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TAKING ON A NEW SHAPE

While the overall business and regulatory environments have provided more than their fair share of challenges to the fund administration industry, it has responded proactively and positively and come into its own over the last 18 months. It is no bad thing, given that many institutional investment firms have not waited for the ink to dry on the rafts of proposed regulation but have already turned to their administrators requiring a deeper service range. Providers up to now have been more than keen to oblige and have wasted no time in expanding and enhancing their array of products. Lynn Strongin Dodds reports on an industry in transition.

THIBAUD DE MAINTENANT, head of domestic custody services, Asia Pacific at Deutsche Bank, says, "There is no doubt that the asset management industry has gone through one of its most testing times ever. There has been much more scrutiny from investors as well as regulators and fund managers needing to rebuild their portfolios. It is a question of cost and they are leveraging the infrastructure of global custodians for their back- and middle-offices. Fund managers are also looking for third party valuation to help restore investor confidence in their products."

According to Paul Rowady, senior analyst at consultancy TABB Group who co-authored the report, *(Hedge) Fund Administration: The Selection Criteria for a New Market*

Reality, in general, fund administrators are playing a larger role in a fund managers' operational infrastructure. "It is no longer just about back-office functions dealing with accounting, valuation and share registration, but covers everything after the trade. In fact, the list of services firms cover has become so exhaustive that it is suffice to say that the only things administrators do not cover are fundraising and asset management," he says.

Fund managers are looking more to fund administrators to become an extension to their back and middle office and provide help in addressing the new demands of the market holds Jonathan Bowler, head of business development, BNY Mellon Asset Servicing, noting that "The key areas include transparency, risk management and reporting, operational efficiency, independent valuations for non vanilla products such as private equity funds, hedge funds, funds of hedge funds. We are also seeing clients want to get more involved in the process. We provide the investment analytics tools which allow them to do their own value at risk calculations and back testing."

Clients are also becoming more selective. Susan Ebenston, head of global fund services at JPMorgan Worldwide Securities Services, says, "We are definitely seeing a greater demand for outsourcing but I am not talking about wholesale outsourcing. Clients are looking at the different regulations that are pending and thinking about the support that they will need for their investment funds. What we have seen after the financial crisis, is that fund managers are adopting a hub and spoke approach with core products at the heart and the higher margin products at the edge, depending on a clients' risk appetite. It is important that administrators have the flexibility and ability to support them as they move into different asset classes and vehicles."

Institutions are also taking the time to review their existing arrangements, according to Hilary Martin, consultant at investment consultancy Investit. "We are at the end of a cycle that started about five to seven years ago when we saw a saturation of outsourcing deals. Fund managers are now looking at their contracts and clarifying whether they received the services and products they signed up to and whether they want to change providers."

It is not just a long only phenomenon. The pressure on hedge funds to show clients that their governance structures are up to scratch is prompting managers to examine what is on offer and with whom. Dermot Butler, chairman of Custom House Fund Services, says, "The Madoff scandal forced investors to conduct more rigorous due diligence and we have definitely seen hedge funds move from self administration to appointing a third party for independent valuation. We have also seen a shift in requests from weekly and monthly reporting to daily reporting and soon I anticipate some clients will want real time reporting."

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many assets are exposed to a particular counterparty or strategy." The firm recently launched a new compliance tool that enables clients to monitor their investments in real time according to their own investment guideline criteria. It looks at the level of portfolio diversification, liquidity risk in the fund, investment strategy and performance attribution."

While the roster of new products may have grown longer since the financial crisis, the main players such as Bank of New York Mellon, JPMorgan Securities Services, BNP Paribas, State Street, Deutsche Bank, Northern Trust, Custom House and GlobeOp Financial Services raised their game a few years ago in response to liability driven investment, new accounting standards and UCITS III. The resulting increase use of derivatives as well as alternative asset classes led to a investor calls for greater transparency, performance measurement, daily reporting as well as increased standardisation and more accurate valuation for OTC instruments as well as illiquid asset classes.



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Bill Tomko, managing director and head of operations at Spectrum Global Fund Administration, a Chicago-based hedge-fund and fund-of-funds administrator, says, "I think investors have been driving the changes in fund administration and are ahead of the regulation. The fund industry is definitely gearing up in anticipation of the new rules but independent administrators were already developing many of these services such as independent pricing, reconciliation and daily reporting in response to investor demands."

The collapse of Lehman Brothers investment bank and the Madoff Ponzi-style fraud have only served to accelerate these trends, according to Vernon Barback, president and chief operating officer of GlobeOp. "There is pending regulation but it will take time to be decided and finalised. I believe the financial crisis has forced investors to ask much tougher questions. We have seen an increase in the demand for much more detailed information and risk reporting at the operational and portfolio level. For example, clients want information about construction of the portfolio, the exposures to counterparties investment such as private placements as well independent valuations around the more illiquid asset classes."

As for the regulation itself, there are various drafts at different stages on the table but the fund administration industry is particularly interested in proposals for the

\$450trn over the counter (OTC) derivative market, the European Directive on Alternative Investment Fund Managers (AIFM) and UCITS IV. On the first issue, US and European regulators may differ on some of the finer points in their impending regulations but the main focus of their proposals is broadly the same. The thrust is to try to shift as many OTC derivatives as possible onto exchanges, where it is deemed that there is more transparency. Moreover, settlement of OTC derivatives trades is to be processed through clearing houses. For those derivatives that are not centrally cleared, there is likely to be a charge and they must be reported to a trade repository.

The result will be that central data repositories, extension of central counterparty (CCP) clearing, contract standardisation, broader authority for the regulators and investor protection through tighter controls on OTC trading eligibility, will take centre stage, says Derek Adler, co-founder and director in charge of business development at the UK-based International Financial Administration Group Ltd (IFINA).

The AIFM, on the other hand, says Adler, is very much a work in progress and is not expected to see the light of day before the end of 2011 or even the year after. It was floated as part of a general effort to tighten up regulation of the financial services sector in the wake of the crisis but has caused uproar in many quarters of the financial services industry. In its latest incarnation, Sweden, the holder of the EU's six-month rotating presidency, recommended removing two of the most contentious aspects of the directive—the leverage cap and the ban on hedge funds domiciled outside the EU, marketing to investors in the region.

The one controversial issue that does remain is the article that requires custodians as European depositaries to take on the liability for situations should sub-custodians, to whom they have delegated, fail to deliver securities owned by investors. In other words, according to the proposal, they would have to reimburse a fund's investors for "any loss of financial instruments" (either the actual securities or the value of the assets lost) unless the custodian can prove that "it could not have avoided the loss." It is a clause that is too rich for most market practitioners.

Most market participants believe this proposal will be diluted because providers would either have to substantially increase their fees to cover the additional liability or they would withdraw from providing the services. Geoff Cook, partner at Brown Brothers Harriman & Co, based in the bank's Luxembourg office, explains: "There is much nervousness about the AIFMD and the final outcome. There have been major changes since the initial draft in April but nonetheless, there has not been the typical consultative approach with the industry. One consequence we are seeing is a number of hedge fund managers creating products under the UCITS banner- that can't be the political intention, surely?"

Cook also believes that UCITS IV will create further opportunities on the new management company passport front, once of course a number of open tax issues have been

resolved. This will enable companies to manage better cross-border fund ranges by not having to appoint service providers in a fund's domicile, apart from the custodian bank. "It will improve the ability for administrators to record assets on a single technology platform less driven by different jurisdictions. Administrators will be better able to help aggregate data across multiple fund ranges; a particular benefit in reporting on shareholder subscription and redemption activity."

Looking ahead, there is no doubt that fund administrators have their tasks cut out, as they battle with supranational regulators that appear to have only a superficial understanding of the nuances within the complex asset management segment. Gavin Nangle, head of business development at State Street, believes they are more than up for the challenge. "The industry is definitely rising to the challenge and has invested in infrastructure to service more complex instruments. If you look back five to six years, funds might have turned to a specialist provider but today they want the scale and breadth of product offering of a larger player."

William Keunen, director of the Citco Group's Fund Services division, adds, "The top administrators see fund administration as a core business so the continuously invest in the business to meet the new challenge. Prime examples are derivative processing and pricing capabilities, annual financial and tax reporting capabilities."

Some may not though have the resources to stay in the game according to Philippe Rozental, head of asset servicing at Société Générale Securities Services. "Several boutiques have appeared in the past two years in the valuation areas. However they do not have the global platform and reach to support client requirements today. I believe we will see consolidation in the near future and several niche players will disappear. You need to be able to invest on a continuous basis in the products and resources. For example, on the valuation front, at SGSS we own the process from beginning to end with state-of-the-art IT platform, valuation models and dedicated market data warehouse."

Chris Adams, global product head for alternative funds at BNP Paribas Securities also emphasises the importance of having a uniform approach, regardless of the regulatory climate. "Whether a fund is based in Dublin, Luxembourg or the Caymans, the most important factor to a fund manager is a consistency of approach. You need to comply with local laws but where a fund is domiciled is arbitrary. They want the same level of support and attention to detail."

Fund administrators also have had to become much more bottom line oriented which might explain why some are looking to extract value from their relationship and not necessarily from the higher margin products. In other words, off the shelf products with more style and service instead of a tailored offering are the order of the day. As Sarah-Jane Dennis, consultant, operations and systems at investment management consultancy Investit, puts it, "There is no doubt that cost has become a big issue. There has been increasing pressure on asset managers to become more transparent and step up their client servicing, which



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costs more, at the same time that their assets under management have fallen, leading to a reduction in fees. They may be looking more at their fund administrators for solutions but they don't want to pay high costs."

Giles Elliott, global product head, securities services at Standard Chartered Bank, adds, "To a certain degree, clients want to expand the list of services but they are also conscious of the cost. It is quite a competitive market and we think one of the best ways to compete is to strengthen the relationship with a select group of key clients."

Ebenston echoes these sentiments. "We have definitely deepened our relationship with our clients in the past two years. We realise that their margins have been squeezed and that they are much more focused on cost. We have a standardised offering which covers about 90% to 95% of a clients' requirements. We can customise the remaining 5% to 10%, but customisation has a different cost. We are finding that clients are often now deciding that they do not need that extra 5% to 10%."

There are exceptions, of course. Bowler at BNY Mellon, says "In the more complicated OTC and central party worlds clients are prepared to pay to a certain extent. However, they expect the transparency and counterparty exposure reporting as included as part of the standard package."