

SAS 70 internal controls - A differentiator for hedge funds

What are the issues?

Institutional investors such as pension plans, foundations and university endowments hold nearly one-third of all hedge fund assets and studies project that these investors will increase their allocations to alternative investments, with some estimates of inflows over the next decade exceeding several hundred billion dollars. Many hedge funds are also trying to attract investment from fund of fund managers.

Hedge fund managers can expect fierce competition for these assets, not only from rival hedge funds but also from private equity funds and from investment companies offering registered products employing such short- extension strategies as 130/30 and 120/20. Fund of fund managers have also developed rigorous due diligence review processes.

Hedge funds hoping to gather additional institutional assets are looking for ways beyond reputation and performance to differentiate themselves from the competition. A recent PwC study suggested that for institutional investors the key driver to invest in hedge funds is not just performance - risk management, compliance and transparency are as important, if not more important than returns.*

Background

One way of hedge funds to achieve differentiation is by providing investors with information relating to the quality and effectiveness of their internal control environment.

Specific focus on the controls over trading and post-trade accounting operations can provide investors with confidence that hedge funds are investing according to investors' mandates or expectations and that investors are provided with accurate and complete reporting of their investments.

Institutional investors concerned about fulfilling their fiduciary responsibilities and meeting regulatory requirements will benefit by receiving this information. Not only will this make the hedge funds more appealing as potential investments, but it also may help them achieve operational efficiencies and improvements, particularly in areas such as trade processing, valuation and overall operational risk management.

Satisfying the demand for providing investors with information on internal controls does not end with the implementation of controls. Instead, fund managers have to be able to demonstrate that the controls are in place and measure them against industry peers or best practices. Because hedge funds and other alternative investment products are subject to far fewer regulatory and reporting requirements than mutual funds, there are relatively few common standards against which managers can benchmark themselves and provide transparent differentiation.

What is our response?

The internal controls reporting that hedge fund managers need can be provided through the SAS 70 audit process. SAS 70 is the abbreviated term for "Statement on Auditing Standards No/70: Service Organizations." Issued by the Auditing Standards Board of the American Institute of Certified Public Accountants. SAS 70 outlines the standards external auditors use to assess the internal controls of the service organization and how to report this information to third parties.

SAS 70 audit reporting has been around for years in the registered investments arena, particularly with respect to registered investment advisors, mutual funds and mutual fund services providers (e.g. fund accountants, administrators, custodians). Many institutional investors have been receiving these reports from their registered advisors for years, are comfortable with their form and content, and request the reports as part of the process of selecting new investment advisors. For hedge fund managers, the SAS 70 could serve as a valuable third-party validation that sufficient internal controls are in place and are operating effectively.

Fund managers who are understaffed, especially in their operations, are often concerned that their controls are immature and will not survive external scrutiny. Additionally, they may believe that controls which are strong enough for external reporting could compromise their entrepreneurial spirit or require greater structure than is needed. However, as fund managers continue to grow and fight for institutional assets, they will find that a good control environment also provides operational efficiencies, discipline and a foundation to deal with future growth and industry issues such as calculation of complex securities.

* "Transparency versus returns: The institutional investor view of alternative assets" available at www.pwc.com

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The most effective approach for fund managers would be to undergo a diagnostic evaluation of their current controls to identify gaps and then take steps to address any shortfalls. Following the completion of these steps, the fund manager can advance to the SAS 70 audit process and report issuance. It is important to note that, since the SAS 70 audit covers procedures common to the operations and accounting for the variety of investors, the reports need not to be done for each investor or even each Fund. One report can normally be issued to a group of investors which are processed in a similar manner for variety of investment strategies.

The SAS 70 process offers significant benefits. Hedge fund managers will find that the rigour of the SAS 70 audit process will help them focus resources on the most important controls while avoiding redundancy and streamlining processes. The review will be especially helpful in establishing effective controls over the trading and related accounting, including complex trading strategies such as derivative securities. In addition, controls reports may be helpful in demonstrating good governance not only for prospective clients but also for hedge fund managers seeking outside funding to support growth or exploring exit strategies through an IPO or sale to an outside entity.

Institutional investors will find the SAS 70 reports to be an important certification, based on a set of standards that provide evidence that a fund manager's controls are well designed and functioning. Investors will find that the transparency of the SAS 70 review process provides a superior alternative to the third-party ratings of hedge funds which are now under development by various ratings agencies.

What does this mean?

The growing use of the SAS 70 audit process, like the broader implementation of controls, is not being driven by regulatory action but instead by market forces. PricewaterhouseCoopers believes that the implementation of controls procedures is a differentiating factor for hedge fund managers today, but increasingly will become a prerequisite for securing institutional assets.

This series presents the PricewaterhouseCoopers point of view on a range of issues affecting our clients and our profession.

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