

The New Paradigm - SAS 70 Reports and Alternative Investment Managers

Introduction by Dermot S. L. Butler, Chairman, Custom House Global Fund Services Limited

Except for holy men living on top of poles in Mumbai, everyone in the hedge fund industry knows that there has been a dramatic swing from the avoidance of regulations as far as legally possible ten years ago, to fully embracing regulation (albeit somewhat nervously) today.

As an industry, the members of the hedge fund community have become much more disciplined and have taken their responsibilities as far as corporate governance and risk management, including the management of the portfolio and the procedures and policies they follow in running their hedge funds, much more seriously than in the past, when a somewhat cavalier approach prevailed.

Investors have become much more proactive and, whereas, ten years ago, the amount of due diligence that was carried out on the service providers was negligible, today, the institutional investor will visit, not only the investment manager, but also the administrator and probably the custodian, to establish exactly what they do, how they do it and when. Thus, due diligence visits can be very intense, stressful and expensive, in that they soak up management time and resources. One of the ways of ameliorating this burden is for the 'investigatee' (such as ourselves, as an administrator) to undergo the full SAS 70 treatment so that we can provide the investor's due diligence team with a SAS 70 report.

Some of you will, no doubt, be wondering what a SAS 70 is - indeed, when we first considered applying for a SAS 70 in 2003, I asked several hedge fund managers whether they thought it would be useful for us to have a SAS 70 and I either got a blank look, or the more imaginative asked whether I was talking about a new model SAAB. That has changed. Whereas it used to be only service providers and, in the United States, particularly banks and custodians who underwent the SAS 70 treatment, there is an increasing activity by hedge fund managers who are seeking their own SAS 70s.

However, in 2003, partially because of the general ignorance in the industry about SAS 70s and because we thought it was quite expensive at that stage in our development, we decided not to go for a SAS 70, but to apply for a Moody's Management Quality Rating (MQR). Ironically, we were the only hedge fund manager to receive a Moody's Management Quality Rating, because Moody's withdrew the programme two years later. I understand that one or two other administrators applied for the rating and underwent the review, but never published the results. We can only assume (with a smug smile on our faces) that their rating was not attractive. Be that as it may and because the Moody's MQR was abandoned, we decided, in 2007, to apply for a SAS 70 Report and appointed Ernst & Young to do the job.

On the basis of our experience, I would heartily recommend anyone, who can afford the time for a SAS 70 review to be carried out, to go ahead. The reaction from investors when we show them our SAS 70 is always positive and that is very encouraging. But be warned: the initial process of applying for and acquiring the full SAS 70 treatment is, or we found it to be, very time consuming and, indeed, in some cases, harrowing. In simple terms, the SAS 70 "Type I" is confirmation that we have procedures that would enable us to fulfill our functions in a manner that the auditor - in this case Ernst & Young - thought appropriate.

Producing and documenting those procedures to the satisfaction of a critical accounting firm is a time-consuming operation, but it is nothing to the rigorous process you go through to obtain the "Type II," which you get after the audit firm has come in and checked that you are, in fact, carrying out those procedures for all your funds. However, once you have got it, calm descends upon the firm and, what is

very important, the standard reached to obtain that SAS 70 is then maintained as the new operating standard for the firm. This is not only very satisfactory, but absolutely necessary, as the SAS 70 is reviewed each year and slippage is not acceptable. Thus acquiring and maintaining a SAS 70 standard introduces a very disciplined culture to the firm, which is a huge consequential benefit.

There is a lot more information that I could impart on the SAS 70 but, frankly, there are others who can do that better than I, as you will see from the excellent article that follows. This article entitled "***The New Paradigm - SAS 70 Reports and Alternative Investment Managers***" was written in May of this year by Michael Cyran, Cynthia Doe and Tal Goldhamer, each of whom is either a partner or a principal in the financial services office of Ernst & Young in New York City. Their contact details are shown at the end of the article.

Ernst & Young Financial Services

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By Michael Cyran, Cynthia Doe and Tal Goldhamer

What was once an “auditor to auditor” communication; SAS 70 reports have become an effective and efficient tool for a variety of organizations to communicate their internal control structure to their stakeholders. Not surprisingly, requests for SAS 70 reports have gained significant momentum in the alternative investment management industry as a result of the financial crisis and recent high-profile frauds that shook investor confidence in the financial services industry. Institutional investors, fund of funds due diligence groups and investment consultants are now searching for an enhanced level of understanding and transparency from investment managers, and SAS 70 reports have become an increasingly popular way of obtaining such information.

Developed by the American Institute of Certified Public Accountants (AICPA), Statement on Auditing Standards No. 70, *Service Organizations*, defines the professional standards used by auditors to assess and report on the internal controls of a service organization. Initially, custodians, transfer agents and mutual fund administrators were among the earlier adopters of SAS 70 reports. But in the early part of the past decade, hedge fund administrators began obtaining SAS 70 reports to demonstrate to hedge fund clients and auditors that consistent, effective controls were in place. Hedge fund administrators were able to use the SAS 70 report process to evaluate how their control systems and processes were aligned across their multiple teams and geographic locations.

Today, the need for clear, consistent and comparable control reporting continues to grow. The definition of a service organization has evolved to include alternative investment funds and their investment managers, prime brokers, all types of administrators and pricing services. And SAS 70 report stakeholders have expanded from auditors to users such as investors, management, due diligence firms, investment consultants and governmental regulatory agencies.

What are the benefits of having a SAS 70?

The issuance of a SAS 70 report from an objective third party may boost investor confidence in the governance and controls surrounding the calculation/monitoring of the net asset value (NAV) for alternative funds and their managers. For many investors, receiving annual audited financial statements is no longer sufficient, as it does not address the control environment throughout the reporting period regarding the calculation and reporting of monthly/quarterly NAVs. The ability of an alternative investment manager to demonstrate commitment and investment in strong internal controls can help

differentiate a firm from its peers. The delivery of a SAS 70 report to investors demonstrates trustworthiness given that the alternative investment manager is committed to subject its controls to examination and reporting by independent auditors. By proactively issuing SAS 70 reports, alternative investment management firms can take an offensive — rather than defensive — stance regarding stakeholder demands. While many investors are still learning how to interpret SAS 70 reports, they often view the mere existence of such reports as evidence of an effective internal control environment at an investment management firm.

As useful as the report is to external stakeholders, many alternative investment management firms have benefited significantly from undertaking a SAS 70 examination. In fact, the SAS 70 process is as important as the report. In going through the process, an auditor typically performs a pre-assessment of controls as a precursor to the SAS 70 examination. This pre-assessment is used to identify potential gaps in the existing control environment and often leads to recommendations for control enhancements, greater efficiencies and automation opportunities. Additionally, many management teams have commented on the benefit of having their staff “on notice” regarding their work being possibly subjected to detailed testing as part of the SAS 70 process. This has driven an awareness and improvement in the quality of documentation, attention to detail and overall control consciousness. Another major benefit is the ability for alternative investment firms to provide a single SAS 70 report to multiple investors, reducing the need for often lengthy individual due diligence meetings with investors.

Options for alternative investment managers

A service organization can obtain two types of SAS 70 reports:

- 1) **Type I reports** include the organization’s description of controls at a specific point in time (e.g., 30 June 2010) where the auditor will opine on whether the service organization’s **description** of controls presents fairly, in all material respects, the relevant aspects of the service organization’s controls in operation as of a specified date. The service auditor also opines on whether the controls were **suitably designed** to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.
- 2) **Type II reports** include the same elements of a Type I report, and additionally require that an auditor perform **detailed tests of the service organization’s specified controls** to determine whether the controls were operating with sufficient effectiveness to meet the service organization’s specified control objectives. This testing covers a period of time, which is generally a minimum of six months.

When alternative investment managers first initiate the SAS 70 process, it is common to begin with a pre-assessment. This is usually followed by a period of time where control environment gaps are remediated. The amount of time to remediate depends on the number and complexity of gaps identified, the amount of additional automation desired for the workflow and controls, and the resources needed to do so. Although greater automation creates more-scalable operations, it often requires more time so the decisions a manager makes may affect the timing of the report. Upon remediation, revalidation testing is performed by the auditor, followed by the issuance of the SAS 70 report. In situations where there is specific pressure or demand to have a SAS 70 issued quickly, Type I SAS 70s are most common because they only cover a specific point in time. Therefore, they can be issued relatively shortly after the completion of any remediation. In other cases, particularly where there is more time, the pre-assessment can be directly followed by a Type II SAS 70 report.

Having a Type I SAS 70 report can set the groundwork for obtaining a Type II SAS 70 in the future. Because a Type II SAS 70 includes the detailed testing of controls over a period of time, it is the most sought after form of SAS 70 report, given that it provides and communicates the greatest amount of information around the operating effectiveness of the control environment.

Is a SAS 70 right for your organization?

Many alternative investment managers are evaluating whether a SAS 70 report makes sense for their organizations. This decision is driven in part by the nature of the organization's internal operations.

Self-administered alternative investment managers generally have extensive accounting, operations and information technology teams that support the processes and controls necessary for the calculation of their funds' NAVs and production of investor statements. The lack of third-party involvement has caused these organizations to experience significant pressure from stakeholders regarding the desire for a deeper understanding of, and transparency into, their control environment. Obtaining a SAS 70 helps these stakeholders understand the control environment in more depth and have a stronger sense that controls are in place and operating effectively.

For alternative investment managers that utilize a third-party administrator as their official books- and records-keepers, many of the relevant control objectives and related controls generally reside with the third-party administrator. As a result, stakeholders looking to understand the control environment and operating effectiveness of the controls generally will look to the third-party administrator to provide the SAS 70 report. However, alternative investment managers who use a third-party administrator often have their own internal team shadow the books and records of the administrator to double-check the work product and reporting for accuracy. In these instances, stakeholders often find a SAS 70 report on the alternative investment manager's operations a useful tool.

In deciding whether an alternative investment management firm has sufficient key in-house operations to make a SAS 70 relevant to stakeholders, managers could consult *Asset Manager Guide to SAS 70*, issued by the Securities Industry and Financial Markets Association. This guide is also helpful for developing the baseline scope for the SAS 70 examination.

Updates to the current standard

Alongside the swirl of activity around SAS 70 in the alternative investment industry, the auditing profession is working to understand and communicate the impact of several changes to the current SAS 70 reporting standards.

In December 2009, the International Auditing and Assurance Standards Board issued a new International Standard on Assurance Engagements: ISAE 3402, *Assurance Reports on Controls at a Service Organization*. In April 2010, the AICPA Auditing Standards Board published Statement on Standards for Attestation Engagements — SSAE 16, *Reporting on Controls at a Service Organization* — that is substantially similar to the international standard and will supersede SAS 70. Both standards are effective for reports for periods ending on or after 15 June 2011, with early adoption permitted. While both standards have a 2011 required implementation date, firms considering a SAS 70 should understand how the upcoming changes will affect their approach and preparation for the issuance of their report.

The new standards offer greater flexibility to provide additional coverage to stakeholders in areas that historically were outside of the SAS 70 report's scope. While there are a number of more subtle changes to how the auditor and service organization approach the examination, some of the key differences to consider and discuss include:

- **Management’s written assertion.** This will be the most visible change in the report based on the new standards. Similar to what a public company prepares as part of their assertions related to internal controls over financial reporting this assertion is a separate component of the report, typically on the service organization’s letterhead and signed by a member of management. The assertion communicates the service organization management’s responsibility for the description of the system and asserts to the achievement of the evaluation criteria of the description of the system.
- **Description of the system.** Under the new standards, a service organization provides a description of its system as designed and implemented. While system has many different definitions, a common and useful definition is “the procedures, people, software, data and infrastructure organized to achieve a specific objective.” Controls are only one aspect of a system.
- **Risks that threaten the achievement of the control objectives.** Under the current standard, the auditor is responsible for determining if the controls identified by management sufficiently mitigate the key risks to achieve the control objective. Under the new standard, this responsibility shifts to the service organization. Management must identify their risks and determine that the controls in place would sufficiently mitigate the risks, or the impact of the risks, to achieve each control objective in the report.

In the relatively short time that alternative investment managers have been producing SAS 70 reports, feedback from their respective stakeholders has been positive. By proactively providing transparency in controls to their stakeholders and thereby helping to satisfy both increasing investor and regulator demands, such managers have differentiated themselves from their peers. Moreover, these managers have also realized internal efficiencies such as meeting more productively with investors and auditors and having an independent evaluation of their processes and controls. One alternative investment manager, which recently issued a SAS 70 on its operations, commented that once external stakeholders fully understand the value of the report, it will become the industry standard within the community. SAS 70 reports, along with other targeted third-party reporting, continue to build and maintain trust in the alternative investment management space that is required by investors, regulators and others.

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