
How to Select and Convert Fund Administrators

Converting to a new hedge fund administrator is a major decision that should include a current state assessment, a detailed RFP, and due diligence process as well as comprehensive planning.

About Beacon Consulting Group

Beacon Consulting Group is a trusted advisor to global financial and investment firms seeking to achieve and sustain a competitive edge. Beacon is an operational strategy and systems integration firm that works with investment managers, third party administrators, and technology vendors to improve efficiency, controls, and profitability of middle and back office operations. We leverage our proven results and consulting competency to deliver value to our clients on the basis of competitive positioning, improved operating performance, optimized technology deployment, and effective risk management. Beacon acknowledges the significant contributions by Brian Malone in the creation of this paper.

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Opportunity for Change

The unprecedented volatility and precipitous declines in the financial markets have had many consequences for hedge fund managers including a renewed focus on operational transparency, efficiency, and cost. Accordingly, some hedge fund managers are beginning to review the relationship with their current fund administrators or, in the case of self-administered funds, are reviewing their current operating models.

Even before the market's downturn, many hedge fund managers already began reviewing their fund administrator relationships. Administrators may have previously satisfied a hedge fund manager's requirements, but changes in portfolio strategy, the marketplace, and even turnover of internal personnel may necessitate a review of the current administrator's service model and capabilities.

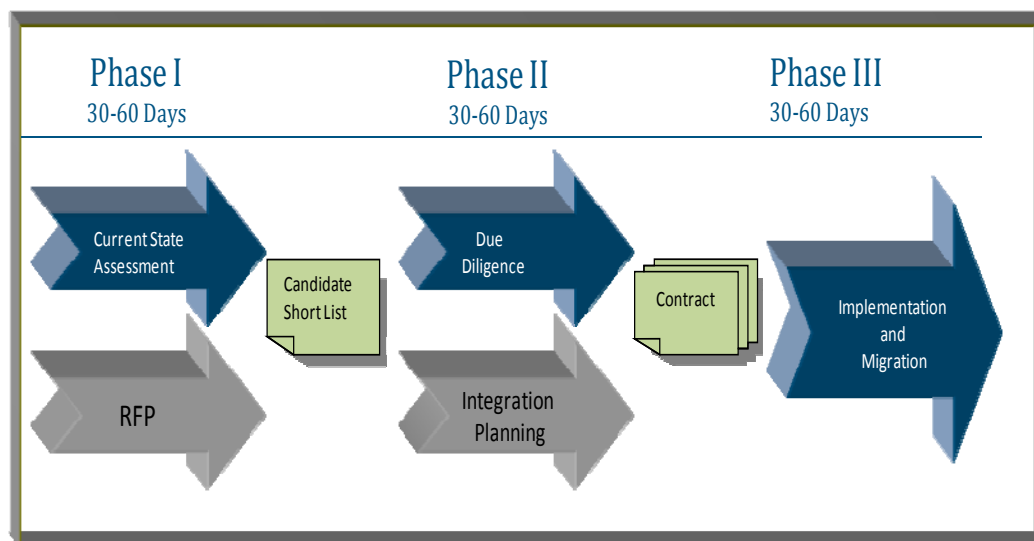
In the case of funds that are self-administered, fund managers are yielding to concerns from investors over the lack of independent recordkeeping and are considering outsourcing their fund administration.

Transitioning to a new fund administrator is an important process and the consequences can be far reaching, right down to the investor level. The objective of this article is to provide hedge fund managers with some key considerations when transitioning to a new fund administrator.

Recommended Process

The decision to select a fund administrator is one that requires careful deliberation and thorough consideration of all alternatives, including the option to retain the current service provider. The reality is that no single fund administrator is perfect in all areas. A hedge fund manager must have the courage to consider the possibility that its own internal processes and technology are broken and are contributing to the difficulties with the current fund administrator.

Experience suggests that the following approach is likely to result in a better selection process and a healthier long term relationship with the new fund administrator. The recommended process occurs in three phases and



begins with a current state assessment. As shown in the diagram to the left, the current state assessment and the RFP process occur simultaneously and results in a "short list" of potential candidates. In Phase II, the due diligence process evaluates the "short list" of fund administrators and

assesses compatibility with current operations and future growth plans. Conversion planning begins after a selection is made. In Phase III, the conversion process begins.

Current State Assessment

When embarking on a fund administrator conversion, a hedge fund manager should ensure that its own house is in order. Managers should perform a thorough current state assessment of internal operations and use the transition as an opportunity to resolve longstanding issues and ensure that ineffective internal processes are not transitioned to the new fund administrator. The current state assessment is the basis for redesigning internal processes that will work in tandem with the new fund administrator's capabilities. The current state findings will be incorporated into the RFP.

The current state assessment should focus on four major areas:

1. Management's objectives
2. Operations
3. Policies and procedures, and
4. Data integrity

Prioritizing the manager's strategic objectives, including growth and expansion plans, new portfolio strategies, and potential new products, will ensure that the new fund administrator will be capable of accommodating key growth initiatives.

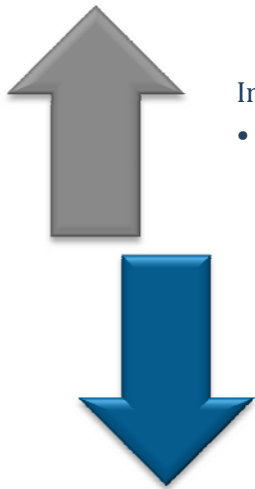
From an operations perspective, the current state assessment must engage every operational area that interacts with the fund administrator. A comprehensive inventory of data feeds, reconciliations, reports, and current workarounds should be created. In addition, the hedge fund manager should identify and review each of the major issues with the current fund administrator to determine where the ultimate cause of the problems lies. Issues between the manager's front office and back office frequently manifest themselves as problems with the fund administrator.

“Issues between the manager's front office and back office frequently manifest themselves as problems with the fund administrator.”

All written policies and procedures should be examined and brought up to date. While this is not a requirement for unregistered investment advisors, this is the time to ensure that the manager's operational procedures are in line with best practices, especially the pricing policy.

The current state assessment should also ensure that data is of consistently high quality to support good decision-making, accurate valuations, and efficient month-end processing. Synchronizing data-related activities will result in operational improvement, reduced risk, and improved front office support.

A comprehensive current state assessment is an investment that will ensure the hedge fund manager optimizes the capabilities of their new fund administrator. This assessment will create a blueprint for the future that is aligned with management's long term objectives using a framework that is supported by industry best practices.



Internal Focus

- Current State Assessment

External Focus

- RFP
- Due Diligence
- Conversion Planning

The remaining phases of the process now transition from an internal to an external focus as the RFP, due diligence, and conversion processes begin.

Request for Proposal (RFP)

The process to select a fund administrator should be essentially the same regardless of whether it is a start-up, transition, or shift from self-administration. It is important that the hedge fund manager perform a thorough due diligence to ensure a deep understanding of the strengths and weaknesses of each candidate.

The information gained in the current state assessment will be the basis for the RFP. The goal is to immediately convey high expectations for the relationship, beginning with the RFP process. In order to minimize time spent answering follow-up questions from respondents, the RFP should clearly describe and incorporate all of the manager's requirements. It is beneficial to informally interview administrators prior to distributing the RFP. This provides the manager with the opportunity to learn about emerging trends and services which then could be included in the RFP. The RFP should outline the process and the timeline, including due dates by which responses should be submitted. The Alternative Investment Management Association Hedge Fund Administrators Due Diligence Questionnaire should be requested to facilitate the evaluation of responses. Managers can supplement this questionnaire with customized questions. Many fund managers also utilize consulting firms to manage the RFP process, expediting all phases of the project.

Once the RFP is created, potential fund administrators should be contacted and pre-screened to determine the recipients of the RFP. Meetings should be scheduled with the RFP respondents to review their proposals and to answer any questions. Each RFP response should be evaluated using a scoring matrix that assigns weightings to services based upon manager priorities, giving most weight to the "must-have" services. Each RFP respondent would then be scored on its ability to meet the critical requirement. Once all responses are evaluated, the "short list" should be created and due diligence on the final candidates begins.

Due Diligence

Once the RFPs are reviewed and the likely candidates are selected, the due diligence process begins. The due diligence team needs to develop appropriate checklists and matrices and should schedule due diligence visits. The team performing the review should have a thorough understanding of the current state findings including current requirements, capabilities, and reports. During the due diligence process, hedge fund managers should not be afraid to ask for sample reports, system demonstrations, and meetings with the potential service teams. An important task is to perform reference checks with the administrator's current clients with similar strategies and complexity.

The table below outlines a sample of functional areas and several key considerations that must be satisfactorily addressed during the due diligence process:

TRADE COMMUNICATION	<ul style="list-style-type: none"> ▪ Preferred format of trade data files vs. manager's capabilities ▪ Delivery time frames for trade data files ▪ Impact of new administrator to internal trade operations ▪ Assessment of additional data or pricing service requirements
TAX SERVICES	<ul style="list-style-type: none"> ▪ Range of tax service offerings ▪ Information flow from administrator to tax preparer ▪ Tax expertise at investor and fund level ▪ Ensure recent tax lot reconciliation performed
PRICING/VALUATION	<ul style="list-style-type: none"> ▪ Valuation in accordance with fund documents, written pricing policy, or other relevant documents ▪ Administrator pricing policy/procedures ▪ Availability of independent pricing committee at the administrator ▪ Pricing sources/inputs utilized by administrator (e.g. London 12pm or NY 4pm FX rate) ▪ Impact on internal valuation models and methodologies ▪ Use of models for derivative valuations ▪ Administrator access to licensed external pricing data
INVESTOR REPORTING	<ul style="list-style-type: none"> ▪ Notification to investors ▪ Investor statement distribution options ▪ Supplemental manager letter with investor statement ▪ Impact of conversion on investor statement format
INVESTOR PROCESSING	<ul style="list-style-type: none"> ▪ Administrator and Manager roles and responsibilities for Anti-Money Laundering processes ▪ Conversion data requirements ▪ Process utilized to contact investors ▪ Ensure accuracy of legacy investor data
FEE CALCULATIONS	<ul style="list-style-type: none"> ▪ Administrator fee calculation capabilities ▪ Level of automation ▪ Test administrator fee incentive calculations (e.g. for up years, flat years, down years, claw backs, etc) ▪ Administrator's internal controls ▪ Responsibility for fee calculations

RECONCILIATIONS	<ul style="list-style-type: none"> ▪ Responsibility for resolving reconciliation breaks ▪ Availability of reconciliation reports ▪ Level of automation ▪ Access to third party data (e.g. prime brokers, custodians) ▪ Application of tolerance levels ▪ Administrator reconciliation policy/procedures
REPORTING	<ul style="list-style-type: none"> ▪ Format and frequency of reporting from administrator ▪ Report availability (types, delivery times, retrieval access) ▪ Applicable interface costs ▪ Availability of ad hoc reporting ▪ KPI reporting
OTHER CONSIDERATIONS	<ul style="list-style-type: none"> ▪ Conversion process (parallel NAV, data requirements, resource requirements, timing, etc) ▪ Monthly reporting process ▪ Corporate action processing ▪ Side pocket agreement processing ▪ Relationship management ▪ Staff rotation and retention history ▪ Administrator's new client integration process and resources

The hedge fund manager also needs to consider whether the current fund administrator offers ancillary services that are not offered by the new fund administrator. For example, some administrators have special deals with data providers or cash management facilities. Where such services are not available from the new fund administrator, comparable services may need to be obtained elsewhere at some incremental cost. Another issue that needs to be addressed is the possibility that licensing agreements have been negotiated via the original fund administrator and cannot be transferred, perhaps requiring the fund to pay for any early termination of contracts.

The final decision on selection should be made by the steering committee established to oversee the process. The committee should consider the full scope of services being offered and the potential administrator's approach to support the firm's future growth plans. The team should make the decision knowing that all service providers have different strengths and weaknesses. In instances where the fund manager is moving from self administration to outsourcing, it is important to realize that there will absolutely be bumps in the road and maybe even a tinge of buyer's remorse at some stage, but both sides must be dedicated to making the relationship work.

Once the due diligence process is completed and the hedge fund manager selects the new administrator, the two parties need to finalize the administration agreement. The seeds for a successful relationship with any fund administrator are sown during the negotiation process. An integral part of the process is obtaining a service level agreement (SLA) or at least a clear statement of responsibilities. If there is not a proper SLA in place that clearly articulates the required timing and deliverables of both parties and an agreed upon process to escalate and resolve issues, then it is difficult to see how the relationship can work. It is difficult to get an SLA in place

after a relationship has started and it is almost impossible to get a satisfactory one in place during a period of poor service.

Converting to a New Fund Administrator

There are several considerations to nail down when approaching a conversion initiative and primary among them is planning. A comprehensive project plan that highlights critical tasks should be developed. Examples include:

- Coordinate with the current administrator to develop transition plan.
- Document the data requirements (trade files, data feeds, etc.).
- Assess the impact on investors.
- Define responsibilities for the parallel period.

The timing of the transition and the resources dedicated to the transition should be carefully considered so as not to overload existing staff. Typically where the transition is due to service related issues, the investment management staff may be already working overtime. Timing the conversion is a balancing act between expediting the conversion and minimizing disruption of daily activities.



The production and audit of annual financial statements is an additional burden for staff and these times should normally be avoided. Most of the day-to-day work in a hedge fund back office is process related and typically teams are organized accordingly. Transitioning to a new fund administrator is much more project orientated and is something with which staff typically does not have extensive experience. Almost all transitions will involve a degree of parallel processing which will significantly increase the volume of work performed by operations staff. There are practical difficulties associated with running both the new and existing fund administrators but these can be resolved with careful planning and the appropriate resources.

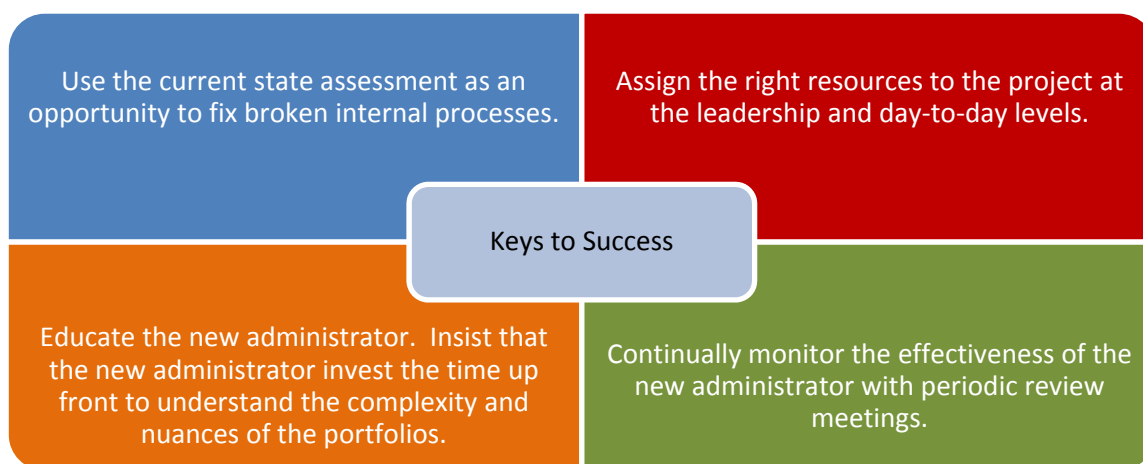
Although it may not seem ideal, transitioning to a new fund administrator following an audit has the advantage that security positions and cash balances have been subject to an independent review. This situation should be considered in cases where there is some doubt over the quality of the existing records and the additional assurance of an audit could defend the manager against questions from investors.

If there is no urgent need to transition at a particular time then the hedge fund should choose a time that will be least disruptive to its operations. However, hedge fund managers should be aware that termination provisions are usually bilateral and that a fund administrator can also terminate the relationship within a designated timeframe. The hedge fund manager may not have the luxury of being able to time the transition and may need to make the resources available to manage the transition.

Consideration should also be given to either using experienced temporary staff under the control of a back office manager or outsourcing the transition to outside consultants with the requisite experience. This point is particularly relevant if extensive re-engineering of internal processes needs to be carried out within the same timeframe.

Conclusion

There are monumental forces shaping the operating environment for hedge fund managers. The recent focus on operational transparency, efficiency, and cost has prompted many hedge fund managers to review the relationship with their fund administrator. Transitioning fund administrators is an important decision whose consequences can be far reaching, right down to the investor level. The keys to overall success are highlighted below:



A well-planned and disciplined selection and transition process can ensure a successful, long term relationship with the fund administrator. As stated earlier, a comprehensive current state assessment is essential to execute a successful RFP process and ensures an effective evaluation of how the hedge fund manager's processes will map to the new fund administrator's services.

A hedge fund manager should take advantage of the conversion to improve its business operations and consider whether its current practices are compatible with industry best practices.

Beacon Consulting Group is a trusted advisor to leading global and financial and investment firms seeking to achieve and sustain a competitive edge. Our investment operations experts leverage knowledge that is second to none. We deliver optimal solutions that achieve cost savings and process efficiencies while at the same time mitigating risk for our clients.

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