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Stepping In Where Larger Prime Brokers Step Back: An Interview with Sam McIngvale, Apex Clearing's Chief Product Officer, About Its New Prime Brokerage Services

Boutique and smaller hedge fund managers have been pigeonholed by prime brokers newly facing domestic and global regulatory requirements that force them to reassess their book of hedge fund clients. One industry report noted that in 2012, nearly 55% of new hedge funds worked with just one prime broker, but by 2015, that number had climbed to 71%, leaving these managers—considered by many prime brokers as not worth the risk they bring to the balance sheet for the revenue they generate—vulnerable in the event their only prime broker takes a hit or otherwise runs into trouble.

To address this gap created by a shifting regulatory environment, Apex Clearing recently launched Prime Brokerage Solutions, specifically servicing smaller hedge funds whose custody, lending, financing, technology, operational support and risk management needs may be neglected. We spoke with Sam McIngvale, Apex Clearing's chief product officer, to explain the product; why certain firms are able to offer services and products that other firms may not; guidelines for hedge fund managers performing due diligence on smaller prime brokers; terms to negotiate in advance of engaging a smaller prime broker; and what a smaller prime brokerage product offering actually looks like.

What challenges currently facing the prime brokerage business as a whole created a space in the market for your new product offering?

We're seeing what everyone else is likely seeing – which is that the big, traditional prime brokerage players are starting to pull back. I think the large SIFIs (Systemically Important Financial Institution) continue to be in a fight to raise capital levels and improve ROEs and will continue to face regulatory environments that make balance sheet growth unlikely. Interestingly, with the new administration and their expectations of de-regulation, we don't really see—or believe—that will result in a meaningful reversal of the trend toward higher capital standards.

The time it took us to conceptualize a prime brokerage and launch it – was less than six months, and the reason for that is we had all the pieces in place. We were already self-clearing, we were already self-financed, and we already serviced a number of small clients in effectively a PB fashion. So all we had to do was formalize these pieces and put them together in a slightly different configuration, maybe add a little icing on the cake, and we had a prime brokerage that we could bring to market relatively quickly.

What has the reception been?

The reception has been strong from the funds that fit our target market. We're trying to fill a very specific void in the market right now, and within that void we resonate exceptionally well. We've found that when there's a good fit between the client and Apex the relationship is outstanding and both sides look at each other and say 'I can't get this anywhere else.' So inside our current target market, it's great. Outside our current target market, people are looking for new entrants who are willing to step into the space with some conviction, and that is what we're doing. But we are a nascent offering, so we don't immediately make sense for a multi-billion dollar multi-strategy fund. We're not going to resonate for that market quite yet.

What are some of the challenges smaller prime brokers face?

The general regulatory issues have been pretty well discussed, and we don't believe they are going away. What's interesting is that even though those regulatory challenges are aimed at the large SIFIs, they have a trickle-down effect that negatively impacts our direct competitors. Since all of our competitors have to introduce to those large banks, they're going to be subjected to the same challenges, the same ratios, the same capital constraints, which puts them in an even worse situation because they don't directly control the balance sheet. Why we were able to bring our PB offering to market so quickly is because we didn't realize we have the keys to a huge barrier to entry, which is self-clearing and self-finance.

So Dodd-Frank and Basel III demands increased capitalization requirements at the large banks, the people at the top of the food chain. They add constraints on leverage. They force a focus on liquidity and risk. If you are a smaller PB or an emerging PB and you have to introduce to those banks, you are subject to all of those constraints and requirements. But the problem is you're not the person who gets to deal with them directly. You're effectively an intermediary between the hedge fund customer and where their assets are custodied, the risk manager, the person providing the financing to that hedge fund, which is the bank. You get caught in this man-in-the-middle situation. Even though you think you're introducing assets, you're introducing strategies; you're introducing hedge funds to a bank that you think meets their hurdle rates, but you don't know what their hurdle rates are going to be next month or how they're evolving or how they're thinking about where their business is going.

So I think the biggest challenge is just transparency and that the fund managers feel pressure because they don't understand how their assets, their strategies and their revenues they bring to the small PB, but specifically to where their assets sit, are being viewed. The intermediary PBs don't have direct insight into that and so they can't control whether they can keep certain clients or what's going to happen to the rates they have to mark up to their hedge fund customers.

What are some of the challenges facing smaller hedge fund managers in their prime broker relationship(s)?

Similar to the PB industry, the hedge fund industry is under a lot of pressure. We've seen assets and the number of funds decline in recent quarters. Asset returns have been up, but I think this general trend of money flowing out of active investment into passive investment is going to continue for a little bit. So there are some headwinds for the hedge fund industry in general. The challenge for the smaller managers is that you need to focus – your job as a smaller or emerging manager is to fundraise. And if you have to worry about how your assets are viewed by the bank—your ROE, your risk profile, your internal hurdle rates—that's a distraction from what should be your primary business concern, which is fundraising. Fund managers, especially the smaller ones, have to ask themselves: 'Can my strategy work at this PB?' Getting to the heart of that question is the crux of the challenge, because if you don't have ultimate transparency as to where your assets are being custodied, you can't answer that question unequivocally. That is going to produce some amount of discontent that takes time and energy away from fundraising.

What prime brokerage services are you providing to smaller hedge funds? How do they differ from services offered by large prime brokers?

Apex offers a relatively limited set of products relative to the large PB offerings. Certainly equities, options, fixed income, international equities – we handle all that, and we're expanding our product set every day. But the reality is we're fortunate in that we have a little more streamlined offering today, which enables us to keep things simple and efficient. Our biggest differentiator from the large prime brokers is that we're willing to have very forward and very engaging conversations to understand the specific trading and financing needs of smaller managers. The upside of that is that if we can understand and comprehend and support your strategy and financing needs, we will, and we will do that without onerous capital RWA ratios on the back end having to push back on your strategy.

There are three broad points that distinguish us. First, we're self-clearing and self-financed. We're not a bank. We're not a SIFI. And if you understand the pain the industry has been experiencing—both from the fund manager and PB side—you immediately understand why that makes us different from the vast majority of competitors. Second, our management team and our parent company in Chicago, Peak6, bring a great understanding of risk to our firm. That doesn't mean we tend to be risky, but that we're risk-engaged. We're willing to support leverage. The third point is our Fintech heritage. We're a very modern firm that has re-constructed our technology, our operations and our whole business in the last three years. Being a new offering means we have a built-from-scratch structure which gives us unrivaled flexibility to pass through efficiencies and pricing to our clients. It also means that we can provide fantastic efficiencies to emerging managers who need to focus their time on their businesses.

From a product perspective, our bread and butter is equities, options and fixed income. We are rolling out a much more robust futures offering, although we do clear and service futures today. International equities, international fixed income, currencies is all stuff we can handle. We don't have much breadth right now around some of the more exotic instruments out there, like in the CDS and swap space, which actually dovetails well with our current client base. We think fundamentally fund managers and investors will have different expectations about how their investment needs are met in the near future.

Are you subject to different regulatory requirements that enable you to provide these services? How are you able to provide services to smaller funds that the larger PBs are not?

Absolutely. Apex is different because we self-clear and we self-finance, but we're not a bank and we're not a SIFI. So what that means is we don't have to introduce assets to those banks. More importantly, we're not subject to the same regulatory requirements from Dodd-Frank and Basel III as the banks and SIFIs. So until we are subjected to those—which we won't be in the foreseeable future since we're not close to becoming a bank and not close to becoming a SIFI—we are able to do a little regulatory arbitrage versus those other prime brokers and anyone forced to introduce assets to those prime brokers.

Apex Prime is available to managers with up to $200 million in AUM. What happens when managers approach and later surpass that threshold? Do the managers have to find a new prime broker? How do you assist with the transition to a new prime broker?

We will happily, and effectively, service much larger hedge funds to as high as they can go. We think that our current offering resonates most with the sub-$200 million emerging managers. But our intention is to swim upstream, not just growing the funds we currently service, and growing with them as they climb in AUM, but bringing in in the near future funds that are well over that threshold.

What is your primary source of funding? Is this any different than the larger PB firms?

It's really no different than a larger PB. We're a privately held firm. Our bank lines and capital exist just to support this business. We have a stock loan desk for rehypothecation and further financing. But the bottom line is we're self-funded.

What are some best practices in selecting a PB, in particular for smaller managers? What are some of the terms a hedge fund manager should watch out for when working with a smaller prime broker vs. a larger prime broker?

I think you have to ask the question, 'Can my strategy work at this prime broker?' And the answer to that question is obtained through transparency. So the most important thing you have to do when selecting a prime broker is to get a feel for their transparency. How much are they capable and willing to share with you? What's your impact on their balance sheet? Are you comfortable with the returns you're providing them and are you comfortable they're happy with that return so they don't raise your rates or show you the door next month? Answering questions like, 'What if my strategy changes and I trade less next month?' and 'How is that going to impact the prime broker?' The PB has to be able to have frank conversations with you about these different circumstances so you don't have to worry if they are going to be a good home for your assets long term.

We have seen investors [reaching out to perform due diligence on us as an extension of their due diligence on the fund]. We tend to get past the balance sheet conversation very quickly, or we don't. You can comprehend our balance sheet. Whether it's adequate for your business and for your assets – that's a binary decision. What people are digging into more these days is the technology, and that's where Apex's heritage really resonates. We grew up as a technology firm servicing the Fintech space more so than as a clearing firm. We really think our technology brings us another advantage and differentiator in the space because it is very modern and efficient and it's very easy to interface with. Beyond that, the clients we service are very simple so there's not a whole lot of diligence that needs to be done on us. Our regulatory track record is very clean.

What are some of the problematic terms that should be considered, and how do you deal with those issues?

In the emerging manager space—the sub-$200 million funds—we haven't run into many issues around concerns with rehypothecation, or financing and leverage. A lot of the firms that are a good fit for us are derivative-heavy strategies that don't work with the larger PBs because of their impact on the RWA ratios. The terms I would advise to pay attention to would be around transparency. How much forewarning can you get explicitly before your rates double or before you get shown the door – so that you can go to bed at night with some comfort that you're not going to have to look for a new PB the next day. If you can get explicit terms around that, or at least get comfortable that the PB partner with you on the other side of the table,is going to have an open conversation with you about that, then that's fantastic, and that might be the most important term for you to get comfortable with.

One challenge facing hedge fund managers' selection of a prime broker is their investors' confidence in the prime broker. Has investor reticence been an issue?

We absolutely have seen investor reticence, and that focuses on the size of our balance sheet versus the size of a much larger PB's balance sheet. More often than not, we can get past the reticence with some education. The way we like to talk about our balance sheet is that it's more than adequate for the businesses we service. But the upside of our balance sheet versus the balance sheet of a larger firm is that ours is simple. It's not levered. We don't do any prop trading. Our balance sheet and our bank lines exist just to support our clearing operation. And when you think about when investors have gotten into trouble priming assets somewhere—Lehman being the most spectacular example in our industry—they had a thriving prime brokerage business. It wasn't that the PB business itself was over-levered or that its capital ratios weren't correct. It was their exposures and leverages elsewhere on their balance sheet. Theirs was a very difficult balance sheet to understand. So we think that while our size is different in order of magnitude from the very large prime brokers, the simplicity and the transparency of our balance sheet should bring a comfort to investors that you aren't going to find with SIFIs. There's no way you're going to understand fully the impacts of a SIFI's entire breadth of their business on a balance sheet and the safety of your assets. Whereas with Apex, I can show you very clearly in two or three minutes everything we do and why we're adequately capitalized for all of those lines of business.