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Game changers in fund administration

In the past 12 months, these five forces have altered the landscape of private equity fund administration.

posted - 07 Jun 2010
updated - 07 Jun 2010
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From new regulations to pressure from lower management fees, new forces have buffeted the world of fund administration in the. Here are five changes that have both GPs and outsourced service providers rethinking their approach.

1. Cost pressure

In tough economic times, more firms are looking to outsource their fund operations as a way to reduce costs. Newly empowered LPs, however, are willing to foot the outsourcing bill. The result is GPs are increasingly having to negotiate outsourcing expenses with LPs.
Fiduciary Compliance Associates principal Charles Lerner told PEI this year that the first thing GPs need to do when allocating expenses is look at the offering memorandum. "That will spell out what expenses the advisor or the general partner pays for and what expenses the fund pays for," he said. "But then you have to look and see, does this benefit the fund or does this benefit the advisor? Because the advisor is getting paid money to manage the fund, and his expenses – office space, computer, things like that – are really their expenses."

One controller said that generally believing that fund administration is something that can always be charged back to the fund is not always the right way to look at it, especially when "grey areas" come up. "A grey area would be when your document doesn't specifically say that you can do that, that you can reimburse yourself," he said. "If you have a grey area it is very difficult unless it had been required of your investors to make the case that it should be a fund expense. You could have two or three [internal] people for half the price of an administrator, so I think an administrator is an expensive charge, which is why managers are so hesitant to charge that back sometimes."
Traditional back office operations such as bookkeeping are areas that are clearly borne by the management company, but not when a firm is required to get a CPA to do its yearly audit of financial statements. "Those cost are without question viewed by the industry as being borne by the fund regardless of whether it is a CPA firm in the States or elsewhere," said Jerry Chacon, a fund formation lawyer at Goodwin Procter.

2. Consolidation

Consolidation in the fund administration market has stepped up considerably over the past several months. Administrators that are looking to focus resources elsewhere or are wary to commit to new technology are accounting for the current wave of consolidation, according to a fund formation lawyer.

2010 has seen some notable deals. In April, JP Morgan Worldwide Securities Services (WSS) bought the private equity administration services business of Schroders for an undisclosed sum. WSS has $15.3 trillion in assets under custody and $6.5 trillion in funds under administration. Schroders has $240 billion under management.

Schroders' private equity administration business was initially developed to support Schroder Ventures, an in-house private equity business that is no longer part of the Schroders Group, and later expanded into third-party administration.

BNY Mellon and State Street also picked up new administration business this year. In February, BNY Mellon agreed to acquire PNC's global investment servicing business for $2.31 billion, including the purchase of $1.57 billion of stock and repayment of intercompany debt from PNC. PNC's investment servicing business provides custody, fund accounting, transfer agency and outsourcing solutions for asset managers and financial advisors.

The acquisition added $855 billion in assets under administration, including $460 billion in assets under custody, to BNY's platform. The deal doubled the number of funds serviced for accounting and administration.

State Street announced in January that it acquired Mourant International Finance Administration (MIFA), a smaller European competitor based in Jersey. Boston-headquartered State Street, which provides fund accounting and administration services, took over MIFA's 650 employees and $170 billion in assets under administration in Europe
and Asia.

"Our primary objective was to get into markets where we didn't have market share," said Jack Klinck, global head of State Street's alternative investment solutions team. Up until now the core of State Street's administration activity has centred on the US.

MIFA was owned by the partners of Jersey-based law firm Mourant du Feu & Jeune, who, following the transaction continued on as a separate entity focused solely on law.

3. European regulation

The EU's proposed Alternative Investment Fund Managers' directive could prove costly for GPs in terms of time and money.

"If the directive passes, it would bring new annual reporting requirements to investors and regulators," according to a fund formation lawyer.

The directive would bring additional offering memorandum disclosure requirements and regulatory reporting about assets in which funds are invested, he said. Ongoing compliance costs will rise for funds directly or through their service providers.

One-off compliance costs could rise by between €110 million and €2.2 billion in total for private equity, hedge funds and venture capital, according to an impact assessment commissioned by the European Parliament.

A previous impact study by the UK Financial Services Authority said that EU regulations could impose one-off compliance costs of up to €3.2 billion, while a report released by London-based research organisation Open Europe estimated that that additional compliance costs could total as much as €1.9 billion in the first year of implementation and €985 million annually after that.

EU fund managers would also have to hire independent valuators and depositories to hold assets in segregated accounts.

If all or even some of the new transparency measures above become law, hiring an outsourced fund administrator will start to look very appealing.

4. US custody rules

The US Securities and Exchange Commission last year made a number of amendments to the Investment Advisors Act of 1940 – specifically Rules 206(4) and 204-2, and Forms ADV and ADV-E. The changes impose a number of burdens on RIAs, more of whom would be subject to annual surprise audits, disclosure requirements regarding assets under management and some client information, and more extensive record-keeping rules. The costs associated with these changes could put small firms out of business, commentators say.

The new rules, which the SEC were spurred by several enforcement actions it has brought against “investment advisors and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets”, create a stricter custody regime in order to better protect clients’ assets from misuse, and to uncover fraud earlier. The SEC estimates that, advisors incur additional compliance fees of $8,100 annually.

One finance professional at a private equity firm said: “Although we keep our LPs’ assets with a bank custodian, the mere fact that we direct them to pay fund expenses causes us to fall under the rule. This is especially difficult when you have a fund with only one remaining but illiquid asset.”
With the complications presented by the new rules, private equity firms who were previously self-administered are turning to third party administrators to make life easier.

5. New and better “seals of approval”

In the last twelve months several private equity funds of funds, including Adveq, HarbourVest, and Capital Dynamics, completed the thorough and expensive SAS 70 audit.

While SAS 70 has been around for decades, it has rarely been undertaken by private equity managers. It is typically a process that third party fund administrators who have custody of client assets would undergo. But Capital Dynamics and HarbourVest both said they went through the third-party review due to increasing requests from their investors.

There are two types of SAS 70 audits, one which measures the rigour of a firm’s internal controls at a point in time, and a lengthier type which measures the effectiveness of those controls over a period of time.

The downside is the audit process can be time-consuming and expensive. Both Type I and II can cost up to $100,000 each. But for firms that want to be seen as best in class by LPs, they may find it is time and money well spent.