

Regulatory scrutiny of funds drives new administration business

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As hedge funds grapple with investor calls for greater transparency, an unlikely beneficiary has been the fund administration industry that was otherwise braced for a downturn amid declining assets. Administrators now expect a rush of new business to come from management firms that plan to outsource functions such as net asset value determination, trade reconciliation and cash management.

Another fresh impetus is being driven by rising regulatory scrutiny aimed at bringing the 'secretive' world of hedge funds out of the shadows. This could generate a flurry of activity for independent verification of assets, performance, valuations and the like. For administrators, that's good news for sure.

But a few questions remain: What impact are hedge fund liquidations and dwindling assets under management having on fund administration pricing and margins? Will fewer new fund launches translate to moribund revenues in the near term? And what impact will cost cutting have on their overall quality of service? On these counts, the short-term business outlook appears somewhat tentative, say industry participants.

As part of an established international fund administration hub, Bermuda firms are closely watching industry developments. The island, smaller in size than Manhattan, is home to numerous providers ranging from banking behemoths such as Citibank and J.P. Morgan to startups such as Equinox Alternative Investment Services. While most firms have seen their assets under administration shrink by at least 20%-30% because of losses and investor redemptions at clients, resulting in some staff redundancies, things could have been much worse, industry practitioners say.

'The picture here is consistent with that of the global industry,' says Stephen Castree, chief executive of Hamilton-based Equinox. 'The environment has certainly suffered...and Bermuda corporations are reacting in similar ways to their peers in other domiciles.' Look past the unfavorable press attention hedge funds in general have generated, and you will find that funds and service providers operating on the island have mostly benefited from closer oversight of the Bermuda Monetary Authority (BMA), as well as the many years of experience, says Castree.

Even so, administrators have seen their revenues drop, since they typically get paid based on the asset-base they service, adds Castree. Yet, the workload of funds in liquidation or restructuring has risen, often requiring higher-level expertise. Despite that, administrators' minimum fees are under pressure as managers attempt to lower their own costs. In response, administrators are adopting diametrically opposing tacks: Barring minor tweaks, some are keeping their operations the same or are even adding new services with the view that over time, hedge funds will become profitable again. Others, meanwhile, are cutting costs or slashing prices.

As for Equinox's business, the outlook is positive, says Castree. Since Equinox is around two years old and has newer funds as clients, it isn't saddled with legacy fund liquidity problems that some of its competitors are facing. 'Since we were just starting out when the market troubles began, we escaped the problems that some of our competitors are facing. For us, there's no modus operandi to change, no fires to put out. We count ourselves fortunate.' Nonetheless, the market for new business is undoubtedly difficult and this is true on a global basis, he adds.

Tom Davis, chairman of Hamilton-based Meridian Fund Services, says one of the most significant developments over the last eight months or so is the moves by financial regulators around the globe to step up their oversight of hedge funds. In response, managers will be required to dramatically adjust their business models. This would present service providers with a raft of new business

opportunities.

For instance, the U.S. Securities and Exchange Commission is expected to call for manager registration and subsequent compliance with its rules. Says Davis: 'Typically, one would expect to have an in-house general counsel and a compliance officer handle the new requirements. But some managers won't have enough fee revenue required to afford such resources. In such cases, we can serve that role.' Meridian Fund Advisers, launched last month, provides outsourcing general counsel and compliance services to managers.

Contrary to perceptions in some quarters, pressures being faced by offshore and onshore funds are the same. 'Other than the difference in their investor bases, the problems faced by Bermuda funds in terms of poor performance or investor-redemptions are the same as those of onshore funds,' says Davis. Yet, only a handful of local funds have gone out of business. 'Those who've made up their mind to continue their operations are in this for the long haul and are, it would appear, seeing redemptions bottoming out. Sure, things could remain somewhat fragile for some time but we seem to be out of survival mode.'

Of course, the erosion of assets has pushed all administrators to re-evaluate their business plans and trim their operational costs. In Meridian's case, its lower-cost servicing center located in Halifax, Canada, delivered additional benefit to its bottom line: The Canadian dollar's decline in value versus the U.S. dollar during 2008 helped to lower its cost base even further.

'Once the dust settles, we expect people to focus on corporate governance of funds,' Davis says. 'Administrators won't be called upon only to crank out monthly NAVs; as we've witnessed recently, a lot can happen during the course of a month. Some managers, with encouragement and sometimes at the insistence of their investors, are moving toward weekly and even daily estimates of NAV and reconciliations of positions.' Eventually, fund administrators will be involved more deeply in providing independent oversight and reporting of fund activity on investors' behalf, he adds.

Such moves are signs of fund administration becoming a mature and more sophisticated business, says Jason Bibb, managing director at ISIS Fund Services in Bermuda. In light of recent scandals, changing demands of investors and increasing complexity of investment mandates, 60% of North American funds that currently self-administer are taking steps to outsource their back offices to third parties, with the goal of safeguarding interests of existing investors and also to secure new ones.

'The days of administration being conducted without requisite experience, skills, understanding and technology have long since past. These days, clients are demanding institutional quality infrastructure from administrators in an effort to connect front, middle and back office operations.'

Due diligence of potential administrators has become an important part of the process of winning a client, says Bibb. Under Bermuda statute, administrators are required to be licensed by the BMA, which conducts annual due diligence visits to ensure that firms are following its rules and have the proper controls and procedures in place to protect their clients' interests.

Bibb anticipates the historic role of a fund director may also change. Some individuals have provided directorial services to over 100 funds each in previous years. With a large number of funds now facing restructuring, valuation, side pocketing and redemption-related issues, 'the practicality of managing and staying informed of the activities of all the companies at the same time isn't possible.'

Going forward, investors will expect offshore fund directors to be more forceful in keeping managers compliant with their fund investment guidelines and in monitoring valuations. ISIS, meanwhile, is focused on developing its 'bespoke' business by combining stability and expertise of a large organisation with the flexibility, autonomy and character of a boutique, says Bibb.

Butterfield Fulcrum, which as the combined administration businesses of Bank of Butterfield and Fulcrum Group is among the larger players in Bermuda, is able to keep its own business costs low with its twin focus - it utilises a scalable technology platform and performs process-heavy functions in lower cost hubs such as Canada and India. All told, its outposts in nine countries administer 700 entities.

Greg Bennett, head of business development Americas at Butterfield Fulcrum, says there's an upshot for management firms in outsourcing of middle and back office to an outside administrator. The move would help defray some of their operational costs, as it is often more cost effective to outsource these functions.

For service providers, investors' push to lower fund management fees is having an impact. "Given the negative performance on average over the past year investors are questioning now, more than ever, traditional fee arrangements. Managers will need to be flexible and creative regarding fees in order to balance the demands of existing and new investors while still building a profitable model that will sustain a longer term business plan," says Chris Gauk, partner, Ernst & Young.

On the fund administration front, Butterfield Fulcrum's Bennett notes that numerous players are revisiting their pricing models and while the trend may be to revert to a transaction-based pricing model from the current asset-based one, there has to be risk premium for the increased independence that's being asked of administrators in everything from NAV calculations to independent verification of assets and valuations.

Apex Fund Services' chief executive Peter Hughes indicates that following a reorganisation of the overall hedge fund industry, it is moving forward with fewer - but larger - established managers. New fund launches are taking place, but with smaller amounts of capital, which may not be the best news for now, but is a sure sign that the worst is over and the industry is now looking to rebuild.

Jessel Mendes, partner, Ernst & Young, concludes, "Bermuda has not been immune to the current industry challenges, but we're holding our own. Many of us in industry, government and our regulator, have been engaging in constructive, open dialogue locally and internationally. We are waving the Bermuda flag and, where necessary, dispelling myths. Bermuda has always been a major player in the global hedge fund industry with the unique ability to offer on the ground solutions to all hedge fund needs. We are well known, well regulated, and our reputation for quality speaks for itself. We are poised, ready and bullish about the long term future of the industry."

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