



## Hedge fund administration: The new paradigm – step up or step out

### William Keunen, director, Citco Fund Services

These are halcyon times for the alternative investment industry. While the attention rightly spotlights talented fund managers and the institutional investors who are sponsoring them, administrators have seized the opportunity to assume a more integral role in the investment process and have participated enthusiastically in the ride.

The primary reason for this development is the increased focus on the integrity of the operational infrastructure of a fund, resulting in the search for an added-value fund administration service that meets their needs. Fund administrators see this as the opportunity to create a service offering that is integral to a hedge fund's investment process.

Unfortunately, however, for a variety of reasons, the quality delivered by such a world-class opportunity tends to be a mixed bag, with many administration mandates overselling rather than providing what a fund really needs. The result could be a match made in hell and the recipe for a painful separation.

And, as fund administrators scramble to enhance their offering to meet the expectations of an increasingly complex and demanding marketplace, the industry is fed a daily diet of fund administration-related PR announcements that include acquisitions, mergers, new mandates (never lost ones), new and enhanced services, links to software platforms and increased capacity.

Entrants into this space include niche players, hedge funds establishing their own outfits, and prime brokers and banks either buying or estab-

lishing fund administration arms to maximise cross-selling opportunities.

This all adds up to an impressive menu of choices for funds making the unenviable decision as to who to select as their fund administration partner (more of partnerships later). Clearly, one size does not fit all and the dialogue between fund manager and administrator during the selection process is of critical importance.

How can funds avail themselves of the specialists who work hard to provide dedicated, well-tailored service solutions? And what should the fund administration community do to cement a more deserving reputation with somewhat suspicious fund managers and a needy investor community?

#### **The six core pillars of the fund administration process**

The fundamental value proposition of the fund administrator is their ability to process the fund's activities efficiently and seamlessly, to report breaks and P&L, and to provide investors with independently prepared, accurate and timely information. The related core processes comprise:

- investment transaction processing;
- reconciliations;
- portfolio pricing;
- fee computations;
- investor-related activities processing; and
- reporting.

Everything else is an add-on. Given the complex nature of hedge funds, the administrator needs to

be able to demonstrate significant investment in people, process and technology to pull off these seemingly basic requirements. Fund administrators who lose sight of these core functions do so at their peril, and risk doing their funds a grave disservice.

Realistically, for the majority of funds, the managers must remain in control of their own destiny; with anything pre-trade, it's their own responsibility while all post-trade activities are mapped out between manager and administrator in the form of:

- Formal, documented procedures and hand-offs
- Provision for checks and balances by the administrator of the fund manager AND vice versa
- Service level agreements
- Remedial provisions
- Full and proper disclosure covering all responsibilities

Where new funds are being established, it should be relatively easy to establish an effective partnership (between manager and administrator) and form a proper operational infrastructure.

But, for existing funds, it can be difficult to make a clean break from the status quo, where legacy practices are often out-of-step with the modern hedge fund environment, where the bar has been raised by a more educated, demanding investor community.

### **Taking fund administration to the next level**

In addition to the core functions, administrators are adding a suite of new services including front-end systems, middle-office services, expanded valuations capabilities, treasury, collateral management, risk reporting and compliance services – to name a few. Whatever the offering, fund administration 101 dictates that the market will determine what a fund administrator does well, what they need to improve and finally what the gaps are in their offering.

The key is to demonstrate that the administration function adds value to both the investment process and investor communications, at the level that suits a particular fund's needs.

### **Selection of the fund administrator – three key criteria**

Even with such intense competition, the choice of an administrator remains tricky but, if the selection process is handled properly, it should be rewarding.

The fund manager should determine which one of three approaches to adopt, always remembering that you get what you pay for:

- Build the infrastructure in-house (using proprietary or third-party systems) supported by in-house operations and back-office teams – in

which case the administrator typically supplies a more traditional suite of services.

- Partner with the administrator to provide a pre-defined suite of services that could include systems and middle-office services.
- A mix of the above to suit the specific needs of the fund.

### **Rattling the cage or rattling the sabre**

While the rationale for switching an administrator is usually perfectly valid, based for example on the desire to ramp up services, I am surprised at how often conversion mandates are embraced (presumably because of the prospect of mouth-watering revenues) without first fully assessing the nature of the operational hazards.

Whenever we have been invited to participate in a tender for an existing fund, we have been inclined to decline the opportunity unless we felt we could provide an added-value solution that was meaningful in the context of the fund.

It may be an over-simplification but, following the demise of one of the "big 5" accounting firms, the bar on their approach to managing their risk profile seemed to be raised significantly. The limits placed on the activities of the remaining accounting firms have, of course, been compounded by both regulatory and governmental agencies with initiatives such as *Sarbanes Oxley* in the US. Unless the fund administration sector is prepared to set and manage expectations more effectively and adhere to its responsibilities to provide checks and balances more robustly (rather than chase assets), the same could happen to one of our own. After all, we can all congratulate ourselves on our growth record, but one bad fund can bring the entire empire down.

In any event, regulators, investors, agencies and associations (eg AIMA, IOSCO and MFA) are exerting an influence on how funds should operate, with the result that the meaningful money is only being invested where there is a proper infrastructure.

And, as developments in the industry proceed at a lightning pace, with managers and/or the funds themselves now staging initial public offerings, the scrutiny on the role of each of a fund's counterparties will naturally intensify and expose those who are not up to the task.

That is ultimately how self-regulation works best – either step up or step out.

### **Industry trends that impact fund administration**

- While there were less mega-start-ups in 2006

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and this trend seems to continue into 2007, capital inflows continue at record levels with existing, well-established funds seemingly able to attract as much capital as they wish while also expanding their roster of funds. This asset growth is fuelling the entire industry and administrators who invest the increased revenues in technology to improve automation will be better positioned to manage their capacity successfully.

- Fund complexity – primarily the composition of the portfolio by way of exotic derivatives and illiquid investments, but also convoluted legal structures to facilitate and ring-fence investments, and to accommodate investors. The most novel developments inevitably represent a learning curve for the service providers.
- The increased use of complex derivatives and the need for staff who understand them and specialists who can price them.
- The sheer volume of derivatives being traded, giving rise to an urgent need for systems and tools to process them – plus the ability to persuade counterparty participants to be part of the solution and supply affirmation and confirmation information on a timely basis.
- The convergence of strategies – many hedge funds are no longer hedge funds; they have added long-only strategies, private equity and real estate. This has created opportunities for true asset servicing agents that have the capability to offer administration services across multiple asset classes.
- Public listings and ratings, a nascent trend that everyone is watching.
- Regulation – the on-off saga of the SEC's registra-

tion requirement and what will ultimately come down in the formal versus self-regulation debate.

- Fund blow-ups, such as Amaranth, and the knee-jerk reaction of the media to any negative news about the industry.
- The proliferation of surveys, many of which add little value because they really don't offer like-for-like service quality of capability comparatives in an industry where the operational support of a complex multi-strategy fund with perhaps 3,000 open positions (of which 2,000 are probably unlisted) is on a completely different level than that of a long/short equity fund with 100 positions.
- The challenge of how to satisfy investors' appetite for information and transparency without compromising the integrity of the fund.
- Conflicts of interest and how they will eventually be addressed. An example of this was the comment by one of the largest banks/prime brokers in the wake of Amaranth: "Through hedge fund relationships, such as trade clearing, we have insight into what's going on in these funds and can respond quickly to opportunities when they come up. Amaranth was an obvious example of that – where our ability to be on the inside, but not compromised, is extremely powerful to generate profits!"

Finally, I never cease to be amazed at the high level of commitment shown by fund administration staff in their efforts to meet client expectations. Their integrity and capacity is a great asset to the industry and is generally under-appreciated. Perhaps, that is why so many of our staff end up working at hedge funds!

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