

## **Committee: Pension Fund Advisory Committee**

**Date: 17 March 2015**

Agenda item:

Wards: All

### **Subject: Annual Review of Investment Managers and Custodian Statement of Internal Control**

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Lead member: Councillor Imran Uddin

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#### **Recommendations:**

1. Members are recommended to note this report.
2. The review of fund managers' SAS 70 /FRAG 21 reports provides assurance to the Pension Fund (Members and Trustees) that fund managers have adequate controls and safeguards in place for managing the Fund assets. It is appropriate for the committee and Fund members to be kept abreast of any risks identified through this process and the likely impact of such risks to the Fund.
3. It is a statutory requirement that the Pension Fund administrators review the controls and safeguards in place for managing the Fund assets and report the outcome of the review to the Trustees and Members of the Fund.

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#### **1. PURPOSE OF REPORT AND EXECUTIVE SUMMARY**

- 1.1 This report provides an update on the internal audit control review of the Pension Funds Custody and Investment arrangements.  
The SAS 70 standard was replaced by new accounting standard Statement on Standards for Attestation Engagements No. 16 (SSAE 16) and its global counterparty, International Standards for Assurance Engagements No. 3402 (ISAE 3402). The Standard requires that a report be produced on the controls over the processing of transactions and safekeeping of assets for global securities and custody clients.
- 1.2 SAS 70 is an auditing standard designed to enable an independent auditor to evaluate and issue an opinion on a service organization's controls.  
Each fund manager is required to submit to the Council an audited Statement of Auditing Standards No. 70 (SAS 70). All the SAS 70 reports have been audited and approved by independent auditors. Officers have also reviewed these reports and are satisfied that the internal controls that are in place are satisfactory.  
The Panel is charged under the Council's constitution with the duty to consider pension matters and meet the obligations and the duties of the Council under the Superannuation Act 1972, and the various statutory requirements in respect of investment matters.  
Under the principals of good governance Members need to satisfy themselves that appropriate checks and balances are built into the pension administration system to demonstrate that it is adequate and effective.

This report is demonstrating one of those checks and balances as it reviews the internal control measures of the fund managers.

## 1.2 Fund Managers

The London Borough of Merton Pension Fund has three Fund managers – Aberdeen Asset Management, UBS and BlackRock.

## 1.3 Aberdeen

The Aberdeen internal control report provided covers the period 1<sup>st</sup> July 2013 to 30<sup>th</sup> June 2014. The report includes a description of Aberdeen's investment management services, prepared by the company and reviewed by Aberdeen's external auditor, PricewaterhouseCoopers LLP (PWC).

PWC also evaluated the design suitability and effectiveness of Aberdeen's internal controls including: the process for accepting new clients; authorizing and processing transactions; maintaining financial and other records, cash management; safeguarding assets; monitoring compliance and reporting to clients.

There were three exceptions noted:

- 1) Secondary review of proxy votes (1 out of 25 not signed);
- 2) Independent fire inspection at data centers (untimely);
- 3) Secondary review of bank reconciliations (1 out of 20 not signed).

The response of Aberdeen management can be found in Section VIII of the report. They indicate that where exceptions are found, management was either aware of the issue and/or have intention of ensuring that these (apparent) exception are mitigated in the future.

The overall audit opinion was that in all material respects, the controls are suitably designed and operated effectively throughout the period to provide reasonable assurance that the specified control objectives were achieved. There is no direct impact on the Merton Fund.

## 1.4 UBS

The UBS internal control report covering the period 1 January 2014 to 31 December 2014 is to be published at the end of March 2015. Officers will report on the UBS internal controls in June 2015. It should be noted that the March 2014 report prepared by the managers auditors Ernst & Young had eight exceptions some of which have been noted below.

The external auditor Ernst & Young examined the procedures and controls, relating to: account set up, processing transactions, maintaining financial and other records, monitoring compliance, reporting to clients, global real estate, application change management, logical access management and IT operations.

There were eight exceptions noted:

- 1) For one out of eight samples, an element of the checklist in relation to bank reconciliations was not completed. Management confirms that all process had

been completed and evidence to confirm this was provided to E&Y. The team has been informed that additional diligence is required around the manual completion of the checklist, to ensure going forward all elements will be completed.

- 2) For one out of six NAV samples, the NAV per the fund investor report differed from the final approved NAV presented in the Valuations Committee. Management confirms that the relevant procedures have been updated to ensure the correct NAV is used going forward.

Ernst & Young's overall conclusion was that, in all material aspects, the controls were reasonably designed to be able to provide assurance that the controls objectives were met. There was no direct impact on the Merton Fund.

A summary of the Internal Control report relating to 1<sup>st</sup> January 2013 to 31<sup>st</sup> December 2014 will be presented to Committee at the next Pension Fund Advisory Committee Meeting in June.

## 1.5 BLACKROCK

Internal control report received was for the period 1<sup>st</sup> Oct 2013 to 30<sup>st</sup> September 2014. The report includes a description of the systems relating to the asset management, record keeping and reporting services for assets managed by BlackRock, Inc, which was prepared by the company and reviewed by the external auditor Deloitte & Touche LLP.

The areas of controls tested include: portfolio onboarding and maintenance, transaction processing, corporate action, cash management, economy and market data, portfolio compliance, reconciliations, performance measurement, client reporting, securities lending, outsourced arrangements and oversight, risk analytics model validation and IT controls.

There were two exceptions noted:

- 1) 1 out of 25 benchmark and investment guideline modifications was not monitored for timely processing. Management response admits to manual oversight whereby the system request to update did not flow through the appropriate channels. Management rectified this particular modification – however, we may require further confirmation that the channel of communication is now open and no further exceptions are to be expected. It should be noted that this does not have a direct impact on the Merton Pension Fund.
- 2) 1 of 3556 new hires, transfers and terminations were not sent timely by HR to corporate groups. 6 of 118 individuals noted that HR-act notifications were not sent timely. Both resulted in enterprise access not being revoked timely. Management response was that the importance of timely notification was emphasized to Management throughout the firm, HR is now tracking timeliness of terminations processing through key metrics, including cases of non-compliance which is reported to Senior Management on a periodic basis. This has no impact on the Merton Fund.

The external auditor, Deloitte & Touche LLP, considered that in all material respects, the controls were suitably designed to provide reasonable assurance that it would, if operated effectively, achieve the control objectives.

## **2.0 Custody**

The Fund currently has a number of direct and indirect arrangements with a number of custodians – JPMorgan Chase (direct arrangement), State Street Bank (indirect custody arrangement) and Nova

The report usually describes internal controls on custody and related securities processing for its clients. It however does not cover all aspects of services provided. It is also industry practice for some custodians to outsource some of their activities.

### **2.1 JP Morgan Chase**

JP Morgan provided the Global Custody report for the period 1<sup>st</sup> October 2013 to 30<sup>th</sup> September 2014. In the report, the external auditor, PricewaterhouseCoopers LLP (PWC), examines the controls relating to maintenance of client data, security reference file records, authentication, recording & settlement of transactions, cash availability, and security of assets, sub custodians, corporate action and investment income, amongst others.

There are no significant concerns raised. However, one exception is noted relating to U.S. voluntary corporate actions, where one discrepancy was not identified before the processing deadline, out of a sample of 25 corporate actions. The report does not contain a management response to this exception.

The auditor concluded that the controls over the processing of transactions for clients using the global custody operations were suitably designed, and implemented with sufficient effectiveness to provide reasonable assurance that the control objectives were achieved during the period.

### **2.2 State Street Bank**

Internal control report provided related to the period 1<sup>st</sup> Oct 2013 to 30<sup>th</sup> September 2014. Ernest & Young LLP, their external auditors, examined the descriptions of controls related to accounting, custody, securities lending and financial reporting controls applicable to State Street's custody function around the world.

The control objectives and controls tested relate to account set up, transaction processing, sub-custodian monitoring, income and corporate action, portfolio accounting, fund administration and securities finance.

Sixteen deviations were noted however they do not have a direct impact on the Merton Fund. Some of these have been summarised below;

1. For 1 of 58 manually loaded trades into OTC Hub, evidence of review could not be provided. Management acknowledged this but confirmed that the trade had been input accurately.

2. For 2 of 23 samples of reconciliations between MCH and Investment Manager documentation, reconciliations were not performed for a period greater than one month. Management confirmed that for the two samples, the reconciliations have been updated and are now current.
3. For 7 of 32 income accruals report selected for testing in the UK, evidence of accurate review of out of tolerance income accruals could not be provided. Management has reviewed these income accruals and confirms that they were calculated accurately.
4. For 2 of 40 Cash Sweep set-ups or modifications selected for testing, the funds were not set up in accordance with client/investment manager instructions. Management notes that for one fund, the default sweep vehicle was modified without client authorisation and for a period of 5 days, cash was swept into an investment sweep vehicle that had not been authorized by the client. During the routine review of the cash receipts, the issue was identified and the authorised investment sweep vehicle was reinstated. For the second fund, the sweep vehicle selected has been updated in the Cash Sweep application.
5. For 1 of 40 samples selected for sample in Australia, evidence of review of a reconciliation of capital stock activity was not available. Management notes that the reconciliation of capital stock activity was prepared accurately and timely and discrepancies were researched and resolved with the transfer agent or other designated record keeper.
6. For 1 of 40 expense accruals selected for testing in Germany, evidence of review of the manually posted expense accrual could not be provided. Management notes upon review that the expense accrual was accurately posted to MCH.
7. For 3 of 75 Holdings Appraisals and/or Fair Value Summary Reports selected for testing in the U.S., there was no evidence of secondary review. Management notes that these 3 Holdings Appraisals and/or Fair Value Summary Reports related to 1 Portfolio Administration Group and management has confirmed that the Holdings Appraisals and/or Fair Value Summary Reports were prepared accurately.
8. For 1 of 50 samples of cash collateral investment activity selected for testing, supporting documentation for 1 component of 1 of the balances was not included in the reconciliation packet. Management notes that this is a daily control; any exceptions would be identified in next day's reconciliation.

In all the cases mentioned, management has confirmed that the requirement to meet the control objective has been/will be reinforced with the relevant personnel.

Despite the exceptions found, Ernst & Young considered that, in all material respects, the controls were suitably designed and, if operating effectively, were those necessary to provide reasonable assurance that the control objectives were achieved.

- 4. CONCLUSION**
- 4.1 That members note the fact that none of the Fund managers or Custodian had significant issues raised by their external auditors when internal controls were reviewed. Copies of internal control reports are available on request.
- 5 CONSULTATION UNDERTAKEN OR PROPOSED**
- 5.1. N/A
- 6 FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS**
- 6.1. All relevant implications are included in the report.
- 7 LEGAL AND STATUTORY IMPLICATIONS**
- 7.1. All relevant implications are included in the report.
- 8 HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION IMPLICATIONS**
- 8.1. N/A
- 9 CRIME AND DISORDER IMPLICATIONS**
- 9.1. N/A
- 10 RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS**
- 10.1. The review of the SAS 70 /FRAG 21 internal control reports of third parties that manage Pension Fund assets ensures that fund managers are able to demonstrate that they are properly managing pension fund assets as stewards of the Fund and are following procedures that do not expose fund assets to any undue risks. Pension Fund assets could be exposed to undue risk where SAS 70 reports are not in place or adequate internal controls and safeguard measures are lacking in the management of Fund assets.
- 11 APPENDICES**
- 11.1 N/A
- 12 BACKGROUND PAPERS**
- 12.1. Investment Manager and Custodian Internal Control Reports