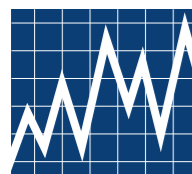


THIRD-PARTY ADMINISTRATION



As the shift towards independent administration within the US hedge fund market becomes increasingly prevalent, *HFMWeek* speaks to two industry experts about the main benefits of outsourcing administrative functions and the key factors which have contributed to recent growth

HFMWeek: What are the primary functions of a third-party administrator?

Dermot Butler (DB): The primary function of a third-party administrator is to maintain the books and records, both statutory and accounting, for the fund. Under that broad heading, the administrator, who will be independent of the manager in the fund, will be expected to verify the asset valuations used when calculating the Nav – this will include verifying the trades and reconciling the trading books. The administrator will also maintain control, or a very close watch, over third-party payments out of the fund's accounts.

Vincent Sarullo (VS): The key elements of the administrator's role are:

Start-up phase services It is important that the administrator is involved as early as possible; we work closely with our clients from the outset to ensure the best advice and value can be provided. The administrator must review, in detail, all operational aspects of the fund prior to launch. It is important that the prospectus comprehensively sets forth the manner in which the administrator will perform its duties to avoid disconnect of expectations between the administrator, manager and investors.

Establishing stature with investors: An independent administrator will add credibility to a fund, which in turn will facilitate investor confidence and lead to increased allocations.

Preparing the Nav: The five main steps are: trade capture, security valuation, reconciliations, expense calculation and Nav calculation, and reporting. The calculation of the Nav is a core administrator task because it is the price at which investors buy and sell the shares or units of the fund and is a key determinant in reporting fund performance, calculating fees and producing financial reports.

Support and review: The board or general partner is generally responsible for the preparation of the financial statements, although the role of formally compiling the accounts is usually delegated to the administrator, with key inputs and advice from the investment manager and auditor.

DERMOT BUTLER

is chairman of Custom House Global Fund Services, a member of the Equity Trust group of companies, which specialises in advising and assisting clients on the structure and the incorporation of offshore funds.

VINCENT M SARULLO

is managing director of Apex Fund Services (US). Previously, he was chief financial officer and chief compliance officer for two private equity and one SEC-registered investment advisor that had investment programmes including hedge funds, FoHFs and SPACs. Vincent has 20 years of experience as a financial professional. He started his accounting career at Deloitte & Touche.

HFMWeek: What are the key benefits of third-party administration as opposed to in-house administration?

VS: Investors are increasingly seeking investment opportunities where the administration role is executed by an independent organisation – the main reason being that independent oversight gives investors a greater level of confidence in the analysis of their investments. It is also well known that there have been less fund frauds in Europe, where administrators are widely used, than in the US, which until recently had a predominantly in-house culture.

DB: The key benefit is the comfort that an independent administrator provides to concerned investors, by providing an independent verification of asset valuation. Also, since Madoff, investors are demanding that the administrator should independently verify the existence of those assets, with regard to, not only hard-to-value and illiquid assets, but also assets held by a custodian or prime broker that is too closely connected to the manager – as with Madoff.

The advantage over in-house or self-administration is the independence factor. There is an argument that if the manager has already applied resources that enable it to calculate the Nav, then it is a waste of the fund's assets to appoint an administrator. This misses the point. The administrator is providing independent verification; the manager should be carrying out its own calculations in this regard in any event, as a risk management exercise.

HFMWeek: In your opinion, how large a shift has occurred from in-house administration to third-party administration in the US over recent years?

VS: Large funds that do not employ third-party administrators are the minority. The increase in institutional assets managed by hedge funds has demanded the use of administrators independent of the fund. For start-ups or funds under \$250m in AuM, there has been a realisation that, in order to attract investors, you need to bring in a third-party administrator, sooner rather than later. There has been a slow shift over the years with Madoff being the catalyst that has increased the pace of change.

DB: There had been a gradual shift from self-administered to independent over several years for US managers, but it was usually limited to having an independent administrator for their offshore fund. The pressure to shift has come from European institutional investors and particularly Swiss banks, post-Madoff. It now seems likely that if any manager

wishes to have foreign institutional investors, they will have to appoint an independent administrator and that will probably happen whether or not any regulation to appoint an independent administrator is passed in the US. The irony is that Madoff never had a fund and, therefore, would never have had an administrator. Nevertheless, we have seen several very large self-administered US funds appoint administrators and that is definitely the trend, which I believe will continue.

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DERMOT BUTLER, CUSTOM HOUSE

HFMWeek: Is this shift been driven by federal legislation, manager evolution, investor pressure or all three? Can you explain?

DB: There is a shift to independent administration in the US, although the shift is similar to trying to persuade a reluctant horse into a horsebox. The primary reason for this shift has been investor pressure, led by two Swiss banks, who are major investors hedge funds.

If 'evolution' means that managers are beginning to 'see the light', then, yes, some of the largest managers have appointed independent administrators, although rumour is that some of those have made 'Nav-Lite' arrangements. As yet, there has been no federal legislation, although street talk suggests that this is also inevitable.

VS: The shift has been influenced by all three factors but is primarily driven by investors. In light of the recent fraudulent activity associated with funds, it is important, now more than ever, for investors to trust their investment is placed with a reputable fund. Federal legislation has led to increased expectations among investors and raised the standard for investment reporting – in other words, administrators enable managers to provide enhanced reputational liability management. There is a global shift towards more regulation with the G20 summit highlighting the changes that will be coming to the global financial services industry and the importance of the role that administrators play is now being appreciated.

HFMWeek: How does the US compare to Europe in terms of its general attitude towards third-party administration? Has this changed over the past few years?

VS: The US does not have the same regulation as Europe, which has a greater emphasis on the use of third-party administrators for funds. In the US, the benefits are slowly being understood but this means that some fund managers will use the cheapest administrator that they can find, thinking that this will satisfy investors. Today, due diligence will also look at factors such as the technology behind the investor reporting and a proper controlled SAS 70 environment for valuations, which may mean that those managers opting for service providers without these skills may well be creating false economies.

DB: Hitherto, US managers have been largely sceptical about the benefits of independent administration. As I mentioned already, the pressure that institutional investors are placing on those managers will now encourage them to become less sceptical and take a more positive attitude. There has not really been an 'attitude' in Europe or the rest of the world because it has been generally accepted that all funds should appoint an independent administrator.

HFMWeek: How important a role does technology play in the success of third-party administrators?

DB: First-class technology is critical. As hedge funds get bigger, so administrative errors become crippling expensive. The demand for accurate and timely reporting means that using spreadsheets is no longer viable, not only because of time, but also because they are error-prone.

There is a definite move towards more frequent valuations – Ucits funds have to be valued at least twice a month – and many funds are now seeking daily valuations. This would be impossible without first-class technology enabling prompt and efficient global trade recapture and portfolio reconciliation, in order to get Navs out on a T+1 basis.

VS: We strongly believe technology is a crucial tool for delivering enhanced products and services to our clients. For example, outside of the core Nav calculation role, a fund might choose to outsource middle-office functions to its administrator. The phrase 'middle office' is not defined, but typically services provided by administrators on a daily basis include, but are not limited to, trade capture and confirmation procedures; corporate action procedures; cash; trade and position reconciliations; portfolio profit and loss calculation; and analysis and detailed portfolio reporting.

HFMWeek: What trends do you expect to see within the US administration industry going forward?

DB: We have already seen a plethora of small administrators start up to service the smaller funds. There is some concern that, because independent administrators (as opposed to administration departments of banks) are not regulated in the US, the risk that one of the smaller administrators could fail is higher than it might be. Regardless of that, I think the likelihood is that, gradually, all funds in the US will appoint an administrator and, therefore, we will have a growth spell in the industry, which will be followed by a consolidation.

This could apply worldwide and not just in the US. Furthermore, there is a current trend for investors to have managed accounts, rather than invest through fund vehicles. Many have complained that this puts a substantial administrative burden on the manager and the investor. This is, of course, unnecessary – few seem to appreciate that a fund is merely a managed account wrapped in a corporate entity. An administrator who can administer a fund can administer a managed account at a lower cost than managing the fund, because there is no corporate entity to be serviced. Therefore, the independent administration of managed accounts will be a growing trend in the US, as well as globally, as investors demand managed accounts in the future.

VS: We are seeing an increased demand for independent third-party administrators, which is not expected to dissipate any time soon. With the continued strength of the emerging markets and the investment opportunities in that part of the world becoming more common place, US funds will have a competitive disadvantage unless they can reach the same standards established in other countries. The US administrator has evolved from merely an added feature to a vital tool in ensuring growth and success. ■