

Financial Services



Hedge fund administrator shadowing

Lowering the costs of third-party oversight

By Keith Caplan and Samer Ojeh

Engaging a third-party administrator to manage and maintain a fund's books and records has its complexities and presents a variety of decision points and cost factors. Not only do virtually all fund managers pay for an administrator's services, but they also elect to maintain some level of in-house operations and technology to oversee or "shadow" their outside administrators. The question then



becomes how can a fund manager create a working relationship with an administrator that is cost effective and within an acceptable risk tolerance? In this paper, we will identify ways to create a more effective (and less costly) governance structure that will provide adequate oversight of fund administration functions. We will also examine evolving single-server administration technologies that could eventually streamline the shadowing processes and lower oversight costs.

Most large alternative investment firms – those with \$5 billion or more in assets under management – use their formidable in-house systems and operations infrastructures to mirror the back-office functions they outsource to third-party fund administrators. This "full shadowing" strategy enables a manager to replicate, and therefore cross-check and validate, an administrator's output, confirming integrity and accuracy of the data that is critical to trading, portfolio management, compliance, risk management and financial reporting to investors. The downside



to this approach, obviously, is duplication of cost. It is expensive to support middle- and back-office operations that are virtually identical to those maintained by administrators. Furthermore, few of these funds have created the most effective governance structure to fully leverage their relationships with the administrators they hire.

The challenge before these firms is determining which operational functions to shadow, and which to entrust solely to the administrator. Finding the right balance can achieve the main objective: decreasing costs while still maintaining adequate operational oversight. Too much or too little trust in a fund administrator may lead to inefficiencies and/or unnecessary operational risk.

To determine the optimal level of shadowing, managers should begin by reviewing their current operating models and outsourcing agreements. The questions below are useful in evaluating the optimal level of shadowing:

- ▶ Are there data aggregation needs resulting from having to receive data feeds from multiple prime brokers, custodians, trustees and other administrators, as well as risk and market data providers?
- ▶ Is your firm under strict regulatory and compliance deadlines or investor reporting demands that require near real-time access to data?
- ▶ Is there a data warehouse model that can be leveraged by all internal fund departments and outsourced service providers so that everyone is working off the same data sets?

- ▶ Is your fund administrator employing the latest technologies, offering financial and operational control dashboards, and providing better workflow automation, transparency and reporting than the fund can provide in-house?

Functions to keep in-house

Breakthrough shadowing technologies may ultimately decrease oversight costs by making certain in-house oversight infrastructure unnecessary. Until these systems are mature, however, fund managers should maintain internal infrastructures to shadow outsourced risk management, valuations and compliance functions, in addition to collateral and margin management, cash management, FX hedging and portfolio rebalancing. Managers should be able to perform their own internal analytics, maintain oversight, and create intra-day and end-of-day profit and loss, position and risk reporting.

Likewise, hedge funds should maintain an investor services team in-house to track and monitor all subscription and redemption activity. Given that investment and hedging decisions are made based on inflows and outflows of cash, it is important that funds maintain oversight and establish controls of outsourced share registry processes. There have been many examples in the market of missed redemptions or subscriptions that have resulted in market risk to the fund and administrator. In light of such incidents, it is vital to shadow investor-facing processes in-house and to work in tandem with administrators to track and monitor trade order activity.

Shadowing technologies

Increasingly, administrators are providing unfettered views into administrative operations by allowing customers direct access to viewing the administrator's systems. Others provide web-based "dashboards" that allow fund managers to log in to secure sites where administrative data is updated daily and posted for review by the fund manager's middle office and operations teams. Both of these options could eventually make expensive in-house shadowing operations unnecessary.

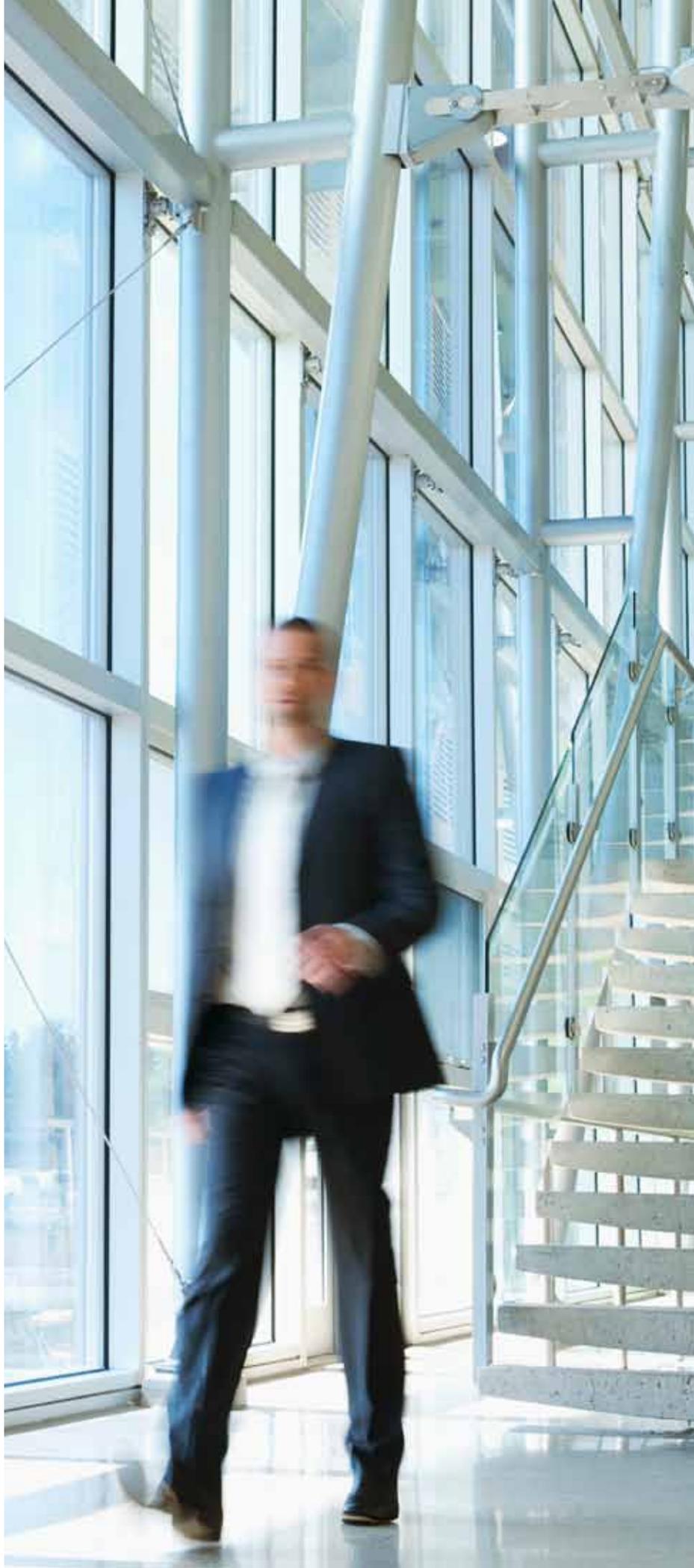
Evolving fund administration technologies offer an alternative to data duplication and to the creation and maintenance of an in-house shadowing infrastructure. These systems are designed to enable both hedge fund client and administrator to work from a single server. Such a straight-through processing model provides traders, as well as middle- and back-office personnel at the fund, with the same applications that fund administration personnel are leveraging. Trades can be captured directly in a single system, where they are recorded and analyzed almost instantly. The system then delivers real-time analytics, performs portfolio stress tests, monitors compliance limits and provides VaR and other risk measures.

Fund managers achieve enhanced control through automated workflow and dashboards that make working in tandem with in-house and third-party personnel seamless. When all parties to a transaction use the same applications and databases in real time,

the information gap between them is effectively closed, thereby reducing the level of shadowing required. The entire trade life cycle is supported by automated workflow that enables all parties to identify and address issues in a manner far outpacing today's practices. These systems will extend real-time fund oversight to middle-office services that are increasingly being outsourced.

Going forward

No matter what specific shadowing approach a fund currently employs, it is vital to revisit the operating model and outsourcing agreement with an eye toward eliminating redundancies while reducing risks. At the same time, funds must satisfy investor demand for transparency and a well-controlled processing environment. Failure to do so can lead to expensive infrastructural imbalances. A manager may be spending too much on maintaining the operations and technology infrastructure needed to shadow functions that do not prudently need to be shadowed. Likewise, if a manager accepts information provided by a fund administrator at face value without any independent confirmation, this can lead to poor investment decisions, increased reputational risk, and ultimately, the loss of long-valued clients. By regularly reviewing a fund's internal processes and working closely with administrators to leverage the latest technologies, managers can improve transparency, create greater efficiencies and significantly lower costs.



Keith Caplan is an executive director in the Financial Services Office of Ernst & Young LLP. Keith is based in New York and can be reached at +1 212 773 3003, or keith.caplan@ey.com.

Samer Ojeh is a principal in the Financial Services Office of Ernst & Young LLP. Samer is based in New York and can be reached at +1 212 773 6486, or samer.ojeh@ey.com.

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity.

Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com

© 2011 EYGM Limited.

All Rights Reserved.

EYG No. CK0468

1109-1293851

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.