

THE NEW SERVICE ORGANIZATION CONTROL (SOC) REPORTING IN THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE ERA

Since its implementation in 1992, the well-known and globally recognized Statement on Auditing Standards No. 70: Service Organizations (“SAS70”) has become the most prominent tool used for third party reporting on service organizations and internal controls over financial reporting.

Multiple factors, such as globalization and regulatory changes have prompted the recent issue by the U.S. American Institute of CPAs (“AICPA”) of the “Standards for Attestation Engagements (“SSAE”) No. 16, Reporting on Controls at a Service Organization” and the issue by the International Auditing and Assurance Standards Board (“IAASB”) of the substantially equivalent “International Standard on Assurance Engagements (“ISAE”) 3402”, collectively known as SOC1 reports. These new standards supersede SAS 70, as new Service Organization Control standards.

The SOC 1 has already been adopted by entities utilizing SAS70. However, AICPA also issued SOC2 and the SOC3 in 2011, both based on the AICPA Trust Criteria (Reporting on Controls at Service Organization Related to Security, Availability, Processing Integrity, Confidentiality and Privacy) and offering the service providers a wider range of reporting options to best suit their type of business.

While Undertakings for Collective Investment in Transferable Securities (“UCITS”) seem to have utilized and capitalized on the SAS70 report in the past to gain assurance with respect to administration, custody and accounting functions, alternative investment funds have yet to follow this trend. The adoption of the Alternative Investment Fund Managers Directive (“AIFMD”) and its transposition into national laws will certainly provide a new perspective to service providers with respect to the SOC reports.

WHY SOC REPORTING?

Service Organizations Control reports are independent internal control reports on the services provided by a service organization. Through system description, management assertion, control objectives and independent control testing results, they provide valuable information to enable the risks associated with an outsourced service be assessed and addressed.

While we see an increase in the outsourcing of activities for various reasons, management retains overall responsibility for outsourced activities and needs to monitor its service organizations. The reliance by management on outsourced controls is certainly one of the motivations for service providers to provide a SOC report.

AICPA OBJECTIVE

SOC recognizes that a service organization's outputs affect not just financial risks, but also operational and compliance related risks. The objective of AICPA is to help service providers in selecting the appropriate report to address their controls and consequently to help them in meeting the specific needs of users.

The AICPA Service Organization Control (SOC) reporting framework, which consists of SOC1, SOC2 and SOC3 reports, represents a significant milestone in the development of independent reporting on controls at service organizations and enables to some extent the “customisation” of reports to the needs and expectations of the users:

- **SOC1 report.** Intended for entities that use service organizations and their auditors. It is targeted at controls over financial reporting. SOC1 engagements are performed mainly under “Statement on

Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization*” and the “International Standard on Assurance Engagements No. 3402, Assurance Reports on Controls at a Service Organization”.

- **SOC2 report.** Intended for a broad range of users who require information and assurance about non-financial reporting controls at a service organization with respect to the information processed by its systems. SOC2 engagements are performed under *Attest Engagements* (AICPA, Professional Standards AT section 101), and the AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*.
- **SOC3 report.** The scope and work performed around the SOC3 report is very similar to SOC2. The key differentiators for the SOC3 are the deliverables which consists of a simplified report limited to testing results, as well as a seal from the AICPA on the service provider's website for all successful selected criteria.

WHO SHOULD CONSIDER THE SOC IN THE AIFM WORLD?

In the alternative investment fund world, the arrival of the new SOC standards coincides with the introduction of the AIFMD. The AIFMD introduces a harmonized European regulatory regime for managers of alternative investment funds (“AIFs”), which inherently has a profound impact on the alternative investment fund industry, both in Europe and internationally. While the main focus of the AIFMD is on managers of funds, the AIFMD will impact not only EU and non-EU alterna-

tive investment funds managers (“AIFM”), but also EU and non-EU domiciled AIFs, service providers to these funds and their investors.

Under the AIFMD, the AIFM will have to adhere to ongoing compliance requirements and apply for authorisation. Authorized AIFM ultimately benefit from a pan-European passport to market their funds across Europe. This will first be available to EU AIFM for their funds.

In addition to investment managers, fund service providers are also impacted under the AIFMD. For example depositories and administrators which will have to meet enhanced disclosure requirements. The 3 SOC reporting options will certainly have to be considered by such service providers, as these reports will provide their clients with relevant information on the control environment of their organizations.

ALIGNING AIFMD EXPECTATIONS WITH SOC REPORTING

Reliance on well defined SOC reports which incorporate adequate measures derived from the AIFM Directive within the control objectives will help readers of the reports to assess compliance with specific measures required by the AIFMD. In fact, by utilizing the new SOC reporting standards, service providers to AIFs will have a proven framework to assess their current compliance gap, ease the transition phase and provide their clients with an independent assessment.

As the AIFMD will impose key provisions around authorization, marketing, conduct of business, functions and service providers, transparency, as well as specific provisions, such as requirements on acquisition of major holdings and control over portfolio companies, the flexibility of SOC reporting will allow for integration of and efficiencies relating to auditing requirements. The six key provisions of the AIFMD and an overview of the related impacts are summarised in the chart below.

As mentioned above, the SOC1 standard aims at reporting to user entities about the internal control system for financial

reporting of a service provider. By defining the control objectives to meet the requirements of the AIFMD, the service provider will “consolidate” compliance testing and enable the reader of the report to assess compliance with certain AIFMD measures.

For example, SOC reporting could allow for reporting on individual controls relating to the following:

- The selection of independent values or functional independence (Chinese walls), and compliance with additional valuation requirements
- Risk management functional independence or selection of third-party service provider
- Risk management procedures, stress testing and liquidity management
- Depository duties, including capacity to meet obligations and liability

As the alternative investment market is set to become increasingly regulated and controlled, management at many service

providers has already looked into options to provide user entities, investors and regulators with relevant information over their control environment.

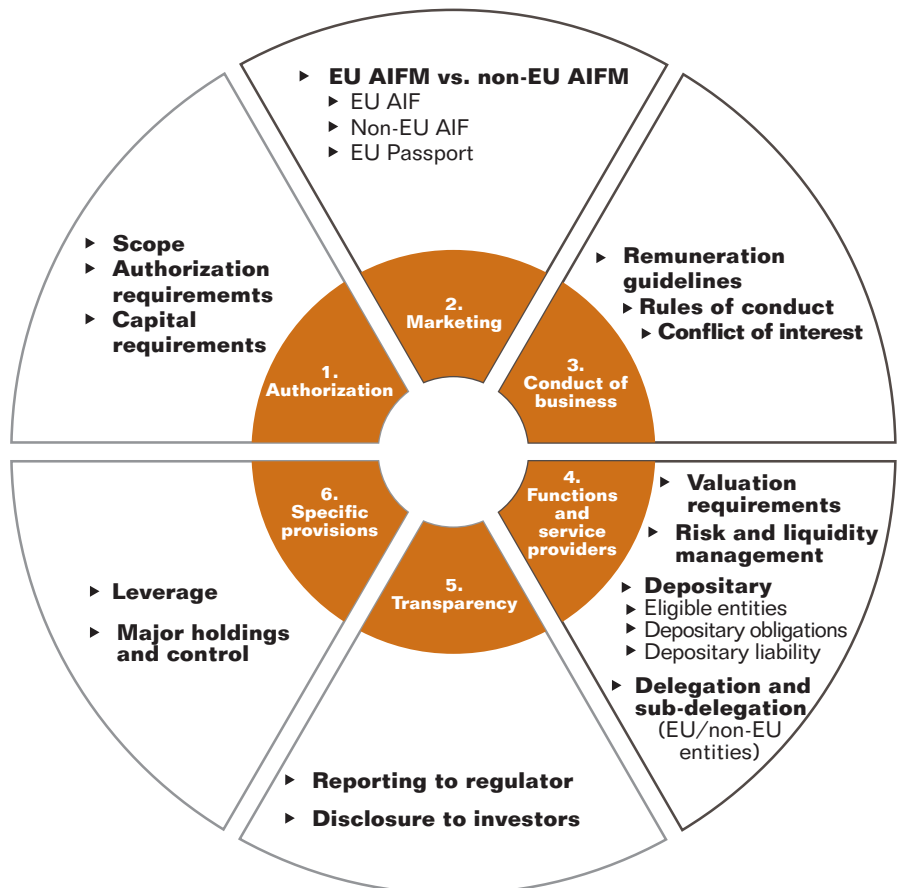
In the AIFMD era, service providers to AIFs might reassess SOC reporting which was previously seen as a burden and turn it into an opportunity for growth, using it as an international marketing tool and a significant means of enhancing the trust placed by current and potential clients and investors in service providers’ systems. ■

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