

FOCUS ON

# FUND ADMINISTRATOR SHADOWING

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



## Samer Ojeh

is a principal in Ernst & Young Asset Management Advisory Services practice. He is based in New York. He has more than 17 years of experience, and leads E&Y's advisory initiatives in the alternative investment marketplace. Ojeh has helped numerous hedge funds and fund administrators in improving and/or expanding the efficacy and effectiveness of their front-, middle- and back-office functions, and in redesigning operational processes to support changes in organisational structures, processes and technology platforms.

Outsourcing back- and middle-office functions has, for many years, been a standard hedge fund and fund-of-fund best practice; this led to an increasing focus on the day-to-day attention of the fund's strategy so as to produce a consistent high level of returns. Indeed, seeking the role of an independent administrator has become an essential ingredient for attracting capital, particularly from the large institutional investors. This trend also enabled funds to reduce their internal costs while, at the same time, increasing their due diligence by benefiting from the expertise of specialised administrators through services such as valuations and financial reporting.

Managers today are now facing greater scrutiny than ever before from both regulators and investors alike. Regulatory requirements, such as Dodd-Frank and Form PF, have forced hedge fund managers to take steps to ensure they clearly and accurately report their net assets, financial and risk-related information. Investors, who are diversifying their asset allocations into a variety of strategies and are increasing their allocations into the alternative asset management industry, are also looking for an increased level of comfort as they seek further checks and balances following the closure of several high-profile firms and the Madoff scandal. We all know that hedge funds have, for a long time, been criticised for a lack of transparency.

It appears that the recent financial crisis may have changed the way hedge fund managers view their third-party administrator, and the reliance they have on having a single provider perform all back- and middle-office functions. Managers found themselves increasingly concerned about the amount of time reporting



took and the accuracy of the figures provided. As more is demanded of managers themselves, the knock-on effect has been that the administration sector is also expected to step up its game. This has led to hedge fund managers reconsidering the value of fund administrator shadowing.

## 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.

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.

“ THE BENEFIT OF FUND ADMINISTRATOR SHADOWING IS THAT THE MANAGER WILL HAVE A BETTER IDEA AS TO THE VALUE OF THE FUND'S ASSETS ”

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 done 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. ■

## ERNST & YOUNG

As a leading service provider to the hedge fund industry, Ernst & Young has assisted numerous hedge funds with the valuation of their operating model, inclusive of their assessment of the level of shadowing, to evaluate its effectiveness to obtain sufficient control and minimise non-value added activities. This allows the manager to focus on their core competencies – portfolio management and risk management. The views expressed herein are those of the author and do not necessarily reflect the views of Ernst & Young LLP.

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