



SAS 70: A Requirement Proposed by the SEC for Certain Asset Managers

SEC Proposed Changes to the Advisor Custody Rule (206(4)-2)

Assessing the potential impact to your organization

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Agenda

Highlights of Proposed Custody Rule Amendments

What is a SAS 70 - Overview

SAS 70 – Drivers, Benefits, and Trends

SAS 70 - Fundamentals

Getting Started

Consideration for the scope of your report

The Evolution of SAS 70

Is SAS 70 right for your organization

Questions & Answers

Highlights proposed custody rule amendments

- On May 20, 2009, the Securities and Exchange Commission proposed rule amendments to substantially increase protections for investors who entrust their money to investment advisers
- Particularly, the amendments relate to the custody rule under the Investment Advisors Act of 1940 and related forms
- The amendments are designed to provide additional safeguards under the Investment Advisors Act when an adviser is deemed to have self-custody of client funds or securities

Key components of proposed changes

- Surprise annual security count
- Delivery of custodian statements
- Changes to disclosures
- Requirement of an internal control report (i.e. Type 2 SAS 70)



Additional considerations of the proposed amendments

Bad Apples

Due to recent scandals, the SEC has prioritized its focus around adviser custody

Comment Period

Closing July 28th – The SEC release has requested comments on several different aspects of the proposal - <http://www.sec.gov/rules/proposed.shtml>

Adoption

If approved, the SEC will likely seek to adopt the amendments by year-end, although a significant number of comments may delay this time frame

Transition

It is expected that there will be a transition period to allow advisers time to comply with the new requirements

What is a SAS 70?

A report that a service organization (investment adviser) can provide to its user organizations (investors/funds) that outlines its control environment and whether those controls that were tested were found to be working over a period of time (Type 2 only).

- What does it cover?
- Where does the standard come from?
- Who can issue a SAS 70?
- What is it that I will get at the end?
- Is this an audit?
- Can I use the same firm to do my SAS 70 as my financial statement auditors?

*SAS 70 was originally designed as an auditor to auditor communication over specified control objectives related to specific business functions; however, **SAS 70 has evolved and reports are now being viewed more broadly.***

Why SAS 70 for an investment adviser?

SAS 70 often is used to support an organization's endeavors to meet investor expectations

SAS70 drivers and benefits

Investors are looking to increase due diligence procedures over investment advisers; they are frequently requesting SAS 70s as part of their initial selection and ongoing monitoring.

Investors also expect that the adviser monitors their third party administrators. If administration is *performed at the adviser*, investors expect a similarly strong control environment.

Provides public companies with documentation for consideration in Sarbanes-Oxley 404 and 302 attestation and related certifications.

Reduces or eliminates questions and site visits from clients and their auditors, and prospective clients.

Provides management and governance bodies with an independent assessment and an internal training tool.

What are current SAS 70 trends?

Individuals in client risk management functions are encountering pressure for transparency from investors, senior management and regulators alike.

SAS 70 assists with their response.

- Increased **due diligence procedures** by investors
- Expectation of **monitoring of third party providers** and a strong control environment
- SAS 70s are being used by fund boards as part of their **oversight responsibilities** for service providers
- SAS 70s are also being used in **support of regulatory and legal obligations**, Sarbanes-Oxley or Chief Compliance Officer (CCO) requirements
- SAS 70s are often being **requested by prospective clients** during the RFP/RFI process
- Often a requirement in **vendor contracts**
- Requests are for the report **issuance dates to align** with client's financial reporting period



From whom are SAS 70 reports being requested?

Investment management requested SAS 70 reports:

- Asset managers
 - Institutional
 - Alternative asset
 - Sub-advisors
- Fund administrators (e.g. Hedge fund, mutual fund)
- 401k plan administrators
- Transfer agents
 - Sub-transfer agents
- Pricing servicers
- Custodians
- Prime brokers
- Application service providers
- Subservice providers

What types of SAS 70 reports are there?

Type 1 SAS 70 report

- Reports on controls placed in operation
(as of point in time)
- Looks at the design and implementation of controls not operating effectiveness
- Considered for information purposes only in planning an audit
- **May not be used by user auditors for control reliance**
- Most often performed only in **the first year** a client has a SAS 70

TYPE 2 SAS 70 report

- Reports on controls placed in operation and tests of operating effectiveness for a period of time
(generally not less than 6 months)
- May be utilized for control reliance purposes
- Includes tests of operating effectiveness and results
- More comprehensive
- Requires more internal and external effort
- More emphasis on evidential matter

Users are requesting Type 2 reports as the industry norm

Test types you can expect

Controls effectiveness testing

Tests of controls typically cover one or more of the following types of tests:

Inquiry	Make inquiries of appropriate personnel and corroborate responses with other personnel to ascertain the operation of the controls
Examination of document	Inspect documents and reports indicating evidence of the performance of the controls
Observation	Observe application of specific controls
Reperformance	Reperform application of the controls

What does the SAS 70 Report structure look like?

Type 1 and 2 SAS 70 reports typically consist of 4 sections:

Section I – Independent service auditors' report (the “opinion”) about whether:

- Description of controls is fairly stated (no omissions or distortions)
- Controls were suitably designed to achieve the stated control objective
- Controls were operating effectively for a period of time (Type 2 SAS 70 only)

Section II – Description of controls

- Includes narrative description of operations and general computer controls
- Includes control objectives and control activities
- This information is provided by the service organization

Section III – Information provided by the independent service auditor

- This includes tests of operating effectiveness and testing results for a Type 2 report

Section IV – Other information provided by the service organization

- This section is at the option of the service organization
- Often covers areas like business continuity or privacy

SAS 70 Considerations

Scope and Focus of Report	<p>The Description of Controls should cover both 1) the services provided to a broad range of users (i.e. clients) and 2) relates to an audit of financial statements</p> <p>If sub-service organizations are involved, a service organization can determine if they wish to cover the sub-service organization's controls in their report (i.e. the Inclusive method) or to provide just information on the nature and functions of the services provided (Carve-out Method)</p>
Timing	<p>SAS 70 reports typically cover at least 6 months and no longer than 12 months</p> <p>Often report periods are aligned to accommodate the financial statement audits for the majority of the user organizations (clients).</p>
Misconceptions	<p>Some believe that SAS 70 is a “certification” process, governed by established criteria</p> <p>It is NOT a certification – It is a framework promulgated by the AICPA (AU 324) to which auditors adhere when reporting on the effectiveness of controls</p>

Getting started – what does it take to get a SAS 70?

- A pre-defined scope
 - Customized for each organization based on an audit of financial statements and the services provided
- Design and implementation of controls
- Evidence of control effectiveness (Type 2)
- Documentation of controls
- Service organization time and cooperation
- Timing of SAS 70 required depends on scope and complexity of the organization and user needs



Consideration factors to consider when planning for a SAS 70

Report Scoping	<ul style="list-style-type: none">Providing alternatives for the scopeIdentifying control objectives common for the type of services provided to users
Report Drafting	<ul style="list-style-type: none">Documenting the service organization's control activities in placePreparing a description of controls (e.g. the narrative)
Considerations before moving forward	<ul style="list-style-type: none">Identifying whether documentation is maintained to evidence operating effectivenessIdentify gaps in the design of the controlsReporting period alignmentListing of documentation that may be utilized as examination evidence for a future SAS 70

Are you ready?

Often organizations aren't sure whether they are ready to move forward with a Type 2 SAS 70 or even if they have what they need in place. Readiness assessment engagements can help management prepare for a future Type 1 or Type 2 SAS 70 examination. This assessment can be an opportunity to identify and remediate any gaps prior to starting a SAS 70 examination.

Many service organizations opt for this prior to embarking on a SAS 70.

SAS 70 Readiness

Readiness engagements may encompass the following:

- Providing alternatives for the scope
- Identifying control objectives common for the type of services provided to users
- Documenting the client's control activities in place
- Identifying whether documentation is maintained to evidence operating effectiveness and assisting clients with alternatives for better ways to incorporate evidence into business process (e.g. workflow, checklist)
- Preparing a description of controls (e.g. the narrative)
- Identify gaps in the design of the controls
- Reporting period alignment

Potential SAS 70 scope areas for investment advisers

Investment advisers	<ul style="list-style-type: none">• New account/security set-up and maintenance• Contributions/distributions• Trading• Investment income• Valuation• Corporate actions• Reconciliations• Client reporting
Fund/investor administration	<ul style="list-style-type: none">• Fund setup and maintenance• Investor setup and maintenance• Investor subscriptions, redemptions and transfers• Fund investment setup and maintenance• Security setup and maintenance• Collateral monitoring• Portfolio position and cash reconciliation process• Fund investment valuation• Security pricing• Corporate actions and dividends• Interest income• Partner capital allocation / portfolio NAV calculation• Client reporting
Technology	<ul style="list-style-type: none">• Information security• Information systems operations• Change management

Potential SAS 70 Scope Areas – Proposed by the SEC

Custodial operations

- Physical securities are safeguarded from loss or misappropriation
- Cash and security positions are reconciled accurately and on a timely basis between the custodian and depositories, and between the custodian and accounting system
- Client-initiated trades are properly authorized and recorded completely and accurately in the client account
- Securities income and corporate action transactions are processed to client accounts in an accurate and timely manner
- Net settlement procedures for delivery and receive transactions are performed accurately
- Documentation for the opening of accounts is received and authenticated, and established completely and accurately on the applicable system
- Market values of securities obtained from various outside pricing sources have been recorded accurately in client accounts
- General Computer Controls

Global Considerations

- Current global environment
- New standard being developed to accommodate global need
- International Standard on Assurance Engagements (ISAE) 3402, *Assurance Reports on Controls at a Third-Party Service Organization*
- May be approved as early as this week.
- Intended to assist service organizations to meet the needs of their clients (“user organizations”) and their auditors, especially for reports issued in one country to meet the requirements of auditors of user organizations in other countries
- Proposed effective date of ISAE 3402 corresponds to the proposed SSAE and is expected to be for examination periods ending on or after June 15, 2011



Ongoing Changes to SAS 70

- Service Organizations Task Force working to developing two standards that will replace AU Section 324, *Service Organizations (SAS 70)*
 - **Auditing standard** to be used by an auditor of the financial statements of an entity that uses a service organization; and
 - **Attestation standard** to be used by a service auditor reporting on controls at a service organization (proposed SSAE).
- Significant difference: Management to provide an assertion covering the description, the design and the operating effectiveness of the controls.
- Proposed effective dates of the proposed SSAE is for examination periods ending after on or after June 15, 2011
- Expected approval date early 2010

Considerations for whether SAS 70 is right for you

- Is there a market demand – Are investors or potential clients requesting or requiring SAS 70?
- Is there an internal demand – Does the Board or Audit Committee require a SAS 70?
- Is there a regulatory requirement (or proposal) requiring a SAS 70?
- Do we need a SAS 70 in order to stay competitive in this market?
- Are we set to get started today?
- Do we know how we'll come out when independently tested?
- What else do we need to know before we get started?

———— *Questions and Answers* ————

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