

Newedge Group

Leading Prime Broker for Derivative-Based Strategies

BILL McINTOSH

The launch of Newedge Group in 2008 as a joint venture between Societe Generale and Credit Agricole reflected an ambitious move to build a global broking powerhouse. In prime brokerage, Newedge is a leader in derivatives-based strategies and has gone on to find success in building out the franchise to equities, fixed income and FX.

A recent interview with Philippe Teilhard, global head of prime brokerage, focused on key features of the firm's independent agency brokerage model and its capital introduction service for hedge fund managers. The discussion extended to new developments in the marketplace affecting alternative fund managers and prime brokers, not least the rapid growth of onshore UCITS funds adopting hedge fund strategies. Jonathan Cantouris, EMEA head of Origination and Structuring in prime brokerage, and Andrew Dollery, Origination and Structuring for UCITS funds, also participated in the interview.

The key principle that underpins Newedge is its organisation as an independent agency broker. In investment banking this means it has minimal proprietary trading activities. Thanks to the Dodd-Frank Reform Act's clamp down on prop trading among the leading investment banks, the agency model has been powerfully vindicated.

"Right from the beginning we had to find a business model which would be orthogonal to the investment bank-prime brokerage offering," says Teilhard. "Everything in the genes of Newedge is about managing conflict of interest better and trying to manage our fiduciary duties and help those of our clients better. We want to demonstrate through the corporate set-up that we have our own governance and are independent. We want to show

that Newedge is a conflict-free place to do business and clients don't run the risk of their investment strategies being copied or taken advantage of."

Transaction revenue model

The revenue streams that Newedge collects come from fees based on customer transactions. It doesn't trade on behalf of its own account. With the fallout from the financial crisis and new regulation, Newedge is well positioned. So far, other investment banks are still putting proprietary capital in play amid widespread uncertainty about how they may be compelled to move away from the trading model and adopt a more customer-driven business approach. The only time Newedge is a counter party to clients is on a back to back basis where for confidentiality or credit reasons a client doesn't want to access the market, but instead buys over-the-counter from the bank. Even in this case Newedge would have transacted for the client at best price and charged a fee for doing so.

"We try to provide clients with the biggest operational comfort possible," says Teilhard. "We try to make sure clients benefit from all our investments and our offering is as competitive as possible. It is geared to being an access product as opposed to a trading product. The job of Newedge is making sure everything is impeccable in terms of the operational risk. That is how the prime brokerage business is positioned. We believe it is the appropriate model for this industry and it has a good tailwind."

Expanding to new locations, including China, India, Dubai, Korea, and covering high growth markets such as Russia, Turkey and Brazil is about more than providing access to frontier markets. It is, crucially, about seeking to provide clients with market opportunities, but with the same operational comfort they enjoy in more mature trading centres. The overriding aim is to make sure that operational risk is minimalised in whatever trading format a client wants to use. This extends to the demand among some hedge fund clients for specialised high frequency trading and the ultra low latency market access it requires.

Rooted in managed accounts

What further typifies the Newedge approach is that its prime brokerage business is rooted in servicing managed accounts. It means the firm has focused on offering access to hedge fund return structures to investors wanting these very specific return characteristics. Indeed, half of the Newedge prime brokerage business remains managed accounts.

"This is the core of the prime brokerage business," Teilhard says. "We have been doing that for a long time. With this investors access hedge fund returns directly through the managed accounts

they open with Newedge and they give trading authorisation to the hedge fund manager of their choice who manages their account *pari passu* with the manager's benchmark fund. That is the type of access product we specialise in."

A global structure

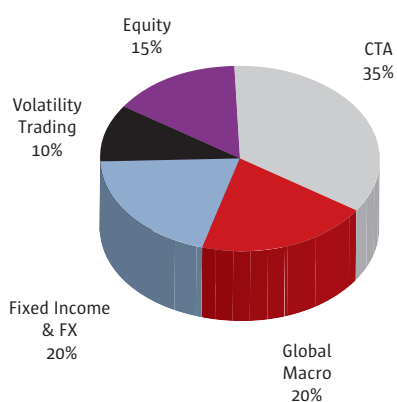
Creating Newedge from scratch in 2008 helped the firm rejuvenate its range of services and clarify the service proposition to clients using a global structure to realign the legacy teams. Except for regulatory purposes and oversight, the former geographic based teams in Europe, Asia and the Americas were melded into one global team with the business operation having a mandate to project clients more effectively around the world (see Fig.1 for a breakdown of hedge fund clients by strategy).

Within prime brokerage, Newedge built teams around five functions. First, hedge fund research provides investors with information, topical research and quantitative analysis so as to support their manager selection work. This underpins a second function: the activity of a global capital introduction team whose physical presence stretches from San Francisco to Hong Kong with representatives in Chicago, New York, London, Geneva, Dubai and Singapore. A third team focuses on origination and structuring. It looks to understand the client requirements and develop structured solutions for them. The fourth team is transition and relationship management, running client on-boarding and day to day relations with hedge fund clients. This team is the interface between Newedge support and control and the stakeholders in the fund structure such as auditors and administrators. The fifth team is advanced trading solutions. It is responsible for everything from low touch to no touch market access worldwide on equities and listed derivatives across trade monitoring and mitigation, stock loans, and the provision of algorithms to clients.

With that footprint Newedge probably doesn't need to make a transformative acquisition. Teilhard, for his part, says, "We never say never" but seems more focused on building on these strong foundations and exploiting the momentum Newedge has gained from its independent agency model.

"Right now we have a very clear plan on how to grow our business organically," he says. "I think Newedge is a good place for attracting people. They like our story. Why would you want to buy a whole business when you can basically incentivise people to join the firm and develop the business together? We are actively recruiting people, particularly in America, where Newedge is under-represented in the prime brokerage space. Even though Newedge is very big in its core businesses – futures, OTC and equities clearing and execution – in prime

Fig.1 Breakdown by strategy Source: Newedge



brokerage, we are nowhere near where we want to be.”

Open architecture

The key benefit to hedge fund clients of Newedge’s open architecture model is the way it minimises operational risk (see Fig.2). Offering managers the ability to plug into a highly variable arrangement of service providers also minimises disruptions in their businesses.

“Having an open architecture model and the flexibility that allows managers to use the stake holders they need to successfully run their business is a big benefit,” says origination and structuring head Cantouris. “Open architecture gives managers the ability to access a suite of different services that we offer. Open architecture also allows managers to execute transactions with a number of different counter parties. In that respect, acting as a central hub, offering a suite of different services, managers can chose which executing brokers or liquidity providers they can transact with which is important to getting best execution for their funds.”

In addition, the centralised hub allows managers to run all of their trading and clearing though one account. It also allows a fund to have risk centralised across all of its positions. If there is a lot of hedging in the portfolio, it means the risk margin will typically be reduced.

Committed to cap intro

The base of the Newedge prime brokerage offering is built around capital introduction and related hedge fund research. It is an important service to help emerging managers develop their businesses and raise capital. Newedge has a long-term perspective on cap intro’s value to not only hedge funds, but investors.

“Cap intro is part of making sure that the best providers of investment returns come to the market as it is a benefit to investors,” says Teilhard. “That is why Newedge has this service and underpins it with our research. It is important that investors have good, quantitative information when they want to allocate to hedge funds.” What’s more, the scope of the firm’s cap intro and investor research extends beyond its hedge fund clients to a far broader set of hedge funds.

UCITS expansion

Before 2008 investors weren’t really interested in UCITS products with hedge fund characteristics. For investors unwilling to invest in a typical Cayman structure, managed accounts were the main alternative. But the financial crisis, amplified by subsequent political and regulatory pressure, led investors to look for transparency and liquidity. The

result has given impetus to onshore funds. Over the past three years, Newedge estimates at least \$80-100 billion has flowed into UCITS products with hedge fund characteristics.

“As a prime broker, we have had to create new solutions and refine our existing operating models to be able to service the unique requirements of these funds,” says Andrew Dollery, who handles UCITS Origination and Structuring. “For example, much of their trading has to be structured synthetically and counterparty exposure must be managed, often through the use of pledge accounts.”

One area where Newedge has in-depth expertise is in structuring commodity trading advisor funds to qualify for a UCITS wrapper. UCITS funds can’t trade commodities directly, but managers may seek regulatory approval to create their own UCITS-compliant financial index. Once authorised, the manager can systematically trade the index constituents, in a manner equivalent to their CTA strategy, through a hedge account at Newedge. The P&L from this account directly effects changes in the index value. Exposure to the index is then transferred to the UCITS fund through a Total Return Swap written by Newedge.

Branding and control

The Newedge approach to UCITS sticks closely to the agency model used in prime brokerage. “From the hedge fund’s point of view it is about branding and control,” says Dollery. “They own it and hire and fire service providers as they see fit. When you join someone else’s SICAV you are effectively renting a sub fund and are often stuck with the service providers of that SICAV. Our own research shows that 20% of hedge fund UCITS are on platforms and 80% are not. We think that number will continue to increase as the hedge fund UCITS market matures.

As firms launch their second and subsequent funds, I don’t think that uncertainty about UCITS requirements and regulations, which is often the rationale for doing a joint venture with a platform, will apply to the same extent it did initially.”

Newedge has helped clients Estlander and Aspect Capital set up UCITS versions of their CTA products. It has another eight funds in the process of coming to launch with an additional 20 funds in the pipeline. The firm will service forex and macro UCITS funds, but expects to service more CTA and equity long/short products.

The flexibility of open architecture means that Newedge can be the swap counterparty for financial indices, but let hedge funds retain the same operational support they use in their established business. Managers get reduced operational risk, continuity of service and the freedom to domicile a UCITS fund wherever it best suits them. That approach to UCITS underscores the flexibility Newedge prime services offers every hedge fund manager.

“For a long time prime brokerage was a cottage industry with very high returns coupled with the trading revenue made from the bank’s trading operations,” says Teilhard. “I think it is becoming much more of a competitive model, more of a fee business and more industrial with operating margins going down. Prime brokerage is growing in size, stature and scope. Now it is not about being just an equity prime broker. It is about delivering a non-conflicted global access product for clients whilst being a safe keeper of different types of assets such as cash, securities, margin assets for derivatives and the like – all of this across multiple instrument types such as securities, listed and OTC derivatives. It is a much wider range.” **THFJ**

Fig.2 Newedge Prime Brokerage model

Source: Newedge

Newedge Model	Benefits
Single legal entity	Simple legal structure
Independent bank backed by two deposit-taking shareholders	Fully regulated bank with strong corporate governance
Integrated platform	Single contact point
Full cross-asset portfolio margining	Capital optimisation
Agency-based model: limited proprietary trading	Minimal conflicts