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PE Firms Increasingly Turn to Administrators as Regulatory and Investor Pressure Mount (Part One of Two)

The last decade has brought dramatic changes to the investment industry: The 2007–2008 market meltdown drove firms across asset classes to rethink what it takes to run a resilient and operationally-sound business. Five years later, regulators widened their purview to avert a recurrence of the crisis by requiring private fund investment advisers to register with the Securities and Exchange Commission under the Dodd–Frank Wall Street Reform and Consumer Protection Act. In many regards, the changes have transformed the way the industry does business.

Particularly impacted is the private equity asset class, which has enjoyed solid growth as investors have sought more diversified portfolio returns. According to the 2016 Preqin Global Private Equity and Venture Capital Report, PE assets under management reached a new high of $2.4 trillion as of June 2015, compared with only $700 billion in 2000; and inflows are expected to continue.

The strong growth in private equity has been fueled by an influx of institutional investors, including pension plans, funds-of-funds, insurance companies, family offices, endowments and foundations that view PE as a means of generating significant long-term returns compared with other asset classes. The good news: institutional investors generally view PE performance favorably, and plan for continued investment in the asset class. The bad news is that such strong and sustained growth does not come without challenges. Much larger investors are more cautious and demanding than ever, while fund managers and general partners—already struggling to manage often strained operations—are again compelled to rethink what it takes to run a resilient business.

Against this backdrop, PE fund managers have turned to third-party administrators to meet more rigorous regulatory requirements while keeping up with a growing and increasingly sophisticated client base. In 2015, BNY Mellon estimated that in the hedge fund sector some 90% of fund administration was outsourced compared with only 20-30% of PE fund administration managed by a third party. But that statistic is changing, as PE firms are increasingly embracing independent fund administration services.

This article, the first in a two-part series, explains why private equity managers are transitioning certain functions to TPAs, the scope of TPAs' services and the benefits of and challenges posed by outsourcing fund administration. The second article in the series will cover the selection process for engaging a third-party fund administrator, including due diligence considerations, contract terms and points of negotiation, as well as legal and compliance issues that can arise when hiring a TPA.

Causes of Third-Party Administrator Adoption

PE historically has lagged behind hedge funds in TPA adoption for several reasons. First and foremost, traditional PE fund administration has been simpler than hedge fund administration given the latter's relatively high-volume, high-frequency trading style, and the complexity of hedge fund instruments, structures and valuations. Thus, PE fund managers have been

inclined to carry out their own administration work, and PE investors have been relatively relaxed about reporting methods and transparency.

But that has changed as PE funds have become larger and more complex. Indeed, PE fund managers have made up for lost time, their rate of TPA adoption significantly outpacing that of hedge funds in recent years. PE firms migrating to TPAs have cited various reasons, including:

- Desire to Focus on Core Competency
- Improved Regulatory Reporting and Investor Transparency
- Access to Skilled Operational Talent Amid Staffing Shortages
- Improved Data Management, Integration and Technology Capabilities
- Avoidance of Technology and Data Management Capital Expenditure
- Ability to Support Complex Accounting and Portfolio Management
- Back-office Efficiency; Eased Integration with Affiliate Platforms

The reason the rate of PE firms' TPA adoption exceeds hedge funds' is clear when comparing the asset class' growth statistics over the last few years. According to institutional investor data and analytics solutions provider eVestment, hedge fund assets under administration totaled $3.92 trillion at the end of 2016. This compares favorably with the $3.73 trillion reported at the end of 2015, an increase of 5.18% year-over-year. But PE firms' AUA growth has been prodigious: The total reported PE AUA for year-end 2016 totaled $2.16 trillion, a 43.86% increase of total reported PE AUA compared with the prior year.

While growth of global PE AUA was found across geographies, the North American market, in particular, soared. Using data from firms that provided regional AUA breakdowns for year-ends 2015 and 2016, eVestment says North American AUA rose from $650 billion at the end of the prior period to $1.12 trillion at the end of 2016, a stunning increase of 72.08%. "Private equity fund administration was an accretive area for most firms with sizeable gains prevalent among both large and small players; growth in the PE space was particularly robust in comparison to hedge funds and funds of hedge funds. Administrators generally agreed that there continues to be increased scrutiny placed on the various fees, and investment practices in general of private equity funds, and that this sentiment has likely driven TPA adoption," eVestment explained in its industry survey, Alternative Fund Administration 2017.

Ronan Daly, founding partner of fund administration services provider Centaur Fund Services, says a negligible number of funds started using TPAs as early as the 1990s. Although he sees PE TPA adoption in the nascent stages compared with hedge funds, he anticipates a continued increase. "We anticipate the adoption of TPAs in the space will continue very strongly over the coming years, such that it will become unusual for a PE fund to not outsource its administration," he said.

Scope of TPA Services

As the PE investor base has shifted to a more institutional makeup, regulations have proliferated and investor reporting has become more complex, PE firms have been operationally stressed beyond capacity and turned to TPAs as a consequence. TPA services are seen as a sustainable means to increase operational capacity, delivering expertise without the need to necessarily staff up in-house.

Fund administrators provide a host of outsourced services to PE fund managers, the most common of which support a firm's back-office operations, including:

- Investor Onboarding (commitment tracking, wire processing, etc.)
- Investment Processing, Capital Calls, Distributions to General and Limited Partners
- Technology Services, including Portfolio Systems and Data Management
- Fund Accounting (Subscriptions, Redemptions, Fee/Expense Administration, Change of Ownership Shares)
- Monthly and Quarterly General Ledger Accounting
- Preparation of Annual and Semi-Annual Financial Statements
- State and Federal Regulatory Reporting, Such as Common Reporting Standard (CRS) and Foreign Account Tax Compliance Act (FATCA)
- Corporate Secretarial Support for the General Partner (GP)

Functions less-commonly outsourced include anti-money laundering oversight, administration of special purpose vehicles and holding companies, valuations and deal flow due diligence, coordination with auditors, compliance consultants and other independent service providers, as well as cash management and forecasting.

Fund managers have reported that TPA outsourcing enables them to focus more on their business, and in some cases reduce costs, such as capital outlay for operating and technology expenditure. Naturally, avoidance of capital expenditure is a more acute motivator for small- to mid-sized firms that are often not ready to build out an integrated technology-powered platform.

Fund managers have also said the use of TPAs allows them to sidestep the competition for talented staff to support the more complex aspects of their operations. The ability of fund managers and GPs to carry out their accounting and back office functions has been strained as they realize significant investment in technology and skilled staffing resources is required, a distraction from their primary task of investing and generating returns.

This problem has been exacerbated by a raft of new regulations with which private equity funds now need to comply, combined with an increasing desire from institutional investors to see institutional level processes, technology and fund governance.

According to the EY 2017 Global Private Equity Survey, which canvassed 103 PE chief financial officers, outsourcing tactical tasks was among the top areas where respondents expect TPAs can significantly improve the efficiency of their operating model, freeing up staff to spend more time on their core functions, including analyzing portfolio opportunities and investor relations. According to the survey, “The vast majority of firms currently outsource at least one function. Tactical functions such as fund accounting, tax and technology continue to be the tasks most outsourced, which is consistent with our survey results two years ago. Strategic functions such as valuation, portfolio analytics and investor relations are still being completed in-house, as firms don’t consider third parties as being able to handle them properly.”

But while the use of TPAs has risen in recent years, Christopher Elvin, Preqin Head of Private Equity Products, says consolidation is taking place in the industry, including several large acquisitions last year. Noteworthy among them were MUFG Investor Services’ acquisition of Capital Analytics, Neuberger Berman’s fund services arm, and SS&C Technologies’ acquisition of Wells Fargo Global Fund Services. “With regulatory changes, increased reporting requirements and competition for clients changing the economics of the business, we may see further consolidation in the year ahead, as some firms seek to grow their client base while others decide to exit the industry entirely,” observed Elvin.

Benefits of Offloading Fund Management Challenges to the TPA

Although there may be fewer players to share the pie, PE fund managers are expected to continue outsourcing parts of their operations where the greatest benefits may be derived. According to fund administrator SEI Investment Manager Services, PE firms tend to perform more functions in-house than managers of other asset classes, and TPA deployment models are flexible enough to accommodate firms’ operational needs. Many PE firms employ a hybrid approach to pairing outsourced provider expertise and capabilities with in-house staffing resources.

In addition, increasingly complex reporting requests from institutional investors and regulatory agencies drive fund managers to outsource as a means of improving data analytics, process and reporting. Bryan Astheimer, a director at SEI, explained, “Procedures and systems that many firms had in place before the global financial crisis are likely insufficient to effectively handle the complexity of data analysis now required in the new regulatory environment. Add on the LP requests, which are often customized and not exactly the same as those from regulators, and it becomes a difficult challenge for PE firms to perform consistently and with scale.” This is particularly true as funds venture into new investment strategies, distribution channels or jurisdictions. “GPs planning for the future will differentiate through operational excellence and more sophisticated value-added investor services, both of which rely heavily on a robust operating and technology platform,” said Astheimer.

Others concurred that the ability to meet investor and regulatory demands for greater transparency along with increased operational agility are among the top benefits driving TPA uptake in PE. Dan Houlihan, Head of Global Fund Services North America at Northern Trust, pointed out that a TPA can bring global scale and financial strength, along with specialized skill and technology. "The cost benefits can be compelling, especially when you factor in the specialized accounting platform costs, training and best practices consulting an administrator can provide. Outsourcing also compartmentalizes the administrative costs, relieving the manager of having to allocate staff time across multiple entities and people."

Houlihan added that as funds grow and their structures become more complex to accommodate unique investor needs, in-house administration can become riskier and more costly in terms of systems and staffing. "To be compliant, a GP not only has to understand the laws and requirements but have the capabilities and expertise to satisfy them. Only the largest PE shops can afford to build out their operations and staff to meet these needs. By outsourcing, the administrator can mitigate risks for their fund manager clients."

What Are the Disadvantages?

According to several TPAs, prospective and existing clients cite a list of disadvantages in outsourcing fund administration. At the top of the list is a perceived loss of processing control. For instance, some clients complain about less immediate access to accounting information and reporting, since requests for interim reports need to go through the TPA, a process which typically takes time to review and fulfill. As well, many TPAs suffer from high turnover, and some industry experts contend their business models can make them inherently less committed to the success of an individual client than a PE firm's own invested employees. TPA fees can also be an issue if performance goals or capital raise estimates aren't met. Some clients have complained of redundant costs shared by in-house and TPA staff.

The current state of TPAs' technological capabilities may also be a drawback. According to the EY survey, TPA technical capabilities for handling complex PE fund operations are not nearly as mature as those available to mutual funds and hedge funds, though some TPAs are further along than others in developing technology solutions. "Private equity firms continue to invest in technology, particularly in relation to portfolio analytics, to handle large amounts of data, regulatory compliance demands, and investor requests. Their investments are a challenge to implement due to the uniqueness of private equity fund structures and have yet to add meaningful efficiencies for the overall business operations. The cost of implementing and maintaining these solutions and training employees to become competent using them is still a major potential cost to fund managers. Theoretically, these solutions could provide meaningful returns and efficiencies to fund managers once strategically implemented, but … unfortunately, the promise of a single solution for accounting, portfolio management and investor relations remains unfulfilled," said EY.

Additional disadvantages include reducing internal resistance and maintaining employee buy-in when outside professionals are brought in. A number of respondents also noted the difficulties of managing a TPA's activities and performance.

These concerns notwithstanding, many C-level executives at PE firms said they see the benefits of fund administration outsourcing and are committed to making it work. According to the EY report, "This can be achieved by carefully selecting the right vendor, negotiating a smart agreement, and managing external colleagues even more carefully than a fund's own employees."

In view of the potential drawbacks to engaging a TPA, during the selection process, fund managers should carefully assess the provider's technological capabilities, how easily the TPA can integrate with a firm's systems and the TPA's PE-specific business acumen. Particularly because the PE industry has grown increasingly complex, it behooves fund managers to scrutinize not only the provider's technical capabilities, but its understanding of the latest investment products and strategies, changing regulations and other core facets of fund administration.

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Private equity fund managers are migrating to outsourced fund administrative services to cope with a confluence of factors: a proliferation of regulations, the shift to a more demanding institutional client base, increased regulatory assets under management and a constrained pool of specialized talent needed to run a PE firm. Outsourcing enables fund managers to have experts handle operations instead of shifting focus from their raison d'être: deal-making, portfolio construction and profitability. TPAs can also free up a firm's resources, particularly if managing operations becomes exceedingly time-consuming or costly, or distracts from a firm's core business. "No one raises a fund so they can focus on back-office operations," said Dan Houlihan, Head of Global Fund Services in North America at Northern Trust. "We typically see firms look to outsource when they are just starting up, when an established [general partner] decides to spin off or start his or her own firm; or when a GP hits an inflection point, like raising a second or third fund."

At such critical junctures in the life cycle of a PE firm, managers should know in advance the steps entailed in engaging a TPA, because the search process can be unpredictable—it can take as little as a few weeks or up to six months. This article is the second in a two-part series covering the growing trend of private equity managers transitioning operational functions to TPAs and provides a primer on the mechanics of engaging them—from conducting an internal needs assessment to due diligence considerations and TPA testing to contract terms and legal and compliance issues that can arise. The first article outlined the scope of the services PE firms typically outsource to TPAs, and the perceived advantages and disadvantages of doing so.

Five Steps for Engaging a TPA

The TPA option begs the age old buy-versus-build question: Is it better to build and manage operations in house, or offload the challenge to a provider that specializes in fund administration? Choosing to engage a TPA can be a sustainable means to meeting a fund's operational needs without necessarily staffing up in-house. However, fund managers must critically assess their needs, along with the experience and technological capabilities of the TPA, before contracting out any operations.

"The TPA selection process provides a unique opportunity to systematically address operational risks that otherwise might never come to light," said Alaric Compliance director Jerry Cummins. "An operational hitch that threatens efficient and accurate processing, especially if the industry continues to grow, can result in insurmountable reputational damage to a PE fund sponsor or manager."

The following steps for engaging a TPA are intended to ease the process for firms that follow their roadmap.

Conduct an Internal Needs Assessment

The TPA selection process is driven by the scope of services a PE firm wants to outsource. Thus, the first step in the process of engaging a TPA is to conduct a needs assessment to document the benefits a firm hopes to derive. These include cost savings, reduced key man

risk, increased operational independence in response to investor demand and/or the ability to scale a business quickly and efficiently.

It can be useful to engage a firm's established service providers, such as legal counsel or a compliance consultant, to objectively shepherd the selection process, including the needs assessment. Although working with counsel or a consultant can add time to the overall process, it can give PE firms added peace of mind that they are asking the right questions to make the best choice.

Cummins said taking the extra time can pay dividends. "Careful due diligence is critical to any private equity sponsor that trusts a fund's finances and operations to an outsourced administrator. PE funds can be structurally complex from an intercompany, multiple series, special allocations or tax perspective, even if the balance sheet is relatively straight-forward. This requires a level of accounting expertise in the administrator's personnel, lower turnover and appropriate incentives to retain sufficient accounting talent."

Among the most commonly outsourced functions firms should consider when conducting their needs assessment are fund and general ledger accounting, preparation of financial statements (e.g., IRRs, etc.) as well as back office and technology operations, including portfolio systems and data management. The identified needs, benefits and goals should be used to assess TPAs' capabilities and pricing.

Issue Requests for Proposal and Conduct Due Diligence

Once a needs assessment is conducted, managers can identify a targeted group of TPA service providers and develop a due diligence questionnaire. Referrals from trusted colleagues can play an invaluable role in the TPA selection process, and managers should review their TPA search criteria (needs and goals) with industry contacts that may have completed or been involved in a TPA search.

Thorough due diligence is a crucial step in the search for an administrator. Fund managers should develop a due diligence questionnaire that maps to the benefits they hope to achieve. Whether or not this questionnaire is provided to the potential list of administrators, at a minimum, it can serve to keep a search on track and focused.

Among the criteria PE firms should consider, Cummins suggested comparing a fund's RAUM to the administrator's assets under administration because parity of size matters. "Smaller PE firms can get lost at the largest administrators, and smaller administrators may not be able to properly service the largest PE firms."

Managers should ask potential TPAs the following questions when conducting due diligence:

- What is the size of the TPA's AUA?
- What PE operational experience does the TPA have similar to what's needed?
- Does the TPA timely and effectively perform the services they claim they can?
- Does the provider have a reputation for high-caliber client service?
- How does the provider track and meet its deadlines?
- How standard are the TPA's technologies, and how smoothly will they integrate?
- What ancillary services, such as tax reporting or Form PF production, are offered?

Ronan Daly, a founding partner of Centaur FS, said the due diligence process has become extensive. "Increasingly, we see private equity firms preparing a detailed RFP sent out to several TPAs. The RFP covers a wide variety of topics related to the administrator's staffing, technology, financial stability, service capabilities, insurance cover, regulatory status and the like."

Similar to the due diligence process for other service providers, TPAs must complete the RFP process within a designated period of time, after which the PE fund typically narrows down the candidates to the top two or three based upon their RFP responses. The RFP also should ask the provider to outline its pricing structure and fee proposal.

Although pricing is important, it should be weighed against other factors, including a TPA's staffing and service model and its technical capabilities. Since many of these functions are easier to assess live and in

person, the next step in the selection process usually involves on-site meetings with the short-listed candidates, so that fund managers can personalize their search.

Conduct Multiple On-Site Visits

Once a GP has identified its needs and narrowed its search, site visits are typically conducted to evaluate the TPA's capabilities and culture, which are best assessed face-to-face. "We've had some GPs visit us on site to see our operations and meet staff. Some even ask if an LP or two can conduct on-site due diligence," said Houlihan.

A primary purpose of the site visit(s) is to determine if the TPA is capable and flexible enough to support a fund manager's business as it changes over time, in terms of both staffing and systems. Evaluating a TPA's support structure while on-site is equally important to observing the firm culture. To determine if a TPA is a good match, managers should assess how duties, such as financial reporting and investor servicing, are segregated; who the GP's point of contact for each function will be; and how succession planning for key financial personnel is handled.

Likewise, since TPAs' service models are driven by technology, managers should determine which software a prospective TPA uses to support the accounting and investor servicing functions; how seamlessly the TPA's systems integrate with each other and with the fund's back office; whether the software is based on standard technologies; and how the TPA's technology platform is maintained, and what resources are budgeted for infrastructure upgrades.

Kick the Tires: Assessing TPAs' Capabilities

Given major cybersecurity and other operational breaches in recent years, many PE firms go a step further in the due diligence process and conduct pre-engagement testing to ensure that functions interoperate as expected and that systems meet fund manager and LP requirements. Managers should assess the robustness of a provider's technology platform and whether it can handle a broad range of fund types, including infrastructure, venture capital, real estate and buyouts; whether the TPA has expertise and solutions needed to support the GP's unique investment focus, domicile, geographic requirements and relevant regulations; and whether the staff and supporting systems have the requisite specialized accounting and operational skills.

Ross Ellis, vice president of Investment Manager Services at SEI, said TPA testing was rare 10 years ago, but is occurring with increased frequency. "It's not all prospects to be sure, but some of the more complex multi-asset managers aren't willing to just take our word. They are providing us with sample portfolios to see how we would be able to process them and then providing custom reporting back. It used to be 'trust;' then 'trust and verify.' Now it's heading towards 'trust, verify and demonstrate'."

Understanding the cybersecurity protections a TPA has in place has also increased in importance as attacks have become the norm, since registered investment advisers to private funds are responsible for TPA oversight, which includes safeguarding their clients' and employees' personally identifiable information, even if housed at an administrator. Fund managers should understand the TPA's cybersecurity, business continuity, disaster recovery and transition plans; the historical performance of these plans, if implemented; whether the TPA has written policies and procedures related to cyber controls, and whether they've been tested by a third party; and historical data on system availability and reliability. Firms should also determine whether any additional indicators of a strong technology infrastructure and risk management controls are in place.

Houlihan said that as funds grow and their structures become more complex, fund administration can become riskier from legal and compliance perspectives. Therefore, he said, thorough TPA testing is a valuable way to answer suitability questions. "To be compliant, a GP not only has to understand the laws and requirements but have the capabilities and expertise to satisfy them. Only the largest PE shops can afford to build out their operations and staff to meet these needs. By outsourcing, the administrator can mitigate risks for the fund manager. Testing a TPA's capabilities is a prudent measure to ensure the provider is up to the task."

Finalizing Terms and Conditions

Once a TPA is tested and vetted, the PE firm's needs assessment, due diligence and vetting processes become the baseline for the TPA services agreement, which is typically a standard contract tailored for the fund/GP by the administrator. Fund managers should consult with counsel to review the agreement's terms and conditions.

The following are several common points of negotiation in standard TPA contracts:

- TPA duties and obligations
- fees and expenses
- compliance services
- handling and ownership of books and records
- standards of care and indemnification

Among the more common contract terms specified is the frequency of financial reporting. Registered firms generally rely on the audit provision of the Custody Rule under the Advisers Act, which requires funds to be audited annually and to have their audit results distributed to investors.

Many PE firms also attach a Service Level Agreement, which not only outlines the services to be provided, but sets timeframes and milestones for service deliverables, as well as how often a TPA can miss milestones before penalties accrue (i.e., reversals of fees charged to the fund). The failure of a TPA to provide timely reporting to a fund's auditors and clients, or to properly complete a fund's statements, puts a fund and its clients at risk from both a financial and regulatory perspective. Penalties defined in a TPA's terms and conditions incentivize an administrator to prioritize this deliverable to offset the cost of a surprise audit or potential deficiency finding.

Counsel and/or the compliance department should also pay particular attention to the terms and conditions specifying standards of care and indemnifications that limit TPA liability. Gross negligence is the standard of care for almost all contract breaches, but it typically leaves advisers with little room to maneuver after-the-fact, for instance, if money is moved improperly. Accordingly, establishing strong and detailed procedures in the SLA is especially important, since managers may have few options to mitigate all risk contractually.

Limitations of TPA Engagement

Given heightened compliance and regulatory risk sensitivity, some fund managers conclude that the choice of a well-qualified TPA boosts investor confidence. Since registered funds must disclose key third-party service providers on Form ADV, a TPA's brand and reputation could make a difference in the selection process. The qualities funds prioritize in this regard include the provider's experience managing complex PE operations; independence; technological sophistication; financial strength; and longevity.

But while a TPA's reputation can give GPs and investors a sense of comfort, observed Ellis, "It would be inappropriate for investors to forego their normal due diligence process or make assumptions that the manager and all the portfolios managed are above reproach, or necessarily the highest quality. Investors should consider TPA-related information as part of their overall due diligence, not give the fund or GP a 'good housekeeping' award just because a TPA is used."