Five reasons why US fund managers are turning to outsourcing

Outsourcing in the US is alive and well, with recent estimates suggesting that at least 40% of managers outsource some element of their back office or fund operations to a specialist fund administrator. In this article, we outline five key reasons why US managers are embracing outsourcing and offer guidance on what they should look for in an outsourcing partner.

First things first – what is outsourcing?

Broadly speaking, outsourcing involves a fund manager appointing a third-party service provider to undertake certain activities relating to the day-to-day operation of a fund. The scope of the role is as narrow or as broad as the manager determines and can range from delivering specific services to support an in-house back-office team, to providing most of the back office and operational support necessary for a fund to function.

Typically, more comprehensive outsourcing relationships will see the outsourcing partner assume responsibility for the administration of the fund, investment and carry vehicles, as well as performing key regulatory roles.

The outsourcing role is usually fulfilled by a professional administration business specializing in the provision of administration, accounting, regulatory and compliance services. These businesses range from financial institutions that service multiple industries to independent specialists that work exclusively with fund managers.

Five key outsourcing drivers

1. **Reprioritization in a buoyant market**

US private markets are thriving with recent data showing that 35% of all SEC registered advisors service private markets – a 70% increase over the last five years. In fact, private markets are now a $18 trillion marketplace seeing annual growth of 10% since 2010.

It remains an extremely buoyant market that, for many managers, has brought about a strategic rethink. Managers are increasingly recognizing that their ability to capitalize on new opportunities and ride the wave of exponential growth in the market will be dependent on their ability to quickly “scale up” their operations to accommodate their ambitions.

Scaling up at pace can be challenging. Recruiting new staff with very different expertise and skill sets, investing in training and new technology, and adapting controls and procedures can not only be costly but also very difficult to achieve in a short space of time.

The outsourcing model enables managers to grow at a pace that suits their goals because the professional administration business will already have the people, technology and operating platform in place. What’s more, the onus is on the outsourcing partner to continually enhance their operational capabilities to support their clients’ ongoing requirements – capital investment that is largely made by the professional administration business rather than the manager.

2. **Tighter regulation**

While fund managers operating in private markets in Europe have had to contend with an onerous and burdensome regulatory environment for a number of years, the US has historically been comparatively “light touch” given the absence of a US equivalent to Europe’s Alternative Investment Fund Managers Directive. This, however, seems all set to change.

The SEC has recently put forward several new proposals that will increase the compliance and reporting burden for fund managers, not only those running public companies, but those in private markets too.

One such proposal, which ended its consultation in early April, involves the introduction of new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act). The proposed changes, which aim to protect private fund investors by increasing transparency, competition and efficiency, will create new requirements for private fund advisors relating to fund audits, reporting and adviser-led secondary transactions.

For example, one of the reporting requirements proposed under the amendments to the Advisers Act relates to the preparation of quarterly statements pertaining to fees, expenses and the performance of any private fund. The distribution of such statements, which must contain disclosures at both fund and portfolio investment level, must be presented to the private fund's investors within 45 days after each calendar quarter end.

The proposal, if passed, would also require all registered advisers, including those that don't advise private funds, to document the annual review of their compliance policies and procedures in writing.

That's not all. We are also seeing a raft of proposals in a range of other areas as well, including cybersecurity and climate change, which will impose additional reporting and operational requirements on managers. As professional fund administrators invest significantly in these areas and their regulatory and wider reporting capabilities, they are well-placed to help managers contend with an increasingly arduous regulatory environment and manage the associated challenges, while minimizing any disruption to their core investment activities.

3. **An increasingly global portfolio and investor base**

Private markets are becoming an increasingly global industry with growing numbers of US managers raising private capital, investing in or launching funds in Europe. This strategy, of course, brings opportunities but it also brings numerous challenges and implications from an operational, regulatory and fund structuring perspective.

However, by partnering with a professional administration business, managers are able to leverage local expertise and resources to meet their international requirements without having to build a presence or operation of scale in a new jurisdiction.

For example, many US mangers operating in Europe will establish a sufficient local presence to meet their local substance requirements, while appointing a professional administration business to provide many of the services critical to the effective day-to-day operation of the fund.

4. **Investors driving the need for new operational solutions**

Arguably the most significant shake up we have seen in the world of fund operations in recent years relates to the influence of investors.

Historically, investors would focus exclusively on returns. However, in a recent survey we carried out among private capital CFOs and COOs, 98% of respondents said that investors were now driving the need for new operational solutions. This is because investors recognize that their interaction with the fund manager, from onboarding and data collection to reporting and ongoing correspondence, will largely be shaped and delivered by the fund's back office and operations team.

Not only has the emergence of operationally savvy investors led to a growing number of fund managers naturally choosing to partner with third party fund administrators and operational specialists, in many cases cornerstone investors are now demanding their appointment and even playing a central role in the administrator selection process. It is an arrangement that provides comfort and assurance to investors that the fund manager is harnessing the extensive resources, experience and independent view of a "back-office specialist".

As a professional administer, we've seen investors exert their influence across the full spectrum of fund operations in recent years. This ranges from voicing expectations in relation to AML and due diligence procedures and the deployment of particular tools and systems, to specific requests around reporting such as the adoption of ILPA compliant templates.

In our experience, investors expect to be treated as an extension of the client relationship that exists between the third-party administrator and fund manager.

5. **Operational best practice**

While many of the points raised above are very often the catalyst for a manager deciding to outsource, the simple fact of the matter is there is a growing appreciation in the US that fund administration has become a specialist role crucial to a manager's long-term success in a high growth environment.

Today's operating environment is more complex than ever before, and professional administrators are well placed to help fund managers navigate that complexity. And that role doesn't just extend to navigating challenges such as the growing compliance and reporting burden and increase in cybercrime, but also helping managers to develop, evolve and, in some cases, even redesign their operating models to achieve operational efficiencies, make more informed decisions through best practice reporting and enhancing investor relations through more timely and professional communications.

Managers may even want to go further than the traditional back and middle-office outsourcing model and leverage the evolving technology of professional administration businesses to assist with front office functions, such as ESG governance.

Choosing an outsourcing partner

In summary, the right administrator can add genuine value across all aspects of a fund manager's business, which means it's a decision the manager must get right. Taking the time to do proper due diligence on a potential outsourcing partner and thorough assessment of their credentials is critical. In our experience, managers typically want to "deep dive" the following areas as part of that process:

- Level of experience, particularly the outsourcing partner's track record of working in the manager's target asset class and jurisdiction
- History of investment in new technology and systems, and commitment to embracing innovation
- Whether the service model is relationship-based and delivers a stable, dedicated and consistent team over the life of the fund
- Level of emphasis placed on building long term partnerships and ability to meet managers' evolving requirements
- Robustness of the operating platform including industry best practice controls and procedures
- Depth and breadth of expertise
- Client advocacy including retention rates, NPS scores and testimonials that endorse service quality
- Ability to provide services from the leading fund jurisdictions and local expertise available in those locations

Every manager will, of course, place their own level of importance on each these areas but more often than not the decision will consider multiple factors. Ultimately, managers want to know not just how you're set up to meet their needs of today but how you can adapt your offering to meet their requirements of tomorrow.