Internal audit in an AIFMD world

Jérôme Sosnowski
Director
Business Risk
Deloitte

Giulio Brenna
Manager
Business Risk
Deloitte

The choice of the internal auditor in this context will prove just as crucial, since it will be difficult, often just for the obvious reasons of cost, to have a permanent, full-time employee within the company

Introduction

The enactment of the Law of 12 July 2013 on Alternative Investment Fund Managers (AIFM) has introduced new challenges for the alternative asset management industry. The demand by regulators, both at European and at Luxembourg level, for enhanced risk governance and risk management accountability at board and executive level, has reached unprecedented levels and is extended from now on to management companies managing non-Undertakings for Collective Investment in Transferable Securities (UCITS) funds, while, at the same time, the law also clarifies and broadens the role and duties of banks through their depositary function for non-UCITS.
In the new regulatory framework, the role and the importance of the internal audit function has taken on a new dimension: as well as becoming a regulatory obligation within all types of AIFM, internal audit now has an advisory role at board and executive level within the organisations impacted by the AIFM law. In addition, new competencies will be required in order to properly cover enhanced technical areas.

Enhanced role of the internal audit function within AIFM

The difference compared with UCITS regulations is significant, as all AIFMs now have to establish a permanent internal audit function. All funds under AIF status will be required to pass from an 'uncontrolled situation' or 'controlled at a minimum' to a situation equivalent to the one of management companies operating under Chapter 15 status. The requirement goes even further in the case of self-managed hedge funds, which unlike their equivalents under UCITS law, must also have a permanent internal audit function.

In such a situation, there are at least two crucial issues for AIFMs to address. First of all, how do you get these companies to focus on the need for a permanent internal audit function, when they often have neither the relevant knowledge nor expertise? The second question is: how do you choose a good internal auditor?

The first key factor will be the awareness of the corporate body ultimately responsible for the sound management of the AIF: the board of directors. The board should be in a position either to directly discuss the results of the work of internal audit, to appoint the internal auditor, to set the roles and the responsibilities of the function in an internal audit charter or to delegate this responsibility to an audit committee. The audit committee will, ideally, comprise three members whose responsibilities will be to cover all internal audit-related matters and the external audit questions, as well as the second line of defence (i.e. the compliance function and the risk management function)—when not delegated to a separate risk and/or compliance committee. In all cases, the roles and responsibilities of the board of directors will be significantly reinforced: to correctly address this situation, it will have to appoint members with internal audit expertise.

The choice of the internal auditor in this context will prove just as crucial, since it will be difficult, often just for the obvious reasons of cost, to have a permanent, full-time employee within the company. Similarly, it will be difficult for self-managed funds, for reasons of independence, to appoint an internal auditor for the fund sponsor or a service provider where operational activities have been delegated.

In light of the above, the outsourcing of the internal audit function appears as one of the solutions to be considered, especially if the individual chosen has already developed a strong expertise in running the internal audit functions of other management companies in Luxembourg. In addition, the firm appointed to the role of internal auditor, if well-chosen, will be able to provide access to a wide range of specialists who will add significant value.

However, it is worth remembering, in this context, that the quality and professionalism of the service provider chosen for the outsourcing of the internal audit function is of paramount importance, and that the board is solely responsible for the quality of internal audit services that will be delivered by the third party. A decision taken only on the basis of cost reasons would be an unwise move, with potentially dramatic consequences for the AIF, AIFM, board members, and lastly, the investors.

New areas of focus for internal audit policy under AIFM

While in many of its aspects, the AIFM law is similar to the UCITS regulations, especially regarding operational matters (e.g. remuneration, conflicts of interest, delegation), new areas of focus are emerging that will have to be included in the internal audit policy. These new areas are:

- **Risk management**
  As with UCITS, each AIFM will have to implement a risk management function and respect its independence from operating units, including matters relating to portfolio management, in accordance with the principle of proportionality. The internal audit function will of course have to monitor, on an annual basis, that the risk management function has been implemented according to these principles, but its role will also be to ensure that the risk management system taken as a whole is appropriate "*to identify, measure, manage and monitor all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed*".
- **Liquidity management**
  For each open-ended AIF that the AIFM manages, it will have to employ an appropriate liquidity management system and implement a management system that will enable it to efficiently monitor the liquidity risk facing each AIF. The role of the internal auditor will be to test the liquidity management system developed by the AIFM and to review its liquidity risk management procedures, the stress tests performed by the AIFM and the coherence between its AIFs, the investment strategies, the liquidity profiles and the redemption policies.
- **Asset valuations**
  This point is probably the most sensitive, mainly because of the nature of the assets in which AIFs invest, e.g. real estate, infrastructure, artworks, land, plantation, etc. The types of assets are so diverse that it is not possible to use a single methodology to obtain the fair value.

Choosing the correct asset valuation methodology is thus a challenge for asset managers. The method by which assets are valued is determined by a number of variables, such as the underlying asset itself, the reason the asset is held, regulatory guidance and prevailing market conditions. Once the valuation method has been selected, it is important to ensure that adequate controls are in place to value the assets accurately using this methodology. This could mean ensuring the accurate capture of asset cash flows, or alternatively, ensuring that up-to-date and accurate market information is obtained. Furthermore, having appropriate systems and controls in place will help to manage valuation difficulties and guard against questionable prices going unidentified.

While the role of the internal auditor in this specific case is not to ensure that the valuation of assets is correct (this is the role of the external auditor), the internal auditor will have to ensure that the rules applicable to the valuation of assets are *"laid down in the law of the country where the AIF is established and/or in the AIF management regulations or instruments of incorporation"*. In order to prevent any conflicts of interest, the internal auditor will also have to ensure that the valuation function, whether it is under the responsibility of a third party or within the AIFM organisation itself, is independent, and respect the rules defined in the AIFM Law.

- **Fair value**
  In this environment, determining 'fair value' and what constitutes fair value is becoming increasingly complicated. There is indeed a number of additional factors to consider:
  - Is the input used representative of a price that is observable in an active market?
  - Is trading activity thin and the last price stale or not representative of the fair value on the date of valuation?
  - Is a discount warranted where market participants would not be willing to transact at the quoted price?
  - Is the price accessible to the entity in its principal market?
  - Does the last trade result in an anomalous price relative to other trades on the date of valuation?

  Internal audit can assess the existing valuation process to identify areas where additional procedures should be implemented to ensure that the robustness of the process is consistent with market expectations in determining fair value. This function can also analyse the valuation inputs used and assess whether they are representative of fair value on the valuation date by examining whether all necessary fair value considerations have been incorporated into the valuation process.

- **Broker quotes and pricing services**
  Currently, there is increased pressure on the entity performing the procedures to understand the quotes received from brokers, the pricing services and how the valuations have been determined. In this context, asset management entities may consider the following:
  - Is the broker internationally recognised?
  - Are multiple quotes available, and comparable within an acceptable variance threshold?
  - Is the quote price reflective of a market that the entity can access and transact in?
  - Does the broker trade or make a market in the quoted security?
  - Is the quote based on recent trades or on a valuation model?
  - What are the significant assumptions used in the model?
  - Are inputs based on available/observable market data?
  - Was the model subject to price validation procedures by the broker?
  - Are the inputs the same as those used for the entity's books and records?

While the role of the internal auditor in this specific case is not to ensure that the valuation of assets is correct

To respond to these concerns, the internal audit function may assess the reliability of the price obtained and whether it is reflective of the fair value of the security. It should also understand the inputs and assumptions used by the broker and challenge the reasonableness of the inputs and assumptions used and the appropriateness to the entity. Finally, the internal audit function will have to compare the consistency of inputs and assumptions used with those included in the entity's books and records.

The focus on these particular areas that fall under the scope of the internal audit function evidences that, more than being an expert in internal audit, subject matter experts will have to be involved in order to ensure an appropriate review of the most sensitive techniques. Depending on the complexity of AIFs managed by AIFMs, the impact on the internal audit budget will also have to be adjusted in order to enable the function to cover the most complex activities appropriately.

Enhanced role of depositary banks

Should the new regulatory obligations lead to significant changes in the internal organisation of AIFMs, the depositary function of banks will also have to be controlled carefully by the internal audit function, for the following reasons:

1. The first main impact identified for depositary banks relates to the new regulatory obligations of AIFM Law, which can be summarised into three main key areas:
   - *"The depositary shall be liable to the AIF or to investors of the AIF, for the loss by the depositary (…) of financial instruments"*, meaning that in the event of a loss, the depositary will have to provide compensation or return a similar financial instrument of the same type. The depositary can be considered not liable only if the asset was not a transferable security capable of being safe kept or if the loss was due to an "*external event beyond reasonable control"*
   - The extension of safekeeping responsibility meaning that:
     - Collateral provided to or provided by a third party is considered to be an asset held in custody if the AIF retains or receives title to the collateral
     - The prime broker will have to be considered as the sub-custodian

- The depositary's asset supervision duties apply to funds that are held in a nominee account in the name of the depositary
- For fund of funds, the depositary's asset supervision duties apply on a look-through basis when the underlying fund does not have a depositary or is domiciled in a third country that is not deemed as equivalent for AIFMD

• The new depositary duties:

- Cash management duties where all cash flows associated with the fund, including cash not held with the depositary, will have to be monitored by the depositary
- Subscription/redemption monitoring to ensure that all payments made by or on behalf of investors for the subscription of shares or units of an AIF have been received and booked in one or more cash accounts. The depositary should ensure it receives the relevant information it needs to properly monitor the reception of investors' payments from the AIFM
- The depositary must ensure that appropriate valuation policies and procedures for the assets of the AIF have been implemented
- The depositary has to set up a procedure to verify, on an ex-post basis, the AIF's compliance with the applicable laws and regulations and the AIF rules and instruments of incorporation
- The depositary must ensure that income is probably received and should verify the completeness and accuracy of the income distribution, and more particularly, the dividend payments

2. In addition to these new obligations, the internal auditor will have to pay particular attention to additional elements, such as the client acceptance/risk profile, the operating model, the monitoring process of the applicable risk model, the escalation and reporting performed by the depositary bank to internal committees/external parties and regulators and contracts

The AIFM Law clarifies and broadens not only the role and duties of AIFM but also the ones of depositary banks' role and duties for all non-UCITS funds, including in light of the UCITS V directive.

Internal audit will have to understand the regulations, know how to pragmatically ensure that in all situations rules will be respected, and proactively advise the management, providing appropriate recommendations to prevent risk crystallisation and add value to the company's governance, risk management and control processes.

The internal audit function will have to compare the consistency of inputs and assumptions used with those included in the entity's books and records