

Changing Role of the Fund Administrator as Hedge Funds Face New Regulations

We are very mindful of the classic line in the film *Wizard of Oz* spoken by Dorothy: "Toto, I've a feeling that we're not in Kansas anymore."

And like Dorothy, the Hedge Fund industry got caught up in its own tornados (Madoff, Reserve Fund, Wall Street crisis) which transported it out of Kansas and into the new regulatory world of *Oz*, where the mighty Wizard was prone to legislate and regulate by issuing decrees throughout the land.

There are convincing arguments that Kansas, (United States), does not need new regulations, rather regulators who can enforce them. Unfortunately that is not how government works, and as the Wizard bellowed to Dorothy: "Do not arouse the wrath of the great and powerful Oz." Like the meekly lion, the Hedge Fund industry will be required to accept changes in the regulatory landscape in the coming months.

ADMINISTRATION'S PROPOSALS:

1. Requiring Registration of Hedge Funds - Investment Advisers whose assets under management exceed a certain threshold would be required to register with the SEC and establish a comprehensive compliance program.

2. SEC Enforcement Authority - Funds would be subject to SEC examination and recordkeeping requirements.

3. Disclosure Requirements - Funds would be subject to regulatory reporting requirements to investors and counter parties.

4. Providing Information Necessary to Assess Threats to Financial Stability - Funds would be required to report on a confidential basis, information such as assets under management, leverage, off-balance sheet exposure, trading positions, and other information.

This past June, President Obama and Treasury Secretary Geithner released the Administration's blueprint for financial services reform. It is very clear from these directives that the Hedge Fund industry will be required to raise its internal and external administrative reporting and compliance levels, which in turn will require additional resources in three main areas: **information technology and operations, risk management, and regulatory and investor reporting.**

Some of the regulatory changes may require increased staffing of the hedge fund manager's back-office, which translates into higher internal operating costs at a time when many hedge fund managers will resist these costs, especially since the investment returns are under-water and investor redemptions on the rise. Self-administration is also a distraction for the fund manager, when his/her top priority must be the investment portfolio.

At the same time, investors are starting to take action by demanding that Hedge Fund portfolios have an independent administrator that can provide greater transparency, and timely, accurate accounting reports.

It is imperative to the well being and success of Hedge Funds that they form a relationship with an Administrator that cannot only be perceived as a working partner with the firm but also can provide full administration and back-office support, while eliminating reporting risk, reducing costs and elevating service levels.

Mandated Accounting and Auditing Requirements:

Audit firms are starting to prepare their hedge fund clients to be ready to respond to the new legislation and are advising them to consider undertaking sufficient compliance measures in the operational back office modeled after the “Best Practices” approach of registered investment companies.

Hedge funds that register with the SEC must be prepared for additional oversight and a more aggressive and comprehensive examination agenda; these hedge funds will be required to implement a complete internal control and compliance infrastructure in order to be prepared for the regulatory examination process. Undoubtedly, hedge fund managers will look towards reliable administrators to support them.

Those administrators who are only capable of providing “light administration” services, which is essentially copying and pasting the data from prime broker statements onto spreadsheets for determining the portfolio’s Net Asset Value, will phase out over time and become extinct. Administrators who are able to provide “full administration” for the client will be the minimum standard in tomorrow’s marketplace.

The accounting industry has long recognized that data from prime brokers is not considered Generally Accepted Accounting Principles (GAAP) accounting records, but only a portfolio transaction record. Auditors want to see a control environment over the reporting process and error-prone spreadsheets manually compiled from prime broker information will be rendered inadequate. Moreover, funds themselves would be subject to the SEC’s books and records disclosure regulations which require an accounting process that can provide detailed GAAP records.

The control process around the generation of financial, accounting and performance reports will be more important than ever to comply with the disclosure demands in a timely and efficient manner.

Administrator’s Best Practices:

- 1. Maintains accounting records on a comprehensive General Ledger system.*
- 2. Receives an independent trade blotter directly from the hedge fund.*
- 3. Reconciles cash balances, portfolio trades and security positions against the Custodian and/or Prime Broker accounts on a daily basis.*
- 4. Market values of securities are independently priced by a third party, with complete documentation on any security that is fair valued.*
- 5. Subscription receipts are deposited into an “escrow” account.*
- 6. Contributions and withdrawals are independently confirmed to the investor by the Administrator.*
- 7. The Administrator co-signs any transfer of money from the fund’s trading account.*
- 8. A complete month-end accounting report package that includes each general ledger account reconciled with complete documentation, be prepared, reviewed and signed-off by the Administrator.*

The Role of the Administrator

In their role, the Administrators are responsible for maintaining accurate independent accounting records and for ensuring the efficient operation of a fund. This outsourced responsibility helps the investment manager to clearly focus on what they do best - managing the assets of the fund.

At the baseline, Fund Administration consists of two essential components – good qualified accounting people supported by state of the art technology. Jeffrey I. Rosenthal, CPA, Partner in Charge of Financial Services at Anchin, Block & Anchin LLP, defines Fund Administration as “*Accounting - which is performed best by accountants.*” To try and perform administration in the complex world of hedge funds by personnel with clerical backgrounds will result in sub-par service and errors in the reporting process.

Professional Staff. People are the most important asset of any Fund Administrator. Experience and understanding of the business is crucial.

Staff should be qualified professional accountants who understand the client’s needs of providing consistent timely and accurate information to their investors. They should not only have open communications with the fund manager, but are also able to identify and anticipate any issues or developments that may need additional evaluation and resources.

Technology. State of the art technology should deliver what the client wants and not what comes out of the one size fits all “IT box.” It should be flexible and provide tailored solutions to individual client’s needs.

The accounting software system should consist of a fully integrated general ledger, portfolio accounting, performance and investor reporting platform. The data being processed should limit the use of any disparate, mostly manual process for greater efficiency and control.

To meet the investors’ demands for greater transparency, a technology platform that allows for Web access to the investors’ account balance and account information would be required. The fund’s portfolio holdings and other data could also be provided to parties designated by the fund manager.

With fund accounting information being held in an electronic database that can be readily available, information technology will play a big role for firms in complying with demands for more disclosure and information.

Fund Administrators Qualification Requirements:

- ✓ Staff Expertise
- ✓ High Level of Automation
- ✓ Internal Controls
- ✓ Operations Scalability
- ✓ Customized Reporting Capabilities
- ✓ Quick Turnaround Time for Monthly Reports
- ✓ Team Centric Service Model

Conclusion

The Regulatory Proposals will certainly raise the bar of the standards for Fund Administration services. It will be no longer acceptable for an Administrator to depend on manual processes and spreadsheets to meet the recordkeeping requirements. Fund auditors will play a key role in requiring higher standards in the fund reporting and control process. As a result of these mandates, an Administrator that has the infrastructure, technology, people and experience of providing “full administration” will be the key component for supporting the hedge funds’ back office operations.

About the Author

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Gene recently served as Senior Vice-President & Managing Director of alternative investments for UMB Fund Services. He held a senior level position at CMS Companies. He was a Director of Alternative Investments at PFPC Global Fund Services of Wilmington, DE, where he oversaw servicing alternative investment products. Prior to PFPC, he was a principal and Vice-President at Delaware Management Company in Philadelphia and served as the Controller for the Delaware Group of Mutual Funds.

About Crederian Fund Services

Crederian Fund Services provides full-level Administration & Accounting services to Investment managers, which in turn, enables them to focus on managing their assets and raising additional funds. We believe there is no substitute for experience. The founding partners, who have over 50 years of combined experience, designed Crederian with the primary purpose of partnering with the investment manager and providing the highest level of client service.

Our accounting procedures provide for a very controlled process. We reconcile trade activity, cash balances, and security positions daily. We have continually embraced “best-practices” in our services process. Our servicing approach provides for a highly responsive and customized customer focus which exceeds client expectations.