Samer Ojjeh of Ernst & Young explains the ins and outs of fund administrator shadowing

The phenomenon of fund administrator shadowing really caught the attention of the hedge fund industry, and the media as well, through reports of large hedge fund firms appointing a second administrator to “shadow” certain back- and middle-office services already performed by the primary administrator. Stated hopes have included increased report accuracy and, therefore, renewed investor confidence in risk management and portfolio oversight.

**CONTROL AND ACCURACY**

There are numerous reasons why fund administrator shadowing is used by hedge fund managers. The main strength of this approach, however, is increased valuation and trade execution accuracy and availability. At the end of the day, this is always the responsibility of the manager. With cross-checking the financial books producing greater accuracy, this will not only provide additional comfort to the investor, but also the managers themselves who can be confident in their NAV figures, for example.

Heightened investor and regulatory demand is also leading to a desire for more frequent financial reporting, which requires additional and more accessible data. This reporting could be as frequent as daily or weekly. The benefit of fund administrator shadowing, in this regard, is that the manager will have a better idea as to the value of the fund’s assets without having to wait for the official statistics from their primary third-party administrator, particularly if this shadowing is done in-house using the firm’s internal operations.

**FULL OR PARTIAL?**

Of course, mirroring the work of the third-party administrator does not necessarily require all its functions being shadowed 100%, given the significant amount of resources required to do this. Many of the world’s largest hedge fund managers are now considering a new approach whereby only some of the third-party administrator’s functions are cross-checked; this is known as partial shadowing. The key decision for hedge fund managers, if they choose this model, is deciding which functions to oversee. Should shadowing include back-office processes such as reconciliation, NAV calculation and fund statement administration? Should it include middle-office tasks such as collateral management and some treasury services? If the decision is made to take a partial shadowing approach, it will take a high degree of planning and preparation. The fund will need to extensively analyse the current state of its systems, technology, data and architecture. With this information at hand, the manager will then be able to decide which functions will be shadowed, and which will be handled solely by the administrator.

**CONCLUSION**

Increased calls for high-quality data and transparency looks set to continue for the near future; 2008 is always in the back of everyone’s mind. It is yet to be seen whether using two outside administrators is a trend that catches on given that investors will be charged for additional administrative fees. This is perhaps an approach best suited to the leading firms with billions in AUM and large institutional investors on board. What we do know, however, is that investors are no longer satisfied with administration being done entirely in-house, or entirely via a third party.

**THE BENEFIT OF FUND ADMINISTRATOR SHADOWING IS THAT THE MANAGER WILL HAVE A BETTER IDEA AS TO THE VALUE OF THE FUND’S ASSETS**

This strategy of maintaining a parallel set of books and records allows the hedge fund manager to cross-check and validate an administrator’s output, confirming data accuracy that is critical to trading, portfolio management, compliance, risk management and financial reporting to investors and regulators. The fund’s data needs to be complete, timely and accurate to satisfy the demands of both the regulators and investors. A negative aspect of this approach is the potential additional costs that may be incurred. Indeed, our survey found that only 53% of investors felt that the shadow accounting hedge funds perform is worth the costs that may be passed on to a fund.

**WHAT IS IT ANYWAY?**

The popularity of fund administrator shadowing is seen in Ernst & Young’s global hedge fund and investor survey 2012, which showed that 89% of managers favoured a certain degree of shadowing of their accounts. One in four respondents also stated that they had increased the amount of shadowing they do over the year. With such a high level of interest, what exactly is fund administrator shadowing?

Fund administrator shadowing is essentially the mirroring of services already provided by the primary third-party administrator including, for example, valuation, asset servicing, fund accounting and market data management. This so-called shadowing can either be done in-house through a firm’s internal operations or, as has happened more recently, through the hiring of a second outside administrator.

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“AS MORE IS DEManded OF MANAGERS, THE ADMINISTRATION SECTOR IS ALSO EXPECTED TO STEP UP ITS GAME”