Due Diligence of Fund Administrators

Introduction

The Securities and Exchange Commission (SEC) recently settled charges against Theorem Fund Services LLC (TFS), a Florida-based fund administrator. The charges revolve around TFS's failures to respond adequately to multiple red flags and clear indications of fraudulent activities associated with EIA All Weather Alpha Fund Partners and its manager.

TFS's failures highlight the pressing need for fund administrators to remain independent, vigilant, transparent, and committed to their responsibilities to protect investors.

Fund administrators are entrusted with the essential tasks of fund accounting, valuations, shareholder services, regulatory compliance, and more. Given the significance of these roles, alternative investors and investment managers need to ensure their chosen fund administrators are fit for purpose. Investors and investment managers should conduct thorough due diligence of fund administrators when investing into or, appointing them to oversee, a fund.

Key Due Diligence Considerations

Ensuring Expertise and Efficiency: Alternative investments, given their complexity, require a high degree of expertise. Through due diligence, investors and alternative investment managers can ascertain the administrator's capability, track record, and experience in handling similar assets.

Smaller administrators may require more thorough analysis and review. However, larger and more established administrators should not receive a ‘free-pass’ simply based on reputation. Each new appointment must be assessed on the specific risks involved.

Mitigating Operational Risks: By evaluating a fund administrator's operational processes, technology infrastructure and disaster recovery plans, potential pitfalls can be identified and mitigated. This can ensure the continuity and stability of fund operations.

Protecting against Conflicts of Interest: An independent fund administrator should maintain objectivity and impartiality. Due diligence can help uncover any undisclosed affiliations or conflicts that might compromise the administrator's independence in ensuring transparency and fairness in reporting.

Consideration should be given to key relationships that could lead a fund administrator to favour particular clients. Key relationships, which create reliance, can exist if one fund/investment manager contributes significantly to overall revenue or profitability. Monitoring changes in the share of revenue generated by these key relationships over time can help determine whether an administrator may have their independence compromised through reliance on certain client relationships.

Regulatory Compliance: The regulatory environment is more complex than ever for alternative investment managers and service providers. Investors and managers should thoroughly check publicly available records to identify any previous material regulatory actions or fines levied for failures.

A lapse in this area could lead to severe financial and reputational repercussions. Background checks, dependent on jurisdiction, can also be conducted on key personnel to ensure the highest levels of probity.

Increased scrutiny from regulators as to how fund administrators oversee and monitor their own outsourced and delegated relationships is another area of concern. The ability of a fund administrator and its outsourced relationships to weather periods of operational instability from an infrastructure or cyber security perspective should be assessed to understand how resilient the operational model is.

Strengthening Investor Confidence: Fund administrators can strengthen trust with investors and investment managers by being transparent about their operations and infrastructure – allowing access to due diligence teams, engaging with auditors in performance of internal control testing, and providing investors with reporting such as the SBAI's Administrator Transparency Report (ATR): https://www.sbai.org/toolbox/administrator-transparency-reporting-atr.html

Independent internal controls testing is a minimum standard for any fund administrator who wishes to be considered institutional. SOC1 testing is acceptable for start-up or new entrants, with SOC2 testing viewed as being necessary for established businesses.

Conclusion

Independent fund administrators have a significant role to play in creating and maintaining trust and confidence in the alternative investment industry. Failure to act in a truly independent manner and to hold investment managers to account can erode trust and undermine the confidence of investors.

Thorough due diligence on independent fund administrators is not just best practice, but a necessity.