

FOCUS ON

## ADMINISTRATION

Jim Kelly, co-founder of HedgeServ, examines the evolution of the hedge fund administration industry, and looks at how a shift in priorities following the financial crisis has brought the importance of third-party administration, and capable technology solutions, to the fore for both managers and hedge fund investors

**T**he hedge fund administrator is now ideally positioned to help managers address the challenges of increased business, investor, and regulatory demands. This evolution is driven by the concept of data convergence, where the administrator delivers the fund a single-sourced, complete and accurate set of enriched portfolio data fully reconciled to the fund books and records.

How is this achieved? The administrator initiates its processes from a logical front-office starting point, using a technology platform that captures all manager trades in their native form, regardless of asset class. Trade capture is augmented with manager-defined tags at the instrument, trade, strategy, fund and firm-wide levels. This results in an enriched security master reflecting all relevant market and economic data for each trade. Once

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captured, trades flow straight through into a real-time enterprise risk and portfolio management system, integrated with a general ledger accounting engine – all underpinned by a single database. The administrator then performs rigorous daily processes, including independent price verification of the entire manager portfolio and reconciliation of all trades, positions, and cash.

The result is a high-quality data set that enables funds and their managers to speak the same language when viewing their data – internally across their business functions, with counterparties and with investors. Data convergence empowers funds and their managers with the option to perform portfolio and risk management, regulatory and compliance reporting, and investor

reporting from a centralised third-party information source. This 360-degree view of the manager's portfolio reduces operational risk and produces the unbroken chain of accounting and reporting independence that investors demand. Administrators with these capabilities are in the best position to effectively maintain a fund's official books and records without the manager sacrificing control, timeliness or accuracy.

This has not always been the case. Historically, confidence in the administrator's ability to produce net asset value (Nav) calculations often only existed in scenarios where the fund or their manager 'shadowed', or internally reproduced, the accounting and calculation agent work performed on their behalf by their administrator.

This lack of industry confidence was well founded during the 1980s and early 1990s. Traditional administration was spawned by the 'Ten Commandments', which allowed US-based hedge funds to be exempt from certain taxes on US source income, providing specific administrative functions took place offshore. In theory, exemption required a model where preparation of the official books and records and calculation of the Nav were independently performed by the administrator.

In reality, administrators at that time lacked the ability to independently produce a set of books and records. Their limitations were rooted in under-qualified staff, inefficient workflows, and manual spreadsheets. The administrator never truly took responsibility for the books and records, instead relying on manager data to produce the Nav. Because the administrator simply verified the figures provided by the manager at month-end in a process known as 'Nav Lite', published Navs were typically late and often inaccurate. This led funds, managers and investors to view shadow accounting as an operational best practice.

**THE MID-1990S SAW THE** administration industry make significant advances in addressing its shortfalls. A new model emerged delivering accurate and timely Navs underpinned by robust daily accounting and middle-office services. Despite these improvements and the repeal of the Ten Commandments in 1997, many funds and managers continued to perform accounting and reporting in-house using previously built infrastructure. Self-administration and Nav Lite ceased to be acceptable, however, following the Lehman collapse and Madoff fraud in 2008. Investors insisted that a reputable third-party administrator independently prepare funds' books and records.

Administration continues to evolve since 2008. A new generation of administrators has developed the capability to effectively produce the official books and records and provide funds and managers with full operational transparency into all Nav-related workflows and calculations. Best-in-class administrators are delivering confidence to managers and investors by employing hedge fund-calibre professionals, adhering to institutional processes and using powerful technology platforms.

Market sentiment has migrated away from insistence on shadow accounting as a requirement. In its place is the growing belief that the administrator, through the delivery of data convergence, is now best positioned to truly own the fund's books and records. After all, it is the administrator, and not the hedge fund manager, that has this legal responsibility – a critical distinction overlooked far too often. ■