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# The Four Critical Questions to Ask Your Outsourced Trading Firm

**By Tim O'Halloran** – *Tourmaline Partners*

The level of service and capability being delivered by outsourced trading firms varies significantly. A fund's process to explore trading firm structures will likely bring to light the key differences between models and in many instances it will identify inherent conflicts that challenge the majority of providers.

We believe it is essential for asset managers considering engaging an outsourced trading firm, to consider four key areas when trying to navigate a sector that is seeing a steady flow of new entrants. Corporate structure and governance, execution capability/delivery, research access capability and operational infrastructure all need to feature heavily in a due diligence process. Thoroughly understanding these four aspects should help a fund properly evaluate and identify the most comprehensive, compliant and suitable trading partner and identify critical differences between firms.

The level of service and capability being delivered by outsourced trading firms varies significantly. A fund's process to explore trading firm structures will likely bring to light the key differences between models and in many instances it will identify inherent conflicts that challenge the majority of providers. Those conflicts must be considered against the fund's trading objectives, the fund's organisational values and the need to deliver an unbiased function for the direct benefit of the fund's members or asset contributors.

If implemented well, the advantages of utilising an unconflicted outsourced trading firm are material and some are broadly similar to those derived from utilising an independent external fiduciary – the asset manager benefits from an unconflicted partner, delivering unbiased and significant expertise to a critical function of the fund. The relationship brings up-to-date and ongoing regulatory compliance, enhanced controls plus performance and efficiency benefits from immediate scale, typically well beyond the asset managers existing network. It should also deliver operational excellence. Once a niche business that appealed largely to emerging hedge funds, outsourced trading has become increasingly relevant and valued by managers ranging across to the AUM to now include the >$1 trillion AUM managers.

**Functionality checklist**

**1. CORPORATE STRUCTURE AND GOVERNANCE**

Is the firm independent or part of an investment bank or custodial bank that competes with the sell-side?

Some of the key recommendations of the Financial Services Royal Commission addressed the need for independent, impartial and unbiased financial services into superannuation funds. With this in mind, the corporate structure of the provider should be carefully reviewed to determine whether it is entirely independent. If the business resides within a bank or competes in some way with the sell-side firms, further questions must be asked to determine the significance of inherent conflicts of interest and how they impact the trading team from engaging directly with the sell-side. Are they delivering a buy-side trading solution or is a sell-side delivery where flow is marketed, do they have preferred trading venues or routes or are they unbiased on routes to market? Are they required to 'internalize' flow? Does their structure compete with the sell-side, limiting access to critical liquidity?

Similarly, an outsourced trading provider which is part of a competing investment management firm needs to be reviewed for appropriate compliance walls. The ideal scenario is that your provider is positioned as an independent, broker-agnostic firm with no businesses that directly compete with the sell-side. It should provide no research, conduct no investment banking activities, not undertake ECM activity or offer prime brokerage services. All these compete with the sell-side and serve to limit access to coverage, liquidity and information.

A recent report from Tabb Group predicted that governance structure — that is, the question of an outsourced trading firm's true independence — will become an increasingly important consideration as the industry continues to grow.

**2. EXECUTION CAPABILITIES**

Does the firm have experienced traders, the latest technology and global reach?

The provider's execution capabilities should be analysed so that the asset manager can have confidence in the trading expertise it is partnering with. Seasoned, experienced traders are core to a quality service proposition. Additionally, the firm should have the necessary scale to be pertinent with the sell-side, have access to the latest algorithmic tools, dark pool and ATSs, as well as global high-touch coverage and a broad scope of trading intelligence, timely information and news. Again, independence and flexibility remain critically important here as well, as providers should not be biased towards their own proprietary tools.

**3. RESEARCH ACCESS CAPABILITIES**

Can the firm truly operate like a buy-side trader would, managing and funding research budgets using CCAs, CSAs, aggregation and attributed trading?

Research acquisition capabilities will need to be considered to ensure that the provider has sufficient experience in commission management and a comprehensive and flexible suite of offerings. This is of paramount importance in an unbundled world. This should include technology to provide detailed reporting and transparency along with up-to-date advice on best practices and global regulatory requirements.

**4. OPERATIONAL INFRASTRUCTURE & EXPERTISE**

Does the firm have a global operational infrastructure, and can it manage the full trade lifecycle?

Asset managers must scrutinize the provider's operational infrastructure to make sure it can manage the full trade lifecycle, from execution through to clearing and settlement. If a firm is offering an outsourced trading function, it should be transparent about where its capabilities start and end. An outsourced trading firm needs to be clear about whether they are only operating as an authorized trader or if they are handling all of the back-office operational functions, creating efficiencies that help a fund to better manage their counterparty list and reduce both costs and risk. A fund should expect to see delivered operational excellences as much as trading expertise. Pre-trade compliance and pre/post trade analysis should be standard offerings.

While these four main questions should provide a broad framework for assessing an outsourced trading provider, there are additional considerations to take into account as well. A full checklist comprising many more specific questions under each of these core themes can be accessed here.

While a wide range of firms might claim to offer outsourced trading today and others will seek to enter the business, we expect that effective due diligence will help asset managers narrow the scope of their search. When an asset manager chooses to engage outside expertise to supplement their trading, the provider they choose should have the right answers to all of the above questions. How will the outsourced trading landscape look in five years? We expect that ultimately asset managers will gravitate to the pure play trading firms. This represents a recognition of the unavoidable conflicts and inherent limitations that may arise when more traditional sell-side and/or buy-side players diversify into "outsourced trading" – in reality, just repackaging existing services – as they look to take advantage of a "new" sector that is actually two decades old.

***Tim O'Halloran is a Managing Director at Tourmaline Partners, LLC.***

For further information
visit our website:
**www.tourmalinellc.com**

**US:**
**Aaron Hantman**
**CEO**
680 Washington Blvd, 10th Floor
Stamford CT 06901
**t:** +1 (203) 302-7300

**Europe:**
**Andrew Walton**
**Head of European Business**
5th Floor, 8 Waterloo Place
London, SW1Y 4BE United Kingdom
**t:** +44 (203) 142 8322

**Australia:**
**James Santo**
**Managing Director**
111 Elizabeth St, Level 6
Sydney NSW 2000
**t:** +61 2-8325-1760