OUTSOURCED TRADING: ARE YOU ASKING THE RIGHT QUESTIONS?

Outsourced trading is a hot topic in the industry today. By all accounts, there is a fast-growing trend amongst asset managers to outsource some or all of their front office trade execution activities to third parties. In fact, a recent study from Greenwich Associates[1] found that one third of US buy-side firms are now actively looking at outsourced trading.

There are many good reasons for this, not least of which are the margin pressures that asset managers face today as they compete with low cost passive exchange traded funds (ETFs). To maintain profit margins, many buy side firms are now questioning whether it makes sense to continue operating costly trading desks for what can be a non-alpha generating activity.

Outsourced trading doesn't have to be an 'all or nothing' approach.

Regulatory pressures are also accelerating the trend towards outsourcing the trading function. Keeping up with ever changing trading regulations in multiple global jurisdictions incurs significant time and expense, and many asset managers are keen to remove that burden.

The recent pandemic and the shift to working from home has proven that it is no longer necessary for traders and portfolio managers to be in close proximity to each other. It has become abundantly clear in the last twelve months that investment firms can continue to communicate effectively when traders are working remotely from others in the organisation.

Outsourced trading doesn't have to be an 'all or nothing' approach. For larger institutions with well established trading desks, supplementing those desks with outsourced trading can offer greater flexibility when accessing new markets in global locations, and allowing firms to scale quickly without incurring additional fixed long-term costs.

Outsourced trading has clearly become increasingly attractive to the buy side. So what are some of the key issues to be aware of when engaging with an outsourced trading provider? And what are the potential pitfalls to avoid?

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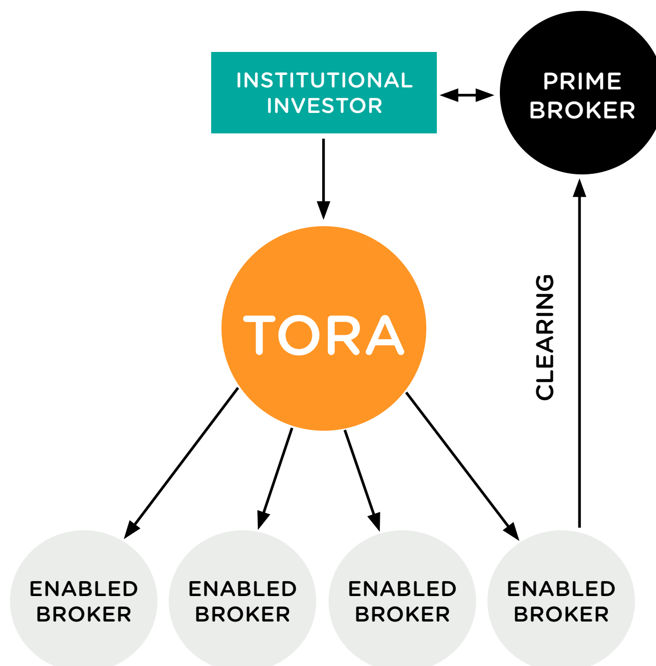
PASS-THROUGH VERSUS AGENCY MODELS

Typically, outsourced trading is conducted in one of two ways. At TORA, we call these the pass-through model and the agency model.

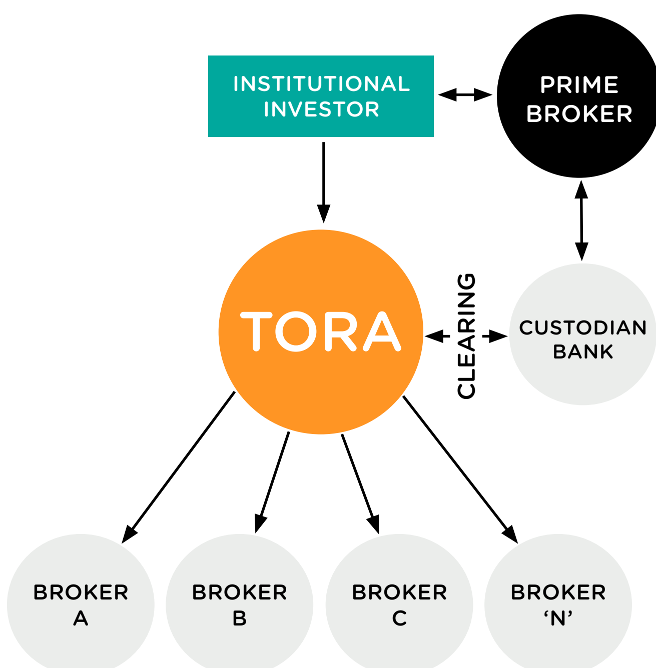
The **pass-through model** is where the outsourcer essentially operates as an extension of the client's internal dealing desk, transacting in the client's name, and replicating as far as possible the client's existing workflows and compliance controls. This model preserves the client-broker relationship and as such is generally preferred by brokers because it makes account attribution more straightforward. Also, acting solely as the buy side desk removes any conflicts or concerns around self-dealing that can arise when acting as principal.

Additionally, in some emerging markets this is required when investor ID's are part of the regulatory landscape. Lastly, it is very simple in a contingency capacity, as client orders are essentially routed the same way (cash/swap/ID) and the post-trade operations are unchanged.

PASS-THRU TRADING MODEL



AGENCY TRADING MODEL



The **agency model** is where the outsourcer operates an external dealing desk, transacting in its own name on the client's behalf, acting in an agency capacity to provide a conduit to brokers, with commission attribution. The primary appeal of this model is the simplicity of transacting with one counterparty while gaining access to multiple brokers, markets and liquidity sources. It also allows the end client to remain anonymous to the street since the outsourced provider sits in between the client and the executing broker. This model is especially common with funds that either don't trade frequently or their size prevents them from having multiple brokerage accounts.

Neither model is necessarily better or worse than the other. The key thing is that the outsourcer's objectives should be aligned with those of its clients, and that it should be able to provide unconflicted execution.

TORA offers both models.

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OUTSOURCED TRADING PROVIDERS

With the increasing interest in outsourced trading, it is perhaps not surprising that the list of providers entering the market is constantly growing.

Many of these entrants are sell side firms such as agency brokers, broker dealers, banks,[1] custodians and fund administrators, who see the potential of outsourced trading as an additional revenue stream, one that gives them the opportunity to cross sell other products and services.

Other entrants are specialist firms whose main business activity is outsourced trading. Some of these firms might specialise in a particular geographic region, or in a particular asset class, for example.

There are however various factors to consider when working with either type of provider.

If an investment management firm is outsourcing its trading through a sell side firm, it needs to be aware of potential conflicts of interest. Banks and brokers that provide prime brokerage or research services could potentially be competing against their outsourced trading clients, so firms need to ensure that the provider's incentives are fully aligned with their own.

The outsourced trader should perform the exact same role as an in house trader and as such, order management and trade execution should be their sole focus, not order solicitation. The client therefore needs to fully understand how the broker is getting paid. Outsourced trading desks often have access to their clients' portfolios and watchlists, so if that desk also acts as a broker who is compensated by pitching trade ideas, a potential conflict of interest can arise. Likewise, if the broker or bank is internalising and crossing order flow, and sitting on both sides of the trade, that may also create an incentive conflict. The end client needs to be able to trust their outsourced trading provider with this sensitive data.

Another factor to consider when outsourcing through a sell-side firm, particularly if it is an agency broker operating an outsourced trading desk, is that it can be difficult for that provider to be entirely broker agnostic. The role of the trader is to be the eyes and ears of the fund manager when executing trades, and to source the best access to liquidity. That is dependent upon the trader being able to pick up the phone or chat with sell side brokers who don't view the trader as a competitor. Brokers are less likely to be fully forthright when sharing information if they have concerns about how that information might be used.

A specialist outsourced trading provider, on the other hand, can be completely broker-neutral and is unlikely to have such conflicts of interest. However, the majority of these types of providers rely upon third-party technology to run their trading desks, which can be problematic in its own right.

THE IMPORTANCE OF TECHNOLOGY

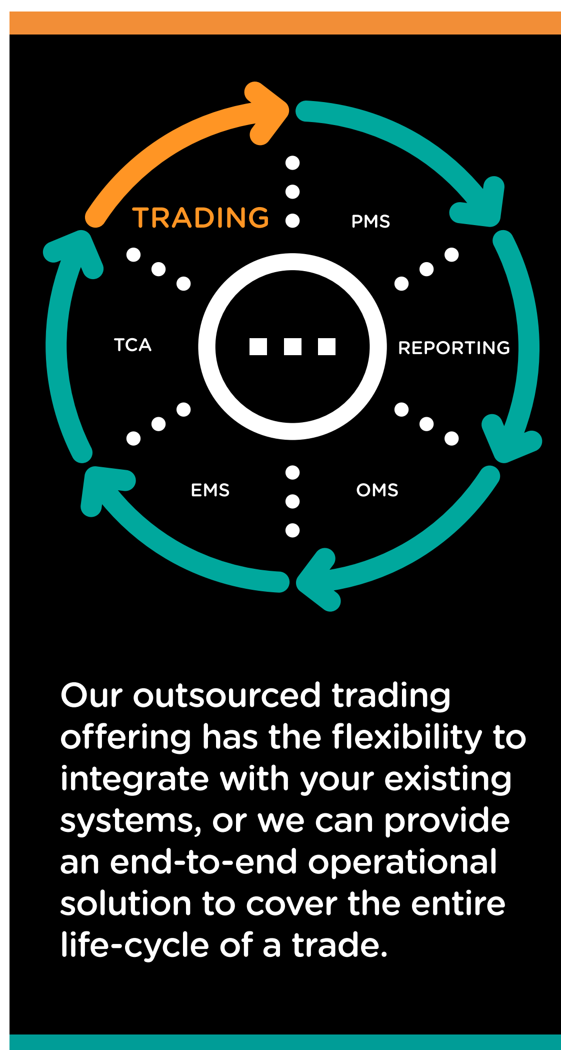
There are very few outsourced trading firms who are also technology companies, where both the trading team and those responsible for the design, development, implementation and support of the trading technology are under the same roof.

This is an important issue, because if these functions are split and the outsourced provider licenses third party software, in effect, the outsourcer is itself outsourcing its technology. Whereas if the outsourced trading provider is also fully in control of the trading technology, not only does it foster a deeper understanding of the client's requirements, it allows much more flexibility and significantly improves implementation response times.

A fundamental requirement for an outsourcer is to be able to completely replicate its client's setup. But this is not just a 'set and forget' exercise. Client implementations are constantly evolving, with new trading books, new swap accounts, new broker connections, and so on. Workflows that need to be mapped are often complex, particularly around compliance. A client might, for example, have specific rules around limits and offsetting that need to be factored into the trading workflow. If both the client and the outsourcer have to sit in a third party vendor's queue when implementing this kind of functionality, it can seriously impact their ability to trade.

If the outsourced trading provider has built its own technology on the other hand, it can be much more responsive to the changing needs of its clients, and can rapidly provide customisation down to fund or portfolio level, enabling trading from NAV values for example, or executing pairs or basket trades, or ensuring that a fund is not long selling through zero and that there is enough borrow in place when short selling.

Every buy side client has its own specific requirements when it comes to trading, so if the outsourced trading provider can accommodate those requirements without having to rely on a third party software vendor to make the necessary changes, it can rapidly improve speed to market.



CONCLUSION

It's clear that there are many benefits that outsourced trading can offer. It is also, equally clear, that there is no 'one size fits all'. Investment firms looking to outsource some or all of their trading therefore need to consider all of the options available and pay particular attention not only to areas where potential conflicts may arise, but also to how responsive the outsourced trading provider is likely to be when accommodating their specific needs.

At TORA, we offer broker-neutral outsourced trading, with a choice of operating models, using our own, proven technology, that can be swiftly customised specifically to suit our clients' workflows. That is unique in the industry.

ABOUT TORA

TORA is the leading global provider of advanced investment management technologies supporting the full trading lifecycle. TORA has a full suite of cloud-based SaaS delivered execution, analytics and compliance tools, as well as order, portfolio and risk management capabilities and a global FIX network.

TORA's products are utilised by hundreds of the industry's leading hedge funds, asset managers, proprietary trading firms and sell-side trading desks globally. TORA has over 250 employees globally. With its headquarters in San Francisco TORA has offices across the globe including New York, Hong Kong, Tokyo, Jersey, Romania, Singapore and Sydney.

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