

Chapter One: The Continued Evolution of Fund Administration

William Keunen,
Citco Fund Services,
Dublin

Until a few years ago, the majority of hedge fund managers, and their investors, took minimal interest in the fund administration side of the business. The choice of a fund administrator was often an afterthought based on the recommendation of a friend or adviser. Due diligence was virtually non-existent. And the squeeze on fees meant that varying forms of compromised services were embraced. But over the course of the last couple of years, the perceived importance of the administrative side of the fund business has grown significantly. First there was the debacle of the Manhattan Fund at the end of 1999. Then there was the advent of the institutional investor, and the detailed due diligence exercises they perform. Finally, there are the enhanced expectations of a more knowledgeable investor community as a whole, which demands greater transparency on a more timely basis. If fund administration is moving to the fore, what is taking place to ensure that fund administration as a service has a meaningful contribution to make?

Full independent administration

First is the notion that the fund administrator must be independent to be taken seriously. The definition of independence in the context of traditional fund administration includes some of the following parameters:

Accounting services and net asset value calculations

- The trade activities of a fund are received from the prime brokers via a secure encrypted electronic feed, which is processed via straight through processing. Automated reconciliations are prevalent.
- Securities are linked to conformed securities identifiers (CUSIP, Telekurs, SEDOL, ISIN) within a uniform securities database, to facilitate recognition of prices and corporate actions that are market-oriented.
- Fund activities are tied out and reconciled to counterparty confirms and statements and then reconciled to the investment manager's records.
- All bank, broker and custody balances are agreed, and the portfolio is priced independently. Administrators use independent pricing services and analyse variances.
- Sundry accounting entries are processed in accordance with the rules of the fund, as disclosed in its offering documentation. This includes accruals for fees and expenses, the amortisation of organisation expenses and the calculation of fees. Performance fees may be subject to convoluted equalisation provisions (equalisation credit, hurdle rates, high-water marks, series of shares) and specific calculations must be processed carefully.
- Currency hedging techniques and the related accounting conventions must be conformed to ensure correct treatment and recording.
- The net asset value per share is calculated based on the recognition of the fund's capital activity. Financial statements are produced and disseminated.

Investor-related services

- The administrator is responsible for dealing with all capital inflows and outflows within a fund. This often includes the treasury function.
- Investors are required to conform to a fund's application procedures.
- The prospective investor is verified in accordance with the requisite anti-money laundering compliance requirements.
- Confirmations of subscription applications are disseminated.
- Subscription moneys are received and applied. Remittance advices are sent out.

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Offshore Funds

- Share confirmations are sent to investors upon finalisation of the net asset values per share.
- At each reporting interval, reports are sent to all investors confirming the price of the fund, its performance and the investor's holding. Thus, investors are kept informed of the welfare of their positions from an independent source.
- The administrator will communicate all necessary information to shareholders, in particular ordinary events such as shareholder meetings, distributions and the dissemination of annual reports, and extraordinary events such as changes in the structure of a fund, compulsory actions and wind-downs.
- Upon redemption, the redeeming investor's instructions are checked for authenticity.
- Redemption settlements are conducted in accordance with a fund's rules to include proper treatment of, inter alia, required notice provisions, and the crystallisation of performance fees with reference to equalisation calculations.

Ad hoc services

- Corporate services, such as maintaining the principal corporate records, convening meetings and dealing with local regulatory requirements are typically seen as standard fare by the administrator.
- As an increased number of funds seek a listing on a stock exchange, stock exchange listing reporting has also become part of the administrator's remit.
- Investment restriction monitoring is part of an ever-expanding compliance mandate that provides comfort to investors.
- Tax reporting is now considered an added-value service that funds with US investors look to an administrator for.
- Finally, in the event of a dispute amongst the participants in a fund, the administrator is often called upon to act as arbiter.

Due diligence

As the hedge fund industry matures, and with the increased participation of the institutional investor, the selection process of the administrator is becoming more sophisticated. The choice of administrator is now considered on an equal footing to that of a prime

broker. In this environment, how do administrators differentiate themselves?

Requests for proposals and 'kicking the tyres'

Prior to selecting an administrator, detailed requests for proposals (RFPs) are now common practice. RFPs are an effective means by which selectors seek to gauge an administrator's capabilities through formal responses to a questionnaire. In addition, prior to investing in a hedge fund, investment managers and investors conduct elaborate due diligence exercises that include 'kick the tyres' visits of not only the fund's investment manager but also its administrator.

Initial face-to-face meetings are essential when striking up a relationship in which trust and professional ethics are fundamental to the success of the product. In addition to understanding the investment philosophy of an investment manager, it is equally important that there is the right chemistry between the key participants. Each hedge fund is different, and the relationship aspect forms a critical part of the day-to-day interaction between investment manager and administrator.

Experience and knowledge

The administrator's experience with the types of security that the fund intends to trade should be demonstrable. Client references of funds with similar strategies should be made available. The staff employed to work on a fund should be sufficiently qualified to understand the different types of structure that a fund may adopt and how to implement them from an accounting, corporate and investor perspective.

Add to this the need for continuity of contact and the ability to meet ad hoc demands responsively, and the relationship begins to form a successful edge.

Technological edge

In the age of increased expectations as to timely reporting and transparency, the trend in the industry is heading towards the provision of enhanced reporting capabilities. Administrators will be required to demonstrate a commitment to technological

capabilities that point to integrated systems featuring real-time automated processing and reconciliations, the use of independent pricing services, and reporting capabilities with multiple features, such as multi-currency and multi-security functionality. Demonstrations of systems by the relevant staff, together with the output that is available, will help gauge such capabilities.

Location

The location of the administrator is not an insignificant consideration. While coincidence of time zone and proximity between a fund's administrator, investment manager and its investors may not always be compatible, it is nevertheless axiomatic that the administrator is able to communicate effectively with the main players in a fund (typically the investment manager and the investors) to ensure that it runs smoothly. The administrator that demonstrates local knowledge (be it of a domiciliary, tax or regulatory nature) and a willingness to respond proactively will succeed over the competition.

Trends in fund administration

In providing this overview of the state of the fund administration industry, I would like to finish with some brief comments about the challenges that lie ahead.

The growth in the hedge fund industry

Today's volatile markets are ideally suited to the concept of the hedge fund. But the expanding profile of the hedge fund industry presents some important challenges. The high number of new entrants into the market will inevitably put pressure on the infrastructure to cope with the volume of new work. Furthermore, where fund managers seek to focus solely on their core competency of money management, they will seek to outsource those aspects of their business that do not differentiate them in the marketplace. As a general comment, the increased sophistication of investors has meant that new money is being directed towards the genuinely talented investment managers who are still accepting capital growth.

Straight through processing

The role of the fund administrator is gradually evolving from a service provider that produces results on a monthly basis after the fact, into a back-office outfit that calculates daily P&L numbers and net asset values. Where systems are built to track an investment manager's activities straight through to back-end accounting systems, the administrator will learn to track the results of the fund seamlessly. Pressure for this service comes from both the managers who prefer to outsource this work and the investors who crave the information that gives them a more interactive role. The challenge to the successful implementation of these processes comes from the very nature of the hedge fund product which is still so varied and unique in its application.

Web-enabled reporting

Technological advances mean that the Internet will be the preferred delivery medium for critical information. Subject to appropriate security, both investment managers and investors are already receiving reports via secure-access websites.

Multiple prime broker relationships

Where sizeable funds seek to execute trades in multiple securities in numerous markets, the coverage offered within the single prime brokerage relationship can occasionally become stretched. Add to this the competition offered by best execution and the concept of counterparty risk, and the argument in favour of multiple prime brokerage relationships gathers momentum. The downside is the operational inefficiency of handling multiple counterparties.

Conclusion

The administrator's role in the hedge fund process continues to evolve. In addition to the specialist knowledge that can only come with the experience gained by working with complex securities and structures, the administrator must wear many hats to survive and succeed. But the administrator's primary responsibility is as a fiduciary agent to a fund's investors. In addition, the administrator should be relied upon for an independent verification role that is efficient and accurate. If this is combined with added-value responsiveness, a fund's administrator selection process has for all intents and purposes succeeded.

