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Is your prime broker or administrator the biggest threat to the success of your business?

Managers have become so wearily familiar with completing and issuing due diligence questionnaires that there is talk of a box-ticking culture taking hold of the hedge fund industry. Investors, conscious of the perils of form over substance, are now probing beyond the management company itself to encompass its service providers, of which the most important are prime brokers and administrators. Investors are also pressing managers to assess and mitigate service provider risks other than the obvious.

The due diligence questionnaire has become a standard feature of the investment process for hedge fund managers. Yet managers have, until recently, paid less attention to one key issue than their investors: the risks posed by their service providers. These include auditors, law firms, technology suppliers, back and middle office service agents, compliance consultants, payroll providers, insurers, real estate agents and – especially in Europe – the depositary bank. Investors assess all of these, but they focus their attention on what are easily the most important service providers of any: the prime brokers and the fund administrators.

Clearly, assessing prime brokers and administrators is secondary to understanding the investment strategy that is being pursued by a manager. But satisfying themselves that the firm is operationally robust, and manages its business risks effectively, is the next most important task. Within those twin areas, the choice of service providers is the most important consideration. Investors are no longer impressed by household names. They look always for managers to choose service providers that can underpin the investment strategy by providing the services a fund of that specific type actually needs, to the highest ongoing standard, and which can adapt those services successfully as the fund grows.

In fact, it is not hyperbolic to say that in some cases the investors are effectively selecting prime brokers and administrators on behalf of managers. In Europe at least, that effect is amplified by the need for fund managers to appoint depositary banks under the Alternative Investment Fund Managers Directive (AIFMD) and, from 2016, the fifth iteration of the Undertakings for Collective Investment in Transferable Securities Directive (UCITS V). The depositary is charged with ensuring the assets of investors are kept safely, through ongoing cash monitoring, safekeeping and oversight, including when held by prime brokers and their local market agents.

This puts the depositary bank in a uniquely powerful position. Fulfilling its duty of asset protection could in theory see a depositary bank inviting a manager to change its prime broker, or insist assets are moved from an agent favoured by its prime broker, or limit country exposure. Managers now need to choose prime brokers with that potential risk in mind because from 2018, when the current private placement and “depositary lite” exemptions under AIFMD come to an end, every manager with European investors will be forced to comply with the full depositary regime.

In the same way, investors increasingly look beyond the mere operational capabilities of prime brokers and administrators. They expect managers to understand and mitigate the counterparty credit and financing risks posed by their prime brokers, and to appoint administrators that can implement the valuation policy of the fund. This is why investors favour multiple prime brokers, segregated accounts, and the placement of unencumbered securities, cash and even margin posted to central counterparty clearing houses (CCPs) with third party banks. Investors now expect managers to treat cash as an entirely separate risk from securities, and to have a fully developed strategy to protect it.

It is not easy to devise one in a market where no bank is hungry for cash, thanks to shrunken net interest margin and the increased capital cost of holding it, and even securities are increasingly difficult to re-use. Yet the ability to demonstrate - and document – these forms of risk mitigation is the most important responsibility of the COO. Any COO that cannot explain how the firm will deal with the retrenchment or failure of a prime broker, or how it manages the valuation process with its administrator, relationship with the depositary, or how these providers will adapt to the expansion of the firm into new markets, asset classes and fund vehicles, will likely do enough damage to cost a fund both additional investment and potentially existing assets.

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It follows that neither brand nor price are sound criteria by which to choose a service provider. The more important tests are the knowledge and experience of the individuals working on the fund; the quality of the technology; the volume of human and technological resources that will be devoted to the fund; the willingness of the service provider to account for its performance on a regular basis; and the rapidity with which issues can be resolved or escalated.

Investors will always be impressed by a manager which conducts thorough due diligence prior to the appointment of a service provider, negotiates and understands the detail of the contracts it signs rather than relying on legal counsel alone, and not only reviews the relationship regularly but documents its evolution. In fact, one clear signal to an investor not to make an investment is a manager who is unwilling to share documents as crucial as prime brokerage agreements and International Swaps and Derivatives Association agreements (ISDAs).

This open as well as regular and detailed engagement with service providers was never more important than it is today when regulation is causing banks to sell or withdraw from businesses or restrict services – and it is no longer quick or easy to appoint an alternative. This is an especially problematic risk for investment strategies which are illiquid, or less profitable, or which entail the purchase of assets which are hard-to-value or finance. Managers need to keep up-to-date on how their service providers are evaluating their business, probe how the business strategies and policies of their providers are changing, and understand the risks and trigger points in their contractual arrangements with service providers, or they could fall victim to an unpleasant surprise.

In fact, in managing their relationships with their prime brokers and administrators, the biggest danger for managers is complacency. It is easy to get overly comfortable with a longstanding relationship. Which is why investors value managers that document their relationships, manage counterparty risks actively, assess the value providers add regularly, and which are willing to rotate prime brokers and administrators in much the same way that companies alternate their auditors.

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Investors appreciate managers that not only understand the internal dynamics of their service providers, but scour the market constantly for more suitable or sustainable alternatives. After all, investors themselves are checking existing and alternative providers constantly, as part of their due diligence on fund managers. This continuous exposure to the marketplace means they can lose confidence in a particular provider long before a manager does.

It follows that an annual review of relationships, which assesses the financing, liquidity, asset safety, technology and even staffing risks posed by a provider, is now essential to retain the confidence of investors. At the very least, an annual review verifies that nothing material has changed, while at its best a review will provide early warning of under-investment or strategic changes that might have an adverse effect on a manager. Signs that a prime broker is looking, for example, to focus on equity long/short funds is a clear warning to illiquid strategies to look for a new provider.

Yet the annual review of service providers is still the exception rather than the rule among managers. This is partly because managers lack the resources to conduct annual reviews. But it also reflects the fact that most managers have retained a one-dimensional view of prime broker risk: namely, the threat of insolvency. This is unsurprising, given the impact on the industry of the collapse of Lehman Brothers and the near-collapse of Bear Stearns. But it ignores the continuum of other risks which prime brokers represent. These include the inability of the prime broker to fund itself even in normal market conditions, and its ability to avoid operational errors.

In addition to these are a series of risks that are specific to the bi- lateral relationship between a manager and a prime broker. Chief among them is the profitability threshold set by the prime broker. For prime brokers, regulatory pressure to raise capital and liquidity ratios has reduced the importance of revenue and increased the importance of return on assets. Other prime broker-specific risks include the contractual elements in prime brokerage and ISDA agreements that govern the services delivered by the prime broker. The reliability of its cyber-security is another issue.

Fund administrators represent similar risks to prime brokers. Although they are less susceptible to outright financial failure, disruptive changes of ownership are commonplace. In much the same way that prime brokers are concentrating on their larger and more profitable clients, administrators are also shedding their smaller or limited revenue fund managers.

Valuation - the core responsibility of the administrator - is a substantial risk, because some assets are intrinsically difficult to price. Errors are not only expensive to correct but can prompt investors to withdraw their investment. Nor are all administrators created equal. Each manager needs to find an administrator that is properly equipped to value the assets, and provide timely and accurate support of the activity levels of their chosen investment strategy. A better match of needs and service capabilities of this kind is more likely to translate into a productive partnership that helps a fund to grow, and which permits both more demanding service level agreements and preferential fee structures.

At present, however, the average administrator is so focused on the standardisation and automation of its own processes that it lacks the flexibility to build genuine partnerships with fund managers based on tailoring services to the needs of the manager. This is unacceptable when modern technology platforms – such as the industry standard, Advent Geneva – can support a wide variety of accounting, valuation and reporting methods and data storage and presentation techniques.

It is easy to underestimate the importance of data. Administrators are, at bottom, custodians of data on behalf of fund managers. So are prime brokers, and indeed other service providers, such as auditors, technology providers and even legal counsel. Investors were made aware of the risks this represents by the notorious hacking of credit card data held by Target, the US retailer, through a service provider.

This is why investors are now taking an interest in data security as well as asset safety at service providers. Naturally, it is hard for managers to exert leverage over the cyber-security inadequacies of their service providers, but investors are increasingly exercised about this threat. They are sensitive not only to the potential for loss, but to the risk that their own investments may become public knowledge.

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Accordingly, investors do now expect managers to demonstrate how they will maintain communications with core service providers in the event of disruption of technology or telecommunications. They expect service providers to encrypt their transactional and investor data, both when it is at rest and when it is in transit. They look to managers to check that their service providers have fully documented procedures to control which people inside and outside the firm have access to the data belonging to their clients, and how they intend to manage inadvertent disclosures and hacking incidents. In most cases, they look for evidence that links are tested regularly, and for certification of procedures by auditors or consultants.

To provide documented, certified reassurance to investors about third party service providers down to this level of detail represents a major commitment of time and resources by managers.

Emerging and smaller managers are bound to struggle to make the investment. Yet, because they are being shunned by major prime brokers and administrators operating to return-on-asset or minimum revenue requirements, their need to document and explain their choice of service providers to investors is even greater than that of larger and more established funds. One source of comfort for them is that working with less well-known service providers will not only cost them less, but almost certainly be less risky than reliance on a major provider, which will be much readier to jettison their business.

This is a reminder that the risks posed to the success and sustainability of a fund management business by prime brokers, fund administrators and other service providers are not always obvious. Losing a provider is just as real a threat as a provider failing, or losing assets, or failing to impress an investor. Fund managers need to understand and manage the many different risks they incur via their provider relationships, whether they are general or bi-lateral.

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