

# ALL ABOUT THE FUND

Outsourcing, regulation and automation are fundamental concerns for fund servicing providers. In an exclusive panel discussion, providers debate the impact each of these factors will have on their organisation and the industry at large.

**David Aldrich** joined The Bank of New York in 2003 as head of Securities Industry Banking in London. He is responsible for relationship management and sales for the hedge fund and broker dealer industries in Europe. Aldrich and his team advise BNY's clients how to best leverage the Bank's core business of securities services in order to deliver more value to their end clients. Prior to joining the Bank, Aldrich was a senior manager at JP Morgan Chase London.

**Kevin Milne** joined SS&C Technologies in June 2004 as Senior Vice President - International. Milne has over 20 years of senior level experience in Global financial markets working in both Europe and Asia. Milne spent six years at the London Stock Exchange in various positions before joining Thomson Financial.

**Ruth Murphy** is currently Director of Marketing at Citco Fund Services (London). She joined Citco's European fund of hedge funds operations in Amsterdam in 1998. In 2002, she assumed the role of Marketing and Business Development Manager for Citco's Dublin administration operation focusing on the London single strategy hedge fund market. In 2004, she was promoted to Marketing Director - Citco Fund Services London.

**Marc Schammo** joined Dexia Bil Luxembourg in 1985. He holds an MBA in Financial Services and spent part of his career specialising in the fixed income markets. Schammo joined Dexia Fund Services in 2002 and took the position of Head of Sales in July 2004.

**Rob Wright**, Managing Director of RBC Global Services, Institutional & Investor Services (IIS), International Division, is responsible for the development of the global business strategy for custody and related services. Prior to his role as managing director, he was Vice President, Sales and Relationship Management, RBC Global Services, responsible for business development and strategic management.

David Aldrich



Kevin Milne



Ruth Murphy



Marc Schammo



Rob Wright



### What were the highlights for fund servicing providers in 2004?

**Aldrich:** The implementation of the Investment Modernisation Act in Germany was the landmark European event of the year. To date we have seen only a very limited number of hedge fund vehicles incorporated in Germany and Luxembourg with the specific aim of utilising the Act to target the new investor pools. The hope is that both the institutional investor and the retail investor will become active investors in fund of hedge funds and the most sophisticated institutions will invest directly into single strategy funds. Of course Germany has for long had the hedge fund “certificates”, which are estimated to have attracted investments of over EUR 10 bn from the High Net Worth (HNW) sector to date, and these investors have not yet seen a convincing argument to move into direct fund vehicles rather than structured products. The main factor that may cause such a move could be the fact that the fund of hedge fund (FoHF) products have lower levels of fees compared to the certificates. Other contributory issues include the fact that FoHFs offer greater liquidity, a more directed investment approach, and, arguably, higher transparency of investment performance.

**Murphy:** The growth of the hedge fund industry can largely be attributed to an expansion from a traditional hedge fund investor base of high net worth clients to institutional investors seeking diversification into alternative asset classes, paired with their quest for low volatility which many hedge funds can offer. The increasing institutionalisation of the hedge fund industry has been another notable positive development in the landscape of the industry in the past year, the entry into the alternative investment arena of an increasing number of US and European institutions has led to an increased demand for outsourcing, creating opportunities for service providers to develop and enhance their offerings. Citco’s Front to Back solution powered by Aexeo Technology provides the manager with online trading software and analytical tools, a robust middle office service complimented by a shared database as well as the traditional core administration functions of fund accounting, valuation and investor related services.

**Schammo:** We experienced a substantial increase in the demand for alternative structures in 2004, particularly in real estate investment vehicles, venture capital structures and hedge funds. In Luxembourg, the creation of a specific legislation on venture capital vehicles (i.e. the SICAR) triggered a lot of demand from varying parties. While only a few of these demands have materialised into concrete projects, we expect 2005 to be a very active year in the alternative funds segment.

**Wright:** There is an increased acceptance of outsourcing as a strategic business option, particularly in the UK and Europe. A few years ago, the (financial) market was debating whether or not outsourcing should be considered as a strategic business option, and fund managers were monitoring the early adopters of this principle. Now conversations have evolved to what the definition of those business options and models should be. For many fund managers it’s not so much a question of if but when, and to whom. In the outsourcing deals themselves, we see a more experienced approach to deal structures that acknowledge the complexity of outsourcing arrangements. The commercial structure of outsourcing deals, while not yet benchmarked from an industry standard, is becoming more mature. Global fund managers are buying services on the basis of

“We expect 2005 to be a very active year in the alternative funds segment”

global propositions (that leverage the service provider’s operations in several jurisdictions).

**Milne:** When we look back on 2004, it will be viewed as a year of realisation for all fund administrators but not all for the same reasons. For many it was the realisation that keeping up with the demands of the market was just too hard and too expensive. Hedge funds, by definition are at the leading edge when it comes to complex strategies and instrument types. When you combine these with ever increasing demands for more frequent reporting schedules, transparency requirements and the systems to support them, the job has proved too difficult for many. The good news for many of these administrators was that there was no shortage of eager banks willing to pay top dollar to provide a dignified and lucrative exit for some administrators. For the others, it was a realisation that the bets they had placed on technology, process and scalability appeared to be paying off.

**Comment on the impact of regulation on your business and the business of your clients. The Securities and Exchange Commission (SEC) in the US recently voted to make hedge fund manager registration the norm. Do you consider regulation to be a threat to your business?**

**Aldrich:** One of the most interesting elements of the SEC registration debate is the fact that the SEC regime is, in practice, considered by most practitioners to be a much “lighter touch” than the stringent requirements of the European regulators, for example the Financial Services Authority in the UK. Therefore the practical impact of such regulation is not to increase investor protection, but to add regulatory burdens for those man-

agers and additional direct costs to the funds. The result can only be a decrease in observed investment performance, especially on the smaller funds by asset size. The issue of SEC regulation of managers should not be confused with the choice of domicile of the fund. The growth of Luxembourg and Ireland as domiciles within the European Union, and the attempt by Jersey and Guernsey to compete with the popular fund centres of the Caribbean, is largely founded on the premise of ensuring relatively greater regulation and investor protection. During 2004, BNY saw an increased emphasis on intelligent domicile selection by promoters, as they refine their marketing efforts towards both European institutional and retail investors. BNY has heard some European hedge fund managers say that the SEC extra-jurisdictional reach has further encouraged them to forbid US investor entry to their hedge funds, as they are

“There is an increased acceptance of outsourcing as a strategic business option, particularly in the UK and Europe”

uncertain where this development will lead, except into the courts. If the costs of having US investors on board become too onerous then the risk is that funds will reject investment from the USA – presenting an unintended opportunity cost to US investors entirely. One prominent Swedish manager is on record as saying that US investors are not welcome now or in the future to either their Swedish Kroner or foreign currency share classes due to the litigious nature of US citizens. The move by the SEC has only strengthened their resolve in this matter.

**Murphy:** The advent of regulated hedge fund managers in the US will undoubtedly bring increased credibility to the industry and increased investor confidence in the asset class. Investor perception of hedge funds as unregulated products has gradually changed to a positive perspective whereby hedge funds are viewed as regulated products providing transparency and steady returns; further regulation can only aid this process. Furthermore, from an investor base perspective, hedge fund's investor bases have traditionally been largely comprised of high net worth individuals, increased regulation has and will continue to attract a more varied investor base; institutional investors, funds of funds, insurance companies and pension funds. On the other hand it will lead to greater scrutiny of the administrator's policies, procedures and controls. Also hedge funds and their investors, in turn will benefit from greater technological enhancements being developed by their service providers driven by the requirement for greater transparency.

**Schammo:** Regulation, or over-regulation, can be a threat to the (funds) industry in the sense that too much of it creates excessive costs. Cost weighs on the return of the products, specifically in a market environment with slowly increasing stock prices and low interest rates. This situation can deter investors from regulated products to unregulated products, and thus the stronger regulation for better investor protection has a completely opposite effect. Regulation, if adequate and well balanced, can be an added value in the sense that it could create a climate of confidence among investors and contribute to the positive evolution of a product / industry. An adequate balance between regulation and cost (impact on return) is important when it comes to adding new laws to a product/market.

**Wright:** Increased regulation is an implicit consideration when assessing the value of an outsourcing arrangement. For our clients, the increasing regulatory burden requires that resources be allocated away from core competencies of gathering and managing assets. This trend may lead fund managers to require compliance related reporting as well as a dashboard of analytical tools from service providers. Accordingly, we do not see this (regulation) as a threat but rather an opportunity to provide more comprehensive services to our clients.

**Milne:** We have only seen the tip of the iceberg in terms of the impact of regulation. Much of the debate surrounding regulation has been confused by jurisdictional issues and the concept that changing the domicile of the fund can in some way make these issues go away. From an administrator's point of view, these issues fade into insignificance when you step back and analyse the potential impact of what many believe can and will be imposed. It is not only the regulation that pertains to the fund itself but in many cases the regulatory position of the investor. 2004 saw a dramatic increase in traditional long only players such as mutual funds and pension funds making hedge funds part of their asset allocation. Both of these fund types are subject to deep and broad regulatory oversight. To satisfactorily cater for this oversight alone will require a substantial overhaul of systems and processes.

**How will the word 'outsourcing' evolve over the next few of years?**

**Aldrich:** BNY sees full outsourcing growing in 2005 and beyond for alternative asset managers, as we have seen in 2004 in the traditional asset management space. Outsourcing will involve both the lift out of operational staff from within the mature hedge fund management businesses, plus the provision of ready-made infrastructure specifically designed for new start up managers.

AD

Providing this infrastructure on a fully scalable basis is the challenge and only a few providers have a realistic opportunity to stay in the frame over the long term. BNY sees its leading position as a global outsourcer of investment management operations giving the Bank a significant advantage as the hedge funds industry grows. Tremont (hedge fund research company) recently predicted that assets under management in the hedge fund universe will grow within four years to \$ 2.35 trillion from their current level of about \$ 900 bn to \$ 1 trillion.

**Murphy:** Outsourcing will become more and more bespoke over time whereby service providers will have the flexibility to provide solutions tailored to meet the needs of the individual hedge fund firm. Irrespective of whether they are a boutique hedge fund operation or a large institutional asset management outfit, the offer-

“Regulation, if adequate and well balanced, can be an added value in the sense that it could create a climate of confidence among investors”

ings will be tailored to compliment their existing in-house expertise, allowing them to outsource areas of weakness to a resource-rich service provider and giving them the opportunity to concentrate on those areas they are strongest in. Essentially the manager will be in a position to choose an unbundled suite of services and pick and choose the disciplines they seek to outsource. Similarly, administrators providing outsourced solutions will continue to develop their business models overtime and focus on specific areas of strength.

**Schammo:** We expect outsourcing to be a key subject in the forthcoming years. There will be further consolidation in the banking industry in Europe. This is also true for the fund administration industry. Smaller players may want to step out of business completely and thus put their fund administration business on offer. Certain medium to large sized players may want to concentrate more on their core activities and consider fund administration as non-core, or they may seek third party solutions rather than investing heavily in the development of their own administration business. We expect the outsourcing market to become more complex, in the sense that outsourcers will not just seek a third party administrator capable of offering the standard custody, accountancy and transfer agency services. Clients will increasingly seek complete back-office or even middle-office solutions.

**Wright:** The word “outsourcing” will evolve to encompass all activities that a fund manager considers non-core. For some fund managers, only asset management activities such as research and investment decision-

making will be deemed to be core. For other fund managers, only manager selection and fund promotion will be considered to be core (and investment management will be outsourced). These long-term trends should become more prevalent over the next five years. Lift-outs in various jurisdictions around the world will continue at the same pace as 2004, but we expect that 2005 will be the peak in activity for three reasons: first, the opportunity set has shrunk. Secondly, there are a number of deals currently on the table that will be digested over the next 12 to 24 months. Thirdly, the economics from the providers’ point of view need to make sense: the business model needs to be sustainable, replicable and profitable.

**Milne:** I am not sure that outsourcing will necessarily evolve over the next few years. The idea of core competence concentration and outsourcing the rest will be with us for many years to come as some functions are just too difficult, too expensive and too much of a management distraction for many hedge funds to contemplate. However, the providers themselves will clearly have to evolve and it will certainly not be a painless evolution. If an administrator is to survive over the next few years it will need to have several core competencies, including scalability, sophistication, spread and a sense of urgency. Many administrators are heavily dependent on manual processing and the lack of suitably qualified staff is a major hurdle to achieving scalability for many firms. As hedge funds face increased competition from each other they are turning to ever more complex instrument types to achieve their desired returns. The ability to value and process these instruments with the frequency and accuracy required will be a real challenge for those providers without the ability to do so in a highly automated environment. Geographical spread will also become a key factor as reporting frequency increases.

**Do service providers prefer to outsource their technology to an external vendor or developing technology in-house?**

**Aldrich:** Technology is a key differentiator between service providers, and the ability to provide a tailored mix of proprietary technology and third party technology enables the provider to stand out from the crowd. The implementation of third party software can provide custodians and administrators with quantum levels of service differentiation. Anyone can buy a package off the shelf but you must ask the question “as a client, how important am I to the software vendor?” The answer will determine, to a significant degree, your ability to deliver promised value to clients. BNY is one of the largest clients for SunGard’s accounting systems,

enabling us to deliver customised solutions from a third party system. On the other hand, BNY has also implemented a proprietary system called Praeeo to calculate the myriad performance fees demanded by its hedge fund clients. The provision of “white-labelled” systems for areas such as risk reporting is a useful tool for administrators and custodians who require the technical expertise outside of their natural core competency, which is accounting fundamentally.

**Murphy:** Service providers benefit from owning their technology since it is integrated with their operations risk modules as well as Quality Assurance designations such as SAS70. If fund servicing technology were to be entirely outsourced to and supported by an external vendor, the fund management firms would need to achieve operational excellence individually which can become quite expensive. However one can understand how attractive it would be for institutions to white-label service provider’s technology and build their operations around it, managing code, versions and upgrades could however then be extremely onerous. There are some specialist disciplines that may be best left with experts in areas such as risk reporting.

**Schammo:** Some products have established themselves in the market as more or less standard and can be bought off the shelf by administrators. A lot depends on the positioning of the service provider: A large scale service provider for standardised products may want to rely on vendor software that is readily available in the market place. A smaller-scale, niche player would want to maintain flexibility in serving their specific client base and work more efficiently with in-house developed solutions. Provided niche clients are prepared to pay the price for enhanced flexibility, this solution does work.

**Wright:** Where possible, most providers would rather buy than build. The increasing complexity of regulation and constant margin pressure make it extremely challenging to develop and maintain a competitive, robust and scalable proprietary platform. The trend, particularly in Europe, has moved towards a handful of technology vendors dominating the majority of the market. RBC believes in a best of breed approach – especially where there is a clear leader in terms of market dominance and specialisation. We have partnered with RiskMetrics Group and Charles River Development to provide value at risk analysis and compliance monitoring services for both our custody and fund services clients.

**Milne:** Historically, fund administrators have taken applications developed for similar markets and have tried to customise them with varying degrees of success. While many administrators will boast a core competence in

technology, the reality is that few have really been successful in integrating third party applications and even fewer have enjoyed success in building their own. There are very few core applications for hedge fund administration and the majority of them were produced on low budgets by undercapitalised vendors to meet one client’s requirements. To be successful, administrators will need to develop and own their technology. The catch is that few administrators would even know where to start in terms of doing this.

**Comment on the role of fund service providers going forward. Will they become watchdogs of investors’ assets and be held more accountable for the smooth running of the investments industry generally?**

“Smaller players may want to step out of business completely and thus put their fund administration business on offer”

**Aldrich:** Administrators are already the most active watchdogs for investor interests, as their desire to ensure that the fund is run on purely ethical lines is 100 per cent aligned to the interests of the investors. Whilst many observers refer to the Long Term Capital Management blow-out as the defining moment of the past decade the Manhattan/Michael Berger case was of equal importance because of the breathtaking level of fraud allegedly undertaken, and the ease with which high profile “sophisticated” investors were hoodwinked, many of whom were institutions rather than individuals, with responsibility for investing client money. No service provider wants to be associated with fraud and everyone has an interest in being the cleanest monitor of anti-money laundering procedures.

**Schammo:** A pure fund administrator should not be a watchdog of the investors’ assets or a referee for the asset managers’ investment decisions. A service provider may provide tools for monitoring certain regulatory or other requirements. But the ultimate role of deciding whether a given investment decision was good or bad for the investors must increasingly be taken up by fund management companies and the board of directors in place. These functions play an increasingly important role in the supervision of the funds’ corporate and investment life, as well as the protection of investors’ interests. The service providers should provide the tools to detect anomalies.

**Murphy:** Administrators are in a unique position insofar as they are charged with being a conduit between the manager, prime broker and investors yet operating inde-

pendently and autonomously. The administrator's role is ever changing and it will develop in tandem with the evolution of the industry. There is an increasing trend for fund managers to seek out other service providers independently of administrators such as risk system providers, compliance and due diligence consultants and also independent operational consultants. Whilst it is incumbent on the fund's service providers to act responsibly and in the best interests of the investors, it is largely the duty of the regulators in the various jurisdictions to ensure the smooth running of the industry.

**Wright:** We do not believe the fund service provider will become a "watchdog". However, investor protection is a key focus, so fund managers will increasingly be required by regulators to monitor their service providers more carefully – which will lead them to require more

**“Many administrators are heavily dependent on manual processing and the lack of suitably qualified staff is a major hurdle to achieving scalability for many firms”**

compliance related reporting and activities from their service providers. This should lead to more accountability on the part of both fund managers and their service providers. Outsourcing is the way in which fund managers will increasingly look to minimise operational risk. Fund services providers are well-placed in this regard as they contribute to the smooth and seamless running of the fund manager's operation particularly with the bundling of third party administration activities with custody.

**Milne:** I am not sure the administrators' role will fundamentally change; it will just be harder to fulfil it well. The speed at which hedge fund managers operate make it very difficult for administrators to provide some of the services that their on-shore counterparts provide in terms of overseeing the "general well being" of the fund and its investors. However, if an administrator discharges his responsibilities efficiently and accurately it certainly contributes to a smoother running and more accountable industry for all involved. My greater concern is that as the hedge fund industry emerges from its shroud of secrecy, it is important that it does so in a credible way. The on-shore markets are administered to very rigorous levels and we must aim to ensure that these levels are the starting position for the off shore markets.

**Comment on recent consolidation within the fund administration industry. Will we see more purchases of fund administrators over the next year?**

**Aldrich:** BNY were in the vanguard of custodian banks buying niche hedge fund administrators, with the purchase of International Fund Administration agreed in 2002 and completed in January 2003. The recent purchase of International Fund Managers (Barings) by Northern Trust, and of Tranaut by JP Morgan, is simply a continuation of this trend and is more than a "me too" reaction to get into alternatives. It is actually a sensible response to clients' demands for a full service offering across custody and administration regardless of asset class. The next stage will be a consolidation of providers within those that are already large, so as to gain additional significant scale.

**Murphy:** The growth of the hedge fund industry has presented significant opportunities for service providers and has directly led to increased consolidation and a number of acquisitions in the fund administration industry resulting in Citco Fund Services being the sole remaining independent and privately owned provider of hedge fund administration services in the space. With many high profile acquisitions occurring in 2004 alone, it appears this

trend may be set to continue as large investment houses recognise the opportunities inherent in this burgeoning industry.

**Schammo:** We anticipate further consolidation in the industry. In the end, a few large-scale service providers for the "mainstream" business might dominate the industry. At the lower end, there will be a number of small service providers delivering niche services to specific industry segments not sizeable enough for the big ones to consider. This process may take a couple of years, but is typical of a mature industry with pressure on revenue margins in a global market place.

**Wright:** Yes, we expect to see consolidation to continue for two reasons. First, it is becoming increasingly difficult for pure fund service providers (e.g. non custodians) to compete without being able to offer higher margin value-added products (like securities lending and foreign exchange) to compete. Secondly, hedge fund administrators will continue to be acquired – in order to acquire the intellectual capital in the hedge fund area, as much as for the functionality of their proprietary platforms. To achieve the efficiency gains anticipated from the harmonisation of EU markets, several small to medium size players with a strong footprint in their local jurisdictions have become targets for larger groups with a clearly defined growth strategy.

**Milne:** As the demands on fund administrators increase, so do the capital requirements. Happily for some, this

trend has coincided with an increased desire by the banks to get involved, which has provided a timely and lucrative exit route. However questionable the valuation multiples are when compared with other sectors, the norm has been established at a level that does not appear to have deterred the hungry banks. The thirst displayed by the banks for buying administrators shows no sign of being quenched and as the economic pressures increase the acquisitions will continue.

**What can fund servicing providers look forward to in 2005?**

**Aldrich:** In 2005 we expect the “Kraken” (the German hedge fund market) to awake. There are still possibly less than 15 funds, in “pre-production” and awaiting BaFin (the German regulator) approval. Once these launches are underway and assuming the global hedge fund industry posts good returns in early 2005, we expect big things of Germany. Increased competition in the service provider universe is a given, but with a smaller number of credible providers, the opportunities remain positive.

The hedge fund industry is expected to post asset growth of upwards of 35 per cent in 2005, as institutions begin the process of dramatically increasing their hedge fund weightings, as shown in the recently published research by The Bank of New York and CQA: “Institutional Investment in Hedge Funds: New Opportunities and New Standards”. The days of a boutique administrator servicing a boutique manager are not over, but their days are very clearly numbered.

**Murphy:** We expect the trend of institutions allocating an increasing percentage of assets into the alternatives industry to continue in conjunction with increasing numbers of institutions launching their own hedge funds products. Funds of hedge fund growth looks also set to continue with demand for good fund of hedge fund products continuing to outstrip supply. With the 2004 drafting of German legislation to encourage hedge funds opening up to investors in Germany we could see this becoming a major area of growth. Initial guidance issued in September 2004 is expected to be reinforced by further guidance this month and the industry is hoping that this will clarify many of the ambiguities that remain following the introduction of the legislation. The

outsourcing solution which has gathered pace in the last few years should continue and grow further as managers recognise the value of utilising cutting edge technology and resources which have been developed specifically for the challenges they face.

**Schammo:** Outsourcing and alternative investment vehicles will certainly be among the key subjects for 2005. Economic outlook, though not enthusiastic, seems to be positive again and the fund industry should continue to develop. We can expect further pressure on margins as the industry continues to consolidate. Service providers will be asked to provide assistance to fund promoters further up the value chain. Back-office and middle office solutions will increasingly part of the service requested.

**Wright:** I anticipate a peaking of lift-out activity, continuing consolidation of fund managers and fund servicing providers and the definition of “outsourcing” will continue its evolution up the value chain. Pricing pressures and increasing regulatory burdens will hammer away at the resolve of those fund managers who have not yet considered outsourcing as a viable and attractive strategic business option. Fund managers will look for a bundled solution from one service provider (in order to minimise risk and reduce overall costs). Global fund managers will continue to buy services on the basis of cross border propositions that leverage the service provider’s operations in various jurisdictions

**Milne:** At the risk being a doomsayer, I think the light at the end of the tunnel many administrators see may in fact be the lights of an oncoming train. Large parts of the funds administration industry are ill equipped to cope with many of the challenges that will face it in 2005 and beyond. When you look at all of the challenges facing administrators and then place on top of this the predicted number of new funds, the outlook is very scary indeed, especially if you are less than supremely confident of your technology. The reassuring thing, at least for some, is that hedge funds will start to pay much more attention during their due diligence to systems and processes. There will, and should be, a change of focus from what looks good on the prospectus to what is good in reality.

Thank you.

ISJ



**EXPAND YOUR VIEW  
PEOPLE, PRODUCTS, TECHNOLOGY**

Custody | Securities Lending | Fund Services | Treasury | Outsourcing  
 Tax Research & Analytics | Transition Management | Online Services

**RBC Financial Group**

[www.rbcfinancialgroup.com/global](http://www.rbcfinancialgroup.com/global)

The services, marks and logo are approved by the F.I.B. of the United Kingdom and Canada, United States, which is authorized by the F.I.B. The services of RBC Financial Group are provided in Canada, the United States, and in other countries.