

# Automation, specialisation and consolidation

Three lessons for the hedge fund administrator, unearthed in the first part of a roundtable discussion on the future of fund administration relationships. Kim Hunter seeks the opinions of big volume players Goldman Sachs and Citco, and Custom House, which processes a large number of often smaller funds



Administrators should not be involved in risk management, other than providing information to a hedge fund manager or third party to fulfil that function

Dermot Butler

**What do you consider to be the major forces leading the development of the hedge fund industry at the moment?**

**Dermot Butler, Custom House, Dublin:** First, there is an increase in demand for hedge funds from investors who have lost their faith, nerve or desire to invest in the stock market, as well as lost a lot of money over the past 18 months to two years. Then, there is an increased involvement by major institutions in both funds of funds and hedge funds, particularly long/short equity. (The risk of the involvement of very large institutions is that they will soak up capacity and eliminate market inefficiencies, thus driving down margins). The third factor is the possible reintroduction of the global macro fund. [See our cover story – continuity ed.] I think that the potential for major volatility in all sectors of the market will encourage some investors to follow the 'big-bet' traders.

**William Keunen, Citco Fund Administration Services:** Yes, clearly the growth in the hedge fund industry demonstrates the appetite for product. Equally, the attraction of the product has enabled the industry to spread its profile. The arrival of people into hedge fund management from the institutions has changed the way business is done. An ever-broadening group of investors is also increasing in sophistication and starting to include institutional investors.

There is also a geographical shift. Up to five years ago the industry was focused on the east coast of the US. Now it includes the west coast, particularly San Francisco, Europe (mostly London), and is beginning to embrace the Far East.

Inevitably, with an increase in the number of players, the definition of an 'alternative' product will expand. A macro fund is no longer the only – nor even the dominant – type of fund. Some funds until recently have been long only, and there will even be hedge funds that will cause their investors to ask why they have put their assets into cash.

**Greg Swart, Goldman Sachs, Cayman Islands:** We continue to see a significant amount of business from newly formed funds. We are also being approached with many new institutional hedge fund and fund of fund products. This institutionalisation of the hedge fund industry is placing additional demands on administrators in terms of systems, procedures and the timing and detail of information reported.

**How do you see these forces affecting the fund administration offering and client relationships?**

**Greg:** I think the biggest thing is more timeliness in NAV production and reporting. Administrators are being asked to produce daily and weekly NAVs, and are being asked to turn monthly NAVs around much quicker. In particular institutions are more demanding in this regard, as they then have to then take those numbers and disseminate it to their broad distribution of investors. They can't wait two or three weeks for a month-end NAV; they need to have it within two or three days at the latest.

**William:** Yes, for a number of reasons, traditional fund administration was very much of a historic nature. But because manual entry has given way to a more efficient processing method, and because these technological advances have coincided with an appetite for greater transparency, pressure has been brought to provide more timely reporting.

Administration is now moving into the back office, with provision of daily NAVs, formal NAVs, tie-ins, dissemination of weekly estimates. The future definitely lies in the back office.

There is an appetite among certain funds to outsource as much as possible. Managers are saying that to create an infrastructure in-house is costly and the right staff are hard to find. The new managers come from trading desks in institutions, where they didn't have to worry about all that stuff. In some instances, of course, they will want to retain control of execution, treasury and settlement, but many simply say that their skill lies elsewhere. And as the

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### Several specialist hedge fund administration firms focusing on multiple prime brokerage relationships are building an impressive book of business Greg Swart

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sophistication of the service providers increases, more will be tempted to outsource these functions.

Also, a new attitude to the administrator is arising, especially in Europe. In the US, where the fund administrator does less rather than more, the attitude is very fee driven. But in Europe, funds are literally doing a full due diligence on their service providers. They have detailed requests for proposals. That change in attitude is investor driven. There is more investor participation and word of mouth is not an adequate way of doing business. The trend is towards an administrator being selected by the board of directors, and we, at the end of the day, have a fiduciary duty towards the board and investors.

We also see more service level agreements, setting out the reporting discipline and so on, as the levels of service have increased.

**Dermot:** The greater involvement of major institutions in these markets is leading to the greater involvement of the more traditional mutual fund or unit trust administrators. As the hedge fund industry grows and the major institutions become involved, there is likely to be a consolidation of the smaller hedge fund administrators.

That doesn't mean they will all disappear, because the substantial number of 'smaller' hedge fund managers will be looking for administrators who can handle their business at a reasonable price.

The problem with the 'big boys' is that they are not prepared to look at smaller managers, which they would rate as somebody who is starting with less than US\$50 million. If an administrator takes on those clients and does a reasonable job, they are unlikely to move to another administrator, unless they are dissatisfied with the service, so there will remain a demand for the 'niche' administrator.

**How is technology driving this process? What are the most important technological advances?**

**Greg:** In terms of systems, the big problem the hedge

fund industry faces, not just the administrators but the managers too, is the difficulty in finding good middle and back office systems and personnel. The best systems are very expensive to install and operate, so managers are increasingly outsourcing their middle and back office operations. Many administrators are working rapidly to expand the breadth and depth of their systems and operations to accommodate this trend.

**Dermot:** The obvious effect and objective of technology is increased efficiency and increased productivity. It goes without saying that the bigger the institution the more money it can throw at technology and the more money it will throw at technology. That doesn't mean the money is well spent.

The most important technology advances are the introduction of fully automated systems, electronic data transfer and the Web as a communication tool. Automation eliminates the reliance on spreadsheets. Electronic data transfer enables administrators to receive all the information needed to calculate NAVs and maintain books and records electronically and, once the accounting process has been completed, to distribute the information to investors and others by electronic data transfer.

**William:** Technology is central to creating STP techniques, of course. And Web-enabled reporting is an important advance. Multiple prime brokerage relationships also create technology issues. To look at these things as a list, I would say the most important functions are the ability to execute trades with brokers in the system, a risk management system and real-time P&L, settlement and the middle office, and the outsourcing of back office functions. There is an absolute requirement for providing the fund managers with a suite of reports tied out to prime brokerage statements and so on, and an extension to funding requirements, currency exposure and so on.

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William Keunen

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**We have acknowledged that the fund administrator is increasingly taking on back office functions. What other areas do you see as his natural domain?**

**Greg:** As administrators move further toward performing the middle office role for a hedge fund, performance and risk analysis become functions managers will look for them to support.

Most prime brokers provide these types of systems and services to managers now. However, as managers look to establish multiple prime brokerage relationships, they need someone to provide them with consolidated reporting or they need to have the ability to consolidate it themselves. Several specialist hedge fund administration firms focusing on this niche have emerged and are building up an impressive book of business.

Another important part of the administration business that is rapidly evolving is the traditional role of registrar and transfer agency services. As hedge funds are sold to institutional investors in many new jurisdictions, administrators will need to deal with the many different language, cultural, regulatory and tax issues they will encounter in each jurisdiction.

There are many large retail mutual fund administrators and specialist registrar and transfer agents who can have a significant impact in this area. They have significant resources and experience to bring to the hedge fund market place, and if they properly focus on the unique elements of hedge funds can make a powerful impact.

**Dermot:** Actually, I don't think the administrator's natural domain extends beyond administration, in which I would include the administration of back office functions (by which I presume everyone means the fund administrator providing administration service to the fund manager, relating to his back office). I think that is likely to be much more in demand in Europe than it is in the United States, where a large number of managers already receive back office assistance from their prime broker. Bank of America and Bear Stearns, for example, both offer hedge fund managers office facilities.

On the specific subject of risk management, I personally do not believe this is an area in which administrators should become involved, other than providing the information to enable the hedge fund manager or a third party, to oversee the risk management function. I believe that this should not be done by the administrator, because it could result in an unacceptable conflict of interest. I also do not believe that an administrator should get involved in an investment advisory function, and risk management, in the context of portfolio management, is obviously an investment advisory function. It goes without saying that an administrator with a flexible operating system will be able to provide all of the information necessary to assess the risk profile of the portfolio on an ongoing, even real-time basis and thus provide the ammunition for that risk profile to be properly managed.

Having said all that, I think there is a potentially large market for professional risk managers to offer their services to hedge funds, as an independent third party consultant, which would review the portfolio on a regular basis and advise the fund manager and, if necessary, the board of directors of his findings, particularly if he found the risk profile to be unacceptable. But that is not and should not be the administrators' job.

**William:** We would see risk management as a front-middle office function, as well. It comes with the front end system and is tailored to what the fund manager needs to see. As far as risk management is concerned, I guess we would look at it going forward, though we find requirements vary enormously. Our objective is to look closely at the front to back office process, but we'll do this on a piecemeal basis. To do it all at once would be dangerous. Now, for example, we could offer certain functions for plain vanilla investments, but not for complex OTCs.

**What do you see as the most likely outcome of the current fuss about the wide range (and potentially mischievous) valuation methodologies?**

**Greg Swart, Goldman Sachs, Cayman Islands:** This will become more of an issue, particularly for funds that have

a lot of securities that are in distress, and a lot of people especially three years ago wanted to be getting a piece of private equity-type deals, or private investments in public companies. Now a lot of those investments are worthless and the question is how you value them.

It is difficult in the case of an illiquid, totally non-traded security for an administrator to have a basis for valuing it. Fortunately, our portfolio has not had a high concentration of such investments.

**Dermot Butler, Custom House Asset Management, Dublin:** My attitude is that we will value the portfolio in the manner described in the offering memorandum and, if we believe that for any reason that valuation formula is suspect, or has become so because of changes in the market place, we will advise the fund manager of our feelings. If he ignores them, and we deem it necessary, we will also advise the board of directors and the fund's auditor.

A classic example of where market circumstances forced a change in valuation procedures occurred during the Russian debacle. A previously reasonably liquid stock was quoted on the market at US\$11 bid / US\$23 offered. The valuation formula for that particular fund stated that the NAV should be calculated on the basis of the mid price (between the bid and offer price of each share in the portfolio).

If, for the sake of this discussion, we assume that the total portfolio of the fund carried a spread so that the mid price of the funds portfolio was US\$17, with the average bid price being US\$11 and the average offer price US\$23, then the board of directors, the administrator and the fund manager would have a dilemma. It is obvious that to value the fund according to the offering memorandum was not a valid or reasonable procedure in the changed market circumstances.

Anybody who purchased shares on the basis of the NAV, where that NAV was based on a US\$17 mid price, would be diluting the fund at the expense of existing shareholders. Similarly, in the case of redemption at US\$17, existing shareholders would also be disadvan-

taged, because it would not be possible to liquidate the amount of assets, pro rata to the size of the redemption and realise the amount of money that was needed to pay off the redemption, because those assets would be liquidated at US\$11 and the redeemer was being paid US\$17.

If they decided not to use the mid price formula, the fund manager, administrator, directors and auditor had only two choices: to amend the rules/structure of the fund so that the fund would quote bid and offer prices to reflect the market spread, which would involve substantial amendments to the rules of the fund and introduce considerable legal problems; or to suspend dealing in the fund, either until some stability had returned to the market, or with a view to liquidating the fund and therefore instructing the fund manager to only sell assets on the basis of a bid in the market, rather than by forced liquidation. This is in order to try and achieve a price nearer the mid or offer price, rather than the bid price.

Whatever valuation formula or method is specified in the offering memorandum, the administrator, as well as the directors and fund manager should retain flexibility to adapt the valuation policy in the event of major changes or disruption in the market. Of course, whatever decision is made, it should be checked and verified by the auditor.

**Drew Douglas, Bank of Bermuda, London:** Wherever possible the bank provides a fully independent valuation. For some of the more complex funds that have more esoteric instruments, those which involve very specialised valuation models, the bank will ensure that it fully understands the pricing models being used by the analysts and performs an independent check on these models. However, there are still times where the pricing models are very proprietary and the fund may use manager generated prices. In these circumstances, the bank will ensure that the offering documents of the fund fully disclose the manager's involvement in the generation of such prices.

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**William Keunen, Citco:** Clearly, where securities are illiquid, exotic, or where market conditions cause volatile situations, difficulties inevitably arise as to valuation. Our position remains that we aim to price independently using the various sources that are available to us, such as third party price feeds, the use of Reuters and Bloomberg, counterparties or other sources. We aim to get comfortable with the prices we apply and we use a variety of techniques that enable us to achieve the required level of comfort. This often means utilising various forms of analysis. We will also consult with the investment manager, the auditors and if need be the board of directors. We work within the parameters of the offering disclosure and what we believe to be appropriate based on our experience with a particular fund in the markets it invests in. Ultimately, when we are in the process of taking on a new client, we will decline the opportunity to work with a fund that will invest in markets or securities with which we are not familiar.

#### What are the lessons/implications for hedge fund administration in the wake of the WTC disaster?

**Greg Swart, Goldman Sachs:** I'm not sure we're going to know necessarily what the implications are for a while. We may see some outflows at end of the year, but by then hopefully things will have settled down and managers will have put results on the board that will make it a non issue. I think more people are thinking about hot sites and disaster recovery more than they might have before. Here in the Cayman Islands, with the hurricanes, we've always been sensitive to it. People in Manhattan may have been less so.

**Dermot:** Yes, that is not necessarily a lesson learned with relation to the WTC disaster, which I would hope is unlikely to be a common event. But fires are a credible risk. We are almost ready to implement an upgraded recovery plan, under which we will be able to seat our total administration staff at functioning computers within 4-6 hours of being hit by a totally destructive disaster.

We will also be backing up all our computer data onto a server in this facility every seven minutes.

**William:** To date, our sense is that the hedge fund industry has performed adequately since the disaster. We have seen relatively few redemptions but by the same token, we also feel that some capital inflows may have been postponed until say the new year. There are now more enquiries about disaster recovery procedures. Furthermore, participants now understand that proper anti-money laundering procedures are a necessity rather than a hindrance.

#### What do you consider the major operational danger areas for today's hedge fund manager?

**Greg:** Navigating the markets is the biggest problem, and it's tough to try to launch a fund in choppy market conditions. Investors will tend to look to the more experienced guys. Also for new managers it is a challenge to build an infrastructure, with proper back office functions and procedures, in house. People don't always realise how much of their time will be absorbed by managing the operation. That is even more of a challenge in this business environment, when you need to spend more time on the markets, rather than less.

**Dermot:** In my opinion one of the major operational dangers, not only for hedge fund managers, but for all participants in the financial services industry, is a systemic failure in either or both the Internet/web network, or the international banking system.

There is little one can do against acts of blatant terrorism like the WTC disaster, or acts of God, except establish an effective business continuity plan (which should be a high priority on everyone's risk management list). Such plans should cover protection against hackers and viruses. The havoc that could be caused if the international financial system was disabled for any length of time, even just a few days, could be enormous.

I am no 'techie', but it is my understanding that the World Wide Web is operated through six main servers, all of which are situated in the US. If, as we have said,

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one of the most important technological advances in the administration of hedge funds is the ability to accept and deliver data and other information electronically, the operational danger of the collapse of the Internet system becomes a potentially crippling operational danger. It is, I think, an undisputable fact that as a new technology is introduced, most people forget how to operate under the older, slower and perhaps less efficient, but also perhaps less vulnerable technologies.

As technology has advanced and delivery of information has been speeded up, so the size of the market and the ability of investors and portfolio managers to enhance both the size of their positions and the risk profile of those positions has grown. If that information were suddenly no longer available, chaos could flourish.

**Drew:** I would add size to those issues. The size some new managers are considering launching with is sometimes a concern. If you are launching with 5\$ million from one or two investors you are very exposed both to capital flight and to your track record. Typically, we would advise people to launch larger than that.

**William:** In view of the fact that markets are more volatile fund managers will need to be able to prove that they have the ability to manage them effectively. This will mean having both the requisite ability and the tools. Of the latter, we are seeing a trend towards greater outsourcing as creating the proper infrastructure in-house is both expensive and time-consuming. The result is that managers will seek to obtain risk management systems and back-office functions via service level arrangements with third party providers. Another operational danger is that back-up capabilities are in not place in the event of a shutdown of data provision, so that the availability of alternatives sources of data, back up and recovery are paramount.

**How is the issue of service provider liability affecting your business thinking? Are fund administrators bigger targets than in the past?**

**Greg:** We've never been comfortable being directors of a fund and now I see a lot of administrators resigning

those positions, as they realise combining directorships with administration and other service functions makes you very responsible if something goes wrong.

**Drew:** You need to step back and look at the responsibility of the fund administrator, which is to provide independence to the end investor. More and more investors are demanding independence and the administrator's should be expected to back up their prices.

In fact, we see investors looking for administrators to take on a lot more responsibility for the prices they report. More and more institutional investors are coming in to perform full due diligence on fund administrators. It happened more in New York, but it is the beginning of a trend that is crossing the Atlantic. Therefore, when new funds take on an administrators they need to thoroughly investigate its valuation process and its risk and control procedures.

They should also ensure that an administrator has an adequate capital base to support their business and the appropriate insurance in place protect investors.

**Dermot:** Service provider liability has always existed for administrators and they can only protect against it by ensuring that they have proper controls in place and, frankly, by taking out insurance cover. Unfortunately, this year, insurance premiums have risen substantially because of claims in the financial services and fund management area relating to the dot.com collapses. I don't think that administrators are bigger targets than they were in the past – it is just that the general public has become more aware that administrators are a target because of situations like the Manhattan scandal.

The vulnerability to hedge fund administrators has, of course, grown as their business grows, as the size of the market grows and as the volatility and complexity of those markets grows. Thus, in as much as the job of the administrator may be more complex than before, so the risk of error is obviously greater than before. Offsetting that is increased technology, which should eliminate that risk of error. We are continually reviewing our controls

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and systems to try and eliminate these risks.

**William:** We have always been sensitive to the potential risks inherent in the business and I am sure that all administrators are realistic enough to expect some difficult scenarios in this respect. In fact, where a fund is caught up in litigation, all participants can expect to be targets. As a result of the growth in our business and in the context of the industry as a whole, we now devote more resources than ever to risk management and control.

**Is there anything you would like to add to sum up this discussion?**

**Drew:** Investment in technology is the pressing trend in fund administration. The rapid growth of the hedge fund industry and more complex strategies bring risk and capacity constraints. I think this will drive some consolidation within the industry to allow greater investment in core systems support and added value services. There will still be room for smaller administrators but they will likely be concentrating on the less complex strategies that are not as technology dependent and be competing more on price.

**Dermot:** I think the main change is an increased interest in what fund administrators do and how they do it, by fund managers and particularly investors. This is a reaction to the headline stories, such as LTCM, Manhattan and Maricopa, and it is a good thing. What is essential is that anybody who is going to either manage or invest

in a fund that retains an outside administrator must carry out in-depth due diligence on the capabilities of that administrator. Otherwise, frankly, they only have themselves to blame if losses through inefficiencies or miscalculations by the administrator are made.

One particular issue that comes to mind is the potential growth in the demand for administrators from US managers, where the vast majority of hedge funds are self-administered US partnerships. In such cases the general partner is for the most part the fund manager and, as such, is responsible for the administration of the fund (partnership).

This obvious conflict of interest has given some hedge fund managers the opportunity to 'cook the books' when they have a rough month, albeit with the intention of rectifying the situation when the market improves. The problem is, it never does. That was the Manhattan problem. We have recently received several enquiries from American money managers asking us if we can provide administration to their domestic funds and these enquiries have definitely been the result of investor pressure.

**William:** The industry has become more aware of what independent administration has to offer and this has resulted in both a greater appreciation of the qualities of full administration services, but also higher expectations as to timeliness of reporting and transparency. This represents both a continuing challenge to the industry, and an opportunity to provide added value to an increasingly knowledgeable investor base. 