

## HEDGE FUND ADMINISTRATION - A PRACTITIONER'S VIEW

BarclayHedge have been generous enough to offer Custom House the opportunity and the forum, for the next 12 months, to discuss any aspect of the hedge fund industry that we feel appropriate. This could include long term trends, basic fundamental situations or some topical topic. The intention is that our contribution will be primarily educational and will not be obvious promotion for Custom House, although, inevitably, some of the subjects that we will be writing about will be to do with hedge fund administration and, as such, you will be getting the Custom House view.

This is demonstrated by the first three articles which we will be submitted to you and which will be:

- (i) The Pros and Cons of Independent Versus Self-Administration for Hedge Funds, CTA Funds and Managed Accounts;
- (ii) An Explanation Of What An Independent Administrator Does; and
- (iii) How To Go About Selecting An Independent Administrator

As I said, the intention is that these articles should be informative and objective, that is educational rather than commercial, but sometimes that just may not be possible – in which case, we apologise in advance!

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### **The Pros and Cons of Independent vs. Self-Administration for Hedge Funds, CTA Funds and Managed Accounts**

It seems extraordinary to many, coming from a non-US background, that any fund should be self-administered. Self-administration is very definitely an American phenomenon and that is a result of historical circumstances.

In the United States, hedge funds and, for that matter, most other alternative investments, including real estate, oil and movie finance projects, have been structured as Limited Partnerships (LPs) and were self-administered and, indeed, a high proportion still are self-administered. This means that the General Partner (GP) acts, not only as the investment manager, but also the administrator of the LP. This arrangement has been in place for many years and it has to be said that the vast majority – conceivably 99.99% of these LPs – were (and still are) very well run and the GPs meet all their obligations. However, unfortunately, but inevitably, frauds have occurred and these generate juicy headlines, particularly if a hedge fund is involved.

Ironically, post-Madoff, there has been a lot of pressure laid on managers by institutional investors to convert from being self-administered to independently administered. This trend has been largely led by two Swiss banking investors who have allocated many billions into the hedge fund industry and who took this position following the Madoff scandal. It is ironic that Madoff never actually had a fund (notwithstanding that many funds appointed him as their investment manager) and, as such, Madoff would never have needed to employ an administrator. I don't intend to spend much time writing about Madoff, but I think that when the dust is settled, the investment world will have learnt two basic rules - firstly, the importance of in-depth due diligence and secondly that investors should be sceptical and begin to feel uncomfortable as soon as they begin to feel "comfortable." Due diligence is not a "one-off" thing - it is ongoing.

So today the pressure on managers to appoint an independent administrator is coming from investors and, although there is some expectation that the regulators in the US may require independent administrators to be appointed to funds – as yet, that has not happened (to the continual surprise of the whole industry outside the US). As a result of this institutional investor pressure, many US hedge funds and CTAs have now appointed administrators including several of the larger firms, although I did hear a comment at a recent conference that covered this subject, that

there is the belief that several of the larger hedge fund managers have entered into "NAV Lite" agreements with administrators. This could mean that the manager continues to do the work, including producing the numbers and the administrator "rubber stamps" them, which, of course, negates the whole concept of an independent administrator.

But I am moving ahead of myself.

When discussing the pros and cons of independent versus self-administration of hedge funds, there are a number of factors that have to be taken into account.

- Firstly, does independent administration add value? And,
- Secondly, what does it cost?

It should be absolutely clear that these are not the same questions. I strongly believe that many decisions in all walks of life are made on the basis of deception and not factual certainty. It is this perception that forms a large part of the value-added, because of the comfort that independent administration brings to investors. There is no doubt that, if the administration of a fund and, particularly, the calculation of the Net Asset Value, is being carried out by an independent third party – and by independent, I mean independent of the hedge fund manager. Furthermore, that third party uses independent price and transaction data sources when calculating the NAV. If this is the case, then investors will feel more comfortable than they would if the NAV is being calculated by the manager.

Investor comfort is an invaluable commodity. Not only does it mean that existing investors in the fund may be more comfortable in being an investor in the fund, but also the appointment of an independent administrator could well encourage investors who previously would not have considered the fund. This is, of course, a relatively new trend, although at a recent seminar in New York, one of the leading prime brokers stated that they would not take on the account of a fund that did not

have an independent administrator. At the same seminar, the manager of a successful fund of funds said that they would not consider investing in any fund that was self-administered. Obviously, there are other prime brokers and other investors on the street who take a different view, but it would appear that, from a marketing point of view, self-administration is gradually becoming similar to somebody entering a boxing ring with one hand tied behind his back.

In these circumstances, of course, measuring "value added" is impossible, if only because it is impossible to know how many potential investors decided not to invest in a self-administered fund, purely because it was self-administered. That is, I suppose, an example of a Chinese loss, but, nevertheless, it is a loss.

It is claimed that the cost of appointing an independent administrator is relatively high, although there are many in the industry who feel that administrators undercharge for their services (and, not surprisingly, I would agree with them). Nevertheless, there is a well known argument that, for an established fund, which has hitherto been self-administered, the appointment of an independent administrator is expensive. The GP will have installed various systems and employed staff to run their middle office and to produce the valuations of the funds and calculate the value of the interests of individual partners. Such hedge fund managers perceive administrators to merely be duplicating efforts they have already made. There is some truth in this, but it does, I think, miss the real and basic point. I would suggest that any manager who is fulfilling his appropriate risk management obligations would need to know what the position of the fund was, not only in terms of open trading positions, but for the valuation of the fund on a day to day basis, otherwise, how is the manager going to be able to carry out any risk management analysis. In carrying out this function, the manager will be able to calculate the NAV of the fund and its performance, as well as, of course, calculating the position of each of its investors. An independent administrator will, by using some of the same information, but also verifying that information independently and externally, will, most probably, come up virtually the same information, NAV, financial statements, etc. This is perceived to be an expensive duplication, but it is not just duplication. It

is an independent valuation which investors appreciate and the fact that the manager's own calculations agree with the administrator's, does not mean that one of the processes is wasted. It means that the independent administrator has verified what the manager is saying and that is extraordinarily valuable information.

One of the glaring errors that came out of the Madoff case is the fact that no one, neither the investor, the administrator, nor the accountant, could actually verify, or, if they had made the effort, they had failed to verify, the existence of the assets that were supposed to be in the fund, whether that be cash or open positions on the market (for which there were very few, if any, at each month end). It is, therefore, almost certain that, in future, administrators will be required to verify the existence of a funds assets and, of course, this is not information that the GP of a fund should provide because of the GP's conflicts of interest – for the cynical and/or sceptical, there is no benefit in asking the fox whether the hen house is safe.

I think it is also worthwhile briefly mentioning the proposed or draft EU Alternative Investment Fund Managers Directive ("AIFM"). The original draft, which came out at the end of April 2009 was an horrendous piece of proposed legislation and I am glad to say that it has been totally rewritten since then. It is an EU paper and, therefore, it becomes an agenda item for the current President of the EU. When the Swedes took over the presidency in June last year, they took on the AIFM Directive and substantially rewrote it, although they managed to introduce another controversial clause concerning compensation. By the end of December, nothing had been agreed and their compromised draft was passed over to the Spanish, who, initially, downgraded the topic to second priority and then came out very quickly with a new compromise.

Whatever happens, nothing is yet cast in stone and it is unlikely that it will be finalised before the middle or even end of next year, which means that nothing will be implemented before 2012 and even that is open to question. Somebody said recently, the only certain thing about the AIFM Directive is that nobody knows how it will end up.

Having said that, it is likely that there will be restrictions on marketing requirements to European investors from retail to institutional, unless either the manager or fund or both are registered in the EU.

This has, undoubtedly, been one of the drivers behind the precipitous plunge into UCITs funds in Europe, although for most hedge fund strategies, UCITs will not be practical and a "QIF", "SIF" or "PIF" (Qualified Investor Fund, Sophisticated Investor Fund or Professional Investor Fund, depending on the jurisdiction) will be the preferred vehicle. What it is likely to mean is that either the US managers will set up a new stand alone fund in Europe and will have to appoint an independent administrator for that fund, or, in order to pool assets and only have one portfolio to manage, they may be able to structure their new fund as a Master Feeder Fund with either the European fund feeding in the US LP or the US LP feeding into the European "Master Fund."

If the former - the EU fund is feeder into the US fund - then the administrator of the EU fund would probably be very reluctant to accept the numbers relating to the US LP, unless they had also administered that entity or they were given some guarantees that it was being properly administered and those guarantees would have to come from an unconnected third party.

Of course, many US managers have absolutely no desire to get involved in Europe and believe in most cases, quite rightly, that they can survive very happily concentrating on US investors and it works the other way too.

I have two final points to make with regard to this particular debate.

Firstly, I think that the trend in the United States and the attitude of the investors and regulators is such that independent administration is almost inevitable. No doubt, because it's in the States, there will be some qualification or exemption because of the size of a fund - something I have never understood. It seems to me

that it is the smaller player who needs more protection than the larger player and why protection should be imposed for people that have more than, say 25 millions of Dollars or more than 100 shareholders and such protection is not provided for smaller funds or smaller shareholders is extraordinary. But that is the way it is and it may well be that small funds may not be required or expected to have independent administrators, whereas large funds will. In my opinion, whatever the size of the fund, investors will be less inclined to put their money in self-administered funds over the next few years than they have in the past.

My last point is one that is somewhat cynical, but nevertheless, one I have made before. It is inevitable that the occasional mistake will be made, whether that is by a GP on a self-administered fund, or an administrator. And I am talking about mistakes, not fraud. In our industry, mistakes can be horrifically expensive. As a manager, would you not prefer to transfer the risk from your desk to the administrator's desk or, perhaps, more accurately, from your desk to the administrator's insurance company's desk?

Dermot S. L. Butler is Chairman of Custom House Global Fund Services Limited, a member of the Equity Trust group of companies, which offers a full 24/5, “round the world” and “round the clock” administration service out of fully integrated offices in Chicago, Dublin, Guernsey, Luxembourg, Malta, Singapore and The Netherlands.

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