CREATIVITY IN CONTROLS: INNOVATIVE OPERATING FRAMEWORKS

ADVANCES IN TECHNOLOGY AND GROWING DEMANDS FROM INVESTORS AND REGULATORS HAVE LED SOME OF THE MOST FORWARD-THINKING FIRMS TO LEVERAGE EXPERTISE OF THEIR ADMINISTRATION PARTNERS IN ORDER TO DEVELOP CREATIVE MEANS OF EXTENDING THE OUTSOURCING MODEL. **PETER SANCHEZ**, CHIEF EXECUTIVE OFFICER AT **NORTHERN TRUST HEDGE FUND SERVICES**, SHARES USE CASES OF CREATIVE NEW WAYS OF LEVERAGING THIRD-PARTY ADMINISTRATION TO ENHANCE GOVERNANCE, DATA QUALITY AND BUSINESS RESILIENCY

Peter Sanchez
is the CEO of Northern Trust Hedge Fund Services, with responsibility for all aspects of the organisation's global operations. Previously, Peter served as global head of business development and client service for Omnium, acquired by Northern Trust in July 2011. He has more than 20 years' experience in business development, client service and operations.

Since 2008, transparency and efficiency have been the principal themes of the third-party administration industry; managers must meet growing demands from investors and regulators while also curbing overhead expenses and mounting technology costs. The expansion of administration from its "traditional" back office role to include middle office, investment analytics, and regulatory support has shifted from emerging trend to established market practice.

These expectations continue to grow. Investors now engage in rigorous operational due diligence as part of their investment decision-making. The FSA guidance on business continuity and the new governance practice requirements under the AIFMD are but two examples of growing regulatory expectations around controls and risk management. These demands have given rise to a number of creative operating models designed to keep costs in check while enhancing transparency, quality controls and business continuity.

EXAMPLE 1: SHADOW ADMINISTRATION

Many firms maintain extensive internal teams to "shadow" the activity of their third-party administrator. Advances in administrator technologies – real-time data access, strategy tagging, bespoke valuation capabilities etc. – make the expense and resources associated with in-house shadowing more difficult to justify. Even so, some large managers feel that a duplicate set of records is necessary for both business resiliency and quality control purposes.

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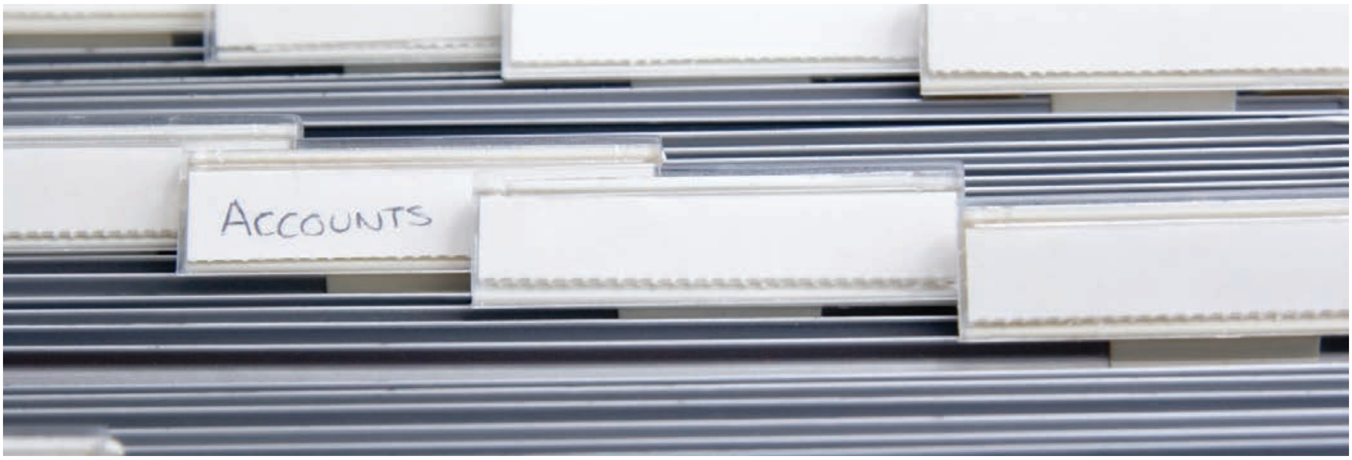
Where managers had historically felt it necessary to maintain shadow records in-house, the levels of automation, sophistication and transparency offered by today's administrators make shadow administration a viable option. Moreover, the cost of a second administrator when compared to the personnel and technology expense of maintaining in-house shadow operations make this a more economically feasible approach than one might think, while also delivering several key benefits:

- Two fully mirrored administration processes allow for the comparison of key outputs – trade capture, lifecycle events, NAVs and allocations – to serve as a quality check on one another.
- Managers outsource operations to insulate themselves from the distraction and expense of having to maintain internal operations. This benefit is limited if the manager retains internal shadowing but can be maximised by outsourcing both primary and shadow responsibilities.
- The arrangement creates healthy competition between primary and shadow administrators to generate higher service quality from both providers.
- A dual administrator model creates powerful resiliency capabilities with the ability to switch from the primary to the shadow provider in a shorter timeframe than if a new administrator needed to be engaged.

INDEPENDENT MIDDLE OFFICE AND "SHADOW LITE"

While the benefits of the dual administrator model can be substantial and less costly that one might think, it is clear that firms must still have significant scale to make such an approach economically viable. As an alternative, innovative mid-sized firms have examined a "best of breed" strategy that engages two separate firms – one to provide back office administration and another to provide middle office operations.

Bifurcating back and middle office functions eliminates the possibility of a full front-to-back operating model, but has the compensatory benefit of creating a corollary to the dual administrator approach without the expense of



full redundancy. The manager now has two independent sets of records that are valued and maintained by separate firms. Holdings, cash, valuations and gross asset values (GAVs) can be compared to support quality controls. In addition, this model can deliver additional benefits:

- Some administrators are stronger in either middle or back office processing; this approach allows the managers to choose a best of breed provider for each function.
- Back office transitions are time, resource and risk intensive – a considerable pain point for many established managers. This model allows managers to transition middle office activity to a new provider without the frustrations and apprehension of a full back office transition.
- While not as robust as full dual administration, this model does enhance business resiliency – in the event the manager needs to transition away from the back office provider, transactions and holdings are already on the middle office provider's platform, reducing the time required to transition.

MULTI-ADMIN DATA AGGREGATION

Effective governance and risk management requires managers to have a comprehensive view of their holdings and exposures. This is a particular challenge for managers that employ multiple administrators for vendor diversification or geographic reasons. The growing number of firm-level regulatory reporting regimes (e.g., Form PF, AIFMD), combined with investor pressure to demonstrate robust risk management practices has left many firms expending considerable time and resources in order to manually aggregate data from multiple providers.

Technology and automation now make data aggregation a viable alternative. Managers can engage one of their administrators (or an independent firm) to receive, tag, and consolidate trade-level information across sources to create an enterprise-wide, "golden" view of all trades and positions, which delivers numerous advantages:

- Management is able to streamline governance and oversight procedures and gains improved transparency into firm-level counterparty exposures.
- A single data set can drive comprehensive risk analytics that account for correlation within the total portfolio.
- Firm-level regulatory reporting (Form PF, AIFMD, etc.) can be supported more efficiently.
- Appointing a third-party aggregator can free up substantial internal resources that had been dedicated to manually aggregating data.
- Management receives improved transparency into counterparty exposures at the firm level.
- The manager is able to support more efficient reporting to investors and regulators.

INDUSTRY IMPACT

While not all managers will pursue these kinds of operational models, these are useful examples of how the role of the administrator is changing. Moreover, these and other operating models will have substantial impact on the industry and on the strategic importance of operational risk management:

- **Managers will compete on controls:** As investors grow more interested in governance and operational risk management, managers are looking to these kinds of structures as a means of giving their investors peace of mind. Managers who successfully support these kinds of highly resilient models will incorporate their control environment into their value propositions.
- **The end of self-administration:** With major global firms pursuing resilient and, in some cases, fully replicated administration models, self-administered hedge funds will face significant regulatory and investor pressure to outsource their back office at minimum, with added pressures from other firms competing on risk management and operational independence.
- **Technology is driving enhanced operational models:** Shadow and data aggregation capabilities are driven by technological advances that allow for automated data transmission, reconciliation, and reporting. As these capabilities become more commonplace, these types of models become a realistic option for a growing number of firms.

The clearest trend, however, is that the strategic importance of the administrator is growing. Beyond cost savings and independent valuations, finding the administration partner with the right technology, industry expertise and cultural fit can add significant value to managers' ability to grow their businesses. ■