

Interdealer broking steps into

Icap's acquisition of Link, an equity derivatives broker, is the beginning of consolidation in this high-growth business, write Natasha de Terán and Renée Schultes

It is not often that successful businesses go unnoticed, least of all in the financial sector, but such is the fragmented nature of the equity derivatives brokerage industry that few of the players are familiar to anyone who is not directly involved in the market. Indeed, until it was snapped up last week in a £135m (€168m) deal by the interdealer broking company Icap, Link Asset & Securities was unknown to many outside its immediate circle.

The interdealer broker equity brokerage industry, which services the interbank market, and increasingly hedge funds, is highly profitable, fast-growing and poised for consolidation.

The five leaders – Icap, GFI Group, Tullett Prebon, Tradition Financial Services and BGC Partners – are well known. Consultancy Celent says they account for 90% of interdealer broker trading revenues.

However, while they may account for the majority of revenues in the core markets – fixed income, rates and credit – they account for a small percentage of revenues in equity derivatives, where a large number of smaller firms compete with them.

Their focus on hedge funds, a large source of growth for the business, has not always been welcomed.

Mark Yallop, chief operating officer at Icap, which is better known in the credit market, said the equity derivatives business

was different to the interest rate brokerage sector: "The market is large and fragmented. Historically, dealers have not objected to interdealer brokers introducing business from hedge fund names to them because we have effectively been working as an outsourced, lower-cost sales force."

The head of one of the smaller interdealer brokers said: "Most hedge fund traders will come from investment banking backgrounds and know full well how large their spreads are. They want to shop around the market and know that they can get much more competitive pricing when they trade through us."

The business is more contentious than the various interdealer broker heads suggest. The head of flow business at a large European dealer said he objected to seeing client business through the brokers and believed clients were better served dealing with banks directly: "Not only do we make better prices direct, but clients run the risk of ruining their relationship with us if we find out they are using the brokers."

Interdealer broker heads acknowledge that some dealers – particularly those that house large sales forces and prime brokerage groups – resent the business going through brokers because they are in effect "giving" away sales revenues as well as paying brokerage and central counterparty charges. However, they do not always have a choice: "Even the banks that do not want to will end up trading with us because otherwise they risk losing the flows altogether," said another broker.

Claude Amar, partner at Sunrise Brokers, takes another view. He said: "This is a business in which risk is recycled. The risk is initiated by end-investors who buy retail structured products, then the banks look to lay off that risk with their customers and in the market. There is a chain and everyone has their place in it. We work hand in hand with the banks."

Growth

Whether or not they are dealing with hedge funds, analysts say equity interdealer brokers have good growth prospects.

Increased liquidity stimulated by the growth of lower cost trading and the increased use of equity derivatives products should all play to the brokers' favour.

Interdealer broker results, reports from the Bank for International Settlements, the US Futures Industry Association, Greenwich Associates and Tabb Group have all

underscored both the recent growth and the market's prospects.

Link last year had total revenues of £81m, a near 70% increase on 2006 levels. Of reported revenues from equities, GFI recorded a near 40% increase to \$239m (€151m) and Tullett Prebon had a 104% increase to £81m. Icap's equity related revenues rose 69% in the year to March 2007.

The latest BIS semi-annual survey showed that the OTC equity derivatives market expanded at a compound annual growth rate of 32% between 2001 and 2006. The Futures Industry Association's annual survey of 58 reporting futures exchanges showed that on a combined basis, equity futures products accounted for 64% of the total volume last year, and more than 71% of the total volume increase. Tabb has also pointed to options volumes reaching a record 2.8 billion contracts in 2007, a 41% jump from 2006's record, in response to a "perfect storm" created by institutional demand and regulatory overhaul.

Patrice Cohen, managing partner of Louis Capital in London, said that in addition the impact of the markets in financial instruments directive and unbundling regulations were creating additional opportunities for the brokers: "It is becoming more common for hedge funds to have a relationship with firms like ours."

The growth of the equity business should not benefit the interdealer brokers alone – it should play to the exchanges' hands, for the bulk of the customer-facing business done by the interdealer brokers is either done on-exchange, or passed through the exchange-run, over-the-counter clearing facilities.

This is where Liffe's Bclear and Eurex's OTC Flexible facilities come into play. Using their services, participants can trade as they would normally in the OTC markets, seeking trading interest through the interdealer brokers without publishing their interest in order books. Once the trades are agreed, the brokers immediately give them up to the exchanges' nominated clearing houses, which step in as counterparties to both sides of the trade.

In this way the interdealer brokers do not need to give up the hedge funds' names to banks, and the end users retain the benefits of OTC market flexibility while enjoying the security, automation, risk management and anonymity of exchange-traded environments. Furthermore, because the

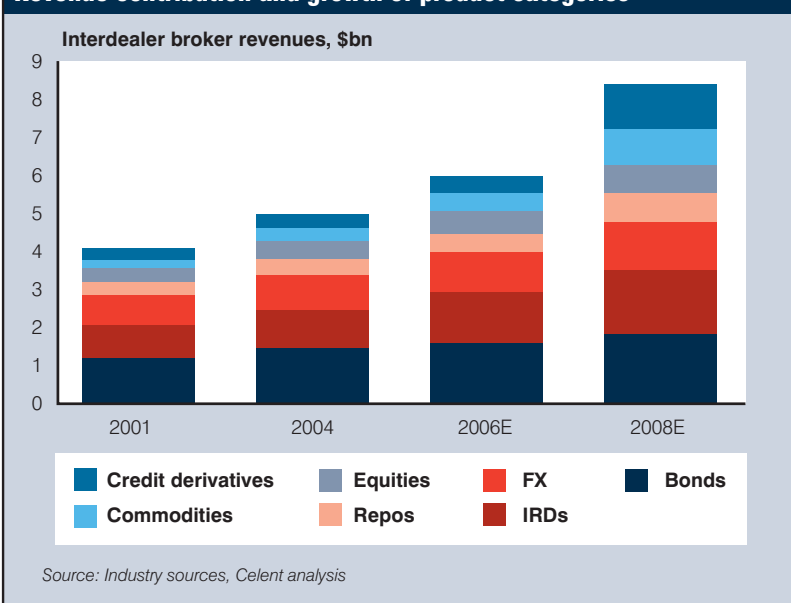


central counterparty clearer steps into the trade, the onerous and credit risk downsides of OTC trading are removed.

The highest margins are to be had in the more exotic derivatives products, which trade on an OTC basis. Almost all the brokers Financial News spoke to are adding in this area. Sunrise Brokers, which was founded in 1991, was the first broker to make a business out of exotic products.

Mike Hudson, chief executive of Sunrise Brokers, said: "There is a natural tendency for large interdealer brokers to turn into factories, broking large volumes. The business scales well, but the margins are

Revenue contribution and growth of product categories



Aespen Brokerage

Office: Amsterdam, New York, London
Founded: 2001
Directors: Marco van den Berg and Dennis van den Berge
Headcount: 28

The business started as part of marketmaker Curvalue Group, which was taken over by Amsterdam-listed Van der Moolen, the securities trading and brokerage firm, in January 2006. The Amsterdam office continues to trade under the Aespen name, which is well known by derivatives traders in the European markets. Aespen concentrates on the Dutch, German, French, Spanish, Belgian and Swiss markets. It offers brokerage services on single stock and index options, futures and cash equities. In August last year the group opened an office in New York, where it trades as Van der Moolen. It has been merged with broker R&H Securities, which was acquired by its Dutch parent last July.

Kyte Equity Derivatives

Offices: London
Founded: 2002
Chief executive: Kamal Haider
Headcount: 20

Kyte Equity Derivatives concentrates on single stock and index options and trades mostly in the interbank market. However, it also has relationships with hedge funds. Kyte is growing its business in exotic equity derivatives, delta one products, variance and correlation swaps and emerging markets. Another part of the business acts as a broker of structured credit products. The broker was set up by Haider, a former equity derivatives trader at BNP Paribas. Johnny Barr joined the business in 2004 from Trio Equity Derivatives, which is part of money broker RP Martin. It clears through the Kyte Group, which was formed in 1985 by David Kyte, one of the founding traders on Liffe.

Link Asset & Securities

Offices: London, New York, Hong Kong
Founded: 1997
Chief executive: Charles Davies
Headcount: 136

The acquisition of Link by Icap is the deal the brokerage community has heralded as the beginning of a wave of consolidation. Icap last week said it will pay an initial sum of £135m (€168m) for Link, and a maximum of £250m. Link has established itself as a credible competitor in single stock and index options to its larger rivals Tullett Prebon, GFI and Tradition Financial Services. In 2005 it set up a European cash equities desk and in 2006 it started a fixed-income business. It covers European, US and Asian markets and claims to service more than 500 customers in the interbank market and buy-side customers. Link was founded by Davies and chairman John Booth. For the year ended December 2007, Link's revenues were £81m.

Louis Capital

Offices: London, New York, Hong Kong
Founded: 1999
Managing partners: Michael Benhamou, Patrice Cohen, Laurent Imbert
Headcount: 150

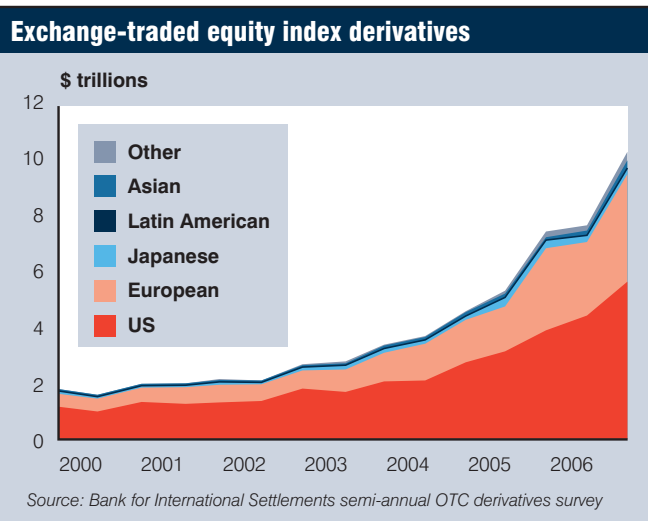
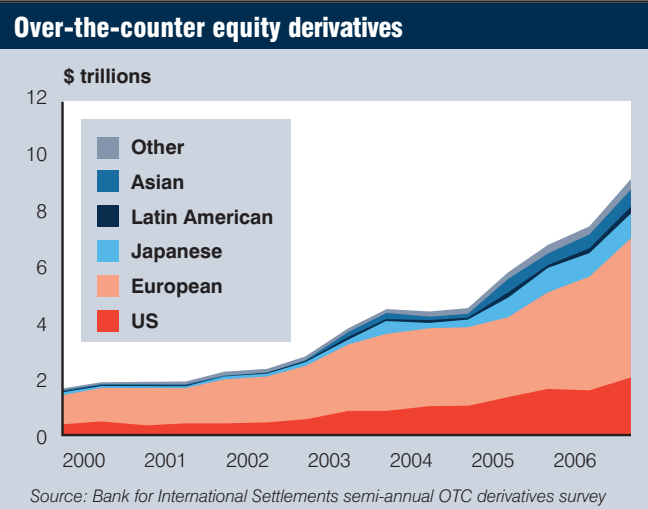
Louis is an agency-only cash equities and derivatives broker, which was formed in New York by foreign exchange traders Benhamou and Imbert in 1999. Cohen, a former foreign exchange derivatives trader at AIG in Greenwich, Connecticut, joined the partnership 2003 to set up the London office. Louis services the interbank market and hedge funds in cash equities and derivatives, but its founders have also returned to their roots and now offer brokerage services in foreign exchange, fixed income and commodities markets. The group is a specialist in equity strategies and employs a team of sales traders, which works with hedge funds. It is looking at opportunities covering emerging markets.

OTCex

Offices: Paris, London, Frankfurt
Founded: 2006
Chairman and chief executive: Frédéric Metz
Headcount: 75

OTCex joined forces with HPC, a money and interest rate brokerage in 2006. The firm has 75 staff, 30 of which are equity derivatives brokers. The company plans to add another 30 brokers in the next 18 months, including graduate-level trainees and former bank trading and sales staff. OTCex was founded by Fabrice Bouland, a former BNP Paribas equity-linked derivatives trader. Metz, the head of HPC and chairman of the combined group, is a former credit and refinancing broker. OTCex is active in European and US cash equities, options on single stocks and indices, as well as in the correlation, variance swap and option markets. It plans to expand its exotic and emerging markets in the coming year.

the spotlight



not defensible. We are trying to build a different kind of relationship with a client in really understanding the product."

Fragmentation

Bank trading desks use a wide range of brokers, including many of the smaller names. A head of equity derivatives trading at a European bank in London said: "The big names are still the ones we do the most business with, so Tullett, GFI, Link and TFS, but there are other emerging brokers like OTCex and Kyte, and some niche players, like Aespen in Amsterdam, XBZ in the UK or Oddo in Spain, which we work with. Sunrise is a name we

use more on the structured derivatives side, along with Prebon."

Consolidation in the market started some time ago. GFI took on a 40-strong team of Paris-based equity and equity derivatives specialists from Refco, shortly before its collapse in 2005, while BGC acquired the Paris-based brokerages, ETC Pollak and Aurel-Leven in 2005 and 2006 respectively. Fimat acquired the UK equity derivatives brokerage Cube in 2006 and last year BGC bought the emerging market equity derivatives unit of the UK-based Marex Financial. Private equity firms are also sniffing around the market, but not all the smaller firms are ready to fall

into the embrace of large firms of financial buyers.

Such is the fragmentation in the market, that even with the Link acquisition, which brings a further 136 staff, Icap will still only account for an estimated 18% of equity interdealer broker market turnover, compared with its near-third share of interdealer broker activity in fixed income and rates.

Yallop estimates that there are 30 to 40 firms competing for this business in Europe; 20 to 30 firms competing in the US and a further 10 to 20 in Asia.

● **Details of some of the lesser known but influential interdealer brokers are listed below**

Quadra Derivatives

Office: Nyon
Founded: 2002
Directors: Per Knudsen, Francisco Veiga Malta, Giuseppe Gambardella, Dale Brandon
Headcount: 15

Quadra, which concentrates on the interbank market, was set up by Knudsen, formerly of Nordea Bank, Veiga Malta, who started his career at Harlow Butler in London and Gambardella, a former bond options broker at Prebon. Brandon joined last year from Kepler Equities in Geneva, where he specialised in emerging markets. The broker covers index and single stock options on most large European markets, but is best known for its coverage of the Italian and Swiss markets. An emerging markets desk set up two years ago has been the firm's biggest growth area since launch. It covers Russia, eastern Europe, Turkey and the Middle East.

Sunrise Brokers

Office: London
Founded: 1991
Partners: Claude Amar, Mike Hudson, Robert Finegold
Headcount: Not disclosed

Sunrise's focus on more complex derivatives products across asset classes, including equities, commodities, credit and hybrids, sets it apart. It was the first London-based broker to focus on over-the-counter derivatives products, rather than the more commoditised products that trade on exchanges. Senior management came from trading and derivatives structuring backgrounds. Before founding the group in 1991, Hudson was a structured products specialist at Nippon Credit Bank and Amar was a derivatives structurer at Morgan Stanley. Finegold, a former derivatives trader, joined seven years ago. Sunrise works mostly in the interbank market.

XBZ

Offices: London
Founded: 1998
Directors: Tony Flynn, Sean Connor, Joe Phillips
Headcount: 13

XBZ is best known for its expertise in UK and European equity and index options. It was founded by Flynn, Connor and Phillips, who are former BZW brokers. The broker works with the interbank market, but has a large hedge fund business. Charles Annandale, who joined in 2003 from Société Générale, runs hedge fund sales for the group. XBZ is known in the trading community for absolute client confidentiality, which is important to hedge funds. XBZ is well known to special situations and event driven hedge funds. It transacts large option volumes in UK and European takeover situations. It wants to expand its cash equities business and, in the longer term, cover the US and Asian markets.

Comment: Natasha de Terán



Exchanges say greater involvement in trades would improve the financial system

Over-the-counter markets in firing line

The over-the-counter derivatives market kept a low profile in the first stage of the credit crisis, with fancy off-balance sheet vehicles, securitisation techniques and collateralised debt obligations shouldering most of the blame for the deterioration of the credit markets.

However, as the crunch shows little sign of improving, the flak is now directed squarely at the OTC business.

The market's critics have had a field day, not least with the near-collapse of Bear Stearns. They have contended that the US Federal Reserve had to save the broker because of the vast amount of risk in the OTC market and the potentially disastrous effects of its unwinding.

That is only partially true. Bear's swaps portfolio and 5,000 derivatives counterparties had a lot to do with it, but it was not for OTC reasons alone that the Fed stepped in.

Ironically, it was a Bear Stearns analyst who provided the most detailed explanations for the Fed salvage. Bear is a big prime broker and one of the largest futures brokers and clearers.

It has 1,000 repo trade partners and has on average more than \$100bn in repo financed positions in Government and mortgage-backed debt. It trades in excess of \$40bn Treasury securities every day and has more than 700 large institutional rates and mortgage accounts.

Bear's demise would have been felt in every corner of the markets – from swaps and derivatives to foreign exchange and US treasuries. Arguably it would have been felt most severely in the precariously poised mortgage and credit markets.

While agreeing that it was not a pure OTC salvage, it must nonetheless be acknowledged that Bear raised the spectre of the forced unwind of a large OTC counterparty.

It has also forced users, critics and regulators to look more closely at OTC operations and counterparty risk.

The exchanges argue that if more trades had been done on-exchange, or if there had been more central counterparties involved in OTC trades, there would have been substantially fewer derivatives-related doubts or dangers.

Counterparties would know where they stood; positions would be independently valued and systematically margined; there would be no room for trade discrepancies and backlogs, no valuation disputes, no missed margin calls and no bilateral credit risk.

While this is true, bringing more complex OTC derivatives on to an exchange or into a central counterparty is a much more complicated proposition.

However, some exchanges have been promoting the idea that their greater involvement in the OTC market would eradicate all the problems and improve the markets and the financial system. Such claims have had a frosty reception in the dealer community, which says that to list or clear contracts, they have to be

standardised – which is possible only with some derivatives.

First, a robust means of risk-managing the derivative positions is needed. It is not evident that any organisation has yet worked out a means of doing so, especially not in the hotly debated credit derivatives market.

Second, it needs to be established who should be qualified to clear through the central counterparty. If all comers were allowed, there is the risk of downgrading the surety of the mechanism that supports it.

The alternative is to limit membership, but then risk will be concentrated with clearing members – and the number of clearing members that have traditionally taken on this sort of business is shrinking and the remainders' financial strength is weakening. So far, no one seems to have an answer to this thorny issue.

Finally, the exchanges' comments ignore the fact that significant counterparty credit risk mitigation is already afforded by the International Swaps and Derivatives Association-led efforts to collateralise trades, and through the legal certainty offered by the close-out netting provisions of the Isda Master Agreement.

Still, the exchange chorus is loud and getting louder and some of its propositions are downright attractive.

Furthermore, it has an attentive audience in a bruised supervisory community that is all too eager to hear about potential solutions.

If the OTC industry is to tackle the problem – without ceding too much ground to the exchanges – it must galvanise itself into swift action.

Dealers are understandably keen to defend the OTC business but they are also ill-prepared to do so. Some face considerable internal problems; others are being confronted by increasingly irascible external foes. Their trading volumes are large, their resources scant and their profits are down. It is not a good state to enter battle in, but the stakes are high and the dealers do not have time on their side.

Where things go from here is anyone's guess. The OTC community has a solid leadership; it seems to have regulatory support and it has some credible partners in the vendor community.

Its efforts to streamline post-trade processes and stimulate pro-active use of portfolio reconciliations will continue to improve things.

But more is going to be needed and it is far from clear that in the stand-off between dealers and exchanges, and, more widely, supervisors, politicians and taxpayers, the dealers are going to win.

The point they – and perhaps the exchanges – may soon have to realise is that wholesale, radical solutions have to be devised and implemented soon, or the battle simply will not be worth fighting. When they digest that, they may also realise that some form of partnership may be the best way forward. Is that really too hard to envisage?