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The thought of bankers having to find a home in Luxembourg’s red light district is just another of the gloriously unexpected outcomes of Britain’s decision to leave the European Union. To be fair, plenty in the finance industry did predict funds would be forced to find new domiciles as the UK approaches Brexit day. But the cranes spiking out of Luxembourg’s historic skyline as more funds move in – and the grumbles by long-time residents that they are being priced out of the local property market – are just another reminder that fund administration involves some big decisions that can have consequences far beyond the back office.

We detail “Lux living” as part of our feature on which domiciles are set to secure a “Brexit bonus” on p. 10. Luxembourg appears to be the big winner in the race to be the domicile of choice for London-based managers, with Ireland second.

The choice of EU fund base is dependent on many factors, but then that’s typical of fund administration, which has grown in complexity in recent years, prompting more GPs to outsource.

That has caused something of an arms race among service providers as Rob Kotecki highlights on p. 4. The reasons are many. LPs have higher reporting standards, regulators are upping the ante and funds are having to adapt to technology. Thirty percent of funds plan to increase the level of outsourcing in technology this year, according to our 2017 CFO survey, with cybersecurity one of the main concerns.

Eric Feldman, chief information officer of The Riverside Company, identifies six steps for managing cyber-risks on p. 30. A well-defined map detailing where all the company data resides is a good first step, he says. We’ve also rounded up a stellar panel of tech experts to answer some of the technology concerns in the private equity industry including how to deal with LP demands for better quality data (p. 20).

There are keynote interviews from SS&C GlobeOp on what GPs should look for in a service provider (p. 8), Alter Domus on why a new generation of CFOs at US firms is starting to embrace outsourcing (p. 14) and Intertrust on how the challenging investment environment is forcing GPs to change tack (p. 18). SEI reports the results of its LP survey, which highlights why transparency is a growing issue for investors (p. 23) and Gen II Fund Services details the sea change seen in the fund administration in recent years (p. 28).

It’s a diverse agenda, but then that sums up the modern fund administration industry. Complicated perhaps, but not without its benefits as Luxembourg can readily admit – provided you can afford to live there.

Enjoy the supplement.

Graeme Kerr

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OUTSOURCING

Future shock

The complexity of fund administration is creating an arms race among service providers for talent and technology, writes Rob Kotecki

GPs may dream of a future where fund administration gets cheaper and simpler, but they’re more likely to get hoverboards first. One fund manager says he has employed more people in the back office than he has to do deals over the years, leading him to wonder if he was actually in the business of investing. The realisation made him outsource his fund administration, and he’s not alone.

Fund administration has only become more complicated as more fund managers raise larger pools of capital and invest in more domiciles. LPs are putting pressure on costs while demanding better reporting from GPs. So, many firms are happy to outsource the headache, which created a boom among service providers, with a wave of new players and plenty of M&A.

But the headache has only been transferred to fund administrators, requiring them to make major investments in technology and talent. Administrators may then find themselves in a hyper-competitive future, as larger, more complex GPs demand more from their service providers.

While it’s not quite _Fury Road_ out there for fund administrators, GPs who don’t outsource should pay attention. They may have to join the arms race themselves, by making investments to keep up with industry standards. This, in turn, can drive outsourcing.

A TIPPING POINT?

Unlike hedge funds, where nearly 90 percent of firms outsource fund administration, only 30 percent of private equity and real estate firms use a third party. According to a recent study from Preqin, that number is likely to jump to 45 percent in 2018. The factors driving that growth are only likely to continue.

Regulatory complexity makes fund administration costly, labour intensive and top-of-mind for LPs. Satisfying the various requirements of regimes around the world can be difficult for an in-house team. “From Alternative Investment Fund Managers Directive to Foreign Account Tax Compliance Act to the new privacy regime in Europe, it can really burden a chief financial officer’s staff,” says David Bailey of Augentius.

At the same time, LPs are demanding more transparency while being sensitive about cost. “CFOs are essentially being asked to deliver better reporting on a smaller budget, which makes outsourcing an attractive option,” Bailey adds. And LPs like the independence of a third party, with one admitting that if an administrator they trust is servicing the fund, they don’t feel the need to double and triple check the...
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numbers. Even the larger groups which may not outsource their entire operation are relying on third-party administrators for smaller projects. “Some of our clients are looking to outsource certain tasks, just to address bandwidth issues,” says Krista McCoy of Leverpoint.

Others are tapping third parties for specific geographies. “They may come seeking Dutch expertise or to look after a Luxembourg feeder fund,” says Bailey. “And what happens over time, as we handle those smaller tasks, is they feel more confident about outsourcing more and more of their work.”

GPs don’t need to use fund administrators to recognise the growth potential of the market. Many have invested in the sector, such as GenStar, which bought Apex Fund Services and Equinoxe Alternative Investment Services to create a single fund administrator. It went on to purchase Deutsche Bank’s Alternative Fund Services business in October.

GROWING GAP
The Deutsche sale wasn’t an outlier. More and more big banks like Wells Fargo and Credit Suisse are shedding their fund services units because of the regulatory risks and the high cost of continuing to invest in technology and expertise required.

“There will be an expanding gap between those administrators that invest in their people and their technology, and those that can’t,” says Jeff Gendel of Gen II Partners. “The barrier to enter the industry and to meet client demands is getting higher and higher.”

Some small and mid-sized service providers are looking to scale up their offerings through M&A, especially into new geographies. Luxembourg-based Alter Domus Group acquired Cortland Capital, which is based in Chicago, in November, while Maitland Group, also in the Grand Duchy, acquired Phoenix Fund Services to enter the UK market. Geography is a key element to the administrator’s offering “GPs are marketing on a global basis,” says Bailey. “A firm that raises $500 million for their debut fund is likely to look at raising close to a billion for their second, and that often requires international investors, with international concerns.”

Not every administrator has the interest or the means to buy their competitors. Some choose to build a network of strategic partnerships that can be tapped as their client grows. And not all those partnerships are with other administrators.

“A lot of firms are vying to serve this space, on a number of different fronts,” says Cesar Estrada of State Street. “Some are figuring out a way to digitise more of the process, some are expanding to offer data management and analytics, and some are looking to address gaps in the current service model.”

So, Estrada finds himself in situations where his firm will partner with a firm in one situation and compete with that same firm in another. “It’s about finding ways to capitalise on these ‘frenemy’ situations which will be increasingly commonplace in the future.”

However, there are times when the service provider will have no choice but to spend capital to address the problems that fund managers are outsourcing to them. Technology is a major spend – a recent survey of administrators by Longitude Research found that 89 percent of them expect to make investments in new systems and technologies by 2020.

Investor communications will always be a vital part of fund administration, and technology has already improved the speed and volume of data being shared. But there’s a paradox at the heart of LP reporting. As McCoy points out, while LPs want transparency, too much data can be hard to sift through. “It can be a double-edged sword, but that doesn’t stop it from being our core focus.” And that focus is on being generous with information in ways LPs can digest.

“We’re aiming to set up our systems so that LPs can look at asset-level data as if they were looking at their very own fund,” says Estrada. “We’re not there yet, but it’s our north star.” Artificial intelligence will help, but it’s not quite clear how yet.

“We’re in the early stages of AI in the industry, so it’s hard to say where it will go,” says Rishi Khanna of SS&C Technologies. “But we think it’ll vastly improve data gathering and collection first, and that may be in the near few years.”

Khanna expects AI may eventually upgrade data analysis to impact valuations and idea generation. But in this day and age, service providers can’t focus on data management to the exclusion of data security.

“There’s an enormous amount of investment in information security, especially in
light of new regulations like General Data Protection Regulation and the Securities and Exchange Commission’s continued focus on the matter,” says Gendel.

GPs and service providers complain about the costs of the training, testing and software which still doesn’t guarantee a breach-free existence. “The costs of staying on the cutting edge is rising exponentially,” adds Gendel.

Even if a provider spends big on reporting systems and security protocols, there’s a new front in the tech wars. “There are now technologies to track the workflow of fund administrators,” says Bailey. “GPs can see exactly where a provider is on distributions or drawdowns, so it’s complete transparency.”

And even the best technology can’t ensure a service provider keeps their clients happy. “Fund administration is a people business that is buttressed by technology, not the other way around,” says Gendel. “So, we invest heavily in the training and professional development of our staff, which leads to higher retention rates.”

Gen II even brought aboard an executive devoted to training its people.

TALENT, TALENT, TALENT
Every fund administrator we spoke to for this story stressed the need to get and retain top talent in the space.

“Turnover is a huge concern for the industry,” says Kevin O’Neill of Broadscope Fund Administrators. “We’ve been fortunate to have a very low turnover rate and we’re always focused on keeping it that way.” That means ensuring compensation is attractive and young associates see a long-term career path, which takes time and money in an industry where clients are sensitive to cost. Further complicating the question is the fact some service providers are expanding their suite of services.

“In the past, the industry has viewed the administrator role as a matter of offering accounting, reporting, and other investor communication,” says O’Neill. “It has become much more robust. For example, we provide significant assistance with regulatory and compliance matters.”

One example is Broadscope’s ability to provide anti-money-laundering/know your customer or Foreign Account Tax Compliance Act assistance if a client requests.

If outsourcing is the future of fund administration, it prompts the question, how happy are those firms who’ve done it? According to a recent survey from Preqin, administrators did not fare well. More than 36 percent of GPs polled had switched their administrators within the year, while only 20 percent of them changed placement agents or auditors, and 24 percent changed law firms.

When asked why, GPs cited cost, portfolio complexity, an inability to cope with regulation and a dissatisfaction with the quality of service. Some experts suggest the dissatisfaction begins when a smaller GP grows and asks more of the service provider than it is capable of handling. Gendel stresses that fund managers should be more aware of their service provider’s ability to scale as the GP grows in size and complexity.

The vast majority of GPs outsourcing their back office are satisfied, but it is clear it is hard to administer a fund, full stop. And even if a GP decides to handle everything in house, their back-office operations will face the same pressures to scale effectively with the firm. The future of fund administration may not be outsourced, but it won’t be getting simpler or cheaper any time soon.
Getting in sync

As LP demands and regulatory complexity fuel growth in outsourcing, Joe Patellaro and Rishi Khanna of SS&C GlobeOp discuss how GPs can select the right service provider and ensure a smooth onboarding process.

Outsourcing can be an appealing option for GPs these days, given the headcount, cost, technology investment and regulatory considerations required to effectively manage a firm’s accounting, financial and reporting functions. Over half of fund managers outsource at least some of their fund administration, according to a recent EY study of private equity CFOs. That has prompted the launch of several new service providers and driven long-term industry players to build bench strength, develop expertise and expand geographic reach.

Joe Patellaro (pictured below), managing director and global head of private equity services, and Rishi Khanna, managing director of alternative assets technology, at SS&C GlobeOp share their insights into what GPs should look for in a service provider and how to best guide the onboarding process.

Some firms outsource from their debut fund, while others wait until they’ve raised a certain amount of capital or moved into a new geography. Is there an ideal time to start outsourcing?

Joe Patellaro: Any of those inflection points can be the right time for this discussion. What we’re finding is that firms are talking to us as part of a broader strategic business evaluation. This can be a proactive review of all their processes to address possible efficiencies, alignment of best practices and plan for the growth.

And that can lead them to explore outsourcing, perhaps for the first time in a while. What they find is an industry that has really evolved from basic fund administration to more complete business solutions for private equity firms and their investors. I’ve been in this business for almost 16 years, and we’re at a point where we have the critical mass and the expertise to provide value to complex, global firms that have multiple products in multiple geographies. For example, in addition to core fund administration and reporting, our ability to provide data in a way that clients can digest in an efficient manner can make a real difference. That’s one of the advantages of having roots as a technology firm.

Nowadays, it’s not just a binary question of whether a GP outsources or not, but of accessing resources that can address their unique needs.

Rishi Khanna: It’s not only increasing investor demands that can prompt GPs to look for outside help. The growth in data from managing bigger portfolios can make distributing monthly and quarterly reports more challenging. And that’s a
keynote interview: ss&c globeop

Q Cybersecurity remains top of mind, especially as firms consider outsourcing their data to a third party. What are some common sense questions they can ask potential service providers about data security?

RK: Some of the basics are questions about how the data is stored and encrypted and how the network is protected. But I think one of the most important questions that rarely gets asked is how they would respond in the event of a data breach. Because there will be a breach. It's inevitable. And they should have a series of protocols in place for when that happens.

But I think a better way to gauge the quality of a cybersecurity program is how thoughtful and rigorous it is. We've been a technology company for 30 years, so it's been a key priority for a long time. We have a dedicated team for information security and we train all our employees. Any service provider should have a robust programme that includes three key elements training, policies and technology. A GP may not understand every element of the programme, but those three elements should be in place.

For those GPs who have realised they need some help, how do they choose the right service provider for their needs?

JP: Private equity funds are by their nature long term – up to 10 years or more depending on the terms. We believe managers need a service provider that has proven themselves dedicated to this space and with whom they can forge a long-term relationship. We feel experience matters, not just in terms of building institutional expertise, but in showing a commitment to serve the asset class.

Another consideration is that a successful firm isn't static. They raise more capital from more investors, they move into new geographies and product offerings. Even if a firm doesn't need global expertise now, that doesn't mean it won't in the future.

GPs need a partner that can serve the firm they are now, and the firm they might be in the future. The fact that we can discuss developments in Singapore or Luxembourg or trends in the credit or real estate space is key.

Are there any red flags GPs should take note of when looking for a fund administrator?

JP: As a buyer, I would be looking for a service provider that can be flexible in designing a solution based around how I work, while bringing discipline, experience, expertise and technology to the process. That requires dialogue and a practical view towards wants and needs that takes into account time, costs and control.

One of the major hurdles to outsourcing a back office is the onboarding process, where the GP uploads their data and learns the service providers systems.

Are there any best practices you can share?

JP: Every onboarding process is unique to the client depending on a myriad of factors specific to that situation. Part of the value of having the experience and scale that we have is that we've seen an awful lot of what's transpired in our space. We don't take anything for granted when onboarding.

So, in addition to the important data aspect, we spend a great deal of time with clients looking at process mapping, laying out how a firm does things now, and how we can integrate the teams and processes. Establishing the appropriate process flow with our clients is as important as understanding the elements of how the fund works.

Onboarding requires deep thinking and an honest assessment of time commitments and client capabilities. And while we have a dedicated onboarding team, there is senior level attention throughout the process.

How important is it to have someone at the GP responsible for the onboarding process?

JP: It's vital, and it's part of our formal governance process and documentation. We identify all the relative constituents on both the client and service side. And that's the discipline we bring to the process; it's the start of building a genuine partnership with our clients, so that we wind up as an extension of their financial, accounting, reporting, investor services or tax functions. The value of being part of a group as large as SS&C is that we have an enormous bench of talent to choose from, so we can find the best fit for that firm's unique culture. Every client relationship has its own nuances and the right service provider will understand and address them. While technology and service execution are certainly fundamental to our process and success, this is still a business of relationships.
Jockeying for position

As the deadline for the UK to leave the EU approaches, Ireland and Luxembourg are winning the race to be the domicile of choice for London-based managers, writes Victoria Robson

Uncertainty may be rife in the Brexit process, but one aspect of Britain’s departure from the EU seems assured: EU-based domiciles will benefit as UK-headquartered fund managers seek to secure passporting rights after Brexit.

Of the domiciles racing to pick up British business, the big winner appears to be Luxembourg, which sits firmly out in front, with Ireland in second, say industry participants.

Blackstone, The Carlyle Group, Intermediate Capital Group and 3i are among GPs to have picked the Grand Duchy for their EU base, while KKR is reportedly looking at Ireland as GPs seek to ensure access to a European marketing passport post-Brexit.

Unpredictability over the terms of the UK’s exit in less than a year, coupled with the characteristics of individual fund structures means there is no clear-cut choice of preferred domicile for UK-based managers weighing up where to secure EU
passporting rights under the Alternative Investment Fund Managers Directive.

Amsterdam, Frankfurt and Paris are also in the running. However, taxes are high in the Netherlands, says one London-based GP who describes Frankfurt as “boring” and Paris as “maybe less international” in outlook and suffering from “issues with [an] addressable pool of talent”.

Adding to the complexity of contingency planning, depending on progress toward AIFMD third-country passporting, Guernsey and Jersey – which already sit outside the EU but have been assessed by the regulator as appropriate regimes for passporting – could, in future, edge ahead of London as attractive domiciles. Both are established fund centres already popular among private equity firms.

Offering a level of stability, the Channel Islands’ trading relationships “with both the UK and EU will remain largely unchanged before, during and after the UK’s divorce from the EU”, says Barry McClay, Guernsey-based chief operating officer at Ipes, a private equity fund administrator.

However, movement toward third-country passporting “is tied up with finding a workable equivalence regime for the UK post-Brexit. That will take time and we do not anticipate the creation of a third-country passport any time soon”, he says.

As funds consider their options, no one expects a flood of managers to quit the UK following Brexit.

“Moving everything out of London would be a huge upheaval and it would not be necessary,” says Simon Witney, London-based special counsel at Debevoise & Plimpton.

“You’ll see a delineation between front office and back office,” adds the London-based GP. “Some people will shift back office functions to these other jurisdictions as a first step, because it’s sensible and because if you want to do more later, it gives you that optionality. You won’t see front offices move until there is more clarity on the deal [between the UK and EU]. And if the deal is good, I don’t think you’ll see people move at all.”

**FIRM ACQUAINTANCES**

Selection of an alternative jurisdiction appears to rely less on fund type and more on how acquainted firms are with the locale. Blackstone has plumped for establishing an Alternative Investment Fund Manager in Luxemburg, where it already employs around 200 staff to oversee its real estate funds. It is adding to its team

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**DELIBERATE CHOICE**

There is more than one solution for London-based GPs seeking continued access to European investors post-Brexit

At 11pm on 29 March 2019 the UK will leave the EU. As the deadline approaches, uncertainty is the norm for UK-based managers. Some may even have become a little complacent, says the London-based GP. “At the non-prepared end people are waiting to panic about it,” he says.

Under the terms of the transition agreement – assuming it remains as it is currently drafted – London-based funds will be able to use their AIFMD passport until December 2020. However, those with large EU-regulated investor bases, or funds contracted to be EU regulated, need to prepare now for life outside the EU, says Simon Witney of Debevoise & Plimpton.

“The approval process to get a regulated entity established is probably between six to 12 months, and there are corporate law and logistical issues around establishing new structures and working out where that should be,” he says.

For large institutions with existing EU outposts, the time and money spent acquiring a new licence may be immaterial. However, for smaller UK-based firms, the bill – ranging from legal fees to office rent – could be prohibitive.

When considering establishing an EU-based AIFM, “it’s balancing the time and expense involved against the alternative of being possibly shut off from the ability to market [in the EU] from next March or later”, says Liam Collins, a Dublin-based partner at Matheson.

For small firms, using a third-party manager might be a solution. “Depending on the size of the GP/private equity manager, we have encountered both [the AIFM and third-party] scenarios,” says McClay.

Another option for firms without a EU presence and a limited pool of European investors would be to simply continue to rely on national private placement regimes and market their funds on a country-by-country basis. In the end, whatever route to market a GP takes will depend on the final details of a financial services deal the UK government reaches with the EU. Should the UK continue to apply European law in order to access European markets, it may be the case that GPs do not have to take any action at all.

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You won’t see front offices move until there is more clarity on the deal [between the UK and EU]

London-based GP
with about a dozen new hires, while its 300-plus London-based staff stays put.

As AIFMD-regulated entities, UK-based funds seeking continued access to the European Economic Area would be familiar with the regulatory set up wherever they go. Luxembourg and Ireland have the advantage of being sizable and proven fund centres hosting a plethora of administrators, depositaries and other ancillary fund services.

“Both jurisdictions are in the EU and have a well established private equity industry, regulatory framework and favourable tax structure,” says McClay. Luxembourg ranks second to the US as the largest fund centre globally, with “tried and tested LP laws and structures in place to support PE fund managers”, he says.

There are more than 200 licenced AIFMs domiciled in the Grand Duchy, says Tom Theobald, deputy chief executive of government agency Luxembourg for Finance. “Luxembourg has long been a hub for investment structuring but we see more and more activity on the private equity side,” he says.

SPEAKING THE SAME LANGUAGE

Appealing to Anglo-Saxon managers, the 800-strong multilingual regulator permits funds to conduct activities in English, such as submitting an application and reporting. “This is not because of Brexit. It has been done for the past 25-30 years,” says Theobald.

At the end of February, US-based sponsors accounted for the highest proportion of Luxembourg’s €4.2 trillion of assets under management with 20.4 percent, closely followed by UK funds with 17.6 percent, according to the Association of the Luxembourg Fund Industry.

For its part, Ireland offers “the ability to conduct business efficiently with regards to language, legal system, service culture
other European markets. Employment has risen on average 3 percent over the past 10-20 years, says Luxembourg for Finance’s Tom Theobald, who believes the impact of Brexit will be “part of the natural growth of the financial centre”.

However, in the already notoriously expensive Grand Duchy, some costs are rising, for instance for housing, which has been increasing 4 percent year-on-year, according to Theobald. Bankers will need their bonuses.

A 73 square-metre, one-bedroom apartment in the Royal-Hamilius residence with city centre views was being marketed by JLL Residential in April at more than €1 million. The apartment will not be available until the third quarter of 2019.

A rise in the labour force will put more cars on the road in the city where many already moan about the traffic. Going some way to address this is the completion of the first phase of a tram project that will eventually link the airport and the train station with other areas.

“That will help with any increase in employment as a result of Brexit. We have people commuting into the city from three countries. We have to deal with traffic jams but this is nothing compared to London or Paris,” says Theobald.

He concedes that the Grand Duchy would benefit from more hotels, particularly during peak occupancy times in June and October when the European Council meets. But visiting managers pining for the nightlife in London or Paris will not be totally disappointed. With the highest number of Michelin stars per capita, those dining out on expenses should not have to fight for a table.

Luxembourg has long been a hub for investment structuring but we see more and more activity on the private equity side

Tom Theobald

and cost evidenced by the success of the hedge fund industry there,” says McClay.

However, “the LP legislation requires to be amended to align it to international private equity funds and AIFMD to make it attractive”.

Asset managers across the alternatives spectrum, including private equity, have applied to establish AIFMs in Ireland, says Liam Collins, Dublin-based partner at Matheson. “It’s a well-worn path and allows such AIFMs to avail of the marketing passport for their Irish (and other EU funds). Irish funds are distributed in over 70 countries worldwide.”

LUXEMBOURG’S GOT TALENT

As hiring among London-based asset management firms slows in light of Brexit, recruiting in Europe is picking up, according to reports. Theobald and Collins highlight the availability of local talent in their respective jurisdictions.

New roles include in compliance, risk management, and legal and client-facing services, says Theobald. “Luxembourg is small but within an hour’s commute live about five million people. The benefit of the single market is that you don’t have any borders,” he says.

And that is exactly what many UK-based funds are looking for post-Brexit.
OUTSOURCING TRENDS

Time to declutter?

Increased complexity in fund management and the rise of technological solutions are leading private equity firms to take a long, hard look at their back and middle office functions, says Emmanuel Raffner of Alter Domus.

Private equity firms are at a crossroads today. More established firms have built out large back and middle office teams to remain compliant in the face of increased regulation, with the Alternative Investment Fund Managers Directive in Europe creating a significant amount of additional workload. Meanwhile, LPs require much more granular information and are increasingly seeking independent verification in areas such as valuations. At the same time, managers have branched out into new asset classes and are managing multiple funds and co-investment vehicles. All this adds up to greater operational complexity and more headaches for those in charge – the CFOs, many of whom are still having to grapple with all these challenges using outdated technology.

Against this backdrop, we spoke to Emmanuel Raffner, head of private equity, infrastructure and corporates at fund and corporate services provider Alter Domus, about how outsourcing providers are developing to meet the industry’s challenges.

It’s clear that the private equity industry needs to find solutions to a variety of pressures today. Where are you seeing most interest?

We are having conversations with clients – both current and prospective – across the spectrum of services we provide, but also across the different fund manager sizes and maturity. So, for example, with first-time managers, the conversations are very much around us providing a fully integrated solution from corporate services right through to fund administration, accounting and reporting with a fully integrated third-party management company (Manco). These managers may not have much expertise in back or middle office functions and, in any case, would be reluctant to invest heavily in these areas when they need to focus on building a track record.

At the other end of the spectrum, we’re seeing many of the larger, non-EU managers looking to use third-party AIFM services so they can continue to promote funds in the European Union, and for many it is too time-consuming and costly to set up licences on their own.

And what about the more established, mid-market players? What are they looking for today?

Often, these clients come to us because they’ve made the decision to outsource part of their operations, for example, to administer their fund and/or SPVs, or help them manage regulatory compliance. They have often reached this decision after looking at whether they want to hire more middle or back office staff, or whether they would be better off investing in front office professionals.

With these clients, it’s often a case of building trust with one type of service in one geography and then extending those services and geographies over time. You have to build a relationship with clients so that, when it comes to launching a new fund or extending into a new asset class, you are well positioned to help them design or redesign their middle and back office functions, or you can help with a move into new regions. But to do this effectively, you need to be able to follow your clients to wherever they operate and offer them services from the fund level right through to the holdco and SPV levels. Overall, we are finding that outsourcing is often a gradual process, but with European managers moving faster than their US counterparts.
Q And how much of a role is technology playing in these decisions?
Technology is a big driver. The industry is in a transition phase and that is one of the key reasons GPs are looking to outsource. In the US, for example, we are having a lot of conversations around this as managers have started to take a step back and look at their IT. What they often see is a mosaic of different systems, none of them integrated, and they realise that they are going to have to invest significantly to streamline their processes and automate data capture, analysis and reporting.

Q Why is there this disparity between US managers and European ones?
There is a clear lag for US managers. Around 30 percent of US managers currently outsource, while the European rate is now close to 70 percent, with a real increase over the last few years. One of the drivers in Europe has been the AIFMD and the ever-increasing regulatory compliance pressures, which has created a need for depository services and a pressure to become compliant.

Nevertheless, we are seeing more US managers look towards outsourcing. Part of this has to do with increased demands from LPs for greater transparency across a range of areas, with many pushing for firms to adopt the ILPA template.

In the US we are seeing a new generation of CFOs who as new incumbents are often prepared to rethink or redesign their firm’s existing operational model. Managers in the US are increasingly recognising the value that specialist third-parties can bring, and, as independent players have built up the services and expertise they can provide, GP expectations are changing. There is a clear shift away from services offered by the traditional banking providers.

Q One of the big concerns about outsourcing among GPs is retaining control over data. How can firms mitigate against this risk?
Yes, control over data is often the first question clients ask us when we meet them for the first time. To a certain extent, technological developments have already mitigated this as clients can now have more data accessible – there is not the same lag now in the way there used to be.

Yet it also comes down to the design of systems and processes. GPs sit down with us and define with them what their process is, what their internal staff do and how we can work with them. The outsourcer shouldn’t be a layer in between GPs and their data or, indeed, their LPs – there is no need for disruption to processes. GPs should also expect there to be dedicated team members at the third-party provider they can talk to. Our team is their team.

Q How do you think outsourcing will evolve in the future?
Technology and integration will continue to develop. However, if you look at what third parties do beyond regulatory compliance matters, we are already gathering, verifying and aggregating data on our clients’ behalf. Yet data is not the end objective – quality reporting and useful information is what third parties should be providing. Increasingly, we are able to help clients focus on their key investment decisions, ensuring they don’t have to spend time benchmarking and by providing them with more value-added reporting.

We can increasingly help alternative investment managers focus on their core business by giving them the relevant information that they need. We are continuously moving towards more value-added services.
The base erosion and profit shifting framework is about to spur a significant and material change in the way private equity funds are structured and staffed. And it’s a change that tax lawyers warn will not be cheap.

BEPS was initiated by the G20 in 2012 and taken up shortly afterwards by the OECD, with the goal of tackling ‘double non-taxation’. This clunky phrase refers to moving profits from a jurisdiction governed by one tax treaty, usually where the primary economic activity of an entity is taking place, to another, usually an offshore or low tax jurisdiction, to drastically lower or wipe out the entity’s income tax bill.

A rash of high-profile cases involving companies such as Apple and Alphabet, plus leaked documents that revealed lawyers were advising clients to use mismatched regimes, kicked politicians into action and the rules are now due to come into force in 2019.

But until recently, the private equity industry had little idea where it stood. In the first drafts of BEPS there was almost no mention of private funds – non-collective investment vehicles in the terminology – and it failed to address the treaty entitlement of non-CIVs. Could private funds continue to exercise treaty benefits (ie, domicile themselves in low-tax jurisdictions regardless of where other business activity is taking place), or were they going to be denied?

The private funds industry demanded answers, so the OECD devised three fund examples to demonstrate how the rules could apply. In the battle to interpret BEPS for private equity, one of these examples has been declared the winner: the regional investment platform.

“Our are seeing a real movement in the market here with fund managers looking to align their holding company structures in Luxembourg with the ‘regional investment platform’ example given by the OECD in the context of how the anti-treaty shopping provisions of BEPS might apply to ‘non-CIV’ funds,” says Laura Charkin, tax partner at law firm Goodwin.

“This means in practice a movement towards using master holding company structures and for those with sufficient scale, moving more business functions to be run from Luxembourg.”

For the funds, that means additional costs as they create a meaningful presence in certain countries. And for low-tax jurisdictions that means plenty of change.

“Funds are going to be moving out of locations where they had no ‘substance’ [as defined by BEPS rules] or moving people in to beef up those functions. For example, we are seeing funds hiring locals in jurisdictions such as Luxembourg to beef up their ability to monitor investments and evaluate potential investments [from there],” says Harold Adrion, partner at tax and consulting firm EisnerAmper.

STANDING ON PRINCIPLE

The issue of ‘substance’ or ‘principle purpose’ are the keys to understanding BEPS. Funds must be able to demonstrate that profits are being taxed where the economic activities generating the profits are being performed.

“I have a rule of thumb,” says Prabhu Narasimhan, a tax partner at law firm White & Case. “If it’s a warm, sunny island with a nice seashore, it’s hard to demonstrate substance. In contrast, onshore jurisdictions have a real depth in human, technical and economic resources to go with a varied economy, and are therefore more likely to be aligned to commercial reality.”

In Europe, “the relevant test in most EU treaties will be one of the ‘principle purpose’ of an entity and not of its substance per se. As such we expect to see more focus on adding additional functions to holding companies in the coming years”, Charkin says.

So key domiciles are likely to see additional staff brought on. And as Adrion says: “The costs of doing this are going to be substantial.”

But funds will bear these costs because they are more economical than the alternative – bringing the fund back to the manager’s home base. It looks as if Luxembourg will benefit. Ireland could too. Adrion says it “has been promoting itself recently” and he has seen “an uptick” in fund structuring activity.

And as for the losers: “Malta. Have you
**A MODEL STRUCTURE**

How the regional investment platform is likely to work for private funds

- Fund is an institutional investor, tax resident in State T.
- A holding company, Master HoldCo, is subject to tax and regulation in State R.
- Master HoldCo is a regional investment platform holding a diverse portfolio. It employs a local team of investment managers.
- State R is chosen due to the availability of knowledgeable directors, skilled workforce, membership of a regional group and use of a regional currency, and an extensive treaty network.
- In reviewing its investment, Master HoldCo considers the benefit under the State R/State S tax treaty (5 percent withholding in contrast to 10 percent withholding between State S and State T). OECD concludes that “this alone would not be sufficient to trigger the application of the principle purpose test”. Instead “it is necessary to consider the context in which the investment was made, including the reasons for establishing [MasterCo] in State R and the investment functions and other activities carried out in State R.”

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ever been there? There’s not a lot going on. It’s hard to get people there,” Adrion says.

**SERVING THE PURPOSE**

Depending on the size of the fund, Charkin says different approaches could be taken to address the issue of principle purpose. “Larger scale businesses may set up their own service company in Luxembourg to provide staff and premises to various entities within their structures.”

For smaller fund management groups with fewer resources, “it is still very common to use two externally sourced directors, with perhaps one ‘house’ director also on the board of Luxembourg holding entities. That house director is now much more likely to travel to attend quarterly board meetings in Luxembourg and avoid taking board-level decisions or signing resolutions outside Luxembourg than a few years ago”.

As well as additional spending on personnel and functions, the proposed BEPS rules are prompting investors to commission external reviews that test a fund’s substance. “We have had more than one situation where a large tax-exempt investor has demanded an annual external substance review should be carried out and any recommendations arising from that adopted,” according to Charkin.

The regional investment platform is the front-runner as the model for private equity funds, but Narasimhan says BEPS is still a work in progress with “much debate” regarding its precise application.

“The global inter-governmental desire to introduce restrictions on claiming tax treaty benefits in what are widely perceived to be ‘inappropriate circumstances’ is proving to be easier to conceptualise than conclusively implement and police,” Narasimhan says. “However, what is becoming increasingly clear is that, whatever the detail, commercial reality and substance needs to be strongly demonstrated to justify the use of particular corporate structures, jurisdictions and tax treaties.”
Held in trust

In an increasingly challenging investment environment, limited partners are focusing more on market risk profiles to drive improved investments, say Intertrust’s Paul Lawrence and James Ferguson

Private equity managers are under pressure. Globally, their share of the M&A market continues to shrink in the face of competition from corporates and they face increased competition from a record number of other general partners in a crowded market. At the end of 2017, dry powder stood at a towering $1.7 trillion across all private capital asset classes. And at an average of 11.2x, multiples are sky-high.

Paul Lawrence, global head of fund services at Intertrust Group, and James Ferguson, managing director Intertrust Americas, describe how GPs are seeking to mitigate risk and generate maximum returns in a challenging investment environment.

The investment environment is competitive and volatile. How are GPs seeking to generate returns?

James Ferguson: GPs are chasing the beta of new capital and balancing that against squeezing existing investments for returns. Private equity, hedge funds and mutual funds are all trying to find different avenues for yield. Asset classes and underlying instruments are diversifying. Asset managers are looking for the next big thing, be it oil and gas, insurance funding, cryptocurrency, blockchain, or fintech. These asset classes are different from traditional equity/fixed income and the underlying investor base is more agile and sophisticated. Those that are ready to accommodate and service new asset types will do well against the competition.

Brexit is a massive source of uncertainty in the UK. What does it mean for UK managers?

PL: UK-based managers are scenario planning around various impacts. Some of that depends on where they are investing today and where they plan to invest in the future; how they are fundraising; and where they are in that fund launch cycle. Those in the early stages of investing their funds have probably got a little more breathing space to see how the land lies.

There are a group of UK-based managers who won’t do anything. They are raising and investing in the UK or can row back to that situation. Others are already starting to look at what options they might need to explore within Europe. This is where we are engaging a lot more with our clients and managers around planning and support if they want to establish a greater presence for example in Dublin or in Luxembourg. A lot of managers might have exposure to one or both jurisdictions already. Expanding operations links into other regulatory and tax headwinds, like BEPS [base erosion and profit shifting]. We can provide direct support up to and including the point of being a third-party manager of their funds.

On the LP side, the industry has seen a trend to consolidate commitments. Why?

Paul Lawrence: Some LPs want to consolidate allocations to a smaller number of GPs to maintain greater control and improve oversight and governance. They don’t want to be swept along with all other LPs and be forced to accept what they are given.

Have President Trump’s tax changes had any impact on investing?

JF: The US market will see the beneficial impact of new tax rules in the next six to nine months as the fiscal year ends. This time next year there will likely be more investment activity because the liquidity pools and balance sheets will have increased. Offshore money should start to be repatriated by mid-tier companies where the tax breaks are largest with companies seeking new investment vehicles. Macro investment allocation should increase. There is definitely a hold mentality at the moment, as managers seek the longer term investment vehicles as the administration volatility stabilises.

And for US-based managers?

JF: Some of the more mature and global players are going into Europe quickly. Some of the bigger asset managers have or are setting up offices and registering with the Central Bank of Ireland, for example, and are hiring people and shifting their organisations. It might be easier to do that now in the noise rather than wait until Brexit is actually implemented. There are managers with current US administration, tax changes, and longer term expansion plans, who are cautious on what their growth strategy may be, so are waiting on an outcome.
Smaller GPs may not have the infrastructure in place to deliver the demanding reporting requirements of larger LPs and may struggle to compete with larger GPs on bigger deals.

However, if you are a smaller LP trying to write the cheques required to get access to some of the mega-funds, it might be a challenge to meet any minimum threshold. On the flip side, LPs want to be a meaningful investor to receive a degree of bespoke treatment, but don’t want the GPs to be overly reliant on them for the successful launch of the fund.

Another theme LPs are considering more and more is transparency.

What are they asking for?

PL: A lot of GPs would argue that they have always been transparent with investors when asked for information. But there is more demand now for upfront transparency, ie, regular reporting that delivers the level of detail that investors want without having to ask. There’s a drive toward more consistent reporting and report types across the different funds LPs invest in such as cost allocations and compliance costs. Investors are also starting to request reporting around ESG matters and more detail around portfolio companies.

JF: Investors are concerned with risk profile, how quickly managers are reacting to market and macro conditions, and the fee break-out. As asset types change or become illiquid or agile, the short to medium term gain is being challenged against the more stable longer-term strategies. At the same time regulatory compliance, increased knowledge and competition is driving transparency of reporting and objectiveness leading LPs to seek those GPs with more third-party oversight of functions like record keeping and reconciliation services.

The issue with private equity is there are many layers: the LP, the GP, the administrator involved and a depositary and an Intertrust partner on top of that. The underlying investor wants to know: is my money safe? Who is reporting and who holds the books and records? Is the structure so complex that I am losing sight of who has my money at any point in time? GPs that are more in tune with LPs, with better investment strategies and clearer transparency, are the guys that are gaining market share.

How is reporting evolving?

JF: All clients want timely, accurate and complete reporting. The underlying content nature of reporting isn’t changing or it may be more finessed; instead, the delivery technology mechanism is becoming more mobile and agile.

PL: It’s about automated processes, portals and the ability to access information and data 24/7, on the hoof, and manipulating the data to the output that you require. We’ve invested and continue to upgrade our technology. We’ve worked closely with our vendors to look at future software developments and prepare for those now.

Is technology driving outsourcing?

PL: Regulation, reporting and transparency demands are all pushing outsourcing. You need to invest in technology to meet these demands. But are you going to become a technology company or are you a fund manager? Our ability to cover everything the manager needs to do except the actual asset management is where we see the most interest in our services. We are assuming the burden of managing that technology platform, which managers don’t want to do.

JF: Clients seek modular [fund administration] “plug and play” services. They want to keep some functionality and processes and outsource resource intensive processes or functions. The challenge is that there are increasing vendors entering the fintech market with partial solutions. A challenge with fintech is that it doesn’t always offer global solutions for end-to-end processing. And there are market challenges in partnering with two or three vendors to get to one solution. Intertrust continues to become technology-savvy so that we can “plug and play” for our clients.
Bridging the digital divide

Whether it’s due diligence, data exchange or tax software, technology poses some of the biggest issues for a modern private equity firm. We asked leading tech experts to answer some of the most common conundrums.

By Graeme Kerr

**Tech Q&A**

**What’s the best way to optimise data exchanges between GPs, LPs and fund administrators?**

**Ludovic Legrand:** Traditionally this has been a significant challenge for the private equity industry, largely due to the lack of formalised market best practice to manage non-homogeneous data in a consistent manner. However, the private equity market has really evolved in recent years to meet investor expectations. One example is the increasing adoption of Institutional Limited Partners Association templates and guidelines, particularly on calls and distributions, capital account statements and fees. This helped push market best practices to a much higher level.

The most advanced fund administrators already offer a client portal such as eFront Investment Café to their clients. Populated by a rich data set, portals allow fund administrators and GPs to provide timely, quality data so that LPs can drill down into their portfolio. Via dashboards that have filtering functions to enable the export of custom data sets, portals provide an excellent way to optimise data exchanges and offer added-value solutions to all stakeholders.

**Fleur Hicks:** The rapid evolution of digital technology now allows us to scrape data in real time. AI provides machine learning that can help disseminate and filter vast volumes of information ever more accurately. An application programming interface (API) feed allows us to access all of this ready-filtered and categorised information immediately in formats that can be exported to reports at the touch of a button.

Technology can be brilliant. But it is not infallible. While it can make a consultant’s life a lot easier, and provide robust information, there can be no replacement for the contextualisation of data. Nor the translation of layered data sets into actionable insights.

There is nothing that can take away from expertise, real-life experience, education and knowledge. And data cannot make an informed investment decision with some gut instinct thrown in, no matter how complex the algorithm. So consultants can and will never be replaced, but technology should be embraced as it can make the process a lot easier and provides much more robust data.

**Can technology-driven data ever replace consultants in the diligence process?**

**MEET THE PANEL**

**Wayne Filin-Matthews**

Crosslake Technologies

Wayne Filin-Matthews is head of software strategy at Crosslake Technologies. He has over three decades experience in the IT industry and a proven track record in maturing architecture practices across the IT lifecycle.

**Fleur Hicks**

OneFourZero

Fleur Hicks is managing director with OneFourZero, a leading digital global diligence agency, and has spent more than 17 years working with private equity firms and blue-chip brands in the B2C and B2B sectors.

**Ludovic Legrand**

eFront

Ludovic Legrand is the head of the asset servicing market for the EMEA region at eFront, a leading software solutions provider for the alternative investment industry.
Wayne Filin-Matthews: It is critical to understand the capabilities of the architecture and whether it supports the business strategy and investment thesis. Shortcomings can take many years and millions of dollars to resolve, negatively impacting ROI. To reduce this risk the critical questions to ask during diligence are: Does the architecture scale up to support expected growth? Are there integration points (APIs) that allow for easy integration with future acquisitions and third-party products?

The level of customisation and effort to upgrade customers to newer versions is another crucial issue, as is the cost to maintain the product and whether you can effectively add new functionality; how up to date are the technologies used and how easy is the platform to replicate? You’ll also want to consider the risk of disruption from new technologies and business models and, of course, issues related to cybersecurity and data protection.

The ultimate issue is whether the business can grow effectively without significant infrastructure investments and how reliable the overall system is; how does it rate in terms of resilience, security, performance, capacity and scalability, and how is it monitored?

**ASK THE EXPERTS**

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**TAXING CONCERNS**

How does a GP decide if a new tax tool is worth the cost? Crowe Horwath’s Rebecca Jordan and Will Ault look at the possibilities

**Q.** Given the sheer wealth of technology dedicated to the tax process these days, what are some of the most promising tools out there?

**Will Ault:** For private equity firms, especially larger GPs required to report to multiple jurisdictions with a wide variety of investors, there’s a big opportunity with the tax compliance and filing packages, and most of these firms use some type of filing software.

But there are new areas where providers have made real advances. For one, they’ve become quite good at tracking the depreciation of assets, which is a thankless task that still needs to be done. Many software packages will have this option as part of their offering. Then there’s technology to track and identify R&D credits for those companies with research and development divisions which can yield substantial rewards.

We still find plenty of companies using Excel spreadsheets to calculate their quarterly tax provisions, when the reality is that the technology out there can make a real difference. And lastly, some of the biggest improvements have been in automating tax processes.

**Q.** Even if a GP is keen to employ some of these new tools, what are some common mis-steps they may make in implementing them?

**Rebecca Jordan:** In my experience, it’s easy to lose track of the pain point that prompted a client to invest in that technology in the first place. These are powerful systems that can do a lot of different things, but it’s key to remember the pain points this new system was meant to address, and see if that new offering has improved them.

**WA:** Too many GPs are willing to let vendors off the hook when it comes to post-implementation testing of these new offerings. There should be tests by experts after the implementation to ensure that the system delivers on its promise before they agree to that three-year licence.

**Q.** What are the tax issues that technology still can’t address?

**RJ:** By its nature, tax compliance can involve a lot of repetitive work and automation can do a lot to relieve that burden. But when there’s a need to interpret data, for instance analysing the terms of a partnership agreement, it’s time for an actual expert to step in and make that judgment call.

**WA:** GPs should not expect the technology to replace human review of new transactions and new situations that the technology can help identify. In an ideal world, that new technology is set up with expert tax counsel, so that the tool reflects the unique priorities and preferences of that firm. These are sophisticated tools, but they also need to be tailored to a firm’s given situation. No matter how automated a process gets, there will still be anomalies and those are when that expert steps in and counsels on how best to handle it.
ASK THE EXPERTS

**Ludovic Legrand:** We find many LPs want to conduct proper risk and performance analysis, but this usually remains wishful thinking. In their defence, historically, a number of elements prevented LPs from conducting in-depth analysis that really added value. The accessibility to quality raw data was one of them.

In fact many GPs continue to periodically send their investor reporting in PDF format, thereby still making it difficult and labour intensive to access the raw data. The granularity and consistency of data that LPs can get varies significantly from one GP to another.

In response, GPs have considerably increased their investment in technology in recent years. To today, the vast majority of GPs offer access to their PDF reporting through an investor portal, and the most advanced GPs understand that LPs are also expecting to interrogate this reporting dynamically by allowing LPs to drill down into their portfolio data through dashboarding and custom reporting functionalities. Furthermore, LPs are also looking to export this data to feed their own centralised reporting systems, to conduct in-depth analysis such as cashflow forecasting, performance contribution and Value at Risk.

**Fleur Hicks:** Yes, absolutely. Not only are our clients using technology-driven data for diligence and strategy, but the digitisation of business is being discussed company-wide. Whether it is related to operational efficiencies or e-commerce, or for acquisition processes or to improve management processes, technology consultants are being employed to tackle a vast array of issues.

Take the example of retail operations. This has implications on a portfolio company level when a network of stores integrates its in-store shopping experiences with app-based shopping, which requires a robust digital technology solution to manage stock, tills, fulfilment and live marketing.

But it also starts to impact at a fund level as the systems are integrated with finance and commercial management. Technology can add to efficiencies and improve the customer experience, and thus must form a key consideration in all the diligence processes as a growth opportunity.

**Wayne Filin-Matthews:** There really is no ‘silver bullet’ here. Technology leaders involved in modernising technologies and applications need first to evaluate legacy systems, looking at both the business and IT drivers behind the upgrade. Choose an approach with the highest effect and value while also considering the cost and risk.

On the demand side, the main drivers are business fit, where new requirements cannot be met by the current application, and business value, where the current system lags in terms of data and the support it offers. There is also the question of agility, where the system is unable to keep up with the pace of external changes and therefore has both costs and associated risks.

Supply side drivers include cost and complexity. Is the cost of operating and changing the current application simply too high in relation to its value? Is the sheer complexity an issue for users? Risk is also a key consideration and can be a compelling reason for upgrading the architecture.
As LPs continue to diversify their alternative portfolios and fund structures flourish and transform, what are investors looking for in their GPs? Investment expertise and all of its components are, of course, critical and core to a manager’s competitiveness. But a survey of alternatives investors by SEI suggests that operational expertise is not only needed to deliver investment results but also to deliver an improved and personalised client experience, which is of vital importance and adds to a GP’s competitive advantage.

Transparency, for example, continues to be a critically important consideration when investors evaluate funds and managers. More than half of all investors in the survey say it’s an extremely important factor, with the remaining 46 percent agreeing that it’s important (figure 1). The trend towards greater transparency is well established, but expectations continue to outpace reality. Only 19 percent of investors have seen significant changes to transparency over the preceding three years (figure 2). And while portfolio manager access is viewed by virtually all investors as an important aspect of transparency, there were very few who say they have seen significant changes in their level of access.

The truth is that many investors remain dissatisfied with the level of transparency available to them. Their frustration extends across a number of areas, but is particularly acute when it comes to operating expenses, which three out of four investors say are not transparent enough. Only 25 percent of investors are pleased with existing levels of transparency surrounding operating expenses, compared to 67 percent of GPs (85 percent and 76 percent respectively) compared to Asian investors who are relatively optimistic, with a relatively low rate of dissatisfaction (29 percent).

Ultimately, GPs thought that transparency was sufficient to a degree greater than LPs did in every category covered by our surveys, revealing a gap could be at least partially bridgeable by the provision of more standardised, comparable reporting. While this survey did not address potential ways to resolve this disparity, it’s reasonable to think that LPs who receive clear and comparable reports from their managers are more likely to trust their managers and feel that nothing is being concealed.

REPORTING FREQUENCY IS KEY

Transparency is closely linked to reporting, so we asked LPs about the frequency and types of reports available. At this juncture, quarterly reporting remains the standard for private equity and most other types of alternative investments. Hedge funds comprise the main exception and generally report on a monthly basis. It should be noted that hedge funds have the widest variety of reporting periods, ranging from a few that report on an annual basis to a sizeable minority that generate weekly reports. While not common, customised reporting is most likely to be found for infrastructure funds. Customised reports are more often provided to large investors, although it’s not clear whether this is because of the size of their investments or they are simply more demanding. Our GP survey revealed that 65 percent of managers already offer customisation. Large diversified managers with multiple asset classes were more likely to offer clear and comparable reports from their managers are more likely to trust their managers and feel that nothing is being concealed.
to offer customised reports, but even 52 percent of the smallest GPs surveyed said they made customised reports available to at least some of their investors.

Four out of five LPs have online access to their accounts, but it does not always extend to all of their investments. Large North American institutions are the most likely to currently enjoy online access for all of their alternative investments. Of those who don’t currently have online access, most express a desire for it.

**EXPECT MORE FEE NEGOTIATIONS**

Almost nine out of 10 investors say it’s important (or extremely important) that they are given the opportunity to negotiate fees. The expectation of fee negotiability rises in tandem with investor size, and not surprisingly, larger LPs have proven to be more successful in negotiating better terms for themselves. More than half of all LPs report at least some changes, but this varies from 73 percent of LPs with more than $25 billion of assets to only 29 percent of investors with less than $1 billion of assets.

Fee negotiations come in many flavours, and one survey participant pointed out the current strong fundraising climate meant many managers are not prepared to negotiate major items like management fees and carry, which remain close to 2 percent and 20 percent. They may, however, be willing to modify peripheral items. The investor went on to say that “managers have to some extent given in to pressure on fees, and market standards have moved slightly in favour of LPs. For instance, GPs are now generally offsetting 100 percent of transaction fees against management fees.”

Another investor concurred and indicated that fee negotiations are more tactical than widespread, saying that “fees have varied from none at all to drastically modified. Some managers will get very creative in order to receive our first investment. We have seen differed transaction fees, and discounts on the promote, but the asset management fee seems to be non-negotiable and it helps to keep the lights on.”

Not all LPs have the same experience, however, with a European investor saying he thought managers were “more willing to shave off management fees than carry. You can get a management fee break if you’re in the first close or if it’s a GP’s first fund, often for a year or until the final close. LPs that can make a $50 million plus commitment are in a better bargaining position.”

Smaller investors validate that sentiment, but they may have less leverage. One survey participant noted that “We’re not writing big enough cheques to negotiate, so the only things I’ve observed is that fees are maybe 25 basis points less than they were a few years ago. The promotes are the part that hasn’t gone down. We work with consultants, and a number of the managers will allow the aggregation of a consultant’s clients for a fee break. We allocate $35m–$50m per fund. $100m-plus is where things begin to get negotiable.”

**OUTSOURCING PREFERENCES**

As expectations shift, standards rise. Manager evaluation still focuses on the investment team and its process, but operational
considerations are becoming more prominent. One survey participant noted that their due diligence procedures “…covered elements of operational due diligence, such as workload, viability of the management company, disaster recovery, business continuity, decision-making, etc. Operational due diligence will become an area of increasing focus going forward.”

Another investor described a division of labour where their organisation devoted their time to performance attribution while their consultants spent more time analysing operational infrastructure. He goes on to point out that they have, in fact, declined to invest in managers “…without real controls and compliance since they seemed to lack institutional quality.”

How operational standards are ultimately met is often left up to the managers. As one LP said when interviewed on the topic, “I assume they can take care of the technical back office or hire it out at their expense.”

This should not be taken to mean that investors are not partial to certain approaches. Any given LP is likely to prefer certain functions be outsourced by their GPs, while preferring that others are done in-house.

Almost half of all investors, for example, prefer that pricing and valuation work be done by an external provider. This rises to 69 percent if those without any particular preference are excluded. As a group, LPs generally express a preference for outsourcing fund administration and accounting functions as well.

There are some interesting discrepancies between investor preferences and GP practices when it comes to outsourcing. Our previous survey of GPs found that 68 percent of them outsourced cybersecurity, for example, but LPs say they prefer that it be handled in-house. Regulatory and compliance functions fit a similar pattern.

Portfolio management is predictably the function that investors would almost universally prefer to see done in-house, but there is little consensus when it comes to most other functions. In general, European LPs are the keenest advocates for outsourcing, while Asian investors are the most likely to prefer in-house solutions. Investment companies and family offices are more likely to prefer outsourcing than other types of investors. Pension plans are more likely to advocate for doing more things in house.

Many investors pointed out that outsourcing decisions are best made on a case-by-case basis, depending on the resources available. Smaller managers may not be equipped to handle legal and compliance issues as well as a larger firm, making it more sensible for them to enlist the services of an external partner. Others may struggle as “the PE industry focuses increasingly on ESG matters, [making this] an area which may also benefit from the use of outside consultants where teams are too small to build their own expertise.”

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Snaring a CFO

With vacancies for finance chiefs at a decade-long high, a seat at the table is increasingly important to back-office job-seekers. By Claire Wilson

When discussions turn to the back office, the need to recruit those with skills beyond number-crunching has become a hot topic. Vacancies for private fund chief financial officers and chief operating officers in 2017 were at their highest level since 2007, according to executive search firm Heidrick & Struggles, while UK-based Private Equity Recruitment placed 14 CFOs or chief financial directors at London-based firms that year.

This demand is expected to be sustained over the next year. More than one-third of respondents to the 2017 pfm and EisnerAmper CFO survey said they plan to further boost their back-office headcount over the coming year.

With back-office staff on the wish-list of so many private fund firms, how can a business differentiate itself from the competition and attract the right candidate for the position? Salary is of course a crucial factor. There are three components to compensation: base salary, bonus and carry. The first two are very much dependent on a firm’s size and its assets under management, says Stuart Patterson, head of finance at Private Equity Recruitment.

“If we combine the two figures, the CFOs in the larger funds may well receive more than twice as much in total annual cash than those in smaller funds. Fund size is the biggest single factor affecting compensation,” Patterson says.

Time in the role also plays into an employee’s salary, and as CFOs tend to stay for many years, there is real opportunity to develop their career and their compensation, he adds.

Carry is becoming ever more important. Back-office staff know they are taking home less than their investment team peers, but there is a degree of competition among firms to offer the best package to new staff. This is increasingly including a bigger share in investment profit, Patterson says.

“Carry is an indicator on how they are viewed, as an employee or an integral member of the team that will benefit from the long-term success of the business. For a high-performing fund this could be millions,” he says.

While compensation remains a leading factor in a candidate’s decision to accept a job, a minority are willing to move to one that pays the same as their current role if the new employer offers the opportunity to move up the organisation’s ladder, says Heidrick & Struggles’s Todd Monti.

Increasingly, back-office staff are looking for a seat at the table, and if they’re not recruited as a partner, they want to know there is the chance they can become one further down the line.

“CFOs and COOs want a voice; they want to have a voice regarding a firm’s strategy and growth, and when joining a firm with a track record, that they can bring best practices to the role,” he says.

This was echoed by Patterson, who adds: “They want to know whether they are a head of back office or a board member/partner in the fund. The latter will attract the best talent.”
CFOs and COOs want a voice; they want to have a voice regarding a firm’s strategy and growth, and when joining a firm with a track record, that they can bring best practices to the role.

It’s no surprise that on the hiring side, candidate criteria have evolved over the past few years as the nature of private fund management has changed. Even in the areas that may have traditionally fallen into a finance professional’s remit, there has been a notable increase in demand for staff with specific experience, such as tax structuring. Around 15 percent of respondents to the pfM/EisnerAmper survey said they expect to boost their in-house tax expertise over the coming 12 months. But beyond that, firms are looking for staff with other skills.

“Some [firms] put the emphasis on the individual having a strong accounting background, while others are looking for people that have the capacity to take on a broader COO/CFO hybrid role,” Monti says.

Building on this point, Patterson says a CFO is now the CFO, COO, CCO and in some cases the head of IT and human resources.

“It is no longer enough just to be able to crunch the numbers. Process and system automation is becoming more and more important, they also need to learn the legal, compliance, deal/fund/tax structuring etc. The breadth and demands of the role naturally dictate the hiring needs.”

CFOs of small funds, under £1 billion ($1.37 billion; €1.13 billion) in AUM, will do everything that isn’t investment. The CFO of a £10 billion-plus fund will likely have a reasonable-sized team below them, but will still have oversight of these functions, Patterson adds.

“In a recent meeting with a CFO of one of the larger funds, she explained to me that she had just completed a large office move that took over two years to complete. This involved everything from identifying a suitable office space to ordering the stationery.”

On that particular day, she had ordered pens, reviewed tax structures in multiple geographies, assisted with the setup of an overseas office, looked over Alternative Investment Fund Managers Directive documentation and performed carry waterfall calculations for a new fund, and of course, met me, he adds.

“This is a very typical day for a CFO; they literally have to be a Jack (or Jill) of all trades,” Patterson says.

TALENT POOL

The requirement for different skillsets has had a ripple effect on the hiring pool. Traditionally, a private fund CFO may have been plucked from an accountancy firm, but a CFO hired recently may be found elsewhere.

“The requirements [of a firm] and resources from which they will draw are very tailored. A large fund, for example, may have a number two who is ready to take the next step and act as a standalone,” Monti says. “Others are looking for people with a specific skillset, which opens up the pool away from public accounting.”

Patterson said those working at an accountancy firm that have been exposed to other areas of the business put themselves in a strong position. While they may have been in a fund accounting role, for example, they may have also been involved in the corporate and management accounting side.

From these positions they can help with tasks such as transaction due diligence, investor relations reports, software implementation and keeping up to date with regulatory aspects. These kind of people will be of increasing value to a fund that needs a CFO to do all non-investment tasks – and despite their job title, are worth considering.
In the midst of a sea change

Today’s fund administrators are a far cry from yesterday’s accounting firm spin-offs, offering services from back office outsourcing through to risk management and performance attribution, says Steven Millner of Gen II Fund Services.

There is a clear trend for private equity firms to outsource their fund administration services as they discover that spreadsheets can’t provide enough detailed regulatory information or meet the data requests of limited partners. Despite this, many firms remain reticent about outsourcing, according to Gen II Fund Services Managing Principal Steven Millner. We spoke to him about the reasons for this and how fund administrators have transformed beyond recognition over the last few years.

Q: You’ve been in fund administration since the early days. What was it like then? The industry started off in the early 1990s and was very different then. At that time, most fund administrators were either boutique firms spawned from accounting firms or part of the large custodial banks. As part of an emerging industry, I spent a lot of my time educating private equity sponsors about the benefits of fund administration – there were very few funds that outsourced. Fund administrators performed the more mundane accounting work and the technology was not very sophisticated.

Q: How would you characterise today’s landscape? It’s much more institutional. The big players, on one side, are still the global custodial banks, but you also have large, publicly-traded companies and firms that perform other services in addition to fund administration. Gen II is a big player with over $180 billion of Assets Under Administration, but we are unique in that we are a large, independent, owner operated player, with a sole focus on private equity fund administration.

The industry is also set for rapid growth over the next five years. This follows a pattern we’re already seeing. Today, about 40 percent of funds use a fund administrator, up from 30 percent a few years ago. Yet when we analysed the ADV forms filed with the SEC over the past year, the capital attributed to in-house administration remained stable between December 2016 and December 2017. That’s despite a significant rise in the amount of capital raised by private equity funds. This implies that the majority of new capital is administered by third parties. Outsourcing is clearly taking hold, with the emerging managers and new funds from established managers out in front.

Q: In what respects are emerging managers leading the way? There is a bifurcation in the market. You have the emerging managers and the legacy managers. The emerging managers, which have raised significant amounts of capital recently, have largely opted to outsource from the start, avoiding large capital expenditures on people and expensive technology. This provides their investors with institutional credibility and enables them to focus on the bigger picture of fundraising and investing their committed capital.

LPs are also increasingly comfortable with the control environment and objectivity that a third party can bring. The services provided by top-tier fund administrators tick all the boxes on LPs’ operational due diligence lists – an area in which we frequently engage with LPs.

Q: So what’s happening with the legacy managers? Many of the legacy managers are overwhelmed by the amount and complexity of information required by increasingly sophisticated LPs, who are themselves armed with the latest technology. LPs now want not just fund-level information, but also portfolio company data. At the same time, the tide of regulation that the private
equity industry faces means that additional reporting is required.

So, while internal teams used to focus on providing information in a set format to LPs, they are now required to provide information in a variety of formats, not just to investors but also to internal compliance and risk management teams. In addition, ILPA’s fee template has increased transparency tremendously, but it is straining internal teams.

What are the key trends in fund administration?

Outsourcing is being embraced by more private equity fund managers and I think we’re at the start of a significant uptrend in third party administration. To stay ahead, fund administrators need to invest in their people, process and technology and they can only do this if they have the benefit of scale. The amount of capital needed to run a fund administration business effectively has doubled over the last five years and that creates barriers to entry. As a result, there will be further consolidation and a big gap is emerging between the large players, who can service the needs of large and mid-sized private equity firms, and the smaller administrators, who will mainly work with small funds.

How can fund administrators manage the greater data protection and cyber-risk?

All top-tier fund administrators are investing heavily in this area. It’s a hot topic, especially as LPs are inquiring about controls over personal data as the new GDPR regulations come into force in the EU. Large fund administrators, because of our scale and focus, have dedicated resources, including experts who can identify and implement best practices – that’s very expensive for a fund manager or a smaller fund administrator to do.

Why has that offering broadened?

It’s largely because new technology tools enable us to do more for our clients. The market-leading administrators are facing the digital divide head-on. By investing in the latest big data and analytics technology, we can now offer much more than capital call processing and accounting services to enable our clients to dig deeper. Fund administration services now reach into many different areas of a private equity firm. We can now look at performance across different metrics determined by the client, for example, to help them see the source of returns. Our relationship used to be with the CFOs, but now we interact with IR and compliance teams as well as other parts of the firm. Having the right people enables us to manage these relationships, and our technology helps to strengthen them.

How has the skillset changed within fund administrators?

Years ago, being a good accountant was the only pre-requisite. We still employ accountants, but we also place emphasis on quantitative and risk management skills, including people who can analyse performance. We have much wider servicing capabilities now in addition to accounting skill.

High staff turnover has also deterred firms from outsourcing in the past, hasn’t it?

Yes, but it’s vastly different today. Staff turnover is the Achilles heel of all service providers and it’s fair to say that fund administrators used to have higher turnover than many of us would have liked. But now there is a real focus on attracting and retaining top talent – a recognition that human capital is vital to the success of fund administration. That’s why we have set up the Gen II Academy, which provides a formal training program that enhances our on-the-job learning. There is also a much clearer career path in fund administration now – the best people don’t have to leave; they can enjoy a meaningful career.

Are you seeing legacy managers move to outsourcing to keep up with these demands?

We talk to legacy firms and they are interested in outsourcing, but it’s not an easy decision. They have outdated systems with high embedded costs. Many still use spreadsheets which do not provide the level of transparency required.

There is a fear of change in certain firms, based, in some respects, on how fund administration used to work. Many GPs are concerned that they won’t have immediate access to the information they need – they fear they will lose control and access to their data. That would have been the case a few years ago, but today fund administrators can provide clients with real-time access to data in a fully transparent format.

How is increased regulation in the US and Europe affecting your clients?

Our clients tend to be located in the US, but private equity is a global business, so what happens around the world has an effect here. AIFMD and GDPR requirements are highly relevant to our clients. Their capital comes from global sources, they make investments globally and so firms need an administrator with the capacity to service their funds on a global basis – this will continue to be a significant trend.

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The six steps for managing cyber-risks

The challenge for many GPs is knowing where to begin the process of identifying points of exposure, says Eric Feldman, chief information officer of The Riverside Company.

Any discussion on cybersecurity should focus on risk tolerance and management. It should not be seen as a purely technical conversation to be led by the IT function within the organisation, but instead be bolted onto the organisation’s existing and approved company-wide risk levels.

The challenge is knowing where to begin. The six cost-effective steps detailed here can mostly be taken by internal staff without third-party assistance. They build on the foundational risk assessment work, security training and awareness programmes, and the current state assessment conducted by a trusted third party.

1. **IDENTIFY YOUR DATA AND KNOW WHERE IT RESIDES**

Few companies have a well-defined map clearly detailing where all the company data resides. Usually there is considerable institutional knowledge of systems inventory across different areas of the firm, but it is often not documented. CRM, HR management systems, fund accounting, file storage and a slew of other systems probably constitute the core of most platforms used in private equity firms, but what about your third-party fund administrator, payroll provider or outside counsel? Are they using systems that store sensitive employee or investor data?

Once this is considered, a firm quickly realises that sensitive data are stored across dozens of different systems, some managed by the firm itself, some in the cloud and some with third parties such as attorneys and tax consultants. A private equity firm must therefore map out exactly where its data sits.

This map can be created using a simple Excel spreadsheet, which will help develop a process to protect this data. Within the spreadsheet, list the name of the system or the application, followed by a brief description of what it does for your business. From there, add a column that defines who the business owner of the application is and what type of data it contains (more on this shortly). Other data points to consider include whether the application is on premise or not, vendor contact information and whether there is a secondary business owner.

2. **ESTABLISH A DATA CLASSIFICATION SYSTEM**

The classification of data is a critical step in the systems inventory process and it should be a separate column in the spreadsheet. An example could be public data vs confidential data vs highly confidential data. Classification can be time-consuming and should identify the business lines that own the information.

The classification system also needs to have controls in place to ensure data confidentiality, integrity and availability are secure and understood by all employees. LPs want to know the private equity firm, as the data steward, is safeguarding their sensitive data. This systems inventory highlights which systems require attention and who, internally, should have access to them.

3. **KNOW WHO IN YOUR ORGANISATION HAS ACCESS RIGHTS TO DATA, AND REVIEW THIS REGULARLY**

Develop a quarterly or biannual entitlement review process of the systems that contain confidential or highly confidential data. An entitlement process requires the business owners of each system or file share that is storing sensitive data to confirm the correct individuals in the organisation have the appropriate access. People change departments and leave the organisation, so this ensures movements within the firm are accurately reflected within the permissions.
of various systems. If a member of the investor relations team, for example, moves to a different department, they may no longer need access to highly sensitive investor subscription documents, and should have their permissions removed.

DEVELOP A PASSWORD MANAGEMENT STRATEGY

Passwords are an important first step in managing access to systems containing sensitive data. Much has been written about the reliability of passwords to protect critical systems and about a future without them. However, we remain dependent on them. Of course, nothing is foolproof and passwords are an elusive means to truly protecting what is important to us all.

Require employees to change their passwords frequently, every 90 days, for example. The important thing is to choose one and make it enforceable with no exceptions. This will not prevent a cyber incident, but it will help catch accounts that slip through the cracks, like interns and temporary employees who have left the firm. Their accounts would automatically terminate after their passwords expire.

INTRODUCE MULTI-FACTOR AUTHENTICATION AND INVEST IN A SINGLE SIGN-ON SOLUTION

Many are familiar with RSA tokens issued by banks over the last decade. This technology has become more ubiquitous and less complicated in the last few years and can help mitigate risks associated with access to key systems. Think of multi-factor authentication, or MFA for short, as using two bits of information you have access to in order to gain access to your sensitive data.

The first is something you know – your password. The second, the MFA piece, is something you have – a token. The two together offer a high degree of protection as you cannot access key corporate systems without both of them. Protecting platforms such as Microsoft Office 365, the corporate VPN and CRM with multi-factor authentication ensures only employees with access to the issued token can gain access to important platforms.

The technical aspects of SSO are beyond the scope of this article, but think of it as an extension of the firm’s identity management system. Many private equity firms today leverage systems in the cloud, which requires separate user names and passwords. With an SSO platform, company-based username and passwords can be extended to these cloud-based platforms. Having one user name and one password greatly simplifies how employees can securely access an expanding world of applications.

PREPARE AN INCIDENT RESPONSE PLAN

Imagine a member of the investor relations team informs you they have accidentally shared all investor subscription documents with someone outside the firm.

Without an incident response plan already designed and tested, the firm is facing a very grim 24 hours. Securing the guidance and support of a cybersecurity third-party consultant to help develop an incident response plan will be of tremendous value.

Consider significant variables, define roles and responsibilities and properly manage communication in the event of a breach. Additionally, there are breach notification laws that differ from state to state and country to country, which are difficult to track and in some cases understand. The bottom line is that when – not if – your private equity firm suffers a data incident or a loss of data, you may have a legal obligation to report it and you certainly have a fiduciary responsibility to manage it. Having a clearly defined plan on who should be involved internally and which external resources to contact makes resolving an uncomfortable and stressful situation easier.

Do not wait to develop a response plan until you are in the middle of an actual cyber incident. Make it a priority to meet with your cybersecurity steering committee and the firm’s management team to build out an incident response plan.

*This is an extract from PEI’s Inside the Fund Management Firm, which is available at www.privateequityinternational.com/bookstore
STATE OF THE MARKET

Consolidating growth

M&A activity remains robust among fund administrators, writes Dominic Diongson

Private equity and debt are expected to be the big drivers of business growth for fund administrators this year, beating out hedge funds, real assets, funds of hedge funds and liquid alternatives, according to the latest report by eVestment.

Institutional investors have been turning to alternatives as a way to improve performance and diversify their portfolios, according to the eVestment Alternative Fund Administration 2018 Survey. Assets in private equity, real estate, hedge funds, funds of funds and liquid alternatives totalled $8.42 trillion at the end of 2017, up 10 percent from the year before.

Private equity assets under administration — a category that was broadened to include private debt — jumped 18 percent to $2.29 trillion in 2017.

The administrator with the most private equity AUA was SS&C GlobeOp, with $574 billion, followed by State Street ($350 billion) and SEI ($270 billion).

Still, there could be more room for growth. Data from eVestment’s Public Plan IQ database showed that US pensions were below their suggested allocations in alternatives, particularly in private equity and real estate funds. It estimated future net inflows of $13.96 billion for private equity and $22.58 billion for real estate.

North America had the most AUA reported by region, at $2.25 trillion, and is seen as the top growth area for fund administration firms; Europe ($1.29 trillion in AUA) and Asia-Pacific ($197 billion) were next in line.

The 2018 survey also showed that 74 percent of alternative fund administration firms expected industry consolidation, up from 47 percent the year before, following robust M&A activity in 2017.
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