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Administrators in the Spotlight

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The service providers facing the most scrutiny from investors are fund administrators, which track clients' money transfers and provide the all-important net asset valuation (NAV). Hedge funds outside the U.S. are generally required to engage fund administrators. That has become de rigueur in the U.S. as well, especially in light of the Securities and Exchange Commission's registration requirement, effective July 21, for hedge fund firms managing more than $150 million in assets.

Besides providing details about the types of investors in their funds and business practices that may represent conflicts of interest, hedge funds will have to list their service providers, including prime brokers, auditors, outside marketers and fund administrators. Any sizable fund without an administrator is bound to attract questions. And even smaller funds are likely to feel the pressure to obtain independent valuation marks for their trades, especially if they're seeking institutional money.

However, fund administrators don't enforce perfection. One customer of Citco, a giant in the administration business, was Greenwich Sentry, a Madoff feeder fund. Another was the Lancer Group, which collapsed in 2003 and cost investors more than $200 million.

Consequently, investors are performing extensive due diligence across the board. Vernon Barback, president and COO of GlobeOp Financial Services, which grew out of the highly regarded back office of the nearly collapsed Long Term Capital Management and has $167 billion in assets under administration, says the number of requests for due diligence information jumped 30% in 2009 from the 2008 level. While the increase leveled off in 2010, the length of due diligence questionnaires has tripled, and on-site visits have doubled.

Barback says investors ask about asset-pricing processes and seek details on reconciliations and proving the existence of assets. Also common are questions about money transfers -- how they are tracked and their signatory controls. "Around valuations," says Barback, "people are interested to understand if the fund has a written valuation policy that we consider best practice."

Just as investment managers are investing in technology to keep pace with regulatory and client demands, not to mention their own needs for greater efficiency, fund administrators are increasingly stepping up their level of automation and skills in such areas as risk management, which is a distinct product line at GlobeOp, for example.

Automation and Accountability

Pittsburgh-based Confluence, a leader in fund administration systems, found in a March 2010 survey that six out of 10 administrators considered automation of manual processes their most important back-office goal. "Companies will differentiate themselves through their service, pricing and ability to scale while mitigating risk," says Confluence executive vice president and COO Kirk Botula. "Data consolidation and process automation will be key to making this happen."

Barback says that not only do investors ask to see a fund administrator's SAS 70 Type II report, which certifies a business' controls and their operating effectiveness, but will ask to be walked through the document. They may even ask for an opinion letter from the auditing firm that conducted the SAS examination and whether any testing exemptions were made. "We are just beginning to see -- I wouldn't call it a trend yet -- the occasional instance where an investment management company is seeking a SAS 70 Type II for itself," Barback notes.

Most traditional hedge funds provide monthly NAVs to their investors. The financial crisis gave rise to the notion of "NAV light," which typically refers to valuing a fund's assets at month's end without reconciling its trades each day throughout the month.

Michael Clark, CEO of Butterfield Fulcrum, a Bermuda-based administrator servicing 800 funds, says clients ultimately determine the type of NAV they want. If administrators are uncomfortable with the choice, they can always decline to produce the NAV.

More Is Better

NAV light "popped up quickly after Madoff," Clark says, and his firm has provided them. But he sees a much more stringent standard developing, and funds, which may previously have marked illiquid assets themselves, are increasingly asking administrators to provide valuation assistance.

The new generation of fund managers understands the benefits of providing more information, says Sal Campo, a partner of Conifer Securities, which outsources a variety of services for hedge funds including administration, a technology platform, trade execution and prime brokerage. His firm does not provide NAV light, which the older generation of hedge fund managers, accustomed to less transparency, are more prone to request.

"Both investors and managers realize more transparency is not a bad thing," says Campo. "If the fund loses money, the investor can say, 'You lost money, but I understood what you were trying to do.' I think NAV light will be used less and less in the future."

Butterfield Fulcrum's Clark also noted investors' attention to detail. If a fund is providing a monthly NAV, investors want to see the administrator reconciling transactions daily.

"They don't want to see transactions un-reconciled for 28 days, and then assets valued right before the NAV," he says. "With separately managed accounts becoming standard fare, most investors want daily NAVs, and the people managing those accounts want intraday profit and loss projections."

Jim Kelly, chairman of New York-based HedgeServ, says his firm "marks 95% -plus" of clients' assets. HedgeServ's software shows the inputs and values of over-the-counter, less liquid assets and compares them to quotes from other market sources such as Bloomberg. Data is provided in real time to clients. Each day, all activity is reconciled electronically, "with signed-off approvals and comments," Kelly says. "At the end of the day, the fund administrator has to take full responsibility for keeping the books and records of the fund."

Stressing Independence

Kelly co-founded HedgeServ in 2007, having earlier founded International Fund Services, which State Street Corp. acquired in 2002. He stresses the importance of independence, saying "it is imperative to have a properly functioning system of controls, that the administrator is independent from the custodian, and that both are independent of the prime broker. Having a service provider perform more than one function reduces the controls and increases operational risk," Kelly asserts.

That is hardly universally accepted. AlphaMetrix, in part a fund of funds, acquired Spectrum Global Fund Administration in December. Prime brokerage, fund administration and custody co-exist under the corporate umbrellas of Goldman Sachs & Co. and Citigroup, among others.

Sandy Kaul, U.S. head of prime finance and business advisory services at Citi Prime Brokerage, says that unit may seek valuation marks from the fund administration side, but fund administration never reveals customer positions. And the relationship between the two units is "one way. The prime broker shows positions to the fund's designated administrator, but the administrator doesn't send any information back."