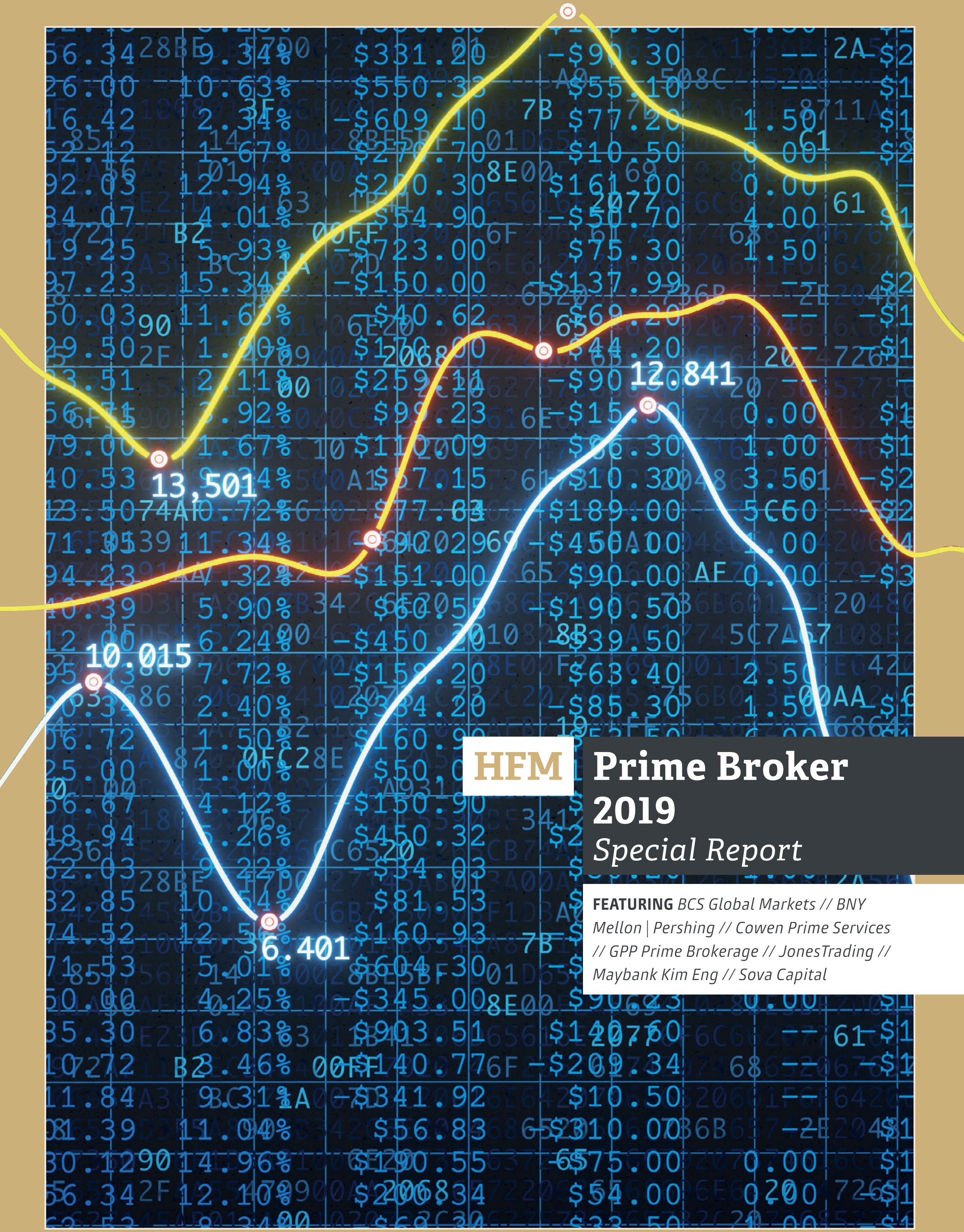

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Prime Broker 2019

Special Report

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Prime services – focusing on today's challenges

Gary Clifford-Newman and Roger Balch of Sova Capital explain their hedge fund prime services' suite and consider how their offering stands out in the crowded prime services space

Gary Clifford-Newman
Sova Capital

Gary Clifford-Newman is vice president, Prime Services Sales. He joined Sova Capital in 2018 and is focused on delivering prime services for Investment Managers, Hedge Funds and Managed Accounts covering Equities, Fixed Income, Futures and Options Execution, Prime and Custody solutions.

Roger Balch
Sova Capital

Roger Balch is director, head of Prime Services Sales. Balch leads the Prime Services Sales team at Sova Capital, where he has built a significant institutional client base over the past six years. Prior to this, he began his career at the London Stock Exchange Group where he worked in the Equity & Derivatives Secondary Markets Department managing the Exchange's relationship with their largest trading clients.

Q Sova Capital were not especially well-known within the prime service's space until several years ago – why is this and how are you any different?

A Many will not know this, but Sova Capital has actually been operating for over 10 years, having first established itself in London in 2007. To this day, we continue to be a leading service provider to some of the world's most prominent banks, brokers, funds and market making firms – providing electronic and high-touch execution capabilities, prime financing, stock-loan, repo and custody services to clients trading equities, fixed income and futures products in the emerging market space.

However, in the past few years we began carefully developing a product suite aimed at providing small- and medium-sized managers with access to developed markets. The reason we did this is that we realised our product suite naturally fulfilled the requirements of such managers, and their prospect investors, which managers within the prime services landscape were otherwise struggling to find; as within the UK, most 'mini-primes' follow a so-called 'aggregation model', which means they utilise an ultimately superior tier 1 prime provider relationship as their sole source of providing prime services. One of the underlying reasons for this is mini-primes tend to be quite 'light' in terms of their balance sheets, relative to the larger banks. Consequently, a key issue arises – whereby the deposits a manager may be placing can often equal or exceed their prime provider's UK balance sheet. In our view this creates a level of increased counterparty risk for the managers and their investors as the managers struggle to identify a provider with the right suite of products but one who is also suitable in terms of counterparty quality.

Outside of the larger prime providers (banks), Sova Capital has a natural solution to such counterparty concerns as we offer a multi-asset suite of prime services backed by an independent, significant UK balance sheet ($386.7m equity share capital, as of 31 December 2018).

As a result, we bridge the gap between the mini-primes and the tier I banks in terms of counterparty quality and product offering. We're now really reaping the benefits of this, in part because now perhaps more than ever, investors want to know where the fund managers are holding their assets and how they're being held. This is when the prime product being offered becomes important.

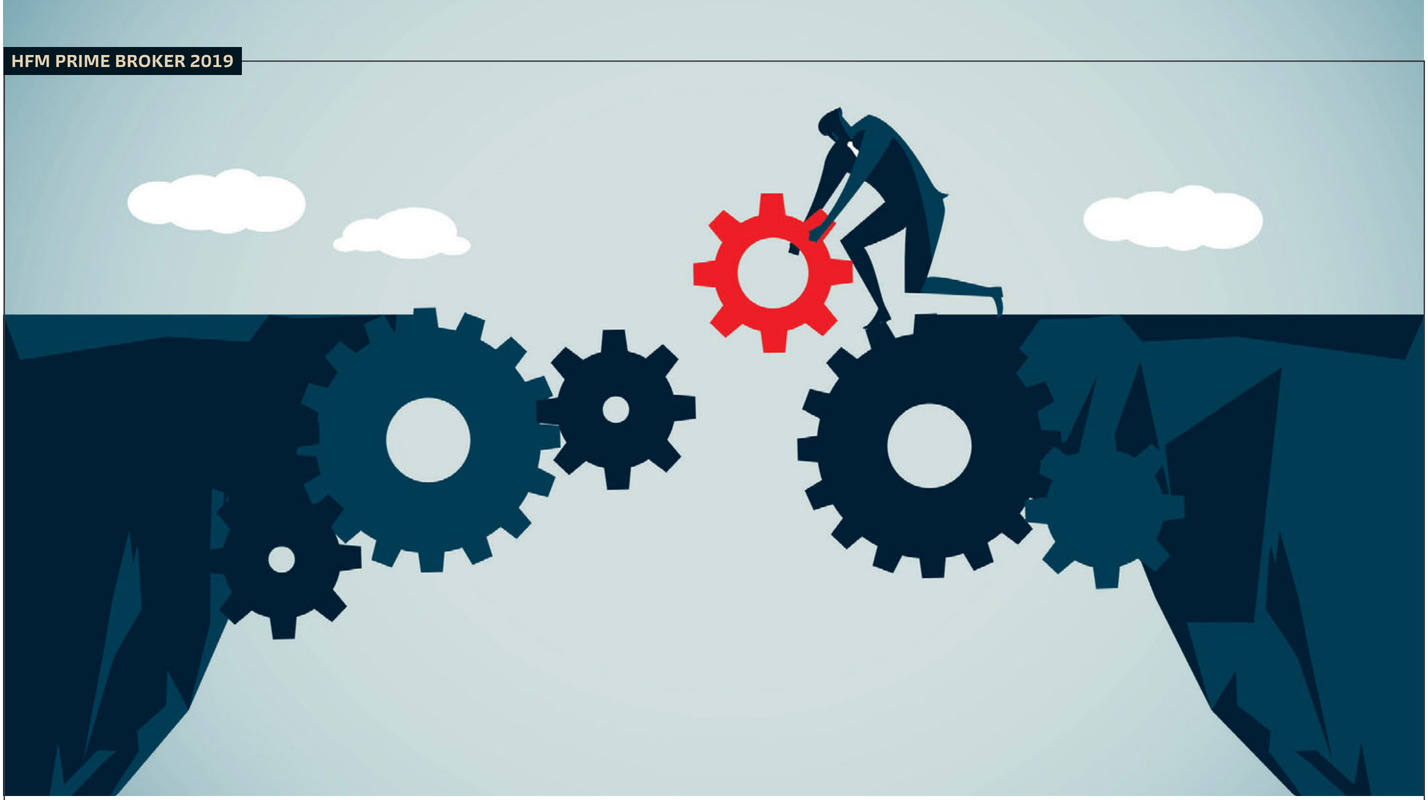
Q Arguably the UK prime services space is already highly competitive and arguably over-serviced – why did you decide to enter the market now?

A In terms of product, we built ours 'from the ground up' with a clear rationale to not just follow the same model used by others; we either do it better, or we don't do it at all.

When speaking to fund managers and their COOs, we found that there were a number of areas in which there has been room for improvement.

Upon selecting their prime services provider and beginning to review their agreements, aside from balance sheet concerns, managers have identified unexpected complexities relating to parent companies and guarantees away from the prime provider's UK entity or that certain services are being provided from different entities altogether. Historically this has created a balance sheet versus quality of product challenge that managers have had to carefully balance based on their current and future requirements.

In terms of futures and options, managers struggle to find a suitable provider within a prime relationship. A number of managers have advised that they would ideally like to access flexible OTC derivatives desks of global banks for various reasons including portfolio, FX or interest rate hedging. Managers would prefer this under an ISDA but they cannot gain access to the banks who can provide such a service due to their lack of sufficient notional volumes traded.



As a last example, from a financing perspective most mini-primes rely on an aggregation model, merely utilising their tier 1 provider relationships with limited stock-loan capabilities outside of these. This is not necessarily a strong solution because the clients ultimately get less of an offering than if they were with a tier 1 provider but they pay more spread for the access.

We believe we have an operating model that addresses each of these issues and this is why clients have selected Sova Capital during this difficult market environment.

Q How would you categorise the types of clients interacting with Sova Capital?

A Broadly speaking, clients who deal with Sova Capital can be placed into two categories. Firstly, there are those who choose us as their sole services provider, and this is commonly the case for those with managed accounts holding circa $5m and above or for those clients who have a Cayman fund structure and whom have AuM ranges from $20m to $100m and above. However, secondly we have also found that those who have chosen Sova Capital have done so because their size warrants the need for a secondary prime provider to an already established tier I prime relationship, but they are conscious of costs and potentially high monthly minimums. As arguably the only legitimate alternative outside of the banks for such clients, they may open an account with Sova Capital – depositing 10%-20% of their total AuM – in such cases clients tend to be much larger in terms of AuM size, and we are very open to these conversations. Consequently, we have a very broad exposure to many clients and understand their key challenges and issues.

We bridge the gap between the mini-primes and the tier 1 banks in terms of both counterparty quality and product offering

Q From your conversations, what challenges do you see your clients and prospects facing and what advice would you give to those looking to launch in the second half of 2019 or early 2020?

A For the emerging managers, it's clear that progression this year has proven difficult for many, with seed investment taking longer than expected to secure. It's clear there's currently a concentration by investors towards the bigger funds. We do envisage this changing, but naturally political uncertainty is leading to some emerging managers finding it harder to get off the ground at a size that they would like. This further justifies the need for ensuring not only an auditable track record but one that it is supported by a sustainable business model.

From what we have seen this year, there are two key points that new managers should focus their attention on, at the earliest possible stage, so as not to jeopardise a potential seed investor coming on board. Firstly, ensuring they have a full business plan in place with sufficient provisions to cover all running costs for the first year, if not longer. Secondly, to be prepared to conduct enhanced due diligence on all potential service providers. The selection process is key across all aspects of a strategy being launched and it is important to select the right service provider that suits a manager's needs and provides the necessary assurances and security expected of their investors. Therefore strong due diligence considerations should be given to selecting the most suitable legal adviser, regulatory umbrella, administrator, EMS/OMS and prime services provider. Ultimately, one size may not fit all but equally a square peg in a round hole doesn't work either. We have seen a number of new managers select the services of an interim COO to assist them in this process, some of whom have strong selection criteria models to assist clients in this process. HFM