

Fund Manager & Custodian Compliance with Statements of Internal Control	
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SUMMARY

This report provides an update of the London Borough of Hillingdon Pension Fund's fund manager and custodian control reviews. These are recommended under the Statement on Accounting Standards (SAS 70) and the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales (AAF 01/06). The reviews give an overview of the third party audit opinion of those controls. Whilst there is no strict requirement to produce these reports and as such not all managers undertake a SAS 70 or AAF01/06 review, it is recommended under best practice.

RECOMMENDATIONS

Committee are requested to:

- 1. Review the content of the report regarding the internal controls in place with the fund managers and custodian.**
- 2. Consider whether sufficient assurance can be obtained in terms of the effectiveness of controls, audit opinions and management responses, or whether further assurance is required, taking the current status of the fund managers into consideration.**

INFORMATION

The Statement on Accounting Standards (SAS 70) and the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales (AAF 01/06) are guidance which allows service organisations to disclose their control activities and processes to their customers and their customers' auditors in a uniform reporting format. The issuance of a service auditor's report prepared in accordance with SAS 70 or AAF 01/06 signifies that a service organisation has had its control objectives and control activities examined by an independent accounting and auditing firm. The service auditor's report, which includes the service auditor's opinion, is issued to the service organisation at the conclusion of the examination.

Officers requested the latest versions of the custodian and fund manager Statements of Internal Control and audit opinions and reviewed the noted exceptions. Reports were provided by Northern Trust, Alliance Bernstein, Goldman Sachs, Marathon, Ruffer, State Street Global Advisors and UBS. Both Fauchier and M&G outsource their back office services to a custodian who provided reports. Adams Street Partners, LGT Capital

Partners and Macquarie have not implemented their own SAS 70/AAF 01/06 review and some additional commentary on each of their processes is included in the appendix. The audit opinion for those managers who undertook an external review showed the described controls were suitably designed to provide reasonable assurance that the specified control objectives would be achieved. However, testing showed some exceptions where the control had not been applied successfully:

- Alliance Bernstein test results detailed exceptions within trade activity where evidence of review could not be provided and asset pricing with incorrect calculations and review inconsistencies. There were also issues regarding IT applications and inappropriate access. Following Committee's decision in March 2011 to terminate the IMA with Alliance Bernstein no further action is required.
- Goldman Sachs had only one exception where a trade input had no evidence of review by a second individual. Goldman Sachs has implemented a new system which now forces a second individual to comment on the trade and therefore this area of concern should now be eliminated, with no further action is required.
- The fund's custodian Northern Trust had a number of exceptions relating to a variety of areas. Although none of the exceptions noted had any impact on the fund and management have taken measures to improve processes, the number and variety of issues raises concerns and should form part of the appraisal criteria when the custody contract is re-tendered later this year.
- Of the exceptions noted for Marathon two have resulted in new procedures being set up. These included ensuring that the Marathon broker counterparty list is accurately recorded and that proxy votes are cast correctly. There is very little direct financial risk to the fund, however, from a governance point of view, Committee may want to discuss the implications should a vote be incorrectly cast in the future and whether this warrants further assurance.
- M&G outsource their administration and custody services to State Street Corporation. The review of State Street showed an exception where a cash reconciliation could not be evidenced and instances relating to application access and amendment. The main area of concern relates to software applications; however management have reiterated the importance of controls and new processes have been implemented.
- SSgA had two areas where exceptions were noted. These included verification of trade authorisation letters and issues surrounding emergency or special access to applications. Management have reiterated the importance of evidencing a call back in terms of authorisation letters and have updated the technology relating to application access.
- Two areas where exceptions were noted for UBS include the recording of client data and access, and issues around database management. New systems and retraining have been initiated to avoid problems in the future
- For M&G, SSgA and UBS the main area of concern relates to application management. The exceptions appear to have been addressed with the reinforcement of controls, retraining and new processes and systems. The

manager's concerned have also advised that any risk relating to Hillingdon is low as the fund would not be liable for any fraudulent activities. As such no further action is recommended.

- There were no exceptions raised in the internal control reports provided by Fauchier or Ruffer and so no further action is required regarding these managers.

The attached appendix shows more detailed information about the controls, where exceptions occurred and the management response to each issue. In addition all parties with exceptions were asked to comment on their reports and advise whether the exceptions had any detrimental impact on the London Borough of Hillingdon Pension Fund. In summary none of the parties claimed there had been an impact on the fund.

Three managers did not undergo an external audit of their controls and these included Adams Street Partners, LGT Capital and Macquarie. Details of their reasoning and alternative approaches are included in the appendix. Committee need to examine the responses and decide whether these provide reasonable assurance or whether further action is required.

FINANCIAL IMPLICATIONS

There are no direct financial implications arising directly from the report

LEGAL IMPLICATIONS

There are no legal implications arising directly from the report

BACKGROUND DOCUMENTS

Fund Manager SAS 70/AAF 01/06 Compliance Reports