Asking the right questions

Limited partners have expressed a growing preference for the third-party fund administration model, and general partners' interest in outsourcing is growing faster than ever. What attributes do fund administrators need to exhibit to satisfy GP and LP requirements?

At the 2016 PEI CFOs and COOs Forum in January, attendees may have noticed a different tone from fund sponsors with respect to outsourced fund administration in comparison to years past. This year, when the topic of third-party fund administration came up on panels and among delegates, many now view these services as a viable option for their firms, and an important choice to consider given the complexities facing the back office.

Indeed, EY made note of this shift in its 2016 Global Private Equity Fund and Investor Survey, which was unveiled at the Forum.

"As capacity constraints develop, finance teams may want to look out-of-house, creating demand for the offerings of asset servicers who see private equity as a major growth opportunity," the survey noted. "Investors, conditioned by hedge fund models, feel comfortable with the concept, so the question is no long whether to outsource, but which functions to outsource and how many providers to rely upon and how to integrate them effectively." The survey also noted the highest level of comfort with outsourcing in recent years on the part of fund sponsors.

So, as more and more private equity managers are considering the switch to third-party fund administration, they need to ask the right questions in requests for proposals (RFPs) and during due diligence. It's vital to ensure the sponsor is meeting the institutional limited partner (LP) requirements for operational excellence and the administrator exhibits best practices for recordkeeping, transparency, and reporting.

"We now see sponsors vetting us in a similar fashion to how LPs due diligence them," says Gen II Fund Services managing director Jeff Gendel. "A fund administrator has to be able to exhibit outstanding marks on a number of key items, like top-tier performance, a highly experienced team, certified processes and procedures, and intimate industry knowledge in the private equity industry."

Many GPs might not know where to start with the administrator diligence process, so we reviewed recent due diligence questionnaires on the topic. Some definite trends emerge from the questions general partners (GPs) ask of their administrator to make sure the administrator can meet their funds' demands, and, in turn, the demands of their LPs.

The processes

The first step every GP and LP will take in reviewing a potential fund administrator is asking whether or not they have an SSAE 16 (Service Organization Control Type 2 [SOC 1] Statement on Standards for Attestation Engagements number 16, issued by the American Institute of Certified Public Accountants). This certification marks the passage of a crucial independent examination of the administrator's control environment, and is a must-have for sponsors and their institutional LPs.

The SOC 1 report provides private equity clients and investors with confidence that the fund administrator has adequately described its controls, processes and procedures, and that its controls, processes and procedures are suitably designed and operating effectively to achieve their specified objectives, notes Steven Alecia, Gen II chief client officer. With the Securities and Exchange Commission (SEC) increasing its oversight role and a more intense focus on recordkeeping for funds, it is understandable that GPs and LPs want to hold their administrator to the highest standards.

"GPs want to know that the administrator has certified processes and procedures to do the work that's required, and as a result, every single RFP that we see asks about the SSAE 16," says Alecia. "In fact, it is usually the first question on the RFP, so it's clear that our GP and LP partners view this as a necessary qualification."

Another important topic GPs and LPs seek to understand is the additional steps taken by the administrator to ensure that client facing items are error-free. Gen II has met this requirement through the establishment of an internal quality control (QC) department, similar to a concurring partner role at an accounting firm, in order to be sure there are extra sets of eyes reviewing all sensitive and client-facing transactions. "QC is among the most important parts of our organization," says Alecia. "Our clients and their LPs take comfort in the additional checks and balances we evidence in our processes."

And while cybersecurity is a hot buzzword throughout the private equity industry of late, many fund managers are struggling to determine what practical steps they can take to approach the matter. Having a fund administrator who is compliant with the US

Securities and Exchange Commission's cybersecurity recommendations is crucial. Not only will the fund manager rest easier knowing their data is in good hands, but they can also turn to the fund administrator for advice on how to approach cybersecurity.

"Each of these attributes – our SSAE 16, our SEC cybersecurity compliance, our quality control team – is an essential part of our service offering and firm infrastructure," says Alecia. "We know these elements are required by all investors, fund managers and regulators as the focus intensifies on quality operational procedures, independent recordkeeping, and full transparency."

The people

Just as an LP would not commit to a fund because it looks good on paper, GPs also should not commit to a fund administrator without learning more about the team that will service them. That team will be an extension of the fund manager's own staff, so it is crucial to know and to trust them, Gendel says.

"You need to dig in and learn about the members comprising the team, their experience in private equity fund administration and how long they've worked together as a team. Have they seen a multitude of situations that enable them to effectively handle whatever comes up while administering one of your funds?" Gendel notes. It's exactly how an LP would investigate a GP's experience in the industries in which the GP is investing. "LPs would think twice about investing with a sponsor that can't evidence a long and successful track record or has lagged in performance."

Another area of interest for GPs in RFPs is how long the administrator's senior team has been working together. Turnover is an issue that has the potential to impact fund administrators, notes Gendel, so GPs must be confident their administrator has the proper structure and incentives in place to ensure that key team members stay for a long time.

"Team continuity is incredibly important in the fund administration industry, and GPs should be asking detailed questions about the stability of the team that will be servicing their funds. It's analogous to an LP asking a GP to explain how they can ensure key team members are incentivized to stay with the firm and how the GP can avoid significant departures from the team. Fund administration is a service business and people are at the heart of it, just like within the private equity firm," notes Gendel.

Equally important, GPs ask about the administrator's knowledge of the private equity industry and experience servicing complex funds. Private equity fund structures become more complex with each passing year. In Gen II's experience, every fund is different, every limited partnership agreement is different, and every organizational structure is different. Private equity sponsors demand a customized approach for their fund rather than a one size fits all methodology.

Whether a firm is just starting out with Fund I, moving from one fund administrator to another or, as the EY survey predicts, moving their operations from in-house to out-of-house, all of the key attributes that LPs look for when considering a GP's fund will translate into the GP-administrator relationship.

GPs are increasingly focused on the administrator's people, processes, performance, and specific expertise. "Sponsors are far more discerning now and smarter about fund operations," says Gendel. "Our industry should be prepared to undergo more scrutiny." ■

The market's requirements

As EY's survey of private equity chief financial officers and investors reveals, outsourced fund administration is becoming a more popular option. In order to meet institutional requirements of private equity firms and investors, GPs and LPs concur that the following attributes are essential for fund administrators:

- Experienced team with long standing private equity fund administration expertise
- Institutional grade infrastructure including:
  - SSAE 16 certification
  - SEC cybersecurity compliance
  - Independent quality control
  - Robust, flexible, and transparent technology
- Evidence of firm performance at the highest levels
- Ability to customize service approach for each fund
- A long-term dedication to the private equity fund administration industry