Introduction to Alternative Investment Service Providers

Alternative investment firms, including hedge funds, private equity funds or fund of hedge all work with third parties in order to assist them in performing both their investment and operational functions. These third parties are vendors that sell goods or services to these funds. The term for the broad collection of these vendors is service providers. We have already introduced several service providers in our previous discussions in this book. These included administrators, prime brokers and executing brokers in relation to our discussion of trade operations in Chap. 2. Some service providers provide primarily fund-level services, while others provide services focused on the larger asset management company. Additionally, certain service providers may provide services at both levels. To continue our conversation of service providers in this chapter, we will first outline the broader role of the administrator in more detail outside of just the trade operations role it plays.

Fund Administrators

One of the most common alternative investment service providers is known as a fund administrator. Fund administrators provide a wide variety of services for funds. The work of fund administrator can generally be classified into two categories, fund accounting and shareholder services.
As a reminder we introduced the fund administrator in Chap. 2 in our discussion of the trade reconciliation process. The role of the administrator in the trading process relates to the accounting services they provide. It is important to note that an administrator often works in conjunction with the operations personnel in-house at an alternative investment fund manager. This is opposed to other services, such as law firms, that largely perform their services independent of the client (i.e. the fund manager). This distinction can be demonstrated, for example, in the area of trade capture. Common administrator services provided in this area would include the following:

- Handling the preprocessing of any trade files to facilitate the automated processing of any trades as applicable
- Setting up and maintaining securities in the administrator’s fund accounting system.
- Recording client-reported trading activity in the administrator’s portfolio accounting system

This could be compared with common fund manager responsibilities to the administrator with regards to trade capture:

- Providing the details of trade activities in a format previously agreed upon, which is usually done in an electronic manner
- Notifying the administrator prior to making any changes in the format or timing of trade files

Administrators often work in conjunction with other fund service providers as well. In a hedge fund context, an example of this would be an administrator receiving trade files from prime brokers as well as the fund manager to facilitate the reconciliation process.

Other common accounting services provided by administrators include the following:

- Calculation of profit and loss for funds
- Cash reconciliation services
- Calculate and verify interest and amortization accrual for fixed income instruments
- Process corporate actions to securities held in the portfolio
- Calculation of fees
- Calculation of the net asset value (NAV) of a fund
- Assisting with the preparation of fund statements and tax-related work
• Investment accounting
• Expense oversight including:
  – Accrue fixed expenses and organizational costs
  – Calculate and accrue fund expenses in accordance with the fund’s offering memorandum
  – Allocate income and expense to each fund share class
• Partnership accounting
• Financial accounting and general ledger maintenance
• Performance measurement
• Other risk and portfolio-level reporting for fund managers and regulators
• Valuation assistance

Shareholder services refer to the tasks performed by the fund administrator with a focus on that information that relates to the investors in a fund. Common shareholder services performed by administrators include the following:

• Managing the process of receiving new capital subscriptions
• Managing the paying out of capital
• Performing anti-money laundering checks

**Conflict of Interest Considerations**

The administrator is commonly paid out of the expenses of the funds to which it provides services. The money to cover these expenses comes from capital provided by investors in the fund. Therefore, in essence the investors are indirectly paying for the services of the fund administrator through a portion of their fund contributions. Investors do this because the administrator plays an important role in assisting the fund manager with operational duties. However, even though the administrator is paid by the fund, and therefore by the investors, ultimately the administrator in most instances based on the structure of funds often defers to the fund manager and not investors. This represents an inherent *conflict of interest* present in the fund administration relationship. While this conflict is common in the alternative investment space, investors should be aware of its presence and the specific ways in which the fund administrator may be carrying out their duties to place the interest of fund managers over that of investors.
Role in Valuation

Additionally, the administrator provides additional resources in the area of valuation oversight.

In regards to valuation in particular, it should be noted that hedge fund administrators do not usually maintain the authority to determine the final valuation of positions held by the fund. Rather, this ability to make a final determinative decision rests with the fund manager themselves. Similarly, the fund manager, not the administrator, generally maintains the final authority to approve the net asset valuation of a fund. These are important points and often one that causes some confusion for fund investors.

In practice, an administrator assists the fund manager in the securities valuation process not by calculating the prices of securities held by a fund themselves but instead by sourcing prices from independent pricing agents. In many cases, guidance on what types of third-party pricing agents are acceptable comes from a fund’s offering memorandum. Additionally, a fund may also maintain a stand-alone pricing policy that provides further guidance in this regard. The purpose of the administrator with regards to valuation in this context is to serve as an independent aggregator of prices from a variety of third parties and then use these prices to calculate the fund’s net asset value, which the fund manager must then approve.

At this point, you may be asking yourself, then what is the point of the administrator? After all, couldn’t the manager simply source these prices themselves? The answer is yes, the manager could indeed source prices for securities themselves without the administrator. The role of the administrator is to serve as a third party that aggregates these prices. The theory is that if a third-party administrator is sourcing the prices and then using them to calculate NAV, there is some level of independent oversight in the process. Now of course, as we have outlined, the fund manager can override the administrator; however, the administrator also has the ability to resign from the engagement if they feel, for example, that the fund manager is incorrectly applying prices. In practice, the fund administrator often attempts to work with a fund manager to document and resolve any pricing differences between themselves and the fund manager in an amicable way.

It should also be noted that in some cases the administrator may not be able to source prices for all securities held by a fund manager. To understand situations in which this can occur, it is helpful to first understand a common grouping of securities utilized in the investment industry. In September 2006, a US organization called the Financial Accounting Standards Board (FASB)
issued a *Statement of Financial Accounting (SFAS) 157*. For reference, in practice this statement was also historically referred to as FAS 157. More recently, FAS 157 became known under a new pronouncement called *ASC 820*. This statement provided a framework for measuring fair value under generally accepted accounting principles (GAAP). Specifically, ASC 820 / FAS 157 outlines three different levels across which securities can be grouped. Level 1 are the assets and liabilities which have the most transparent valuations. It is straightforward to obtain valuations for Level 1 instruments, and an example of such an instrument would be equity stock. Level 2 instruments are more difficult to value than Level 1, and often require indirect valuations. Often positions valued from broker quotes, rather than by observing direct equity prices, are Level 2 instruments. Level 3 positions are those for which the most unobservable levels of valuation inputs exist, and the data utilized for valuation purposes may not be able to be verified. Examples of Level 3 positions may include stock in privately held companies.

Returning to our discussion of the administrators role in sourcing inputs for the fund manager to approve the valuation, if no inputs are available, then the administrator cannot source them. As outlined above in the ASC 820/ FAS 157 hierarchy, inputs are readily available for Level 1 positions and are available in most cases for Level 2 positions. Level 3 positions, in the vast majority of cases, are priced by the fund manager themselves. Another term for these types of positions is *manager marked positions*, because the fund manager is determining the valuation (i.e. mark) on their own. To be clear, this is not to imply that the fund manager simply picks whatever valuation they choose out of thin air. The manager often documents the assumption and reasoning that went into calculating their valuation including any third-party research or external support they utilized in determining the valuation. That being said, ultimately the valuation for Level 3 positions is in the managers discretion.

**Valuation Consultants**

Another type of service provider that an alternative investment fund may utilize is called a *valuation consultant*. These consultants often maintain specialized expertise utilized to value less liquid positions with few or a total lack of third-party observable valuation inputs such as Level 3 positions. In some cases, a fund manager may decide to work a third-party valuation consultant to assist them in determining the valuation of these positions. While hedge funds may utilize these consultants for less liquid positions in their portfolios,
the use of third-party valuation consultants is more common in the alternative investment strategies that hold larger portions of their portfolio in illiquid positions such as private equity and venture capital.

It should be noted that simply because a fund manager maintains difficult-to-value positions in their portfolio, this does not mean that they will automatically engage a third-party valuation consultant to perform an independent valuation of a position. This is often at the discretion of the fund manager, subject to rules outlined in either the fund manager’s private placement memorandum or another document known as a valuation policy. The cost of utilizing valuation consultants can be quite expensive, and, therefore, managers develop rules around their use, in part, to help keep costs down.

Valuation consultants typically provide three types of valuation services to fund managers. These services are provided typically after a fund manager has already attempted to value the position themselves. The first is what is known as negative assurance. This is the least detailed of the three valuation approaches, and often the cheapest. Under a negative assurance approach, the valuation consultant reviews the fund managers valuation policy as well as any specific pricing models the manager may have used in determining their own valuation to determine if they are reasonable in nature. The next level of valuation services is known as positive assurance. It builds upon the negative assurance to also have the valuation consultant review the specific inputs and methodology utilized by the fund manager in pricing the position. The last option is the most detailed and expensive one known as a full valuation. Under this approach, the valuation consultant develops their own pricing model and performs a detailed valuation of the position. The result of this can include a range of acceptable valuations or a specific value. Due to the high cost involved with this approach, it is not utilized very often in practice.

An example of the way a valuation policy rule regarding the use of valuation consultants may be applied in practice would be the following sample excerpt from a valuation policy:

For position in excess of 10% of the fund, third-party valuations will be obtained on at least an annual basis. The fund manager will utilize a third-party valuation consultant from a pre-approved list of vendors.

In this example, positions greater than 10% are required to be valued at least annually. This 10% figure is completely up to the manager to determine. It could have been 15% or 30%. Or as noted above, the manager could have determined not to utilize a third-party valuation consultant at all and simply marked the position themselves. Often the decision to utilize a valuation
consultant is made when the fund is first being structured and in conjunction with the initial large investors in the fund. Similar to the fund administrator, the use of these third-party valuation consultants provides investors with some degree of assurance that a third party is involved in the valuation process. Also similar to the structure employed for the fund administrator, the valuation provided by the valuation consultant is often not binding upon the fund manager. The fund manager could, therefore, disagree with the valuation provided by the consultant and utilize a different valuation.

Different valuation consultants often maintain different expertise with regards to hard-to-value assets and may apply different valuation approaches including the comparable approach and a variety of discount cash flow methods. In real estate, specific real estate model are utilized such as the income approach, the cost approach and the direct capitalization method by specialized valuation consultants called appraisers.

**Compliance Consultant**

A compliance consultant is an alternative investment fund service provider that provides compliance-related services to fund manager. As noted in Chap. 4, certain compliance consultants had historically even taken over the role of chief compliance officer (CCO) of a fund manager; however, this practice has largely been phased out and the CCO title is held in-house by an employee of the fund manager in most cases.

For newly launching fund managers, a compliance consultant may be engaged to assist the fund in preparing a regulatory compliance policies and procedures including a code of ethics and compliance manual. For more established fund managers, the compliance consultant can provide ongoing assistance regarding the operation of the compliance program.

**Personal Trading Program Oversight**

One of the common duties compliance consultants assist with is the oversight regarding a fund managers personal trading program. Also called personal account dealing, this refers to any trades that may be undertaken not by the funds that a firm manages but directly by employees themselves for their own personal accounts. It should be noted that in most cases personal account dealing compliance policies extend not only to fund managers’ employees themselves but also their significant others and close relatives. Personal
trading program compliance policies often require that employees submit trades for compliance, or the designated compliance consultant, for preapproval prior to proceeding with trade execution. In order to determine whether preapproval should be granted or not, fund managers often utilize a restricted list, which is a list that outlines securities that employees are prohibited from executing trades in. There are a variety of reasons why a security could be placed on the restricted list. One of the more common reasons is that the fund received material nonpublic information regarding a certain security, and, therefore, to prevent violations of insider trading rules, the fund manager banned employees from trading in this position.

Another common reason for a security being placed on the restricted list is because the funds that the firm manages currently hold a position in a security and they do not want employees trading in that specific security for their own account. The compliance consultant would cross-reference the submitted names for preapproval with the restricted list to determine if it was on the list or not. If it was not, then preapproval would be granted for the employee to trade. It should be noted that checking the restricted list is an example of only one personal account dealing compliance policy. There are often a host of compliance rules funds institute regarding personal account dealing that would have to be checked. These include the time frame during which an employee can institute a trade and restrictions regarding the frequency and volume of employee trades. In some cases, a fund manager or their compliance consultant may use automated tools to automatically perform checks regarding whether or not a particular employee trade would comply with the firm’s personal trading rules.

Additionally, compliance checks are usually performed on a post-trade basis as well as by comparing brokerage statements from employee brokers with the trades submitted by employee for preapproval. This comparison process ensures that there were no trades that were executed but not submitted for approval by the employee. Depending on the number of employees and the volume of personal account dealing, the amount of work involved in successfully implementing a personal account dealing program can add up quickly. This is why increasingly fund managers are relying on automated tools and compliance consultants to assist with these types of resource-intensive compliance matters.
Electronic Communication Monitoring Oversight

Another common task that fund managers utilize compliance consultants for is to assist with what is known as electronic communication monitoring. Electronic communication includes methods of communicating such as email and instant messaging. Instant messaging is often utilized by traders and research analysts through a variety of popular platforms such as Bloomberg.

Fund manager archive and monitor electronic communications in order to ensure that employees are not violating the firm’s compliance policies through inappropriate communications. The classic example of a violation would be an investor relations employee that tells a prospective investor that they guarantee a certain fund’s investment performance in the future. A fund cannot guarantee performance since it cannot predict the future and, therefore, this is a violation of regulatory and compliance guidelines. Through electronic communication monitoring, searches for keywords commonly associated with violations, such as “guarantee,” can be performed to detect and attempt to prevent future violations. In many cases, automated tools can be utilized to assist for monitoring for the use of certain specific keywords that are commonly associated with violations. Increasingly, electronic communication monitoring has begun to encompass social media reviews as well; however, this is a complicated area due to the privacy laws in different countries influencing employees’ rights to post on social media. In summary, compliance consultants are often engaged to assist with electronic communication monitoring due to the time-intensive nature of this task.

Mock Audits

As with other service providers, it should be noted that the use of a compliance consultant is not mandatory, and some funds simply manage the compliance function entirely in-house. That being said, it is considered best practice for a fund manager to engage with some third parties, be they a law firm or compliance consultant, to provide a third-party evaluation of the firm’s compliance capabilities with some regularity.

To accomplish this third-party evaluation goal, one task compliance consultants are often engaged by fund managers to perform is known as a mock audit. This a review of a fund manager from a compliance and regulatory perspective where the compliance consultant assumes the role of a financial
regulator to which the fund is subject to review. The purpose of this review is to prepare a fund for an actual regulatory review. Oftentimes, mock audits can yield valuable insight to fund managers with regards to compliance deficiencies or potential deficiencies that can be corrected in advance of a real regulatory review. In order to simulate a real regulatory review, the mock audit process often includes the compliance consultant submitting a document request to the fund manager to complete, conducting on-site interviews with personnel and conducting random audits of the fund managers’ implementation of compliance procedures.

Other Services

As the scope of alternative investment fund managers’ compliance obligations has expanded, the tasks of compliance consultants are similarly expanding beyond the traditional realm of historical compliance duties. One primary example of this is the increasing number of service offerings by compliance consultants in the area of cybersecurity management and testing. Another example of that is in the area of business continuity and disaster recovery planning. A topic that has become increasingly important in the wake of extended business disruptions such as 2012’s Hurricane Sandy and the 2019 Novel Coronavirus (COVID-19). For reference, the technology-related aspects of cybersecurity and business continuity planning are discussed in more detail in Chap. 6.

Other services commonly performed by compliance consultants include the following:

- Annual compliance reviews
- Trade surveillance
- Assisting in managing actually regulatory exams
- Compliance training
- Compliance surveillance and testing
- Vendor compliance reviews
- Expert network usage monitoring
- Regulatory reporting and filing
- Review of marketing and other investor facing materials
- Insights on industry happenings
- Regulatory compliant data hosting
Legal Counsel

Like most businesses, alternative investment fund managers utilize third-party law firms in a wide variety of ways. When a new fund is being launched, legal counsel is often utilized to assist the firm in setting up and registered the appropriate legal entities. Third-party law firms are also commonly utilized to assist in drafting the initial fund offering documentation including the private placement memorandum (PPM). Once a fund is up and running, law firms will often assist with revising existing fund documentation to reflect new organization or regulatory changes. These revisions are commonly reflected in separate documents called supplements. Law firms will also typically be called upon to assist with any litigation a firm may be engaged in ranging across a wide variety of issues from employee compensation disputes to investment related litigation dealing with a fund’s investing activities. It should also be noted that depending on the structure of the funds involved and types of legal issues that are being dealt with in many cases, a fund manager may utilize several different law firms both domestically and abroad for different matters.

Increasingly, law firms and compliance consultants are offering overlapping services in competition from increasingly lucrative compliance and regulatory business for fund managers. As such, in recent years law firms now offer a wide variety of compliance-related services including drafting compliance manuals and related documentation, performing mock audits, employee training on compliance issues, ongoing compliance advice.

Accountants and Auditors

Third-party accounting firms often perform a number of services for fund managers. One of the most common services accountants are engaged for is to prepare the audited financial statements for the different funds managed by an alternative investment manager. These statements are typically prepared on an annual basis. In rare cases, to reduce fund expenses a fund manager may decide to hire an accounting firm to prepare audited financials for the fund not every year but for a longer period, such as every two or even three years. This is not considered best practice due to the lack of auditor oversight being extended for a period of greater than one year; but, while rare, such legacy arrangement still do exist, particularly among smaller private equity and venture capital funds. It should also be noted that similar to the use of other
service providers it is not required that a fund manager hire an auditor in all cases.

In an even worse situation than spacing the audits out over several years, there are even rarer cases of small alternative investment fund managers that are still operating today that either prepare their own financial statements or work with an accountant, such as a certified public accountant (CPA) as they are called in the United States, to assist in preparing them but that do not produce fully audited financial statements. Once again, the typical motivation for doing this is motivated by costs concerns. It should be noted that while this decision is voluntary by the manager, the fund manager still has an obligation to investors to disclose in advance that they have opted to not have these financial statements prepared in an audited fashion or that they will be extending the period of the audit beyond the standard one-year time frame.

Other services third-party accounting firms commonly provide to alternative investment fund managers can include the following:

- Management company financial statement preparation
- A variety of tax advice and opinions related to the financial statements as well as potential investments
- Assistance in performing internal control and operational audits
- Auditing the fund manager for compliance with industry certifications such as Statement on Standards for Attestation Engagements (SSAE) 18 (formerly known as SAS 70 and SSAE 16)

**Custodian**

The role of a third-party service provider known as a custodian is to hold the assets of a fund. These assets can include both cash and securities. Custodians function in much the same way a bank does when it holds cash in escrow during the purchase of real estate, for example. In many cases, prime brokers will have related entities that serve as custodians for funds that they provide prime brokerage service to. It is important to note that when a custodian is holding the assets of a fund, it may do so in either the name of the fund or its own name. If a custodian does hold assets in its own name, this exposes the assets of the fund to greater counterparty risk should the custodian itself become insolvent and then the fund’s assets could be exposed to recourse during the insolvency. Therefore, it is generally preferred that a custodian hold assets in the name of the fund as opposed to the name of the custodian.
Other Service Providers

In addition to the key service providers list above, alternative investment fund managers may work with a wide variety of other providers. Alternative investment fund managers are businesses, and in order to run their business from an operational perspective, they are required to interact with a great deal of third parties. Examples of these other service providers include the following:

- Real estate agents to secure office space
- Domestic and offshore banks to facilitate cash holding and movements for fund and management company activities
- Insurance brokers to assist in securing and maintaining insurance coverage
- Information technology consultants to assist in setting up and maintaining the firm’s technology operations. For reference, these are discussed in more detail in Chap. 6.
- Human resources, payroll and benefits consultants
- Utility providers to provide common utilities such as telephones, electricity and heating and cooling services to physical office space

Chapter Summary

This chapter provided an overview of the different third-party service providers utilized by alternative investment firms. We began with an analysis of the role of fund administrators. As part of this discussion, we discussed the fund accounting and shareholder services they perform. We also outlined the inherent conflicts of interest present in the administration relationship, and the role of the administrator in the fund valuation process. We next discussed the role of third-party valuation consultants and the types of assurance services they offer. Next, we outlined the common duties of compliance consultants including assisting with personal trading program oversight and electronic communication monitoring. Finally, we discussed the role of legal counsel, auditors and other service providers that may be utilized. In the next chapter, we will discuss key aspects of the role of information technology in alternative investment operations.