, and soft dollars. The desk manages any necessary third-party broker relationships, in addition to providing market color and research of its own
- Integrates client technology and provides aid in the budgeting process

Enterprise outsourced trading

- Includes customized solutions or technology such as order, execution, or payment management systems integration with the client's own technology, in addition to full-service trading and the possibility of having a trader reside in the client's office.

Typically, smaller hedge funds and investment managers outsource trading to a brokerage firm. However, research suggests 20 percent of firms with over \$50 billion assets under

management may begin outsourcing some or all their trading within the next two years.¹

1. "Outsourced Trading: Helping the Buy Side Improve Execution and Enhance Operational Efficiency", Greenwich Associates Report, December 2018.

Reasons firms <u>buy</u> outsourced trading services	Reasons firms <u>sell</u> outsourced trading services
<p>Cost saving</p> <ul style="list-style-type: none"> • High trading costs and shrinking commission revenue (clients buying more passive investments/ETFs) have larger IMs considering outsourcing • Between 2009 & 2018 US equity research commissions reduced from \$7.8b > \$4.3b • Jones Trading found firms with <\$50 million AUM may face in-house trading costs of nearly \$375k per year vs outsourced costs of between \$25k and \$150k. Even firms with \$1b+ AUM could realize trading cost reductions from \$1.18m originally, to \$1.05m • Typical fund-level expenses of trading desks: OMS, Bloomberg, Market Data, Research, Real Estate, HR, Compliance, salary, taxes • Opportunity to transition fixed costs to variable, ability to resume/cancel service at will • Remove counterparty management as a task and allow PM to focus on clients/ portfolio. 	<p>Firms have been offering due to increased demand in recent years</p> <ul style="list-style-type: none"> • Many large financial institutions (Jefferies, State Street) with existing trade infrastructure and extensive broker networks see outsource trading as an extremely scalable additional revenue stream that without significant investment required, especially with the rise of more advanced trading technology/algorithms catering to individual clients' needs • Trends in regulatory burdens, decreased commission revenues, and constant changes in technologies have pushed demand for Outsourced Trading • Though startups/smaller firms had occupied the space traditionally, larger players like Wells Fargo have recently joined the market • Opportunity to cross sell products (e.g. OTC, Commodities, FI) to investment managers who may need a wider product set or traditional PB services such as financing. Much like PB, OT offers platform to open up the rest of bank to a new client base.
<p>Regulatory demands (MiFID II)</p> <ul style="list-style-type: none"> • EU regulation that requires firms to unbundle, separating payments for research & execution/trading services – therefore pushing firms to pay for their own research and outsource trading purely for execution purposes • Outsourced trading offerings have been able to assist clients in becoming fully compliant or take on all reporting and monitoring responsibilities for trade executions. 	<p>Risks</p> <p>Conflict of interest</p> <ul style="list-style-type: none"> • Large investment banks that provide research, banking, and prime brokerage services in addition to outsourced trading services could potentially be competing/trading against their own OT client base • Control over order flow: how the outsource trading desk will route the orders for execution • Firms could potentially be paying more for an order
<p>Trade support</p> <ul style="list-style-type: none"> • Firms can buy research, access 24-hour trading (key advantage for clients without 24-hour desks, entry into global markets), or for broker networks/ liquidity for higher quality execution <p>International investment</p> <ul style="list-style-type: none"> • Providers can assist in complying/reducing costs associated with global regulations/markets (Greenwich Associates survey indicated that international regulation & varying market expertise were important to 51% / 44% of respondents who had outsourced) • Gaining access to other asset classes (firms specializing in equity or fixed-income trading may seek outsourced trading to learn about derivatives trading). 	<ul style="list-style-type: none"> • Examining provider's SEC 606 disclosure document can reveal whether provider is taking financial incentives from clearing brokers that may negatively affect order price for the client. <p>Information leakage - potential risk exposure of a firm's trading strategy/financial information</p> <p>Other</p> <ul style="list-style-type: none"> • Generally, what level of control & risk are firms willing to extend outsourced traders? In terms of primary revenue streams, does it make sense to outsource those trading desks? How do firms interested in OT intend to vet their providers? • Brand & relationship management risk – some clients may view OT activities as an act that nullifies the value that the asset manager provides.

WHAT NEXT?

Outsourced trading has risen in popularity due to demand, namely from hedge funds who have been under increasing cost pressures but with a wish to scale-up their business operations. We believe this trend will continue, especially given the tough economic conditions arising from the pandemic.

Ten key Capco takeaways:

1. As technology, transparency and service convenience increases, outsourcing is becoming more widely adopted to support core hedge fund strategies (not just smaller funds).
2. Size of the revenue for industry from offering unknown, although there are some estimates.
3. For an established prime broker, it makes sense to offer only if core hedge funds request.
4. Established players could look to grow revenue from their existing client base as more services are used and volumes increase.
5. For those offering outsourced trading, there is an opportunity to cross sell other products to investment managers, e.g. OTC products, financing, etc.
6. As outsourced trading matures, scale and credibility grows, larger hedge funds, especially with working from home being the norm, could start to outsource more middle office functions
7. Shifting key activities such as trading and operations and even research is a mindset change.
8. Whilst advantages such as cost reduction and a move away from fixed costs are clear, advantages such as anonymity, capacity, liquidity and access to niche markets (that wouldn't justify a full-time headcount) may continue to attract larger funds.
9. Providing the OT service would not be a trivial investment for firms. With a need to establish 'Chinese walls' between certain business units, updated policies and procedures as well as IT change will be required.
10. Firms interested in migrating to an OT model may need help shifting their traditional middle/back office functions to the offering firms, which may require additional resourcing to make happen.



KEY FIRMS

Over the years, outsourced trading has particularly grown in the biggest of international financial centers but has particular presence on both the West and East Coast of the United States. Below, we detail the key market players today.

Firm	Located	Detail
BTIG	San Francisco, CA	<ul style="list-style-type: none"> Formed in 2004 - Bass Trading, Baypoint Trading merger 30 traders 24-hour coverage Locations: New York, Dallas, San Francisco, London, Hong Kong, Sydney, Singapore Trade-Execution services separate from prime brokerage Hired Vincent Cutaia from Cowen (Sep 2019) to expand reach among fund managers and family offices on US West Coast.
Capital Institutional Services	Dallas, TX	<ul style="list-style-type: none"> Global trading capabilities in Equities, Derivatives and Fixed-Income securities Works with clients through entire trade lifecycle <ul style="list-style-type: none"> Research, execution, post-trade compliance, commission management Also advises clients on outsourcing middle and back-office functions.
Celadon Financial Group	Chatham, NJ	<ul style="list-style-type: none"> Known as a “mini prime broker” 30+ years offering trade execution services to family offices and Institutional Investors Support strategies: <ul style="list-style-type: none"> Long/short equity, equity market neutral, high frequency trading, volatility arbitrage Wide-range access of Fixed Income instruments Dedicated Options desk Ability to execute complex trades.
CF Global Trading	New York, NY	<ul style="list-style-type: none"> Offers customized, broker-neutral execution services Co-founder Chace began trading career at Tiger Management Clientele include hedge funds, traditional asset managers, pension funds Locations: New York, London and Hong Kong 330+ counterparties network 50+ electronic exchange connections Recently added listed Derivatives, Fixed-Income trading Ability to operate as either: <ul style="list-style-type: none"> Extension of a fund’s own trading desk Fully dedicated service; no additional fixed costs or operational risk.
Cowen	New York, NY	<ul style="list-style-type: none"> Serves 175+ investment managers globally 34 traders Support staff in New York, Stamford, Conn., Atlanta, San Francisco, London and Hong Kong Global prime brokerage co-heads (Michael Rosen, Jack Seibald) - US outsource trading head reports to them.
Dalzell Trading	Boston, MA	<ul style="list-style-type: none"> Markets itself as conflict-free independence Experienced traders (relative to prime broker and bank competitors) Founded in 2018 by Dave Dalzell (Trade-execution specialist / former head of Equity & Options Trading at BlackRock) Provides transaction cost analysis <ul style="list-style-type: none"> Simple fee structures Offers free advice on best execution policies and practices Clients include Disciplined Alpha.
Jefferies Group	New York, NY	<ul style="list-style-type: none"> Nine traders (NYC, London) Outsourced trading unit established in June 2018 <ul style="list-style-type: none"> 100+ clients added since Half of clients are emerging managers that also use Jefferies as a prime broker Clients gain access to Jefferies research Recently rolled out all European trading for cash and swaps In process of building an Asia office.

Firm	Located	Detail
Jones Trading	Westlake Village, CA	<ul style="list-style-type: none"> • 75 clients+ (up from only a handful from 2015 inception) • 15 traders covering U.S. market, 3 focused on Asia, 2 on Europe • Two additional Derivatives traders • Desks in Boston, Chicago, Dallas, London, Los Angeles, New York, San Francisco and West Lake, CA.
Meraki Advisors	Park City, UT	<ul style="list-style-type: none"> • Launched in May 2019 by former Goldman Sachs trader Arnold • Clients include hedge funds, private equity funds, family offices and other asset managers • Trading expertise in global equities, credit and foreign exchange across strategies including fundamental and systematic equity, arbitrage, distressed debt and global macro • Headquartered in Park City, UT; New York and Hong Kong office openings planned for Q4 of 2020.
Northern Trust	London, UK	<ul style="list-style-type: none"> • Formed outsourced-trading unit in September 2017 following acquisition of Aviate Global • 60 clients: mostly long-only shops, but also works with hedge fund managers (Lucerne Capital) • Provides execution services <ul style="list-style-type: none"> • Additionally works with clients' middle office to match/settle trades, coordinate with custodians • Emphasizes willingness to work with custodians other than Northern Trust's own custody unit.
Outset Global	New York, NY	<ul style="list-style-type: none"> • Founded in 2012 <ul style="list-style-type: none"> • NYC headquarters since 2019 (previously in London) • Focuses exclusively on trading; provides 24-hour coverage • 10 global equity traders • 120+ clients <ul style="list-style-type: none"> • Family offices, emerging managers large hedge fund operations, multi-billion dollar institutions.
State Street Corporation	Boston, MA	<ul style="list-style-type: none"> • Founded outsourced trading unit in 2010 • Provides execution across equities, Fixed Income, exchange-traded Derivatives, Foreign Exchange • Additional services: <ul style="list-style-type: none"> • Middle office integration, commission management, analytics, reporting • Investment decision support tools offered through firm's front-to-back platform (State Street Alpha).
Tourmaline Partners	Stamford, CT	<ul style="list-style-type: none"> • Founded in 2011 • Team of 30 traders - average 15+ years' experience • Trading desks in London, Sydney and Stamford, CT • Offers 24-hour buy-side execution across Equities, Derivatives and ETFs worldwide • 400+ clients ranging from startups to firms with more than \$100 billion of assets <ul style="list-style-type: none"> • Hedge funds, mutual funds, family offices, sovereign wealth funds and financial advisors • Provides tools for research, commission management and other trading functions.
Wall Street Access	New York, NY	<ul style="list-style-type: none"> • Independent firm - focused primarily on executing trades for institutional clients • Team of 20 traders • Serves 100+ hedge funds • Founded in 1981 (Wall Street Clearing Co.).
Weeden Prime Services	Greenwich, CT	<ul style="list-style-type: none"> • Formed execution business in 2015 (Weeden & Co.'s prime services unit absorbed trading firm Greenwich Prime) • Caters to small and mid-size hedge fund managers • Parent company acquired by Piper Jaffrey (2019) <ul style="list-style-type: none"> • Prime services unit remains independent • Led by investment veteran David Staudinger <ul style="list-style-type: none"> • Joined Weeden in 2013.
Wells Fargo	San Francisco, CA	<ul style="list-style-type: none"> • Originally Merlin Securities (mini-Prime Broker) <ul style="list-style-type: none"> • Wells Fargo acquisition in 2012 • 6 traders • Touts robust technology infrastructure including transaction cost analysis • Clients gain access to prime-brokerage resources including: <ul style="list-style-type: none"> • Business consulting, capital introduction, risk management and investor reporting.
Williams Trading	Westport, CT	<ul style="list-style-type: none"> • Founded in 1997 to handle trading for Tiger Management spinoff <ul style="list-style-type: none"> • First independent outsourced-trading shop • Offers 24-hour coverage for developed, emerging and frontier markets • Compensates traders based on client satisfaction <ul style="list-style-type: none"> • Rather than trading volume • Partnership with Cowen to offer securities-lending services to large hedge funds <ul style="list-style-type: none"> • Formed in 2019.

For more information about outsourced trading or our global prime brokerage practice, please contact us.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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