

FINAL REPORT

**Fiduciary Performance Audit
of the South Carolina
Retirement System Investment
Commission**

April 18, 2014



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April 18, 2014

Mr. Patrick J. Maley, Inspector General
South Carolina Office of the Inspector General
The Enoree Building, 111 Executive Center Drive, Suite 204
Columbia, South Carolina 29210-8416

Dear Mr. Maley:

Please find attached our final report on the Fiduciary Performance Audit of the South Carolina Retirement System Investment Commission (RSIC). We wish to thank the Commission and its staff, the Public Employee Benefits Authority (PEBA) and the State Treasurer's Office (STO) for their cooperation and participation in this review. Especially for RSIC, the timely accumulation and production of numerous documents, interviews and requests for clarification has been an enormously time consuming process. They are to be commended for their extraordinary responsiveness. We also wish to express our appreciation for the professionalism and cooperation of the Office of the State Inspector General (SIG) for its assistance in coordinating this review.

Recognizing that this review is the first in a series of annual fiduciary performance reviews and that this review contains over 120 recommendations for improvement targeted at the Commission, the STO and the Legislature, it will take some time and resources for the timely implementation of those recommendations which are accepted. Accordingly, we suggest that the scope of such reviews for the next several years be more focused on the status of implementation and a review of priority areas. Also included as an Appendix are our recommendations ranked in order of priority, primary responsibility and estimated degree of difficulty, as well as key stakeholders. This has been developed with input from the RSIC.

We also note that prior to the finalization of this report, the Commission has already taken a number of steps to implement our recommendations. For example, the Commission has approved a Planning Committee to review the FAS report and develop a strategic plan in collaboration with RSIC staff and has developed a charter and selected a chairperson. Appropriate staff members have been identified for each finding (subject to Planning Committee approval) and the Planning Committee has begun work with staff to develop plans to address findings identified by the committee as key focus areas. The Planning Committee intends to make recommendations regarding key recommendation areas during the May 1st Commission meeting.

The Compensation Committee has also met and will be recommending modifications to its charter to include: the addition of HR oversight as a committee responsibility; the addition of required annual

review of RSIC's implementation of the Compensation Policy; the addition of required procurement of a new peer compensation study at least every three years to assess RSIC staff compensation; and they have already developed and posted a new HR Director position description. They have also created the Director of ERM Position.

The Commission's enthusiastic and early embrace of our recommendations is most encouraging as a demonstration of its commitment to continue to fulfill its fiduciary responsibilities, develop its capabilities and move forward. We sincerely hope this report is of value to the RSIC, the beneficiaries of the fund and its key stakeholders as the Commission continues to develop its capabilities and fulfill its fiduciary responsibilities as it continues to move forward.

Very truly yours,

A handwritten signature in blue ink, appearing to read 'Rick Funston', with a stylized, cursive script.

Rick Funston
Managing Partner
Funston Advisory Services LLC

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Executive Summary

In December 2013, the South Carolina Office of the State Inspector General (SIG) engaged Funston Advisory Services LLC (FAS) to conduct a fiduciary performance audit of the Retirement System Investment Commission (RSIC). The purpose of this audit was to critically evaluate the fiduciary roles and responsibilities of the RSIC Commissioners and staff, the relationship with other fiduciaries of the Retirement System, and the operational policies and practices of RSIC. The goal of the review was to identify areas of strengths and weaknesses, provide comparison with leading practices of other public pension plans, and make improvement recommendations.

Because RSIC is a relatively new state agency, the review was designed to be broad in nature, spanning all key functions. The review of these functions was organized into six categories:

1. Governance;
2. Policy Review and Development;
3. Organizational Structure;
4. Investment Administration;
5. Legal Compliance; and
6. Information Technology.

The review of each category required that specific items identified in the Request for Proposal must be addressed; however, those items were not intended to limit our creativity in assessing each category. We were authorized to review any policy, process, or procedure typically reviewed when completing this type of project. We were also asked to use our judgment, experience and creativity in conducting the fiduciary performance audit.

Context

The Retirement System Investment Commission is currently less than ten years old and continues to develop its capabilities. When the RSIC was launched in 2005, there were six commissioners and an Administrative Director/ General Counsel. A new Chief Investment Officer (CIO) came on board in April 2006, roughly six months later, and three full-time employees joined him in January 2007. The new Commission was charged with investing and managing \$25 billion in retirement assets. A key feature of the new statute was to mandate the Commission with diversifying the fund's assets unless "the Commission determines that, because of special circumstances, it is clearly not prudent to do so".

Accordingly, the initial strategy adopted by the Commissioners, in consultation with their general investment consultant, CIO and external managers, was to diversify a traditional stocks and bonds portfolio to improve long-term returns and better manage total fund risk. They also chose to do so rapidly.

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Numerous past practices were examined in this fiduciary performance audit to better understand the context, evolution and maturation of the RSIC. Unfortunately, infrastructure did not keep pace with investment strategies (e.g., private equity, strategic partnerships, etc.) as initial back office and risk management procedures and support systems were often weak, manual and ad hoc. Due to limited resources, the Commissioners also became very involved in investment operations such as due diligence. Many of these legacy weaknesses have since been identified and have been or are being addressed by the Commission. During the past two years, RSIC's processes have evolved to become much more robust and systematic.

Overall Conclusions

1. There are no red flag indicators of malfeasance or misfeasance regarding the Commission's current policies and practices. This is consistent with the findings of the SIG July 2013 report.¹
2. Investment fee transparency, policies and controls have improved significantly; disclosure of total external management fees is the most complete in the industry.
3. Recent RSIC manager selection and due diligence processes are consistent and thorough, although sometimes slower than industry norms.
4. RSIC has been implementing a number of strategies which should result in lower external manager costs. These include:
 - Shifting out of "funds of funds" structures into direct investments in hedge funds.
 - Reducing the number of managers thereby increasing the average size of individual mandates.
 - Renegotiating manager contracts to reduce fees.
 - Adopting more passive investing for publicly traded assets.
5. The lagging development of infrastructure results in growing operational risks, and ultimately financial risk. There are several contributing factors including:
 - The need for the Commission to develop a new long-term strategic plan, including an infrastructure plan;
 - The annual legislative budget approval process;
 - Existing state procurement laws and policies relating to acquisition of investment systems and support;

¹ The Office of the State Inspector General. Review of "Red Flag" Indicators of Potential Wrongdoing At the Retirement System Investment Commission. July 2013.

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- RSIC's consistent under-spending of allocated funds; and,
 - The indirect relationship RSIC has with the custodial bank.
6. A new independent investment cost effectiveness study by CEM Benchmarking was also commissioned as part of this audit. The intent was to gather facts that would enable more of an "apples to apples" comparison of RSIC's performance and fees to those of other funds. Descriptions of the CEM methodology, quality control and the contracting process are contained in Appendix F together with an Executive Summary of the results. While the results are discussed in more detail in *4. Investment Administration*, the CEM study concluded:
- RSIC's portfolio strategy has underperformed its peers over the five year period ending December 31, 2012. This was also true for other funds with asset allocation strategies similar to RSIC, i.e., larger allocation to alternative investments.
 - RSIC staff has been able to add value above the asset allocation policy through its management of the investment portfolio.
 - RSIC's management costs for CY2012 were 103.0 bps, compared to the peer average of 61.1 bps. RSIC's management costs were highest in the peer group, largely due to the heavy weighting to alternatives and their associated higher costs.
 - When compared to other funds with similar asset allocations, RSIC's external management fees are normal and not excessive.
7. RSIC has already implemented many improvement initiatives over the past two years. These include, for example:
- Improved focus on investment management costs, consolidation of managers, and fee reduction.
 - Improved due diligence and contract review processes, including creation of an operational due diligence function.
 - Increased information flow to the Commissioners.
 - Improved Commission meeting agenda development process.
 - Implemented a technology solution to provide for document sharing with the Treasurer's staff and Commissioners.
 - Improved fee validation procedures and data collection process by moving to a quarterly process.
 - Provided a formal management representation letter to PEBA and the external auditor annually.
 - Adopted formal Joint Valuation policies between PEBA and RSIC.
 - Completed a comprehensive review and update of the Governance Policy Manual.

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- Established the Internal Audit and Compliance function and formalized policies and processes.
- Purchased and implemented a research management/contact management database program.
- Improved attention to operational and risk management needs.
- Improved ethics compliance and disclosures, including employee Code of Ethics Acknowledgement, Personal Trading Policy, Gifts and Conflict of Interest Policy, and Whistleblower Policy.

Additional recommendations for improvement are summarized at the end of this section and throughout the body of this report according to each of the six areas of scope.

Pervasive Themes

Five improvement themes have emerged which cut across all areas of scope:

1. Improve assurance and independent reassurance to build trust and confidence.
2. Build capabilities across the organization (including HR, IT, Accounting, etc.).
3. Reset Commissioners' focus on strategy and oversight.
4. Align fiduciary duties and responsibilities.
5. Improve the custodian relationships.

Like the SIG review, we are deeply concerned about the continuing dysfunctional relationship between the Commission and the Treasurer's Office. According to the SIG review, while these dysfunctions may have been triggered by *"actual process shortcomings in management fee accounting, due diligence, and the investment contract approval, and RSIC seemed to not prioritize, until recently, addressing infrastructure process issues..."* *"The genesis of the dysfunctional communication likely has its origins in RSIC's process of disseminating confidential information. Initially, the RSIC implemented cumbersome informational access logistics for the Treasurer, as well as the larger issue of completely excluding his staff's access to confidential information. RSIC's initial restrictive approach was likely the result of a conservative legal analysis. This, in turn, only ramped up the Treasurer's information requests to RSIC staff in both volume and tone, which further strained the relationship."*²

The SIG report concludes, *"This intense RSIC and STO relationship, despite the increasing negativity and dysfunction, did have a 'silver lining' benefit. Over the past two years, this conflict has encouraged RSIC introspection on both operational infrastructure and AI (Alternative Investments) portfolio, in terms of portfolio concentration and fee structure, which have yielded some benefits. However, this conflict has clearly entered into a counter-productive cycle where information exchange or presentations tend to be*

² Ibid. OSIG 2013

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skeptically viewed as slanted, self-serving, and having a bias towards fault finding, thus limiting common ground to move forward. In short, the workplace atmospherics are increasingly toxic and are undermining RSIC's energy and focus on its core mission."

The Treasurer recently vehemently reiterated his view about his right to information in a memo to FAS and SIG.

"With the most serious sentiment I can muster, please know that I believe the genesis of the problematic relationship between the RSIC and STO is the intentional withholding of information that is due to me as a fiduciary. Even though you (FAS and SIG) both have opined on this I want to state as plainly as possible that to this very day I am routinely denied access to important, and in fact necessary information, that I need to perform my duties. I have outstanding requests that have been ignored, or dismissed for over 6 months. Most of these requests (sic) would take a few moments of a junior staffer's time to forward the information, yet, they regularly breach their fiduciary responsibility and deny me the access I am due by law and custom.

Regardless of the other issues you are detailing in the fiduciary audit, this is headline one, page one, chapter one. The RSIC refuses to provide relevant important information to its fiduciaries and until that happens there will be disharmony regardless of any governance or statutory provision that may be in place."³

There is no question the Treasurer, as a fiduciary, has the right to any and all information from RSIC and it should be provided on a timely basis. However, trust is a two-way street. It appears that where the parties stand on an issue depends on where they sit. Unfortunately, from the perspective of RSIC it would appear that the Treasurer's purpose in obtaining such information goes beyond reasonable oversight. While requests for detailed information in selected instances could certainly be an appropriate exercise of oversight, as noted in *Section 4 - Investment Administration*, the SIG report found that in a three month period in 2012, the Treasurer's Office made over ninety information requests (97% of all requests made by Commissioners). This is despite the fact RSIC has an on-line portal to give all Commissioners access to the same data all at the same time. Apparently, many of the Treasurer's requests were made directly to staff bypassing appropriate lines of authority. This matter is further addressed under *Recommendation I19: Commissioner Access to Information*.

Beyond seeking reasonable assurance, given the level of criticism by the Treasurer of RSIC, RSIC came to believe that the primary purpose of the Treasurer was to find fault. As noted by the SIG and as we have found, the pattern continues. RSIC, perceiving itself to be under constant attack and threat of pending litigation, took and continues to take considerable care and caution in responding to such requests. This has created delays in responding to what might otherwise be simple information matters.

The Treasurer concluded his memo with the following statement: *"Trust cannot be earned under these circumstances, and it is unreasonable to believe that good can come out of the willful and premeditated RSIC policies that are illegal and unethical."*

³ Email from C. Loftis to R. Funston (FAS) and P. Maley (SIG) April 17, 2014.

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However, like the SIG, the State Law Enforcement Division (SLED) and the State Ethics Commission investigations (while the fiduciary performance audit was not a forensic investigation), FAS found no evidence of criminal wrong-doing. Nor did we find any evidence of unethical or illegal policies. Quite the contrary, we found that the Commission has made and continues to make considerable strides in improving the robustness of its policies and procedures to prevent and detect any such occurrences. While FAS found RSIC's fee disclosures are the most transparent in the nation, the Treasurer agrees they are among the most transparent. Thus, the continued use of such hyperbole by the Treasurer cannot possibly have a positive effect on restoring an effective working relationship between the co-fiduciaries.

Unfortunately, the fragmented and ambiguous allocation of fiduciary authority contained in the law of South Carolina creates multiple areas for inherent conflict between the various Retirement System fiduciaries, due to overlapping fiduciary powers. There has been a great deal of hyperbole and ad hominem attacks from both the Commission and the Treasurer's Office. Recently, it seems these hostilities have even escalated. Personal attacks undermine the credibility and validity of points made by each party and can be too easily dismissed as either personally or politically motivated. These attacks must stop if there is to be any hope of progress and restoration of trust. The dysfunctional relationship between co-fiduciaries has become what we believe is one of the most significant risks faced by Retirement System participants and stakeholders today.

Once these attacks are stripped away, a fundamental source of disagreement seems to emerge. The Treasurer appears to prefer a more simple and less costly approach to investment management while the Commission has opted for a strategy that is more complex and, therefore, more costly to execute and more difficult to explain.

However, the vote on who has the authority to make such decisions has already been cast by the Legislature when in 2005 it transferred full authority for investment decisions to the RSIC. Thus the appropriate time and place to discuss strategy and asset allocation is within Commission meetings and the cadence of its planning calendar and not in the media. Neither individual Commissioners nor the Treasurer have the authority to make those decisions; the Legislature has assigned that responsibility solely to the full Commission.

The Commission is comprised of one of, if not, the most highly credentialed public pension Boards or Commissions in the country. It has made deliberate decisions in terms of its strategy and related costs that are likely difficult for the layperson to understand. As a public entity, the Commission should recognize that it has a responsibility to proactively communicate that strategy in ways that are understandable to its key stakeholders to avoid potential confusion and conflict.

For the past three years, the Treasurer has raised legitimate concerns about the effectiveness of the strategy and its costs as well as the lack of infrastructure to support such a strategy. He has also raised legitimate questions about RSIC's sense of urgency in improving staffing, systems and controls, and RSIC has responded with many improvements, especially in the last two years as noted above. See also *Appendix B RSIC Improvements Timeline*.

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In each of the last five years, between 19% and 37% of RSIC's appropriated dollars were unspent and returned to the trust funds (remembering these are retirement fund dollars, not the State's General Fund). This somewhat undermines the strength of RSIC's arguments for greater budget autonomy even while there are valid reasons for the Legislature to grant such autonomy, and while the trend nationally is to provide greater budget autonomy to pension funds and investment boards. We do note that there are several factors that constrain the RSIC's ability to spend its allocation within the fiscal year including State procurement and civil service requirements. This issue is discussed further under Section 1 *Governance*. Accordingly, RSIC could and should do a better job of budget planning and management to take advantage of its existing allocations.

In the past three years, there have also been two allegations of conflicts of interest involving current commissioners. As our fiduciary performance audit is not a forensic investigation, we will not comment other than to say both allegations were investigated by the State Law Enforcement Division and, in one case, also by the State Ethics Commission. Neither found evidence of wrong-doing, although the Ethics Commission stated "an appearance of impropriety does exist." Such allegations, in addition to the spate of continuing public confrontations, only serve to erode RSIC's reputation. In February, 2013 RSIC revised its "Standards of Conduct for Commission Members: Conflicts of Interest" policy to provide greater clarity of expectations. We have also made a recommendation to further strengthen those policies. Henceforth, it is essential in the future that all Commissioners avoid even the perception of a conflict of interest or impropriety.

Lack of progress in improving the relationship between the Commission and STO may also be related to a number of legacy governance and structural issues which confound clear fiduciary decision-making authority and reflect a highly fragmented system. For example, there are currently several fracture lines related to issues such as segregation of duties, securities lending, custodial authorities, signatures required, contract reviews, and authorization processes for movement of money. The result is a continuing process of friction and abrasion that often erupts into open conflict between competing authorities. Lack of clear authority also equates to a lack of clear accountability. There are at least five state entities which exercise some fiduciary authority with regard to the five defined benefit plans. Another four provide some type of oversight function to the RSIC. While the current dysfunctions have largely been between the Treasurer's Office and the Commission, it is foreseeable such conflicts could arise between any of the many fiduciaries and oversight bodies.

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Overarching Recommendations

The following overarching recommendations attempt to provide a constructive means to improve the relationship and the effectiveness and efficiency of the Commission. The first three of the five major recommendations are largely within the control of the RSIC to plan and implement.

1. Improve assurance and independent reassurance to build trust and confidence.

As noted earlier, providing reasonable assurance to the Commission is the responsibility of RSIC executives. Typically, such executive assurances include assertions that the organization's people, processes and systems are capable and risks are managed within the agreed upon exposure limits. Independent reassurance should also be obtained that management's report are reliable. Independent reassurance must come from those independent of management, such as external financial audits conducted under the auspices of the State Auditor who selects the external auditor for PEBA and thus for RSIC.

Independent reassurance can also come from consultants retained directly by the Commission, for example, Hewitt EnnisKnupp (HEK), the general investment management consultant. It also includes Internal Audit and Compliance, which reports directly to the Audit Committee. The accounts payable and payroll procedures audit conducted by the Comptroller General as well as fiduciary performance audits under the auspices of the State Inspector General are yet other sources. As noted earlier, while offering reasonable assurance and reassurance, no audit can provide an absolute guarantee of compliance or the absence of misconduct. Nonetheless, reasonable assurance is still a high standard.

There are additional reassurance steps that can and should be taken. For example, as discussed in Section 1. *Governance*, the Commission can directly retain an external firm to assess valuations of underlying investments and/or internal controls. RSIC should also institute a system of Enterprise Risk Management (note: the establishment of a new Enterprise Risk Management function and program was approved at the March 13, 2014 Commission meeting, to take effect as of July 1, 2014). The mandate and investment recommendation responsibilities of the Internal Investment Committee should be clarified to enhance assurance. The Commission should retain the services of an independent expert to perform annual benchmarks of fund returns and management fees.

2. Build capabilities across the organization (including HR, IT, Accounting, etc.).

The Commission relies on certain key personnel for its successful operation. The loss of key personnel would severely jeopardize its operations, and in the current environment, it would be difficult to recruit their replacements. The Commission also needs to build its HR capabilities and IT systems, the continued absence of which will contribute to operational risk. These include needed improvements in infrastructure planning, procurement and governance, and developing an investment accounting capability. We recognize that budgetary approval necessary to build these capabilities is required from the Legislature. This is discussed further below under 4. *Align fiduciary duties and responsibilities*.

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3. Reset Commissioners' focus on strategy and oversight.

When RSIC was launched in 2005, there were six commissioners and an Administrative Director/ General Counsel with an Administrative Coordinator. The new CIO started in April 2006, and three additional full-time investment staff joined in January 2007. They were all charged with investing and managing \$25 billion. Due to limited resources, the Commissioners became very involved in investment operations such as due diligence. Initial back office and risk management procedures were often manual and ad hoc if they existed at all. As noted above, during the past two years RSIC's processes have evolved to become much more robust and systematic.

RSIC has reached a point in its capability development where the Commissioners now need to reset their focus to strategic issues such as asset allocation. They should also develop a statement of investment beliefs to guide the asset allocation and oversee the development of asset class plans. The Commission should also expand the charters of its two standing committees to become Human Resources and Compensation and Audit and Enterprise Risk respectively. RSIC also should improve the Commissioner's self-assessment and self-development processes.

Other improvements, perhaps many of the most significant factors affecting performance, are not within the control of the Commission. There are a number of legacy issues caused by statutory inconsistencies in fiduciary responsibilities and authorities that need to be addressed by either the Legislature or the Budget and Control Board (BCB) and its successors.

4. Align fiduciary duties and responsibilities.

In answer to our earlier questions: "Who are the fiduciaries? What are their authorities? Do their authorities match their duties? Are these duties in conflict with other roles played by the various Commissioners?" we find that the Retirement System has one of the most complex governance structures among state investment boards, with five separate entities that exercise fiduciary powers with overlapping authority for exercising fiduciary functions: the BCB, the Legislature, PEBA, Treasurer as Custodian, and RSIC. The authorities of the Commissioners do not match their responsibilities and duties, there are inherent conflicts in the roles played by the Treasurer as Custodian, and accountabilities are muddled.

The role of the Budget and Control Board (the future Department of Administration and the State Fiscal Accountability Authority), as a Named Trustee and a fiduciary, is unclear with respect to RSIC oversight. Meanwhile, the Legislature has retained authority to approve budgets and staffing for RSIC and also sets the assumed rate of return on retirement system investments.

Retirement system management and administrative responsibilities are divided between PEBA and RSIC; for example, RSIC and PEBA have agreed to assign responsibility for the accounting and audit functions of the retirement fund to PEBA, and PEBA is responsible for the "book of record" for the retirement funds. The State Treasurer, a member of the BCB and a Commissioner, is also the Custodian of the retirement funds, yet RSIC is vested with exclusive investment authority for the retirement system funds.

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Conflicts between fiduciaries have arguably added to retirement system costs, resulted in foregone investment opportunities, and added to enterprise-level risk exposures. Review and rationalization of the statutory structure for allocation of fiduciary authority and responsibilities is needed to address these and other issues.

To address these conclusions, we recommend to the Legislature:

1. Clarify fiduciary responsibilities, if any, which remain with the BCB and, subsequently, with the new Department of Administration and the State Fiscal Accountability Authority.
2. In setting the expected rate of return, regularly review the process and underlying assumptions, or delegate the function to PEBA or RSIC, and establish a 5-year cycle for the review.
3. Enable the Commission to create the position of CEO/Executive Director as a single direct report to the Commission with the CIO reporting to the CEO.
4. Delegate selection of outside counsel to RSIC.
5. Delegate authority to the Commission for operational budgetary control and the setting of staff compensation and performance incentives.
6. Provide an exemption to the State procurement policy for investment management systems (this could also be accomplished through the BCB).
7. Expand the qualification criteria for Commissioners to recognize relevant experience and to allow for Commissioners with expertise in managing large, complex pension funds and investment operations.
8. Increase the number of voting Commissioners by one or three so as to establish an odd number of voting Commissioners. This could include consideration of making the PEBA representative a voting member, recognizing this would require an exemption for a state employee.

5. Improve the custodian relationships.

RSIC describes the custodial relationship with the Treasurer and BNY Mellon as cumbersome, strained and inefficient, and that difficulty has resulted in RSIC looking elsewhere for needed services. This may be due to several factors. First, it should be understood the role of the custodial bank has significantly changed over time, much as has the role of the Treasurer in other jurisdictions. Custody has increased from just safekeeping to include many services which are essential to the smooth and effective functioning of today's public funds. Today's effective custodian is at least as much a technology and data management facility as a lockbox.

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Second, with very few other states as exceptions, it is industry practice to have the fund contract directly with the custodial bank.⁴ The role of the Custodian is discussed further in *Section 4 - Investment Administration*.

Third, there may be conflicts in the role of the Treasurer as a Commissioner and as Custodian. In interpreting the role of the Custodian, the Treasurer may be able to exercise a veto over the Commission's investment decisions. This has already resulted in a lawsuit between the Commission and the Treasurer's office. This is discussed further in *Section 1 - Governance*.

In *Section 4 –Investment Administration*, we present several options and the associated pros and cons to resolve these difficulties with the Custodial bank's role, the Treasurer's role as Custodian and custodial bank contracting, ranging from the status quo, improvements to the status quo, giving RSIC authority to contract with its own custodial bank with the Treasurer remaining as custodian of record, making PEBA custodian of record with RSIC having custodial contracting authority, to transferring full custodial authority to RSIC (the most common model at other public pension funds in the U.S.)

Summary of Recommendations

The following is a summary of recommendations according to each of the six areas of scope. In Appendix Q, we provide our perspective on the priority of implementation, degree of difficulty and suggested responsibility. Note: The numbering of our recommendations is based on the numbering of our conclusions. In some cases, we do not make a recommendation based on the conclusion. For this reason, it may appear that we skipped a recommendation.

1. GOVERNANCE

G1: The Legislature should better align Retirement System governance authority with assignment of obligations and clarify what fiduciary responsibilities, if any, still reside with the BCB and, subsequently, the Department of Administration and the State Fiscal Accountability Authority.

G2: The Legislature should resolve the Treasurer's conflicting fiduciary duties (alternatives are discussed in I17).

G3: The Legislature should delegate selection of the custodial bank and management of the relationship to the RSIC (alternatives are further discussed in I17).

G4: The Legislature should revise legislation to allow the Commission to designate a single direct operating report with the title of either Chief Executive Officer (CEO) or Executive Director, and not require that the Chief Investment Officer (CIO) report directly to the Commission.

⁴ FAS Public Pension Benchmark Database, Funston Advisory Services LLC.

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G5.1: The Legislature should delegate authority for operating budget, staffing and all compensation approval to the Commission.

G5.2: RSIC should review its annual budget planning process to ensure that it is using existing allocations to full advantage and that requests for increased resources are based on a realistic assessment of staff and systems the organization can assimilate during the next budget period. The Commission should conduct a mid-year review of year-to-date and projected expenses compared to budgeted amounts.

G6: The Commission should have an annual external financial audit or an agreed upon procedures review of fund valuations, procedures and/or controls, consistent with other investment boards; either the Commission or a state agency (e.g., the State Auditor) could select the external firm.

G7: Decision-making within strategic partnerships should be assessed in the context of how all RSIC investment decisions are made and adjusted accordingly, if appropriate (see Recommendation I12.1).

G8.1: The Legislature should revise the Commissioner's qualification requirements to achieve a more diverse composition of members, including some Commissioners with a broader business experience beyond investments which is not as reliant on professional certifications when there is significant practical experience.

G8.2: The Legislature should consider adding one or three additional voting members to the Commission to increase diversity, increase beneficiary representation and reduce the potential for tie votes (making the PEBA representative a voting Commissioner could be an option, but would require an exemption from the prohibition for a state employee).

G9: The Legislature should consider imposing term limits for Commissioners.

G10.1: The Commission should work with its general investment consultant and develop a set of investment beliefs to provide a basis for strategic management of the investment portfolio.

G10.2: In addition to an annual review of the asset allocation, throughout the year the Commission should review and discuss asset class strategies with the investment staff and provide oversight.

G10.3: The Commission should shift its emphasis from a focus on advising on specific investments and participating in due diligence to providing oversight and strategic guidance to staff. This would include eliminating the assignment of asset classes to individual Commissioners and, as a general rule, preclude Commissioner's involvement in investment due diligence except as observers for either overseeing staff processes or for Commissioners' education and training purposes.

G12.1: The Commission should plan more frequent meetings, at least bi-monthly, and develop standing agenda items annually and for each meeting (e.g., asset allocation, investment beliefs, specific asset class reviews, infrastructure business plan review, etc.) (see also Recommendation I6.1).

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G12.2: The revised protocol for the agenda setting process should be formally adopted by the Commission and incorporated into the Governance Manual.

G12.3: Improve the effectiveness of Commission self-assessments by providing evaluations of individual Commissioners, utilizing peer-to-peer and upward evaluations (from RSIC staff), and providing individualized feedback and personalized improvement goals.

G12.4: Develop an overall continuing education plan for Commissioners, including an on-going education budget for the Commission and plans for individual Commissioners.

G13.1: The Audit Committee should review and approve the Internal Audit Charter.

G13.2: Develop and implement an Enterprise Risk Program, as called for in the Governance Policy Manual and approved at the March 13, 2014 Commission meeting, and ensure the necessary tools are acquired to support effective risk management and oversight.

G13.3: Add responsibility for Enterprise Risk Management to the Audit Committee charter; consider changing the name to the Audit and Enterprise Risk Committee.

G13.4: An independent third party expert firm should regularly benchmark fund returns and costs (see Recommendations G18.4 and I11.2).

G14: The Commission should adopt a mid-year review process for its direct reports to provide guidance and interim feedback.

G15.1: As part of a shift in emphasis by the Commission to enterprise oversight, the Compensation Committee charter should be expanded to include oversight of human resources and infrastructure and to provide guidance to staff on human resources and capability development.

G15.2: The Compensation Committee should change its name to Human Resources and Compensation to reflect the new focus.

G16.1: The role of the Internal Investment Committee (IIC) should be clarified.

G16.2: If the named member of the IIC is not available (due either to being out of the office, on vacation, or the position being vacant), the next ranking staffer with similar responsibilities should attend IIC meetings to ensure appropriate participation.

G16.3: The CIO should routinely invite other investment, operations and legal staff to attend IIC meetings as visitors so as to facilitate dissemination of information across functional silos.

G16.4: The CIO should consider whether to mandate annual plans by asset class and/or functional area. If so, the plans should be presented to the IIC to facilitate dissemination and cross-silo knowledge sharing.

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G18.1: RSIC's communications policy should be reviewed and revised, as appropriate, to address who is responsible for proactively speaking out on behalf of the RSIC and any policies which might be necessary to develop key messages.

G18.2: RSIC should develop a communications plan which identifies each key stakeholder group, considers what information is important for each stakeholder to know, and identifies responsibility for maintaining stakeholder communications.

G18.3: In the communications plan, RSIC should consider an initiative to draw greater national attention to the need for all public pension funds to disclose costs in a consistent way and for investment managers to provide the level of reporting necessary to accomplish that objective.

G18.4: RSIC should conduct a periodic benchmarking of its returns and costs by an independent expert to provide added assurance to stakeholders about the facts of its performance compared to peers (see Recommendation G13.4).

G19: RISC should confer with PEBA to determine whether legislative action is needed to ensure that a funding mechanism is in place for the State's indemnity and defense obligations that are not covered by insurance.

2. POLICY REVIEW AND DEVELOPMENT

P1.1: The Commission should, as a general rule, preclude Commissioners' involvement in investment due diligence except as an observer for occasional educational purposes (see also Recommendations G10.3 and I5.1).

P1.2: When the Commission's investment beliefs have been articulated, they should be included in the Statement of Investment Objectives and Policies (see Recommendation G10.1).

P1.3: The Governance Policy Manual should be revised to describe the potential role of a Commissioner in due diligence activities as an observer for educational and quality assurance purposes only, and that as a general rule Commissioners are not involved in due diligence activities (see also Recommendations G10.3 and I5.1).

P2.1: A counterparty acceptance and monitoring policy should be developed and implemented.

P2.2: The broker selection policy should be strengthened and require periodic reaffirmation by the fixed income team.

P2.3: RSIC should finalize the proxy voting process rules that are in development, require that investment managers vote in the best interests of plan participants, monitor how managers are voting proxies and include a field to track voting in Tamale.

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P2.4: Policies which describe responsibilities for securities litigation activities should be refined to clarify approval roles of RSIC Legal, the Commission and Attorney General.

P2.5: The staff conflict of interest policies should be modified to include more guidance on what is covered by the statutory standards of conduct.

P2.6: RSIC should consider developing and implementing a policy which requires Commissioners and senior investment staff to disclose personal financial or legal distress.

P2.7: The Sudan divestment policy should be finalized (see Recommendation L4.2).

P2.8: RSIC should consider developing a flowchart which describes the investment review and approval process, including responsibilities and timelines.

P2.9: RSIC should develop a referral tracking and reporting mechanism, like the sourcing and conflict disclosure process used for investments, to cover service provider referrals.

P3.1: Continue to allow standing instructions for the custodial bank to receive incoming funds and allow sweeping of cash to maximize income.

P3.2: Review the positions required to sign to release cash transfers with the custodial bank and revise the requirements to allow two appropriate RSIC signatories, one from investments and the other from operations.

P3.3: Instruct the custodial bank to accept signatory changes based upon a letter from the Commission Chair or the RSIC COO and CIO (or CEO if a CEO position is created).

P3.4: STO should revise its policies to allow electronic payment authorization for release of funds to cover capital calls using the existing technology offered by BNY Mellon.

P4.1: The Compensation Committee should conduct an annual review of RSIC's implementation of the Compensation Policy.

P4.2: The Commission should engage an independent expert to conduct a new peer compensation study at least every three years to assess the current level of RSIC staff compensation and make revisions to the target ranges, as appropriate.

P5: To facilitate timely acquisition and implementation of information systems, RSIC should develop a proposed modified procurement process for approval by the BCB or the Legislature which would allow acceptable transparency and objectivity, improve the ability to evaluate, select and implement new systems, as needed, and include documentation to allow oversight on a post-purchase audit basis (rather than imposing pre-purchase restrictions).

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3. ORGANIZATION STRUCTURE

O1.1: RSIC should consider creating the position of chief executive officer who would be accountable to the Commissioners for managing the entire organization.

O1.2: Given the delay in the migration to internal management, the CIO (hopefully in conjunction with the new senior HR professional) ought to examine the way the investment team is organized today to determine if staffing is aligned with AUM, complexity and risk.

O2: The RSIC should develop an enterprise-wide capabilities and resources assessment and determine:

- 1) What are the overall support needs and priorities?
- 2) Where are the major resource gaps?
- 3) Should the gaps be filled through internal and/or external resources?

O3.1: A senior human resources professional position should be created and filled to lead development of an overall HR strategy to support the organization's business plan.

O3.2: Policies and processes should be developed which ensure that the HR implications of proposed new initiatives are recognized and addressed before launch.

O3.3: RSIC should implement more thorough compensation planning and evaluations to enable recruitment and retention of highly skilled and experienced staff (see Recommendation P4.1).

O3.4: More formalized staff training and development plans and programs should be developed.

O3.5: RSIC should utilize succession planning, including cross-training and other actions, to develop staff for broader responsibilities.

O3.6: The Human Resources function should provide leadership for development of a multi-year (3-5 year time horizon) infrastructure business plan which considers the needs and priorities of the organization.

O3.7: RSIC should develop an internal governance process to plan and manage capability and infrastructure development.

O4: RSIC should adopt a standard process for documenting, approving and updating operational procedures and should continue its effort to provide on-line access to them as they are completed.

4. INVESTMENT ADMINISTRATION

I1: If the Legislature continues to set the expected rate of return, it should regularly review the process and its assumptions on a periodic basis. Ideally, that cycle should be set to take advantage of the information available from the every five year PEBA experience study and RSIC's asset liability study.

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I2: The Commission should spend more time discussing its underlying investment beliefs and ensure that the asset allocation strategy remains consistent with those beliefs (see Recommendation G10.1).

I3.1: As part of an overall infrastructure development plan, the RSIC should continue to prioritize a new risk management system and capability as a top priority.

I3.2: RSIC should create a Risk Management/Investment working group to design the functionality of risk reporting.

I3.3: Investment risk management should be a participating member at all IIC meetings.

I3.4: Risk Management should produce an annual plan which is reviewed and approved at the IIC; this should improve risk discipline, provide a benchmark for performance evaluation, create an opportunity for other investment officers to understand Risk Management capabilities, and improve communication.

I3.5: The RSIC should explore whether the secondary market in LP interests could help it rationalize its private equity portfolio, while keeping in mind the variable inefficiencies of that secondary market.

I4.1: The overall RSIC infrastructure development plan should fully consider and incorporate the staffing, systems and policy requirements to significantly increase internal asset management and manage risk prior to significantly expanding the current limited amount and types of assets managed internally.

I4.2: RSIC should adopt a formal counterparty risk policy (see Recommendation P2.1).

I4.3: RSIC should review its broker/dealer selection policy with an eye towards increasing its robustness by creating objective measures for acceptability and setting a time period for reaffirmation of the acceptable broker/dealers (see Recommendation P2.2).

I5.1: The policy of Commissioner Involvement in due diligence should be changed to limit participation to no more than occasional involvement as an observer for educational or reassurance purposes only; Commissioners could be invited to all manager meetings held in Columbia (see Recommendations G10.3 and P1.3).

I5.2: Ideally operations should perform on-site reviews of all potential new managers. If staffing makes that impractical, the RSIC should adopt a formal operational due diligence calendar so as to a) minimize the number of managers hired without such an on-site visit, and b) prioritize an on-site operational visit as soon as possible following selection.

I5.3: Operational due diligence to the IIC should require a sign off from the head of RSIC operations.

I5.4: RSIC should clarify the level of authority operations has on manager hiring and retention. Two potential options would be to give a veto to operations or, alternately, to mandate that should the CIO decide to recommend an investment despite operational concerns, an operations memorandum should go to the Commission along with the CIO's recommendation explaining why the investment should be made notwithstanding operation's concerns.

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I6.1: RSIC should re-assess its due diligence practices towards identifying opportunities to streamline and reduce the cycle time of activities without impacting the thoroughness or effectiveness of the overall process. Among the possible improvements would be: weekly management report of due diligence progress at the IIC, addition of a paralegal to co-ordinate legal reviews and with outside counsel (see also Recommendation L1.2), and more frequent Commission meetings (see Recommendation G12.1).

I6.2: RSIC legal staff should work with outside counsel to standardize contracting practices where possible. This should reduce delays in the contracting process (see Recommendation L2.1).

I6.3: The Commission should seek alternate means of assuring and reassuring itself as to the quality of the legal review, thereby enabling it to eliminate the 30-day review period before funding.

I7.1: RSIC should consider establishing a formal policy for frequency of site visits to external managers as part of the monitoring process. Leading practice is to make the periodicity annual, but given staff constraints and the existing semi-annual contact requirement, a biannual periodicity could be considered.

I7.2: RSIC should consider how it wants to gain assurance that managerial trading is efficient. It could suggest that its external managers trading in public securities provide independent trade execution measurements, or engage a trade execution management vendor itself to “spot check” external managers.

I9.1: RSIC staff should update the 2012 plan for expanded internal management and include a full business plan which considers all requirements (see Recommendation I4.1).

I9.2: RSIC should continue to pursue reductions in fees where it pays greater costs than its peers, taking into account potential net return and risk.

I9.3: RSIC should consider whether the use of a pool of asset-class specialist consultants to perform due diligence on co-investment opportunities would be beneficial and consistent with current asset allocation plans.

I10.1: RSIC fee reporting for alternative investments should be restructured to improve transparency and comparability with peer funds; management fees should be broken down into invoiced and non-invoiced management fees, performance fees and carried interest, and pass-through fees.

I10.2: Investments in strategic partnerships should be allocated to the appropriate asset classes for performance and fee reporting in the PEBA CAFR.

I11.1: Given the controversy the decision to disclose all external manager fees has engendered, the Commission should more clearly articulate its policy decision.

I11.2: The RSIC should contract with CEM, or a similar service from another provider, on an annual basis to develop a source of “apples-to-apples” benchmarks of investment management costs for each asset

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class and for the entire fund, as well as to provide an additional source for returns performance benchmarking (see Recommendations G13.4 and G18.4).

I12.1: The RSIC should formalize its policies with respect to oversight of the strategic partnerships and controls over underlying investments within RSIC, e.g., use of the IIC to vet investments, two RSIC staff participating in meetings, etc. (see Recommendation G7).

I12.2: RSIC should develop a guideline, rather than current situational decision making, for when and how much long-only, traditional assets should be in strategic partnerships.

I12.3: RSIC should develop a guideline regarding the appropriate level of cash to remain within strategic partnerships and for the return of any cash in excess of partnership needs.

I12.4: The Commission should take increased advantage of the information, insights and experience resident in the RSIC's strategic partners. In-person education programs in Columbia would be one possibility, either in conjunction with regularly scheduled Commission meetings or, as in the past, at special educational or strategic planning retreats in-state.

I13: Rebalancing policies should be revised to require a quarterly rebalancing review to be scheduled on the annual meeting calendar of the IIC or Wednesday markets meeting to ensure compliance with SIOP; in the event the CIO and staff review balancing in the interim due to market movements or otherwise, that should be reflected in the IIC minutes to demonstrate compliance.

I14.1: RSIC should explore alternate transition management programs, such as manager-to-manager transitions (cherry picking) with the remaining securities sold, or principal bids. RSIC should educate itself about when each technique is most appropriate.

I14.2: RSIC should determine if it wants to independently measure transition management costs, at least on a spot check basis.

I16: RSIC should complete development of an annual assessment process for the Commission to evaluate the performance of its general investment consultant and the Commission should adopt and implement the process.

I17: The Legislature should consider four potential options to significantly improve the ability of the RSIC to obtain services from and work with its custodial bank (see Recommendations G2 and G3).

I18.1: The Commission should determine the future of securities lending based on assessment of the potential investment benefits and risks of different approaches to participating in the lending market.

I18.2: RSIC will need to develop new policies and practices if it chooses to continue securities lending through BNYM or another third party; a new policy should include a statement of lending objectives, risk tolerance and guidelines approved by the Commission.

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I18.3: The RSIC securities lending agent should be required to provide quarterly reporting to management and the Commission regarding program activity, including amounts on loan, borrower concentration, return and risk.

I18.4: RSIC should obtain an annual benchmarking of its activities against lending activity across the industry.

I18.5: If RSIC decides to significantly grow securities lending, it should implement enhanced and more automated compliance functions, including compliance reporting from the lender(s) and periodic review by RSIC's compliance officer.

I19: RSIC should ensure that its policy pertaining to Commissioner requests for information from the RSIC staff is followed. This would include timely fulfillment of routine requests, a transparent process for determining the priority of requests which require approval at Commission meetings, and all responses being made available to all Commissioners through the portal.

5. LEGAL COMPLIANCE

L1.1: RSIC's procedure for use of legal counsel should be revised to assign inside or outside counsel to each investment transaction during the final due diligence process prior to approval of the Commissioners, as needed.

L1.2: RSIC should add a paralegal to the legal staff to provide administrative support and assist in document control (see Recommendation I6.1).

L2.1: RSIC should establish a standard side letter and contract clauses to improve bargaining leverage and increase contract consistency, and internal counsel should work with investment staff and outside lawyers on prioritization of the "asks" (see Recommendation I6.2).

L2.2: RSIC should identify investment terms that are deal-breakers and provide those terms to investment counterparties early in the investment due diligence process.

L3.1: RSIC should consider eliminating the 30-day review period and instead rely on an appropriately documented Legal Sufficiency Certificate to confirm that all legal compliance and due diligence is complete. Alternatively, RSIC could shorten the Commission review period and add a provision to the Governance Policy Manual clarifying the purpose for this review period and confirming that it does not delegate Commission authority to individual Commissioners or revoke authority otherwise delegated to the CIO or COO.

L3.2: RSIC could require more frequent Commission meetings to consider investments. (See also Recommendation G12.1). Alternatively, the Commission could consider delegating greater authority for approval of alternative investments to the CIO or Internal Investment Committee.

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L3.3: The Legal Sufficiency Certificate should include confirmation that documentation for each investment is consistent with material terms approved by the Commission and with authority delegated to staff by the Commissioners in the Statement of Investment Objectives and Policies.

L4.1: The Audit Committee should approach the State Ethics Commission and establish an independent audit process for regular confirmation that RSIC Statements of Economic Interests have been reviewed.

L4.2: Consideration should be given to extending coverage of the Sourcing and Conflict Disclosure Form to Commission approval of consultants and professional service providers exempted from State procurement processes.

L4.3: The Sudan divestment policy should be completed and approved by the Commission (See also Recommendation P2.7).

L4.4: The Enterprise Risk Management (ERM) program planning should be completed and the new function launched as soon as practical. (See also Recommendation G13.2.)

L5.1: Outside counsel should be refreshed, since it has been more than six years since the last RFP market test.

L5.2: The process for approval of outside counsel by the Attorney General could be streamlined through development of a pre-approved pool of qualified investment counsel, with agreed engagement contract form and budget standards, and requirements for regular reporting to the Attorney General and Commissioners.

L5.3: Consideration should be given to engagement of qualified, independent fiduciary counsel.

6. INFORMATION TECHNOLOGY SYSTEMS

IT1.1: Guided by an overall business and IT plan, RSIC should complete the acquisition of systems to:

- Track commitments and provide return calculations for private market investments
- Provide security-based risk management that includes position level transparency and risk and performance analytics
- Monitor compliance of investments with investment policies and contracts
- Automate trade order management
- Warehouse data for the whole investment portfolio in order to seamlessly feed other systems for analysis

IT1.2: The QED internal accounting system provided by vendor contract with the State Treasurer's Office should be upgraded or replaced.

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IT2: Guided by a business plan for the whole organization, RSIC should seek the number and types of additional IT staff needed to adequately support its expanding systems infrastructure (See Recommendation O3.6).

IT3.1: Guided by a business plan for the whole organization, RSIC should develop a strategic IT plan with clearly defined objectives, a full assessment of the current state of its systems and a timetable for completing needed improvements (See Recommendation O3.6).

IT3.2: RSIC should establish a project governance process with representation from across the organization to determine IT priorities and monitor progress of initiatives, and to assure resources are appropriately targeted and that issues are addressed promptly.

IT4.1: RSIC should be authorized to procure investment systems under a modified procurement process that includes appropriate accountability (see Recommendation P5).

IT4.2: RSIC should continue to pursue the eventual move of IT support from PEBA to RSIC.

NOTE TO THE READER: The remainder of this document is organized by each area of scope according to the following structure:

- **Scope and Standard for Comparison**
- **Summary of Conclusions**
- **Findings and Recommendations for each Conclusion**

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Background

The Retirement System Investment Commission (RSIC) was created by the South Carolina Legislature on October 1, 2005 with the exclusive authority to manage and invest all assets held in trust for the participants and beneficiaries of five governmental defined benefit plans: South Carolina Retirement System, South Carolina Police Officers Retirement System, Retirement System for Judges and Solicitors of the State of South Carolina, Retirement System for Members of the General Assembly of the State of South Carolina, and the National Guard Retirement System, collectively referred to hereinafter as the “Retirement System.”

The Retirement System had investments totaling approximately \$26.8 billion as of June 30, 2013 for more than 550,000 active and inactive participants, beneficiaries and dependents. While RSIC, as a fiduciary, has exclusive authority to manage and invest the assets held in trust for the Retirement System’s participants and beneficiaries, other fiduciaries and trustees also exercise authority and direction over the Retirement System. These are: the State Budget and Control Board (BCB); the Public Employee Benefit Authority (PEBA); the State Treasurer’s Office (STO); and the Legislature. In addition, the South Carolina Attorney General, Comptroller General, Inspector General, the State Ethics Commission and State Auditor each have selected oversight roles with respect to RSIC.

Particular to South Carolina and a minority of states is the separation of duties between the investment of the Retirement System’s assets and the administration of benefits for beneficiaries and participants. Among the largest 55 U.S. state pension funds (all those with assets over \$10 billion), there are four basic governance models, with variations on each. The South Carolina RSIC is an example of one of the eleven funds utilizing the Investment Board Model (although it is unique with both COO and CIO direct reports). See *Appendix C Fund Governance Models*.

The key benefit administration functions of the Retirement System are managed by PEBA. Additionally, PEBA is responsible for the administration of other non-retirement, state-wide employee benefit programs.

The RSIC is governed by a seven-member Investment Commission (“the Commission”), six of whom have voting privileges. The six voting commissioners include four appointed members, one elected member, and the State Treasurer as an ex officio member; the seventh, non-voting commissioner is the Executive Director of PEBA as an ex officio member. By statute, the Governor, State Comptroller General, Senate Finance Committee Chairman, and House Ways and Means Committee Chairman each appoint one member of the Commission. The elected member represents the state retirees and must be unanimously approved by the voting Commissioners. All appointed members and the elected member must have specific expertise and investment credentials and serve five-year terms. The State Treasurer serves as a commissioner for the length of the term of office. The Treasurer may also designate a qualified person to serve as his representative coterminous with the Treasurer’s term in office. The statutes governing the RSIC are found in the 1976 South Carolina Code of Laws, as amended, Title 9, Chapter 16.

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At the time of this review, the RSIC organization includes 42 approved full-time positions, with a Chief Investment Officer and a Chief Operating Officer both reporting directly to the Commission. This staff is supplemented by 8 part-time interns, and there are 5 vacant full-time investment staff positions and 1 vacant administrative staff position.

Purpose of the Fiduciary Performance Audit

This is the first annual fiduciary performance audit of the Retirement System Investment Commission (RSIC) as required by South Carolina statute under the auspices of the Office of the State Inspector General (SIG). The purpose of this fiduciary performance audit is to focus on the current state of RSIC to critically assess and evaluate:

- The fiduciary roles and responsibilities of RSIC commissioners and staff;
- The relationships with other fiduciaries of the Retirement System; and
- The operational policies and practices of the RSIC.

The SIG led a process to gain the unanimous agreement of key stakeholders on priorities to be addressed within the scope of the review prior to finalizing the RFP. Key stakeholders included RSIC Staff, Commission Chair and Audit Committee Chair, PEBA Staff, and the State Treasurer's Office.

Since RSIC is a relatively new state agency, the review was to be broad in nature spanning all key functions and included six major areas: Governance; Policy Review and Development; Organizational Structure; Key Investment Administration Functions; Legal Compliance; and Information Technology Systems. The RFP also required that specific items identified be addressed within each category; however, these items were not intended to limit creativity in assessing each category.

After a competitive process, the contract was awarded to Funston Advisory Services LLC (FAS), a Michigan firm. Work began on December 4, 2013 and was to be completed by no later than April 30, 2014. Our firm was authorized to review any policy, process, or procedure typically reviewed when completing this type of project. Our recommendations are articulated and prioritized according to significance and urgency and, where feasible, include an analysis of potential pros and cons associated with implementation.

A fiduciary performance audit is intended to provide independent reassurance on the suitability and robustness of governance structures, policies and processes across the six areas of scope. It attempts to answer several key questions given the duties of a fiduciary:

1. Who are the fiduciaries?
2. What are their authorities?
3. Do their authorities match their duties?
4. Are these duties in conflict with other roles played by the various commissioners?
5. How are they performing?

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Reasonable Assurance and Independent Reassurance

It is the responsibility of executive management to provide reasonable assurance to the Commission that there are capable people, processes and systems to invest and manage the fund and the related risks. Third parties independent of management can offer reasonable reassurance that executives' reports are reliable. While no audit can provide an absolute guarantee of compliance or the absence of misconduct, reasonable assurance is still a high standard of assurance.

A fiduciary performance audit is separate and distinct from a forensic investigation, a compliance audit or an audit of the financial statements. Accordingly, we have relied on the reports of others such as the Office of the State Inspector General (SIG), Deloitte & Touche, Hewitt EnnisKnupp (HEK), and CliftonLarsonAllen, the external auditor of the Public Employees Benefit Authority (PEBA), regarding the appropriateness of past practices and the integrity of the financial statements.

Process

Our fiduciary performance audit compared RSIC's current practices with leading practices to understand fiduciary strengths, weaknesses, risks and opportunities for improvement. A number of prior weaknesses have been recognized and are being addressed by the Commission. Past practices were only examined by us to understand the context for the evolution and maturation of RSIC to its present state.

There were three phases to our audit: Initiation, Assessment and Final Report. The review began on December 4, 2013 following the awarding of the contract. We reviewed nearly 800 documents (see *Appendix D List of Documents Reviewed*) and conducted interviews with nearly fifty individuals, many with follow-up interviews including: all seven current and one former Commissioner; nineteen Retirement System Investment Commission (RSIC) staff; three Public Employees Benefit Authority (PEBA) staff; two State Treasurer's Office (STO) staff; fifteen current and two terminated external investment managers; two partners from Hewitt EnnisKnupp (HEK), the RSIC's general investment consultant; the Retirement System's external auditor (CliftonLarsonAllen), the actuary (Gabriel Roeder Smith, and the custodial bank, Bank of New York Mellon (BNYM). See *Appendix E Interviews Conducted by FAS for Fiduciary Performance Audit*.

FAS also designed, conducted and analyzed a custom survey with six peer investment boards. In addition, the RSIC completed three public pension benchmark surveys which FAS had previously conducted with other public pension funds. A new 2014 Investment Cost Effectiveness Analysis was also conducted by the independent firm, CEM Benchmarking Inc. (CEM), as part of this fiduciary performance audit. See *Appendix F CEM Report Executive Summary*.

FAS submitted a Status Report to the SIG on March 3, 2014 with preliminary conclusions and recommendations and provided ten days for written responses from RSIC, PEBA and STO. We then held conference calls with RSIC, PEBA and STO to follow-up and to ensure we understood their feedback. On

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March 28, 2014 FAS submitted a Draft Final Report. Another ten day period was provided for further written feedback. During this time, we continued to respond to questions and comments and complete additional interviews. The written responses of RSIC, STO and PEBA to the Draft Final Report have been included as Appendices N, O and P to this report. The Final RSIC Fiduciary Performance Audit Report was submitted to SIG on April 18, 2014. We plan to meet with the Commission to make our final presentation in Columbia at their May 1, 2014 regular meeting.

The Duties of a Fiduciary

For this review, we use the fiduciary standard found in the South Carolina Code of Laws, Title 9 - Retirement Systems, Chapter 16, Retirement System Funds, Article 1, Duties of the Trustee, Fiduciaries, Agents. According to SECTION 9-16-40. Standards for discharge of duty. A trustee, commission member, or other fiduciary shall discharge duties with respect to a retirement system:

- 1) solely in the interest of the retirement systems, participants, and beneficiaries;
- 2) for the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system;
- 3) with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose;
- 4) impartially, taking into account any differing interests of participants and beneficiaries;
- 5) incurring only costs that are appropriate and reasonable; and
- 6) in accordance with a good faith interpretation of this chapter.

Historical Context

Management of the trust fund's investments has gone through several phases over almost 70 years. From 1945 until 1996, the fiduciary trustee was the state Budget and Control Board (BCB). Investments were limited to fixed income (federal and state bonds, investment grade domestic corporate bonds, certificates of deposit, and collateralized repurchase agreements). The State Treasurer was the custodian and investment decisions were delegated to the Treasurer. Starting in the 1980s, it became more and more common for pension funds in other states to invest in public equities as Legislatures began to relax investment restrictions.

In 1997, the Legislature created the Retirement Systems Investment Panel, an advisory board to the BCB and the Treasurer. In 1998, the panel was appointed and the Treasurer was made Investment Agent of the BCB. At the same time, legislation was passed allowing the fund to invest in domestic public equities.

In 2005, legislation replaced the Investment Panel with the Retirement System Investment Commission (RSIC). The Commission was formed and launched in 2005 and consisted of five voting members (four

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appointees and the State Treasurer, ex officio) and one non-voting retiree member who was elected by the voting commissioners. All investment authorities were transferred from the BCB and the Treasurer to RSIC. The Treasurer remained custodian of the funds, in addition to being an ex officio commissioner, with an option to appoint a qualified representative. More asset classes were allowed for investments, including real estate, private equity, funds of funds, and investment trusts. In 2006 and 2007, the allowable investments were further broadened and clarified to the current policy.

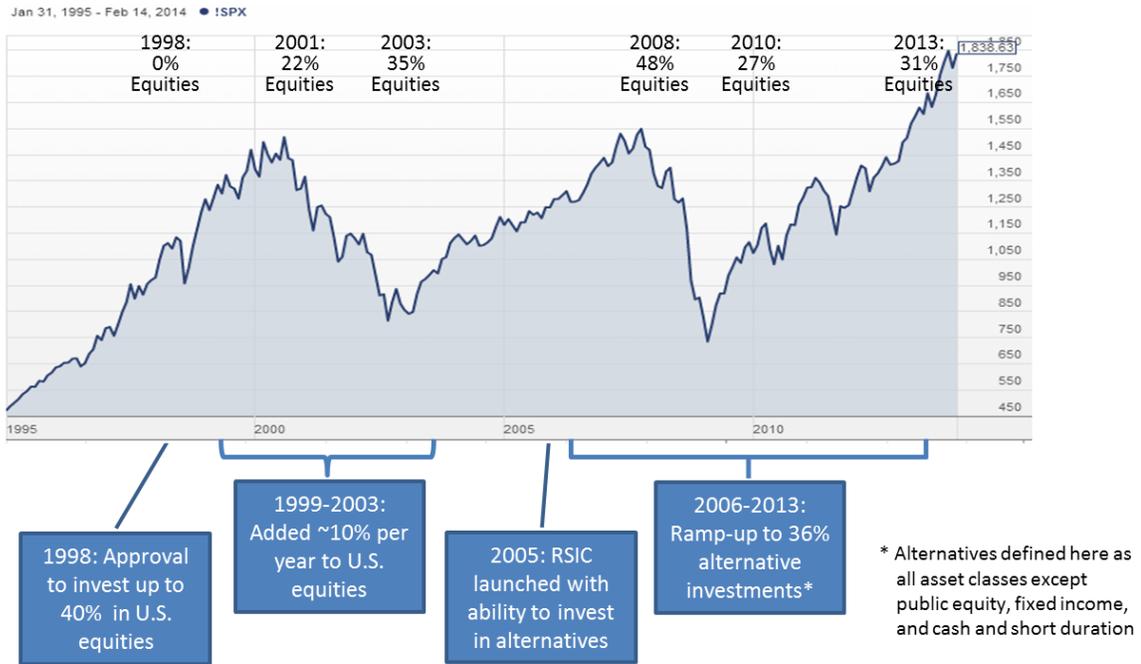
The Commission is currently less than ten years old and is continuing to develop its capabilities. When RSIC was launched in 2005, there were six commissioners and an Administrative Director/ General Counsel and an Administrative Coordinator. A new CIO joined in April 2006, and three additional full-time investment staff members started in January 2007. They were all charged with investing and managing \$25 billion in retirement assets. By statute, the Commission has an obligation to diversify unless “the Commission determines that, because of special circumstances, it is clearly not prudent to do so”. The actions taken by the Commission to diversify the assets reflect this statutory requirement. The initial strategy adopted by the commissioners, in consultation with their general investment consultant, CIO and external managers, was to rapidly diversify what had been a traditional stocks and bonds portfolio to improve long-term returns. Due to limited resources, the Commissioners became very involved in investment operations such as due diligence.

Infrastructure did not keep pace with investment strategies as initial back office and risk management procedures were often manual and ad hoc. During the past two years, RSIC’s processes have evolved to become much more robust and systematic. A number of legacy weaknesses have been recognized and have been or are being addressed by the Commission. Past practices were examined in this audit to better understand the context, as well as the evolution and maturation of the RSIC.

South Carolina was a late adopter of diversification for its pension trust funds, and in both 1998 and 2006 it appears that there was a desire to diversify rapidly. However, as indicated in the chart below, the diversification timing proved to be unfortunate after both the 1998 and 2005 legislative changes.

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S&P 500 History from 1995-present

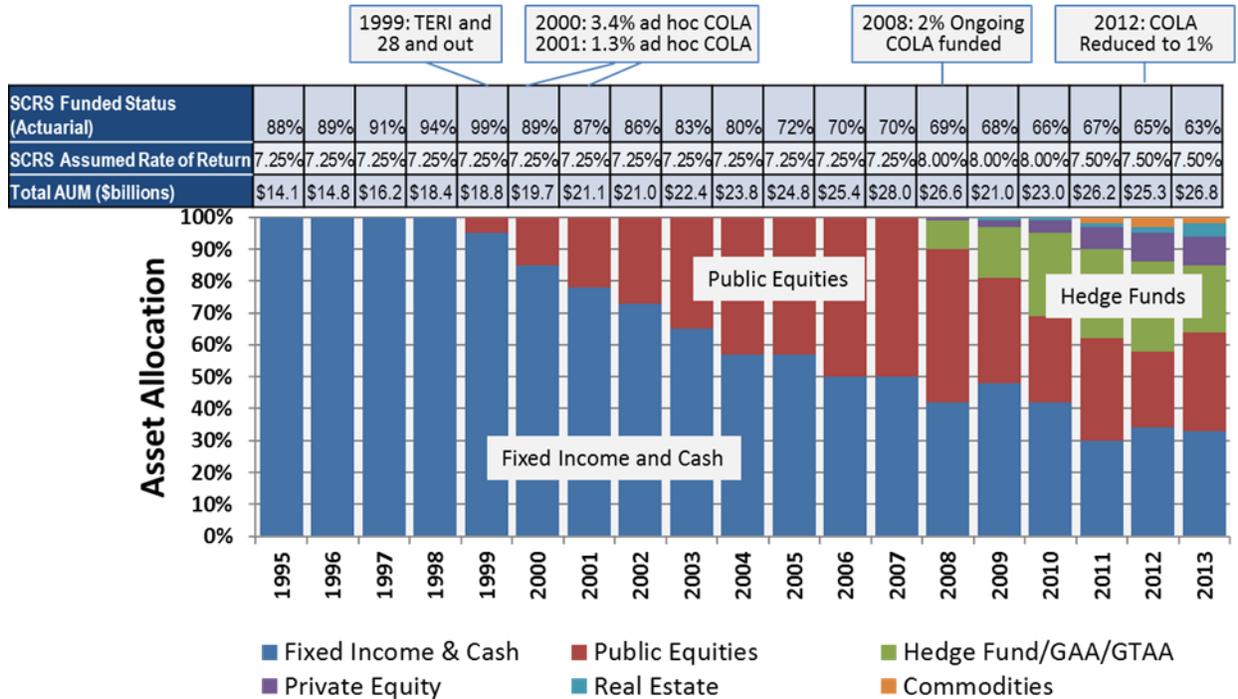


The first diversification strategy into public equities was a deliberate effort to rapidly address the Commission’s diversification mandate. However, the timing proved most unfortunate given the market declines in 2008 when the market value of the Fund's assets fell 28.7% while its peers dropped an average of 27%.

Subsequently, the Commission decided to reduce its exposure to stocks and broaden its asset allocation to include alternative investments in order to reduce exposure to catastrophic loss. Again, this was a deliberate strategy which recognized the high costs of these alternative investments, and was done to dampen the volatility of the portfolio and reduce the potential downside. The reduction of equity holdings meant the Fund was not well positioned to take advantage of the ensuing stock market recovery.

Decline in the funded status has been ongoing since 1999 and was impacted by a combination of increases in benefits and adverse market conditions. As indicated in the chart below, changes in benefits from 1999-2001 and in 2008 all contributed to funded status declines. The funding status impacts of market downturns in 2001 and 2008 were phased in due to 5-year smoothing. Note: Funding status indicated in the chart reflects the actuarial value basis for the SCRS fund, which represents about 86 percent of total retirement system assets.

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Based upon numerous discussions with the Commissioners, investment staff, and the general investment consultant, we identified several critical underlying assumptions which appear to have driven the current asset allocation strategy. The Legislature sets the expected rate of return which currently stands at 7.5%. RSIC assumes the risk-free of rate of return plus the equity premium is about 5-6%; thus hitting the 7.5% return target means the fund must take on additional risk.

RSIC is determined to avoid a “big drawdown” (i.e., major capital loss) which would trigger a special increase in employer and employee contributions, which is perceived as catastrophic for employees, employers, and taxpayers. The ongoing relatively high allocation to hedge funds and other private asset classes by RSIC is based on a belief that these asset classes are less volatile than public markets.

If the retirement plans were 70% funded instead of the current 56% (on a market value basis), RSIC would be comfortable with taking on more public equity risk; however, at the current funded level RSIC believes it must avoid another drawdown similar to 2008-2009.

The Commission states it is taking a long-term view on maintaining the current asset allocation, which they believe best serves all stakeholders, and is not trying to time the market by making changes perceived as advantageous in today’s market environment.

1. Governance

Scope and Standard for Comparison

The governance assessment reviewed the roles of the Commission, staff, and other relevant state agencies in the oversight and management of the retirement fund assets. The assessment evaluated the legal and statutory framework and how this is translated into authorities, roles, responsibilities, accountabilities, policies, and procedures.

We utilized our Powers Reserved Framework of sixty six specific authorities included in nine relevant powers (see *Appendix G Powers Reserved Analysis*). This allowed comparison of the current South Carolina governance structure to other state investment board peers. We also utilized our public pension state regulation, policies and practices database to identify where South Carolina is consistent with or different from other state public pension fund governance structures and policies.

We used the fiduciary standard found in the South Carolina Code of Laws, Title 9 - Retirement Systems, Chapter 16, Retirement System Funds, Article 1, Duties of the Trustee, Fiduciaries, Agents, for this review.

SECTION 9-16-40. Standards for discharge of duty. A trustee, commission member, or other fiduciary shall discharge duties with respect to a retirement system:

- (1) solely in the interest of the retirement systems, participants, and beneficiaries;
- (2) for the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system;
- (3) with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose;
- (4) impartially, taking into account any differing interests of participants and beneficiaries;
- (5) incurring only costs that are appropriate and reasonable; and
- (6) in accordance with a good faith interpretation of this chapter.

The scope of our activities included:

- Review applicable laws, policies and procedures (to include Commission governance manuals, policies and procedures) and compare to other state funds, with an emphasis on other state investment boards, for example:
 - Board composition and member qualifications

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- Board meeting procedures and legal responsibilities
- Travel and expense reimbursement
- Ethics and conflict of interest standards and related training
- Transparency requirements (e.g., open meeting laws, FOIA requirements, availability of RSIC meeting agendas and minutes, etc.)
- Chief Investment Officer duties
- Oversight of the board
- Custody of funds and legal representation
- Staffing and compensation
- Review the Investment Commission charter and compare to other state funds, with an emphasis on other state investment boards
 - Roles and responsibilities of commissioners and powers reserved for the RSIC
 - Identification of fiduciaries and/or the existence of “de facto” fiduciaries
 - Fiduciary and other board education
 - Meeting protocols, transparency, and commissioner time commitments
 - Strategic planning and implementation process, including balance of RSIC oversight vs. operational management
- Review the RSIC self-assessment process and practices and compare to leading and prevailing practices
- Review adequacy of RSIC independent reassurance and compare to leading practices
 - Role of the internal audit department and adequacy of audit plans
 - Role of Audit Committee in policy compliance, and scope of Audit Committee charter
 - Role of the Investment Commission in the annual external financial audit for the Retirement System
- Review RSIC indemnification/use of fiduciary liability insurance and compare to other state funds
- Review the Board, COO, and CIO evaluation processes and criteria and compare to leading practices

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- Review delegations of authority to the COO and CIO (roles and responsibilities) and compare to leading practices
- Review the Investment Commission communication policy and compare to other funds
- Review the investment decision-making process and compare to leading practices
 - Role of the Internal Investment Committee
 - Role of the Investment Commission
 - Role of investment consultants
- Evaluate the alignment of authority and responsibility, with consideration for where expertise resides, and compare to other investment boards

Summary of Governance Conclusions

G1: The statutory allocation of fiduciary authority and responsibilities amongst designated trustees and other entities with fiduciary duties is duplicative and confusing.

G2: The potential for inherent conflicts is demonstrated most acutely by the multiple statutory roles assigned to the South Carolina State Treasurer.

G3: Selection of the custodial bank by the Treasurer is highly unusual among state public pension funds and investment boards.

G4: The dual direct operating executive reporting structure, with both the COO and CIO reporting directly to the Commission, is not leading practice and could result in unclear authority and conflicts.

G5: Legislative control of RSIC's budget and headcount is a misalignment of legal authorities and presents inherent implementation challenges, adding to retirement system costs and increasing enterprise-level risk exposures.

G6: Although the external audit process of PEBA includes RSIC activities, RSIC does not have a direct relationship with the external auditor.

G7: Although significant improvements have been made, investment decision-making in strategic partnerships can still be further improved.

G8: The selection criteria and composition of the Commission rely heavily on certifications and educational credentials, are focused primarily on the "front office" aspect of investing, and do not allow appropriate levels of experience to be recognized as qualifying criteria.

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G9: RSIC has had a number of Commissioners who have served multiple terms, and two current Commissioners have served since inception of the RSIC.

G10: Although the amount of time spent by commissioners on RSIC business is consistent with that of other leading funds, their time should be spent more effectively and focus on higher-value topics.

G11: The Commission committee structure is similar to peer investment boards.

G12: Commission operations are consistent with policies but could be improved in several areas.

G13: Although there have been improvements, reporting and reassurance capabilities still need to be strengthened and have contributed to lack of trust and confidence in RSIC staff and performance.

G14: Delegations from the Commission are generally clear and comprehensive.

G15: The Commission, as well as the Compensation Committee, provides limited, if any, guidance to the RSIC staff in developing human resource capabilities.

G16: RSIC has improved its investment decision making processes with the creation of the Internal Investment Committee, but further enhancements are possible.

G17: The transparency of Commission meetings is leading practice.

G18: The communications policy and practices should be improved.

G19: Most investment boards indemnify their trustees in the case of legal action; RSIC's level of fiduciary liability insurance appears to be consistent with amounts carried at other investment boards with similar asset allocations.

Findings and Recommendations for each Governance Conclusion

Fiduciary Responsibilities and Authorities

There are a variety of entities with fiduciary responsibilities for the retirement trust fund as well as other oversight responsibilities for the RSIC. The following chart indicates the eight entities outside the RSIC which have a role in RSIC governance.

Table 1 Overlapping Responsibilities

(RSIC has exclusive authority to invest and manage investments but has other fiduciary responsibilities without having many of the corresponding authorities)

<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">Legislature</div> <p>Policy and Legal Framework:</p> <ul style="list-style-type: none"> Sets RSIC legal authorities Sets fund assumed rate of return <p>Oversight:</p> <ul style="list-style-type: none"> Approves budget annually Approves headcount annually Approves Performance Incentive Compensation (PIC) plan annually 	<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">Budget & Control Board</div> <p>Named Trustee and Fiduciary</p> <p>Policy and Legal Framework:</p> <ul style="list-style-type: none"> Approves RSIC purchasing policy Appoints 4 of 7 Commissioners 	<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">State Treasurer</div> <p>Fiduciary Responsibilities:</p> <ul style="list-style-type: none"> Custodian of the funds RSIC Commissioner Member of Budget & Control Board
<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">Public Employee Benefit Authority</div> <p>Named Trustee and Fiduciary Responsibilities:</p> <ul style="list-style-type: none"> Sets RSIC accounting policies Provides investment accounting and financial reporting Directs external auditing Provides RSIC IT support 	<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">Retirement System Investment Commission</div> <p>Fiduciary Responsibilities:</p> <ul style="list-style-type: none"> Invests and manages pension funds 	<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">Attorney General</div> <p>Oversight:</p> <ul style="list-style-type: none"> Approves retention and rates of external counsel Approves hiring of temporary internal counsel
<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">Comptroller General</div> <p>Oversight:</p> <ul style="list-style-type: none"> Conducts accounts payable and payroll procedures audit 	<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">Inspector General</div> <p>Oversight:</p> <ul style="list-style-type: none"> Conducts annual fiduciary performance review 	<div style="background-color: #4F81BD; color: white; padding: 10px; text-align: center; margin-bottom: 10px;">State Auditor</div> <p>Oversight:</p> <ul style="list-style-type: none"> Selects external auditor

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Conclusion G1: The statutory allocation of fiduciary authority and responsibilities amongst designated trustees and other entities with fiduciary duties is duplicative and confusing.

Table 1 above describes the overlapping fiduciary responsibilities of RSIC with those of the BCB, the Treasurer, and PEBA. Under Section 9-1-1310, the Investment Commission has the authority to invest and reinvest the funds of the retirement systems, subject to all the terms, conditions, limitations, and restrictions imposed by Section 16, Article X of the South Carolina Constitution, subsection (B) of Section 9-1-1310, and Chapter 16 of Title 9.

Further, Section 9-16-20 gives the Investment Commission the exclusive authority, subject to Chapter 16 of Title 9 and Section 9-1-1310, to invest and manage the retirement systems' assets; and, Section 9-16-315(G) provides that all of the powers and duties of the State Budget and Control Board as investor in equity securities and the State Treasurer's function of investing in fixed income instruments are transferred to and devolved upon the Investment Commission.

By statute, the BCB members appoint four of the six voting members of the Commission. The elected member represents the state retirees and is approved by the voting Commissioners. The BCB (and after July 1, 2015, the State Fiscal Accountability Authority or Department of Administration) is a Named Trustee and a fiduciary, but its role is unclear with respect to RSIC oversight.

Arguably, the BCB may be subject to fiduciary obligations in exercising the powers relating to the RSIC which are listed in Table 1. This is especially important in regard to the effect of BCB decisions on RSIC purchasing policy and on the ability of RSIC to prudently implement its investment management obligations. Where the BCB has fiduciary obligations as a Named Trustee for the Retirement System, it must act in the interest of System beneficiaries. The BCB might also have general fiduciary duties to exercise oversight and monitoring responsibilities in regard to administration and management of the Retirement System by other co-fiduciaries.

In addition, the Treasurer is assigned multiple fiduciary roles, authorities and responsibilities which place the Treasurer in a position where he exercises inherently inconsistent and overlapping functions. As is discussed further on the following pages, the Treasurer is expected, in one fiduciary role, to oversee his performance of fiduciary duties in another role, while also being separately responsible for monitoring his management of both sets of obligations.

The result of differences between the RSIC's fiduciary duties and its actual authorities is a confusing lack of clarity about Retirement System governance, decision-making and accountability. In other words, the Retirement System's current governance design fundamentally encourages conflicts between fiduciaries, dilutes accountability and fosters sub-optimal decision-making, even when all parties are acting in good faith.

Further analysis of the uniquely duplicative and confusing fiduciary governance structure for the Retirement System is included in *Appendix H Fiduciary Duty and Governance Structure Analysis*.

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Recommendation G1: The Legislature should better align Retirement System governance authority with assignment of obligations and clarify what fiduciary responsibilities, if any, still reside with the BCB and, subsequently, the Department of Administration and the State Fiscal Accountability Authority.

Potential for Conflicts

Conclusion G2: The potential for inherent conflicts is demonstrated most acutely by the multiple statutory roles assigned to the South Carolina State Treasurer.

There are a number of legacy governance and structural issues which confound clear fiduciary decision-making authority and reflect a highly fragmented system. There are, for example, currently several fracture lines related to issues such as segregation of duties, custodial authorities, and securities lending. The result is a continuing process of friction and abrasion that often erupts into open conflict between competing authorities. As noted above, lack of clear authority also equates to a lack of clear accountability. While the current dysfunctions have been largely been between the Treasurer's Office and the Commission, it is foreseeable that similar conflicts could arise between any of the many fiduciaries with overlapping and inconsistent roles.

The multiple fiduciary roles, authorities and responsibilities of the Treasurer illustrate these inherent conflicts. The Treasurer's three roles are:

1. *Member of Budget and Control Board (BCB).* The State Treasurer is one of five standing members of the BCB.
2. *Commissioner on Retirement System Investment Council (RSIC).* The State Treasurer serves as the only ex officio voting Commissioner.
3. *Custodian of the funds.* The State Treasurer is an "Other fiduciary" in the designated role as custodian. Nevertheless, the custodian has a ministerial role only, with no investment authority.

First, as a member of the BCB, the Treasurer is in the position of having oversight of himself as a Commissioner. The Commission, in turn, must objectively evaluate the custody services it receives from a fellow Commissioner, who is also an overseer on the BCB.

Second, the Treasurer is also a Commissioner of RSIC and, as such, shares investment authority over the Retirement System funds with the other commissioners. As a Commissioner, the Treasurer is subject to the standards of care described in section 9-16-40 of the South Carolina Code. Consequently, the Treasurer is faced with the challenge of resolving potentially conflicting fiduciary duties between his role as one of several commissioners on the RSIC and his separate obligations as Custodian.

Third, when the statutes vested exclusive investment authority in RSIC, it seemed to preclude subsequent exercise of a de facto veto by one of the commissioners, regardless of the role (in this case as Custodian) in which that fiduciary is acting.

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The Attorney General's opinion (S.C. AG Op. November 16, 2011) muddies the waters by advising that the Treasurer, as custodian of the retirement funds, is also an "other fiduciary," with respect to the fiduciary duties appertaining thereto. The duplicative fiduciary roles of the Treasurer are confusing and problematic. Exactly how the Treasurer's custodial fiduciary duty interacts with RSIC's exclusive authority to make investment decisions (and the Treasurer's fiduciary role as a Commissioner) is unclear. By having the apparent ability to refuse to fund investments the Treasurer objects to (in good faith) in his role as custodian, the Treasurer could be seen as exercising veto power over investment decisions already made with his participation as a fiduciary Commissioner at the RSIC. The existence of such veto authority is inherently inconsistent with the statutory grant of exclusive investment authority to the RSIC.

Use of such a veto could create the risk that the Treasurer might be found to be in breach of his duties as a fiduciary at the RSIC, if losses were incurred as a result of his good faith exercise of separate fiduciary duties as custodian. Increased liability risk is the natural result of these inconsistent and ambiguous fiduciary roles.

The South Carolina Treasurer is the designated custodian of retirement funds by statute. South Carolina Code Ann. Section 9-1-1320, *Custody and disbursement of funds*, provides that "the Treasurer shall be the custodian of the funds of the System. All payments from such funds shall be made by him only upon vouchers signed by two persons designated by the Board." (Here, "Board" means the Board of Directors of the South Carolina Public Employee Benefit Authority.) Aside from the responsibility to make payments from the trust fund, the Treasurer's custodial duties are not defined by statute; policies, authorities and processes are subject to definition and interpretation by whoever is serving as State Treasurer.

Since RSIC's creation in 2005, there have been five different Treasurers; several previous Treasurers have made significantly greater delegations of authority to RSIC than is currently the case. This ambiguity in authority of the Treasurer as custodian, and how the custodian's powers interact with fiduciary responsibilities of RSIC, will expose RSIC to a potential roller coaster of interpretations by different Treasurers. The Legislature should resolve this ambiguity. Further legal analysis of the fiduciary duty inconsistencies and potential conflicts is set forth in *Appendix H Fiduciary Duty and Governance Structure Analysis*.

The State Treasurer does not agree with the above conclusions and has stated: "Funston has concluded that the State Treasurer has conflicting fiduciary roles. This is a false assumption. First, the State Treasurer is a fiduciary in three roles. In two of those roles – a member of RSIC and a member of the Budget & Control Board – he is one of numerous voting members. He has no control over these two fiduciary boards and possesses only one vote on each board. Such an arrangement does not create a conflict among his fiduciary roles. In fact, his overall perspective of SCRS by looking at it from three

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different perspectives makes him more valuable to SCRS and its plan participants and beneficiaries. Most importantly, he is the people's elected representation in these positions."⁵

The Treasurer continues: "Finally, changing the fiduciary structure by giving RSIC or PEBA custodial duties violates the principles of segregation of duties and greatly increases the risk to the State, and its taxpayers who may be forced to make up any shortfall or losses and the plan's participants and beneficiaries. Proper segregation of duties entails separating the following three functions: authorizing investments and cash disbursements (performed by RSIC and to some degree PEBA), performing the accounting for SCRS (done by PEBA), and having custody of the assets of SCRS (done by STO). The Treasurer's fiduciary duties are entrusted to him as an elected representative of the people, including retirees. This representation explains his triple fiduciary responsibilities. The people's presence, in the person of the State Treasurer, creates no conflict."⁶ With respect to the latter, we agree the Treasurer's presence as the Treasurer creates no conflict.

We also agree that segregation of duties (SOD) is one of many important forms of internal control. "Segregation of duties is critical to effective *internal control*; it reduces the risk of both erroneous and inappropriate actions. In general, the approval function, the accounting/reconciling function, and the asset custody function should be separated among employees. When these functions cannot be separated, a detailed supervisory review of related activities is required as a compensating control activity. Segregation of duties is a deterrent to fraud because it requires collusion with another person to perpetrate a fraudulent act."⁷

However, we strongly disagree that it is necessary for separate *external* entities to fill these different roles, as this reduces the effectiveness and efficiency of these processes. It dilutes accountability by fragmenting responsibility and authority. No other state pension fund operates in the same manner as South Carolina for this reason.

Furthermore, Section 5 of the Uniform Management of Employee Retirement Systems Act of 1997 (UMPERSA) recommends granting public pension trustees "exclusive authority" to "establish an administrative budget sufficient to perform the Trustee's duties and, as appropriate and reasonable, draw upon assets of the retirement system to fund the budget" and also to "obtain by [employment or] contract the services necessary to exercise the trustee's powers and perform the trustee's duties, including actuarial, auditing, custodial, investment, and legal services."

It should be noted that UMPERSA is particularly relevant for South Carolina because the legislation which created the primary statutory fiduciary duty provisions applicable to RSIC and the other retirement system trustees and fiduciaries in SC Code Ann. Sections 9-16-30 and 9-16-40 was taken directly from UMPERSA (which had recently been approved).

⁵ The State Treasurer's Office response to the FAS Midpoint Draft Report March 3, 2014

⁶ Ibid. State Treasurer's Office response

⁷ http://www.yale.edu/auditing/balancing/segregation_duties.html

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Recommendation G2: The Legislature should resolve the Treasurer’s conflicting fiduciary duties (alternatives are discussed in I17).

Custodial Bank Selection

Conclusion G3: Selection of the custodial bank by the Treasurer is highly unusual among state public pension funds and investment boards.

Selection of the custodial bank by the Treasurer has created significant delays, costs, and duplication of effort. Lack of direct management of the custodial bank relationship by RSIC staff has contributed to delays in building infrastructure and in obtaining performance data. Although there are several other states where the trustee board of a fund does not contract with and manage the relationship with the custodial bank, it is an unusual practice among public pension funds and often is a source of dysfunction in one state (Ohio) where it is the practice.

Among the six peer investment boards surveyed, the selection of the custodial bank is the responsibility of the investment board and its staff at all of them. No other peer investment boards, even those where the Treasurer is custodian of record, allow for the State Treasurer to select the custodial bank. The State Treasurer is the custodian of record for the Illinois State Investment Board (ISBI), but the responsibility for selecting the custodial bank is given to the Board of Trustees by statute. At the Washington State Investment Board (WSIB), the Treasurer signs the custodial bank contract; however, the WSIB staff prepares the RFP, conducts the selection process and manages the contract and relationship as these responsibilities are delegated. See *Appendix C Fund Governance Models*.

At the two peer investment board funds where the Treasurer is the custodian of legal record (ISBI and WSIB), the Treasurer’s Office has nothing to do with the management of investment funds beyond the Treasurer being a member of the trustee board.

Table 2 Selecting the Custodial Bank

	Responses from the Investment Board Peer Group (N=6)		
	Investment Board of Trustees	Pension Administration Board	State Treasurer
<i>Note: Responses exclude RSIC</i>			
Custodian of legal record	3	1	2
Responsibility for approving the selection of the custodial bank	6	0	0

FAS conducted research in 2013 on the custodial relationship with a peer group of 13 integrated state public pension funds (funds where the trustee board is responsible for both investments and pension

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administration), ranging in size from \$7 billion to \$14 billion of assets under management. In this study, 11 of the 13 funds contract directly with their custodian.

The only two exceptions among this peer group were both Ohio funds, where the Ohio State Treasurer manages the custodian relationship. Over the past two decades, most fiduciary audits of the five Ohio pension funds have identified dysfunctions in the custodial relationship and recommended that the legislature consider allowing the funds to manage their own custodial bank relationships. We have recently been told by the Ohio Retirement Study Council that transferring the custodial bank selection and relationship to the funds is again being debated.

One of the funds, the New Mexico Educational Retirement Board (ERB), has a split responsibility similar to ISBI. In 2011, Senate Bill 269 was passed which “amends the Educational Retirement Act to allow the New Mexico ERB to contract for one or more custodial banks for the purpose of control and collection of ERB investment fund assets.” The State Treasurer, however, remains the custodian of the ERB fund.

The State Treasurer has also cited Federal rules under the Investment Advisers Act of 1940 and segregation of duties principles as supportive of the current custodial structure as a fraud prevention tool and as an argument as to why the Treasurer should be the custodian and RSIC should not. However, in regard to the Investment Advisers Act, public pension funds are specifically exempted by Rule 202(b), which excludes state agencies, instrumentalities, officers and employees from its coverage. RSIC is a trustee and not an investment advisor.

While not applicable to RSIC, Rule 206(4)-2 under the Investment Advisers Act of 1940, also known as the "custody rule," explicitly authorizes investment advisors to engage qualified custodians for their client accounts. However, it is applicable to "qualified custodians" and requires custodian delivery of account statements directly to clients, use of independent audits (including surprise examinations) and internal controls audits to protect clients from fraud. The custody rule also applies to commingled funds.

RSIC obtains confirmations from its managers that they comply with the custody rule. BNYM is also a qualified custodian. Thus, fraud protections of the custody rule can be obtained regardless of whether the Treasurer serves as RSIC's custodian or the custodian is selected and contracted directly by RSIC. As is noted above, this is standard practice at other public pension funds and is recommended by UMPERSA.

Recommendation G3: The Legislature should delegate selection of the custodial bank and management of the relationship to the RSIC (alternatives are further discussed in I17).

Direct Operating Reports to the Commission

Conclusion G4: The dual direct operating executive reporting structure, with both the COO and CIO reporting directly to the Commission, is not leading practice and could result in unclear authority and conflicts.

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Having both the COO and CIO as direct reports to the Commission is a lagging practice for investment board organizations. All other similar investment boards have a single operating executive reporting to the board, typically with the title CEO or Executive Director. Typically, the CIO reports to the CEO or Executive Director (in two of six cases the CEO and CIO roles are combined).

Table 3 Direct Reports

Which executives report directly to the Board? Please check all that apply. (N=6)	Direct Report	RSIC
Chief Executive Officer or Executive Director	6	
Chief Operating Officer or Deputy Director	0	X
Chief Investment Officer (if not also the CEO/ED)	0	X
Director of Internal Audit	3	X

Although there have not been significant issues with the current structure and personalities, there could be confusion regarding authority and accountability for administrative decisions between the COO and CIO. Having a single direct operating report to the Commission could improve executive accountability and clarity of roles and provide a single point of coordination for Commissioner requests, resulting in more effective and efficient Commission and executive decision making. The CEO can also be a buffer between the Commission and investment staff, helping reduce the appearance of undue influence by the Commission. We also believe that, in the current state of duress, it is important that be a single, executive as leader of the staff.

Recommendation G4: The Legislature should revise legislation to allow the Commission to designate a single direct operating report with the title of either Chief Executive Officer (CEO) or Executive Director, and not require that the Chief Investment Officer (CIO) report directly to the Commission.

Budget, Staffing and Compensation Authorities

Conclusion G5: Legislative control of RSIC’s budget and headcount is a misalignment of legal authorities and presents inherent implementation challenges, adding to retirement system costs and increasing enterprise-level risk exposures.

When the Commission was formed in 2005, it was given full and exclusive investment authority, discretion and flexibility to invest approximately \$27 billion. At the same time, it was not given authority to create the necessary staffing and infrastructure to manage those investments, even though the funding comes from the retirement fund itself and not the State General Fund.

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Funds for staff compensation, information systems, research services, consultants, legal services and overhead are appropriated from the Retirement Fund by the Legislature. In FY 2013, RSIC spent \$7.8 million for the appropriated services, which represented less than 2% of its \$427.5 million in total expenses for the year. Nonetheless, in each of the last five years, between 19% and 37% of RSIC’s appropriated dollars were unspent and returned to the trust funds.

Table 4 Appropriations and Expenditures 2009-2013

RSIC Appropriations and Expenditures FY 2009 through FY 2013					
	2009	2010	2011	2012	2013
Authorized Budget	\$4,774,900	\$4,774,900	\$5,810,700	\$10,152,700	\$10,152,700
Actual Expenses	3,850,100	3,432,300	4,712,400	6,406,100	7,810,100
Remaining Authorization	924,800	1,342,600	1,098,300	3,746,500	2,342,600
% Unspent Funds	19%	28%	19%	37%	23%

RSIC cites several reasons for the persistently high level of unspent authority. Its authorized staff positions increased from 19 to 35 over this period. Newly created or vacated positions can take six or more months to fill, resulting in unspent salary, fringe benefit and support funds. Additionally, in some years, staff may not qualify, or only partially qualify, for performance incentive compensation, resulting in appropriately unspent authorized budget.

In FY 2012, the year in which RSIC had the largest amount of unspent authority during this five-year period, twelve additional positions were authorized. Although they were funded for the entire fiscal year, six positions were filled for only a portion of the year and six had not been filled by fiscal-year end. PIC funds are budgeted for new employees although they are not eligible for an award if they are not on staff for the entire fiscal year; that has resulted in additional unused budget authority.

State budgeting processes that assume new positions will be filled for the entire year in which they are first authorized, (and that they will be awarded performance compensation in that year) seem questionable and blur accountability for the resulting underspending. As a result, a significant portion of RSIC’s compensation appropriation has gone unspent, and can leave the impression that RSIC is “overfunded”. In fact, the Commission has unmet staffing needs now and its staffing needs will grow in order to expand internal management. RSIC is also well short of the overall goal of its compensation plan.

In three of the last four fiscal years, RSIC has not used \$725,000 or more of funds appropriated for other operating expenses, such as information systems and contractual services. RSIC indicates that in fiscal years 2012 and 2013 it anticipated using some of these funds to acquire new systems through the custodial bank. However, RSIC states that the protracted process for signing a new custody contract

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precluded the Commission from acquiring the services from BNY Mellon on the schedule assumed in its budget plan.

RSIC decided in fiscal year 2014 to acquire those services from another vendor, and that procurement process has just been completed. With an annual cost of \$1.2 million, RSIC anticipates that this initiative will require more budget authority than it is currently appropriated for such expenses; the Commission is seeking additional spending authority in the FY 2015 budget that is currently before the Legislature.

Like other units of South Carolina state government, RSIC has limited flexibility to move funds between budget categories and cannot carry forward unspent funds from one fiscal year to the next. Those limitations have been challenging for an organization like RSIC that has been going through a period of rapid staff growth and expanding needs for systems.

It is not clear to FAS that the Commission has maximized the use of its budget appropriations to the fullest extent in the past. However, now or through several evolutionary steps, RSIC needs to attain the statutory authority other state investment boards have to fully determine and manage its operating budget, headcount and compensation plan. It would better enable RSIC to make timely, cost-effective choices between internal and external management based upon the option that is expected to achieve the best risk adjusted net return for a particular investment type. This would better align the Commission's management authority with its fiduciary responsibility and clarify accountability.

This need for such alignment was recognized in the Uniform Management of Public Employee Retirements Systems Act (UMPERSA), established by the National Conference of Commissioners on Uniform State Laws, and upon which the fiduciary duty standards for South Carolina retirement system trustees and fiduciaries (SC Code Ann. Sections 9-16-30 and 9-16-40) were explicitly based. UMPERSA recommends granting public pension trustees "exclusive authority" to "establish an administrative budget sufficient to perform the Trustee's duties and, as appropriate and reasonable, draw upon assets of the retirement system to fund the budget" and also to "obtain by [employment or] contract the services necessary to exercise the trustee's powers and perform the trustee's duties, including actuarial, auditing, custodial, investment, and legal services."

The official Comments to Section 5 of UMPERSA explain why public pension fund fiduciaries need independent operating budget authority (as well as procurement authority for actuarial, auditing, custodial, investment and legal services). "This section is intended to ensure that retirement system trustees have a level of independence sufficient to permit them to perform their duties and to do so effectively and efficiently. Trustees are different from other state actors because they are subject to an extensive and stringent set of fiduciary obligations to retirement system participants and beneficiaries. These obligations both require and justify some level of trustee independence. Independence is required because it permits trustees to perform their duties in the face of pressure from others who may not be subject to such obligations."

The South Carolina Legislature's control over the fund operating budget and headcount is unique among peer investment funds. Similarly, the requirement for the Legislature to approve major purchases of

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investment-related purchases is a lagging practice. The results of the investment board peer survey are shown below.

Table 5 Authorities

Do the fund trustees have the final authority to approve:	Investment Board Responses (N=6)		
	Yes	No	RSIC
The overall fund operating budget	6	0	No
The fund headcount	6	0	No
Investment staff base compensation	4	2	Yes
Investment staff bonus pool	5	1	No*
Major purchases of investment-related services (e.g., systems, administrative services)	4	2	No*

* RSIC has authority to recommend only.

Recommendations

G5.1: The Legislature should delegate authority for operating budget, staffing and all compensation approval to the Commission.

G5.2: RSIC should review its annual budget planning process to ensure that it is using existing allocations to full advantage and that requests for increased resources are based on a realistic assessment of staff and systems the organization can assimilate during the next budget period. The Commission should conduct a mid-year review of year-to-date and projected expenses compared to budgeted amounts.

External Audit Responsibility

Conclusion G6: Although the external audit process of PEBA includes RSIC activities, RSIC does not have a direct relationship with the external auditor.

The external auditor is retained by the State Auditor and the direct day-to-day contact with the auditor is through PEBA, not RSIC, which limits the depth of the external audit and the level of reassurance for the Commission. There is no external audit directed by the Commission and no independent audit of RSIC alone.

The financial statements of PEBA, which are required annually, have always included the activity of the Investment Commission. The financial statements are prepared in accordance with Generally Accepted

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Accounting Principles (GAAP) and the financial statements are reviewed by an external audit firm. Those audit firms have always provided an unqualified audit opinion.

Concerns have been raised by the State Treasurer about the reliability of valuations contained in the PEBA Consolidated Annual Financial Report (CAFR). The valuations of private equity, real estate, and private debt investments are determined by the investment managers based upon documented valuation policies. As part of receiving an unqualified external audit, managers must value the assets at fair value according to the Financial Accounting Standards Board (FASB) accounting guidance. Additionally, some managers have their assets valued by independent third party valuation agents or appraisers on a regular basis. Staff at both RSIC and PEBA review the external audits of the managers and ensure they have unqualified audit opinions and are conducted by reputable firms.

The financial statements issued by PEBA are audited annually by CliftonLarsonAllen, and the valuation of the private equity and other alternative asset class investments is a subject of review during those audits. Additionally, a joint valuation team (including staff members of both RSIC and PEBA) meets at least quarterly to review valuation topics. The approach used by PEBA, RSIC and CliftonLarsonAllen to review the fund valuations is standard industry practice. However, based upon our investment board benchmarking, all the peer funds have their own separate external audit performed.

Table 6 External Audit

Does the investment board contract directly with an independent external auditor for an audit of your investment fund accounts, valuations and reporting controls?	Responses (N=6)	RSIC
Yes, with an independent auditing firm	3	
Yes, with a state auditing agency	2	
Yes, an independent auditing firm is retained by Auditor General, paid for by the fund	1	
No, we do not contract with an auditor	0	X

There are issues with coordinating an RSIC financial audit to be included in the RSIC Annual Report. RSIC relies on PEBA to perform the investment accounting services. PEBA has a hard deadline for financial reporting and completing their audit because that organization is a part of the State Comprehensive Annual Report. This early deadline is often before some investment information, such as fees, is finalized. The RSIC Annual Report is issued later after such information is available. The timing of the PEBA audit, state deadline, and lack of investment accounting personnel at the RSIC currently precludes a coordinated audit that would benefit both PEBA and RSIC.

However, having an independent external financial audit or review of RSIC could increase reassurance by focusing on the funds managed by RSIC, rather than relying on a by-product of another entity's audit.

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Establishing a client/auditor relationship would allow the Commission to provide inputs and concerns directly to the auditor before the audit begins and could be a mechanism for the auditor to feed back to the Commission substantive discoveries that do not reach the critical or material level.

In lieu of a financial audit, the RSIC might consider an “agreed upon procedures” contract with an external firm for a valuation, procedures analysis or internal controls review. A similar contract might provide an opinion or assurance of the content (or a portion of the content) of the RSIC Annual Investment Report. If RSIC intends to pursue its strategy of increasing the internal management of assets in the future, then a financial, valuation, and/or control audit becomes even more critical.

Recommendation G6: The Commission should have an annual external financial audit or an agreed upon procedures review of fund valuations, procedures and/or controls, consistent with other investment boards; either the Commission or a state agency (e.g., the State Auditor) could select the external firm.

Investment Decision-Making within Strategic Partnerships

Conclusion G7: Although significant improvements have been made, investment decision-making in strategic partnerships can still be further improved.

Although the Commissioners approve all external investment manager (EIM) hires, major investment decisions occur within the strategic partnerships which require only CIO approval. RSIC now has two investment officers attend quarterly partnership meetings. All new investments within the strategic partnerships are reviewed by the Internal Investment Committee. A review by HEK of each new investment was recently added to the decision-making process. The CIO still has sole authority for RSIC decisions to participate in an investment. Further institutionalization of the review process for investments within strategic partnerships to prevent “single point of failure” types of risks should be encouraged.

There are examples of other funds where investment decision authorities vary by asset class and size of investment. For example, the California State Teachers’ Retirement System (CalSTRS) investment policies give its investment staff authority to commit up to \$300 million in infrastructure investments, \$500 million in private equity, and up to \$1 billion in real estate, without board approval.

Recommendation G7: Decision-making within strategic partnerships should be assessed in the context of how all RSIC investment decisions are made and adjusted accordingly, if appropriate (see Recommendation I12.1).

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Commissioner Qualification and Selection Criteria

Conclusion G8: The selection criteria and composition of the Commission rely heavily on certifications and educational credentials, are focused primarily on the “front office” aspect of investing, and do not allow appropriate levels of experience to be recognized as qualifying criteria.

All appointed Commission members and the elected member must have specific expertise and investment credentials and serve five-year terms. RSIC has the most specific, difficult-to-meet qualifications of any investment board or pension fund the FAS team has encountered, which appears to limit the pool of potential Commissioners and also limit the diversity of Commissioner experience. “A person may not be appointed to the commission unless the person possesses at least one of the following qualifications: (1) the Chartered Financial Analyst credential of the CFA Institute; (2) the Certified Financial Planner credential of the Certified Financial Planner Board of Standards; (3) reserved; (4) at least twenty years professional actuarial experience, including at least ten as an Enrolled Actuary licensed by a Joint Board of the Department of the Treasury and the Department of Labor, to perform a variety of actuarial tasks required of pension plans in the United States by the Employee Retirement Income Security Act of 1974; (5) at least twenty years professional teaching experience in economics or finance, ten of which must have occurred at a doctorate-granting university, master's granting college or university, or a baccalaureate college as classified by the Carnegie Foundation; (6) an earned Ph.D. in economics or finance from a doctorate-granting institution as classified by the Carnegie Foundation; or (7) the Certified Internal Auditor credential of The Institute of Internal Auditors.”

Table 7 Minimum Qualifications

Do the appointed members have minimum qualification standards? (N=6)	Yes	No	No Appointed Members
Responses of the Investment Board peer group	2	3	1
Comments:			
Very general. “Experience in pension management, institutional management or financial markets.”			
“10 years of investment or financial experience.”			

Current RSIC criteria emphasize investment certification and qualifications or academic credentials but do not recognize equivalent experience, and also strongly prefer front-office expertise and experience over general management and back office operations experience. The criteria also limit the potential Commissioner pool of candidates; some current commissioners no longer meet the new criteria and had to be grandfathered.

The composition of the Commission is not consistent with peer investment board funds; most boards have a more diverse mix of experience with less focus on investments per se. Although FAS regards

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having a Commission with a high level of expertise as desirable, we believe the current criteria are not optimal. We have identified two governance models employed by peer investment boards:

1. *Ex Officio Lay Board with Expert Advisory Board*: An ex officio lay board comprised of elected state officials who are advised by an appointed, non-voting expert advisory board.
2. *Lay Oversight Board*: A board with a combination of several appointed expert members, often several ex officio members, and active member and retiree representation.

The current RSIC model is somewhat unique in that it is more of an Expert Oversight Board. See *Appendix C Fund Governance Models*. Beneficiaries are under-represented on the Commission compared to some other investment boards. Examples of each type of investment board governance model are included in the following chart.

Table 8 Board Composition

	Number of Board Members	Investment Advisory Board	Number of Beneficiary Trustees
Ex Officio Lay Board with Expert Advisory Board			
State Board of Administration of Florida (SBA)	3	Yes	0
Minnesota State Board of Investment (SBI)	4	Yes	0
Lay Oversight Board			
Illinois State Board of Investment (ISBI)	9	No	2
Massachusetts Pension Reserves Investment Mgmt. Board (PRIM)	9	Yes	5
Washington State Investment Board (WSIB)	15	No, but 5 non-voting expert board members	2
West Virginia Investment Management Board (WVIMB)	13	No	0
State of Wisconsin Investment Board (SWIB)	9	No	2
Expert Oversight Board			
South Carolina Retirement System Investment Commission (RSIC)	7	No	1

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There is a wide range in the number of trustees (i.e., Commissioners) at the peer investment boards, ranging from 3 (Florida) to 15 (Washington). However, all those smaller than the Commission utilize at least one advisory board to provide advice and counsel.

The current situation with the Commission having six voting members is not leading or prevailing practice, as it can contribute to tie votes (and has on one occasion recently). While tie votes can occur even when there is an odd number of Commission members (if members are absent or recused from voting on a matter) and tie votes merely result in failure to approve the pending motion, prevailing practice seeks to reduce tie votes, as they can contribute to deadlock and exacerbate conflicts. Otherwise, the RSIC policies are consistent with prevailing practices with respect to standard trustee terms, staggered terms, no term limits, and public reporting of attendance.

Recommendations

G8.1: The Legislature should revise the Commissioner qualification requirements to achieve a more diverse composition of members, including a broader business experience beyond investments which is not as reliant on professional certifications when there is significant practical experience.

G8.2: The Legislature should consider adding one or three additional voting members to the Commission to increase diversity, increase beneficiary representation and reduce the potential for tie votes (making the PEBA representative a voting Commissioner could be an option, but would require an exemption from the prohibition for a state employee).

Term Limits

Conclusion G9: RSIC has had a number of Commissioners who have served multiple terms, and two current Commissioners have served since inception of the RSIC.

Currently there are no limits on the number of terms a Commissioner may serve. The State Treasurer serves as a commissioner for the length of the term of office. There are arguments both for and against term limits. The primary advantage of term limits is to provide fresh energy, ideas and expertise to the board. The most commonly cited disadvantage is loss of valuable experience and continuity, particularly as it may take up to a year for many board members to be fully up-to-speed.

In the absence of term limits, leading practice is to have rigorous procedures for evaluating board members and removing those who are not able to fulfill their fiduciary responsibilities effectively. RSIC already has in place a staggered term process which is considered a leading practice. Term limits would provide a continual flow of new participants while retaining a cadre of more experienced members.

Recommendation G9: The Legislature should consider imposing term limits for Commissioners.

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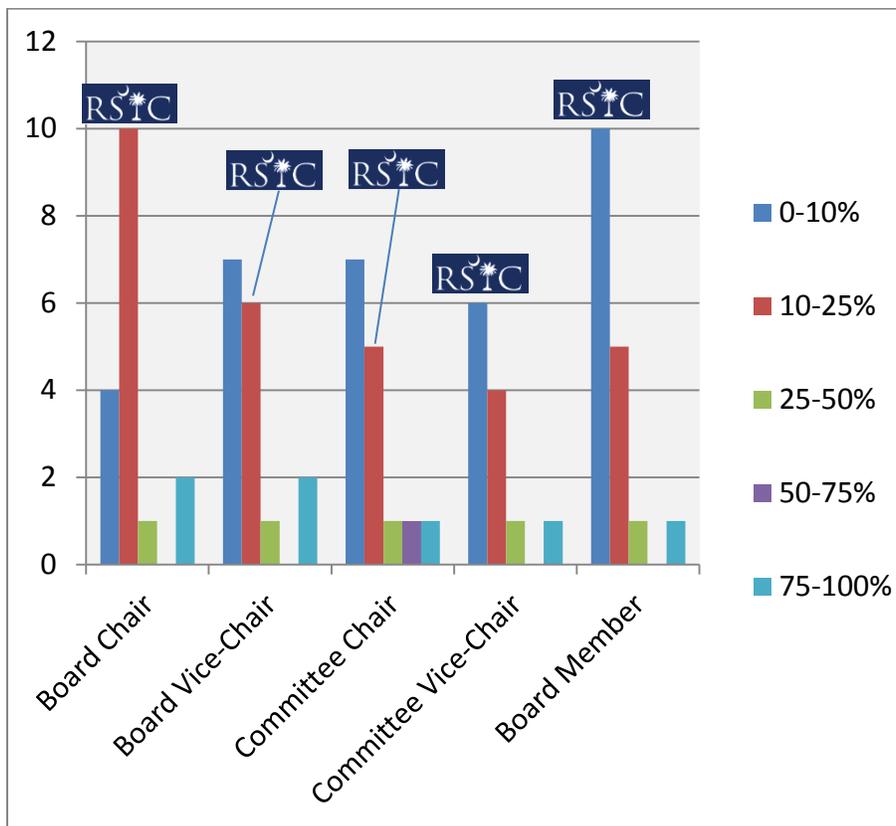
Commission Focus

Conclusion G10: Although the amount of time spent by commissioners on RSIC business is consistent with that of other leading funds, their time should be spent more effectively and focus on higher-value topics.

The amount of time spent by the Commissioners on investment commission business is appropriate and consistent with benchmarks from other leading public pension funds as indicated below.

Table 9 Commission Focus

On a full time equivalent (FTE) basis, how much time do board members dedicate to your board, by category? (Source: CalPERS Governance Survey)



However, in recent years the Commission has been more focused on operations and fire-fighting than on strategy, oversight, governance and accountability. Due to the current Commission dysfunctions, the Commissioners are reluctant to interact as a group and a number of Commissioners have stated that they can no longer have a meaningful discussion during a Commission meeting.

Greater emphasis is needed on long-term strategic planning and asset allocation. The last strategic plan was developed in 2009, and there is currently little, if any, focus on longer-term strategy beyond the asset allocation. Strategic retreats have been suspended, although it appears there may be a strategic retreat scheduled during 2014.

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Although the Commissioners are involved in setting the asset allocation and approving individual investments, there are two gaps in setting the long-term investment direction:

1. They have not articulated their investment beliefs; this would typically include actively discussing and debating topics such as active vs. passive management, risk appetite, the role of internal management, investment costs, long term investing, and impact of the liability structure on investment strategies. The investment beliefs could help shape the asset allocation, facilitate constructive debate, and help develop a more informed view about key assumptions underlying inter-related decisions affecting the portfolio. In addition, they could help guide organizational priorities and ensure alignment between the Commissioners and staff.
2. Asset class strategies (within each asset class) have not been developed and discussed with significant Commission input. Although the investment staff and general investment consultant have developed strategies within each asset class, it appears that there is not typically significant discussion about the asset class and oversight of asset class strategies by the Commission. Leading practice at other public funds is to discuss each asset class once annually to review the role of the asset class in the overall fund portfolio and the specific strategies to be employed within the asset class.

The RSIC is unique in assigning individual Commissioners responsibility for specific asset classes; this is a lagging practice and presents potential conflicts (e.g., potential “majority of one”) and opportunity for undue influence, although we found no evidence of that at the RSIC.

The RSIC is also unique in assigning Commissioners to participate on due diligence teams. Although occasional participation as an observer for training and reassurance purposes may be appropriate, the Commissioners should be providing oversight for the entire investment management process and should not be active participants in day-to-day management. Oversight should be at the enterprise level, not just the investment portfolio, and consider organizational capabilities and risks.

Table 10 Due Diligence

Who typically participates in due diligence of prospective funds/ managers? (N=6)	Investment Due Diligence	Operational Due Diligence	RSIC	
			Investment Due Diligence	Operational Due Diligence
Trustees/Commissioners	0	0	X	
Investment Staff	6	6	X	
Operations Staff	1	4		X
General Investment Consultant	2	1	X	X
Asset Class Consultant	3	2		

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Recommendations

G10.1: The Commission should work with its general investment consultant and develop a set of investment beliefs to provide a basis for strategic management of the investment portfolio.

G10.2: In addition to an annual review of the asset allocation, throughout the year the Commission should review and discuss asset class strategies with the investment staff and provide oversight.

G10.3: The Commission should shift its emphasis from a focus on advising on specific investments and participating in due diligence to providing oversight and strategic guidance to staff. This would include eliminating the assignment of asset classes to individual Commissioners and, as a general rule, preclude Commissioner's involvement in investment due diligence except as observers for either overseeing staff processes or for Commissioner education and training purposes.

Commission Structure

Conclusion G11: The Commission committee structure is similar to peer investment boards.

The standing Audit and Compensation Committees of RSIC are prevailing practice for similar investment boards (see chart below). The number of meetings annually is typical for the Audit Committee and less than average for the Compensation Committee.

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Table 11 Commission Structure & Meetings

Source: NYS Common Fund Survey What types of voting, standing board committees does your organization utilize?	Re-sponses	Sole Fiduciary N=3	Trustee Board		Number of meetings annually	
			Investment N=5	Integrated N=7	Average	RSIC
Audit	10		3	7	4	2-5
Personnel and Compensation	9		2	7	3	1-2
Investment (all asset classes)	7			7	8	
Pension Benefits/Actuarial	6	1		5	4	
Governance	5		2	3	5	
Executive	4		1	3	7	
Risk	3		1	2	5	
Corporate Governance/ESG	3		1	2	4	
Strategic Planning	3		1	1	6	
Legislative/Policy	2			2		
Disability	2			2		
Public Assets	1		1		8	
Private Assets	1		1		8	
Real Estate	1	1			12	
Alternatives	1				NA	
Nominating	1		1		8	
Finance and Administration	1			1	8	
Benchmark	1		1			
Stakeholder	1			1		
Budget	1			1		
Ethics	1			1		

An Ad Hoc Governance Committee, which is also prevailing practice, was disbanded in May 2013 following the most recent review and update to the Governance Policy Manual. Committee assignments are made by the Commission Chair and confirmed by Commission vote. Committee meetings are typically held several weeks in advance of full Commission meetings to allow time to prepare committee findings and recommendations, which is a leading practice.

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The Audit Committee includes the PEBA representative on the Commission (due to PEBA's reliance on investment information from the RSIC), the immediate past Commission Chair, and the current Commission Vice-Chair. Quarterly meetings of the Audit Committee are a prevailing practice.

The Compensation Committee meets once or twice per year, as required. This is less than the typical three times annually at the peer funds. A new Compensation Committee charter is under development.

Commission Operations

Conclusion G12: Commission operations are consistent with policies but could be improved in several areas.

The Commission charter calls for quarterly meetings, but approval of investments often requires meeting more frequently than quarterly. The Commission has met 7-8 times per year for the past two years with numerous special meetings. Initially, the Commission met monthly when it was first formed, then moved to bi-monthly, and finally to a minimum quarterly schedule. Given that the Commission must approve all investments (other than those in strategic partnerships or those managed internally), the quarterly schedule creates an unintended hurdle in timely approvals.

A revised protocol for the agenda setting process was presented by the Chairman at the September 2013 meeting to ensure opportunity for input by all Commissioners in development of the agenda. However, the minutes do not indicate that the amended protocol was adopted by the Commission. While the Chairman indicated he would follow the new protocol, the amendment should be formally adopted by the Commission and incorporated into the Governance Manual.

The Commission currently utilizes a self-assessment process which is prevailing practice. The Commission conducts self-assessments of the entire commission and the committees, but individual member, peer-to-peer, and upward (staff) evaluations are not used. The Commission chair coordinates the self-assessments using a questionnaire and open discussion. There are no individualized feedback or personalized improvement goals.

Although the Commission's self-development policies are prevailing practice, there are opportunities for improvement. Commissioner training is mandatory and the type of training is consistent with the peer group. While there is a training plan for new commissioners, there is no overall plan or budget for the Commission or individual members.

Recommendations

G12.1: The Commission should plan more frequent meetings, at least bi-monthly, and develop standing agenda items annually and for each meeting (e.g., asset allocation, investment beliefs, specific asset class reviews, infrastructure business plan review, etc.) (see also Recommendation I6.1).

G12.2: The revised protocol for the agenda setting process should be formally adopted by the Commission and incorporated into the Governance Manual.

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G12.3: Improve the effectiveness of Commission self-assessments by providing evaluations of individual Commissioners, utilizing peer-to-peer and upward evaluations (from RSIC staff), and providing individualized feedback and personalized improvement goals.

G12.4: Develop an overall continuing education plan for Commissioners, including an on-going education budget for the Commission and plans for individual Commissioners.

Independent Reassurance

Conclusion G13: Although there have been improvements, reporting and reassurance capabilities still need to be strengthened and have contributed to lack of trust and confidence in RSIC staff and performance.

Prior to 2012, the Commission did not have an Internal Audit and Compliance Department (IACD). The effective functioning of this group has been a significant improvement. Internal Audit and Compliance has made significant contributions in policy and procedural development and independent reassurance; considerable effort has been expended in getting to a state where policies and procedures can now be audited. Internal audit plans are adequate and staffing shortages are being addressed through outsourcing. A draft Internal Audit charter has been developed but has not yet been approved.

Consistent with leading practices, the Commission has also established an Audit Committee to oversee the Internal Audit and Compliance functions, the internal control environment, and any engagements with external audit firms; approve internal audit plans, review the findings, and approve and monitor follow-up items; and oversee the process for monitoring compliance with RSIC policies and applicable laws.

Independent reassurance that management reports are reliable, controls are robust and that RSIC staff is capable is still underdeveloped in several key areas:

1. Although the Governance Policy Manual requires an enterprise risk management (ERM) program, it does not yet exist. We do note that at the March 13, 2014 Commission meeting, approval was given to establish an Enterprise Risk Management function with operational reporting responsibility to the Audit Committee, effective July 1, 2014.
2. The Commission does not engage its own external auditor to review the fund valuations and controls (see Recommendation G6).
3. There is not an independent third party expert benchmark of returns and costs (see Recommendations G18.4 and I11.2).
4. The Audit Committee mandate and charter do not include oversight for enterprise risk management (ERM), although we assume this will change based upon the approved direction for the ERM program at the March 13, 2014 Commission meeting.
5. Internal Audit and Compliance capabilities, while very competent, are still evolving.

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Creation of the Internal Investment Committee (IIC) is a leading practice and, as it evolves, the IIC could become an effective reassurance mechanism and an important vehicle for channeling staff input to the Commissioners. External investment reporting for the strategic partnerships is not broken out by asset classes, which limits transparency and comparability.

Recommendations

G13.1: The Audit Committee should review and approve the Internal Audit Charter.

G13.2: Develop and implement an Enterprise Risk Program, as called for in the Governance Policy Manual and approved at the March 13, 2014 Commission meeting, and ensure the necessary tools are acquired to support effective risk management and oversight.

G13.3: Add responsibility for Enterprise Risk Management to the Audit Committee charter; consider changing the name to the Audit and Enterprise Risk Committee.

G13.4: An independent third party expert firm should regularly benchmark fund returns and costs (see Recommendations G18.4 and I11.2).

Powers Reserved and Delegation of Authority

Conclusion G14: Delegations from the Commission are generally clear and comprehensive.

The Governance Policy Manual contains thorough delegations to the CIO and COO. All the information is in one place. The document was approved by the Commission and cannot be changed without Commission approval. The Governance Policy Manual also covers executive evaluation and is fairly comprehensive.

Executive evaluations occur annually. Executives complete a self-evaluation which is then reviewed by the Commissioners. The robustness of the process for Commissioner's input into the process can be improved, as there is no formal feedback process in between annual reviews.

Recommendation G14: The Commission should adopt a mid-year review process for its direct reports to provide guidance and interim feedback.

Compensation Committee

Conclusion G15: The Commission, as well as the Compensation Committee, provides limited, if any, guidance to the RSIC staff in developing human resource capabilities.

Given the human resource challenges faced by RSIC such as morale and reputation, recruitment and retention, key person risk, and succession planning, the Commission does not provide sufficient

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leadership in developing organizational capabilities, particularly in the back office and risk management areas.

The Compensation Committee charter does not include oversight of the adequacy of human resources recruitment, selection and management. The charter defines the Committee's responsibilities as "reviewing and making recommendations related to the RSIC's Compensation Policy, including sections related to Performance Incentive Compensation ("PIC") to ensure the RSIC can recruit and retain superior talent to satisfy the core mission of the Commission."

Recommendations

G15.1: As part of a shift in emphasis by the Commission to enterprise oversight, the Compensation Committee charter should be expanded to include oversight of human resources and infrastructure and to provide guidance to staff on human resources and capability development.

G15.2: The Compensation Committee should change its name to Human Resources and Compensation to reflect the new focus.

Role of the IIC

Conclusion G16: The RSIC has improved its investment decision making processes with the creation of the Internal Investment Committee, but further enhancements are possible.

The development of the Internal Investment Committee (IIC) has been a positive step, but its role and processes are still evolving. Indeed, during this fiduciary review, the IIC meeting was bifurcated to allow one meeting to focus on implementation issues and another to focus on markets and opportunities. Right now, the IIC is effectively an advisory committee to the CIO, who has sole authority to recommend investments to the Commission. As the IIC evolves, the RSIC should consider its role and function. For example, should the IIC remain an advisory body or should it become a decision making body with the CIO's role that of an executive Chair? How much detail of IIC deliberations should be provided to the Commission so that the Commission receives notice of major issues but is not drowned in operational detail?

The IIC could also improve internal investment staff information sharing and become a management tool for creating annual asset class or functional investment-area plans, as well as for better managing due diligence.

Although the Director of Risk Management is a mandated member of the IIC, Risk Management attends only sporadically and is listed as "other attendees". Broader participation in IIC meetings (e.g., other investment, operations and legal staff) could help facilitate dissemination of information across functional silos.

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Recommendations

G16.1: The role of the Internal Investment Committee (IIC) should be clarified.

G16.2: If the named member of the IIC is not available (due either to being out of the office, on vacation, or the position being vacant), the next ranking staffer with similar responsibilities should attend IIC meetings to ensure appropriate participation.

G16.3: The CIO should routinely invite other investment, operations and legal staff to attend IIC meetings as visitors so as to facilitate dissemination of information across functional silos.

G16.4: The CIO should consider whether to mandate annual plans by asset class and/or functional area. If so, the plans should be presented to the IIC to facilitate dissemination and cross-silo knowledge sharing.

Transparency

Conclusion G17: The transparency of Commission meetings is leading practice.

Commission meetings are broadcast live via the RSIC website, and archived video recordings are available for viewing on the website several days after meetings have concluded. RSIC is the only one of the peer investment boards to have this level of transparency with meetings.

Table 12 Transparency

Are your board meetings: (N=6)	Yes	No	RSIC
Broadcast with live audio only	1	5	
Broadcast with live video	0	6	X
Audio recording available on your website	0	6	
Video recording available on your website	0	6	X

In addition, RSIC appears to be in compliance with all applicable requirements of the South Carolina Code of Laws Title 30 - Public Records, Chapter 4, Freedom of Information Act. This includes notification of Commission meetings, holding public meetings, publication of minutes, and availability of public records.

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Communications

Conclusion G18: The communications policy and practices should be improved.

State investment organizations often have policies regarding their external communications. They vary considerably in approach and scope; however, generally their intent is to ensure that communications are coordinated and responsive to the information needs of stakeholders, the public and the media. Such policies seek to safeguard the organization's reputation by providing information that is accurate, consistent and timely.

The Commission's communications policy, and related staff policy in the Employee Handbook, is focused primarily on who may speak on its behalf. It permits the Chair, the Chief Investment Officer (CIO), Chief Operating Officer (COO), or their designee to be spokesperson depending upon the situation. The COO is responsible for written press releases, in consultation with the CIO and Chair, and subject to the approval of Chair and Vice Chair prior to their release. A Chief Executive Officer could provide a central point of accountability for communications and is the leading practice at peer funds.

The communications policy does not proactively address what the Commission believes stakeholders and the public need to know about how the Fund is managed. In 2012, RSIC hired a Public Information Officer (PIO) to be responsible for "the creation and organization of the public message of RSIC". Although the PIO is not mentioned in the communications policy, he is to be the first point of contact for the media and public who have questions or comments. The PIO is also the chief liaison with the General Assembly and other public officials. The PIO coordinates freedom of information requests and is also responsible for RSIC outreach to stakeholders.

It is not clear who is actually speaking for the Commission, given the multiple and conflicting messages communicated by Commissioners and staff for much of the past two years. What does seem clear is that there is no practical way to enforce a policy on public comments made by individual Commissioners when there is open strife within the Commission.

The Commission's 2009 strategic plan included a goal to enhance external communications through three initiatives:

- Develop a plan for managing key stakeholder relationships
- Enhance the RSIC website
- Evaluate and refine external reports

Although overshadowed by controversy, RSIC has made progress in these areas. There has recently been a more proactive outreach to beneficiaries, which RSIC indicates has been well received. The PIO holds quarterly meetings with retiree associations and the CIO participates on occasion.

Improvements have also been made to the website, which includes links to a one page quarterly investment performance update, the annual investment report and minutes of Commission meetings. The Commission's use of live video streaming, and availability of video recordings on its website, is a

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leading practice (and is not practiced by any of the peer investment boards in our survey). The PIO stated the main message he tries to communicate is that RSIC is seeking the best returns with the least risk. Apparently that message is not being heard because of competing views expressed by the Treasurer and some reports and media articles that the Commission's costs are high and its returns low compared to its peers. The matter of RSIC's performance and fees is addressed separately in *Section 4 - Investment Administration* of this report.

RSIC's communications could benefit from a periodic benchmarking of its returns and costs by an independent expert to provide added assurance to stakeholders about the facts of its performance compared to peers (see Recommendations G13.4, G 18.4 and I11.2). RSIC is actually the leader among public pension funds in the level of disclosure of costs, and the 2014 report from CEM Benchmarking indicates that in an "apples to apples" comparison, its costs are "normal" for a fund of its size and asset mix.

The CAFR and annual investment report disclose RSIC's management and performance fees, whether invoiced or netted from returns. However, relatively little explanation was provided in the most recent annual investment report as to why those expenses increased significantly in 2013. The reporting of strategic partnership costs in the CAFR does not provide insight into what is driving the costs of underlying assets.

RSIC needs a formal communications plan that could include an initiative to draw national attention to the need for all public pension funds to more consistently disclose costs and for investment managers to provide the level of reporting necessary to accomplish that objective. This could improve the quality of peer group comparison data, strengthen public disclosure and perhaps lead to better informed contract negotiations with external managers. RSIC has written to the Government Accounting Standards Board (GASB) about this issue but may want to expand its efforts through such national organizations as those that represent State Treasurers, public retirement funds, auditors and public investment officers.

Many state retirement funds find their increasingly complex investment programs challenging to explain to stakeholders. For RSIC, the stakes are especially high. The additional management authority and resources it requires to fulfill its responsibilities depends upon the Commission's ability to effectively explain its activities and to engender public trust. The Commission is comprised of one of, if not the most, highly credentialed Boards or Commissions in the country. It has made deliberate decisions in terms of its strategy and related costs that are likely difficult for the layperson to understand. As a public entity, the Commission should recognize that it has a responsibility to proactively and consistently communicate that strategy in ways that are understandable to its key stakeholders to avoid potential confusion and conflict.

Recommendations

G18.1: RSIC's communications policy should be reviewed and revised, as appropriate, to address who is responsible for proactively speaking out on behalf of the RSIC and any policies which might be necessary to develop key messages.

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G18.2: RSIC should develop a communications plan which identifies each key stakeholder group, considers what information is important for each stakeholder to know, and identifies responsibility for maintaining stakeholder communications.

G18.3: In the communications plan, RSIC should consider an initiative to draw greater national attention to the need for all public pension funds to disclose costs in a consistent way and for investment managers to provide the level of reporting necessary to accomplish that objective.

G18.4: RSIC should conduct a periodic benchmarking of its returns and costs by an independent expert to provide added assurance to stakeholders about the facts of its performance compared to peers (see Recommendation G13.4).

Indemnification

Conclusion G19: Most investment boards indemnify their trustees in the case of legal action; RSIC’s level of fiduciary liability insurance appears to be consistent with amounts carried at other investment boards with similar asset allocations.

RSIC Commissioners are indemnified for damages and lawsuits arising out of fund business based upon the South Carolina Code Ann. Section 9-16-370. Commercial fiduciary liability insurance is purchased by PEBA for the Commission and other Retirement System fiduciaries. The current amount of coverage is \$25 million. Similar to South Carolina, in all but one of the six peer investment boards, the state indemnifies the trustees by statute. Three of the five purchase commercial insurance and the other two self-insure.

Table 13 Indemnification

Are your trustees indemnified for damages and lawsuits arising from fund business? (N=6)	Yes	No	RSIC
Through purchased commercial insurance	3	3	Yes
By statute	5	1	Yes
Comments:			
We are in the process of investigating the extent to which we are covered by insurance and how we might rectify any gaps.			
As long as Trustees are acting in the "scope of employment" they are indemnified by statute. Errors and Omissions insurance is purchased through the State self-funded risk pool. Employee Dishonesty Bond (financial institution bond) is commercially purchased by the fund.			

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PEBA purchases and pays for the RSIC indemnification insurance. In the case of the three peer funds which purchase commercial insurance, the fund pays directly for the insurance in two cases and the state risk management agency purchases it in one instance. The pension administration agency does not appear to have a role in indemnification insurance at any of the peer investment boards.

Table 14 Insurance Purchase and Payment

Who purchases and pays for the fiduciary liability insurance? (N=3)	Purchases	Pays	RSIC
The fund	2	3	
The pension administration board			Purchases & Pays
The attorney general			
State Risk Manager/Administrative Services Office	1		
Not applicable - the state self-insures	3	3	
Comments:			
Purchased through Board of Risk and Insurance Management, but have authority to purchase on the open market as well.			
There are statutory protections in place. Do not have a commercial fiduciary policy.			
South Carolina: The pension administration board purchases and pays for fiduciary liability insurance.			

It appears that the RSIC indemnification coverage, at \$25 million, is somewhat higher than the other two investment boards which responded. However, fiduciary liability insurance coverage often varies significantly depending on portfolio holdings and premium costs. Funds with substantial exposure to alternative investments often opt for higher coverage amounts. According to proprietary fiduciary liability coverage survey data made available to us by The Segal Group (a national fiduciary liability insurance underwriter), RSIC's coverage amount is consistent with levels purchased by other public pension funds that have similar asset allocations.

Table 15 Coverage

What is the amount of coverage, if applicable? (N=2)
\$15 million
Supposedly \$10 million
RSIC: \$25M in aggregate

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There does not appear to be any discernable consistent approach to the level of deductible among the peer group. Since RSIC's insurance is arranged by PEBA, we did not further evaluate policy terms, given the RSIC scope of our review.

Table 16 Amount of Deductible

What is the amount of self-insured retention (deductible), if applicable? (N=2)
\$250K
The first \$5 million is essentially self-insured by Board of Risk and Insurance Management
RSIC: No response.

With three of the peer investment boards, the state is required to provide legal defense if a claim is filed against a trustee or the entire board. Since RSIC falls within the group where defense and indemnity must be provided by the State (under South Carolina Code Ann. Section 9-16-370), regardless of insurance coverage, RSIC should confer with PEBA about whether a specific sum sufficient budget appropriation is in place to fund the State's obligations. If not, consideration should be given to seeking legislation that addresses the issue.

Table 17 Legal Defense

	Yes	No	RSIC
Is the attorney general required to provide defense if a claim is filed? (N=5)	3	2	Yes
Comments:			
It is up to us.			
The Department of Justice is required to provide defense.			
South Carolina: There is a statutory provision requiring "the State" to agree to defend claims brought.			

Recommendation G19: RSIC should confer with PEBA to determine whether legislative action is needed to ensure that a funding mechanism is in place for the State's indemnity and defense obligations that are not covered by insurance.

2. Policy Review and Development

Scope and Standard for Comparison

The policy assessment included an evaluation for reasonableness and adequacy of the RSIC's existing policies and the process of policy development to determine whether RSIC's policies, procedures, practices and functionalities are properly documented, implemented, and reflective of the Investment Commission's established investment goals, risk tolerances and governance. We utilized document reviews, our review team experience, and the FAS public pension fund policy database to compare RSIC's policies, procedures and practices to other funds.

The review addressed the following specific issues:

- Assess investment policy as included in:
 - Annual Investment Plan
 - Statement of Investment Objectives and Policy (including Risk Management)
- Assess the Ethics Policy, including the enforcement process for identifying, disclosing, reporting, and mitigating conflicts of interest and compare to leading practices
 - Travel/gift policy
 - Expense reimbursement policy
 - Personal trading and prohibited transactions policies
- Assess policies contained in the Governance Policy Manual and compare to leading and prevailing practices
- Assess other key policies and compare to leading and prevailing practices, such as:
 - Staff compensation
 - Securities litigation
 - Whistleblower
 - Procurement
- Assess the effectiveness of the investment funding process and compare to leading and prevailing practices
 - Identification of funding requirements

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- Approvals required and timing
- Mechanics of transferring funds

Summary of Policy Review and Development Conclusions

P1: The Statement of Investment Objectives and Policies (SIOP), Annual investment Plan (AIP) and Governance Policy Manual (GPM) are adequate but should be improved.

P2: Although RSIC's policies are generally complete, there are opportunities for improvement.

P3: The funding policies and processes are generally consistent with industry practices, with one big exception: the STO controls are far beyond normal ministerial controls for a custodian.

P4: The Commission revised its staff compensation plan in 2012; there has not been further discussion about reaching the overall goal of the plan, which is constrained by the Legislature's approval of RSIC's budget and incentive plan.

P5: The state procurement policy is a barrier to the RSIC developing its investment infrastructure capabilities in a timely manner.

Findings and Recommendations for each Policy Conclusion

Investment Objectives, Annual Investment Plan and Policy Manual

Conclusion P1: The Statement of Investment Objectives and Policies (SIOP), Annual investment Plan (AIP) and Governance Policy Manual (GPM) are adequate but should be improved.

In a February 2013 letter from Hewitt EnnisKnupp (HEK), RSIC's general investment consultant, a number of recommendations were made to improve the Statement of Investment Objectives and Policies and Governance Policy Manual. The recommendations included better coordination between the two documents, edits to reflect changes in asset allocation and benchmarks, and seventeen other specific suggestions. The incorporation of these HEK recommendations into the SIOP and GPM was an improvement.

The Commission has not articulated a set of investment beliefs to facilitate discussion of investment philosophy and provide guidance during the asset allocation process – this is a leading practice (see recommendation G10.1). Once the Commission's investment beliefs are documented they can be included in the SIOP as further explanation for the rationale of the selected asset allocation.

In the Governance Policy Manual, Policy IV Commission Operations, (D) Education (1) Overview and Continuing Education (a), the policy explicitly states that a Commissioner "may perform due diligence regarding issues such as investment manager selection and custodial bank selection." However, the Commissioners' role in due diligence is not explicitly described or limited, e.g., their relationship to advisors and staff or reporting to Commissioners while engaged in due diligence. As referenced in Recommendation G10.3, FAS believes the Commission should, as a general rule, preclude Commissioners' involvement in investment due diligence except as an observer for occasional educational purposes.

Recommendations

P1.1: The Commission should, as a general rule, preclude Commissioners' involvement in investment due diligence except as an observer for occasional educational purposes (see Recommendations G10.3 and I5.1).

P1.2: When the Commission's investment beliefs have been articulated, they should be included in the Statement of Investment Objectives and Policies (see Recommendation G10.1).

P1.3: The Governance Policy Manual should be revised to describe the potential role of a Commissioner in due diligence activities as an observer for educational and quality assurance purposes only, and that as a general rule Commissioners are not involved in due diligence activities (see Recommendations G10.3 and I5.1).

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Policies

Conclusion P2: Although RSIC's policies are generally complete, there are opportunities for improvement.

The Governance Policy Manual and the Statement of Investment Objectives and Policies are generally complete and well-articulated. Most already demonstrate leading practices. Accordingly, we are not making specific comments on those policies. However, they include the Travel Policy, Personal Trading Policy, Whistleblower Policy, Placement Agent Policy, and general provisions of the Committee Charters. The Placement Agent Policy was adopted in September 2012, and the Employee Compliance policies, with component policies including the Code of Ethics acknowledgement, Personal Trading Policy, Whistleblower Policy, Gifts and Conflicts of Interest Policy, were adopted in December 2013.

In addition, with the few exceptions noted below, policies in the Governance Manual, a revised version of which was adopted in May 2013, are consistent with statutory requirements. *Appendix I Policy Review* contains a sample from the results of our policy review. It compares RSIC's Securities Litigation, Placement Agent, Board and Employee Ethics, Personal Trading, Whistleblower and general Committee Charter policies with those in place at benchmark funds. (The appendix includes only RSIC policies for which benchmark funds had similar stand-alone policies.)

Based upon this review, there are several issues which could be addressed to improve the RSIC's policies.

- There is no counterparty acceptance and monitoring policy (e.g., RSIC has not provided a list of approved counterparties to Russell, though Russell has talked to RSIC about how it selects counterparties).
- The broker selection policy relies on a fixed income team decision without specific requirements.
- Voting of proxies is delegated to managers by provisions in their investment management agreements but is not regularly monitored. We understand that since our initial discussions took place, the proxy voting records for SMA managers for CY2013 have been collected.

There are currently no RSIC proxy voting guidelines in place. Our understanding is that RSIC is in the process of developing an amendment to the SIOP clarifying that separate account managers are authorized to vote proxies in keeping with their fiduciary obligations and setting forth the reporting process managers will be required to follow. The timely reporting of proxy voting records should be regularly monitored.

Under fiduciary law, proxy votes are considered plan assets that must be exercised in accordance with the interests of fund beneficiaries. Peer funds typically have their own proxy voting guidelines, either as stand-alone policies or within their investment policy statements. Out of the twelve benchmark funds referenced in developing *Appendix I Policy Review*, eleven

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have adopted their own custom proxy voting guidelines. At some point in the future, the RSIC should consider developing its own proxy voting guidelines.

- The securities litigation policy details the process used to identify potential securities litigation claims related to fund investments. The initial review of identified claims is completed by RSIC's internal legal counsel. Potential claims are then generally referred to outside securities litigation counsel for further evaluation. However, the policy lacks clarity as to whether and to what extent the Commission or RSIC Legal has final approval in pursuing a claim.

In addition, the policy is unclear regarding the role (if any) of the Attorney General in approving litigation and outside litigation counsel. The statutory standards of conduct in SC Code Ann. Section 9-16-360 are not as fully incorporated into the staff conflicts of interest policy as they are in the Governance Policy Manual for Commissioners, even though the statute covers both employees and Commissioners. The standards include general fiduciary practices and conflicts of interest, such as not taking action to purchase or acquire services or property for the RSIC where an employee has a financial interest in the services or property.

RSIC's Governance Manual Policy section on Commission Roles and Responsibilities describes and applies these standards to Commissioners. However, the same standards are not similarly described in the employee policy. For example, the Conflict of Interest and Receipt of Gifts Policy for employees cites SC Code Ann. Section 9-16-360, but it does not specifically identify the actions which are prohibited. Some, but not all, of these standards are discussed in other RSIC employee policies, such as the Personal Trading policy. However, ethics policies at benchmark funds consistently provide a more robust description of the applicable conflict provisions. Incorporation of similar RSIC descriptions would help to ensure that staff has a clear understanding of the standards with which they must comply.

- Although RSIC requires disclosure of conflicts of interests and a regular confirmation of compliance from both Commissioners and senior staff, there is no requirement for disclosure to the Commission of personal distress (e.g., financial, litigation, health) from commissioners or staff. Disclosures might be accorded confidential treatment. Other funds recognize personal distress as a potential indicator of risk and mandate disclosure. For example, the California Public Employees' Retirement System Board Governance Manual provides: *"Board members must disclose to the Board, within ninety (90) days of first taking the office, all past personal financial hardships that occurred within five (5) years of taking office. If a Board member experiences a personal financial hardship while in the office, the member shall report the event to the Board within forty-five (45) days. Individuals who are Board members at the time of the adoption of this provision must disclose, within ninety (90) days of adoption, all personal financial hardships that have occurred within five (5) years of adoption of this provision. For purposes of this provision, "financial hardships" are the following: bankruptcy filings, insolvencies, assignments for the benefit of creditors, monetary judgments, liens and attachments, wage garnishments, and notices of foreclosure (judicial and non-judicial). Upon disclosure of a personal financial hardship, the Board may, in its discretion, take the following*

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actions: 1) require the member to attend additional training, 2) make changes in the member's committee assignment(s), or 3) suspend or terminate the member's position, if any, as President or Vice President of the Board or chair or vice-chair of any committee or sub-committee."

- SC Code Ann. Section 9-16-55 restricts certain RSIC investments in companies that do business in Sudan. However, the statutory requirement does not apply to all investments in Sudan. It exempts from coverage "indirect beneficial ownership through index funds, commingled funds, limited partnerships, derivative investments or the like." Consequently, it appears that the Sudan investment limits currently apply to only two managers that manage dedicated RSIC separate accounts.

We understand that RSIC has recently begun to develop, but has not yet finalized, a Sudan divestment compliance policy.

- Current RSIC policies require that staff and Commissioners who have participated in due diligence or sourced an investment opportunity complete a sourcing and conflict disclosure form which is made available to all Commissioners prior to final approval of the investment. In addition, RSIC policies require that Commissioner's referral of proposals or communications regarding potential or existing service providers be directed to the CIO or COO, as appropriate. However, there is no official RSIC mechanism for tracking and reporting service provider sourcing referrals like the sourcing and conflict disclosure form used for investments. Some peer funds use referral tracking and reporting requirements for all investment and service provider sourcing.
- There is no flow chart or time line describing required steps in the RSIC investment review and approval process. Because the RSIC investment process varies between asset classes and is complex, a flow chart or time line could help to prevent inadvertent oversights or potential errors. This might also be helpful to Commissioners and independent auditors or reviewers in becoming familiar with RSIC processes.

Recommendations

P2.1: A counterparty acceptance and monitoring policy should be developed and implemented.

P2.2: The broker selection policy should be strengthened and require periodic reaffirmation by the fixed income team.

P2.3: RSIC should finalize the proxy voting process rules guidelines that are in development, require that investment managers vote in the best interests of plan participants, follow the guidelines, monitor how managers are voting proxies and include a field to track voting in Tamale.

P2.4: Policies which describe responsibilities for securities litigation activities should be refined to clarify approval roles of RSIC Legal, the Commission and Attorney General.

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P2.5: The staff conflict of interest policies should be modified to include more guidance on what is covered by the statutory standards of conduct.

P2.6: RSIC should consider developing and implementing a policy which requires Commissioners and senior investment staff to disclose personal financial or legal distress.

P2.7: The Sudan divestment policy should be finalized.

P2.8: RSIC should consider developing a flowchart which describes the investment review and approval process, including responsibilities and timelines.

P2.9: RSIC should develop a referral tracking and reporting mechanism, like the sourcing and conflict disclosure process used for investments, to cover service provider referrals.

Funding Policies and Practices

Conclusion P3: The funding policies and processes are generally consistent with industry practices, with one big exception: the State Treasury Office controls are far beyond normal ministerial controls for a custodian.

Until early February, 2014, multiple signatures were required to receive payments; now standing instructions are used to accept funds and sweep the accounts daily. Other investment board peer funds also use standing instructions. While delays from the prior process were rare, RSIC reports its staff was on high alert and had to make many last minute efforts to prevent delays, as they were aware that such delays could cost RSIC interest earnings. We are not aware that any interest earnings were lost but any future losses would be increased in a normalized interest rate environment.

Table 18 Signatures Required

Do you require signatures for receiving distributions from partnerships or other managers, or do you use standing instructions to your custodian?	Responses (N=5)	RSIC
Signatures are required	0	
Standing instructions	5	X

South Carolina requires four signatures to release funds, two from the Investment Commission and two from the State Treasurer’s Office. This is more than any of the peer funds require. Leading practice is two signatures, one from an investment officer and one from an operations executive such as a Chief Financial Officer or Director of Operations. Approvals for disbursements from outside the fund staff (e.g., Treasurer’s Office) are not found at peer funds. The RSIC COO is not required to provide an operational approval for investment transactions.

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Table 19 Number of Signatures Required

In total, how many signatures are required to release funds?	Responses (N=6)	RSIC
1	2	
2	3	
3	1	
4	0	X

Table 20 Signatories

From whom are individual sign offs (signatures) required to fund capital calls?	Responses (N=6)	RSIC
Fund CEO	1	
Fund CFO	1	
Director of Operations	1	
Portfolio manager	3	
CIO		X

The RSIC states that the State Treasurer’s Office has not accepted requested changes to RSIC signature authorities to move money from the RSIC account to external manager accounts, which is highly unusual. RSIC further states that STO has also refused to allow requested changes to authorization levels and refused to accept requested changes to authorized signatories. STO, on the other hand, states that it has established a protocol for adding authorized signatures, and that RSIC did not follow the protocol when it requested the addition of the COO for signature authority. STO states that it has drafted the letter for RSIC following the format outlined in the protocol, and is waiting for the letter to be signed and submitted to STO.

As indicated from the investment board peer survey, all of the other funds authorize signature changes based upon a letter to the custodial bank from the fund CEO, with the exception of one fund which provides a board resolution. At none of the peer funds does the State Treasurer have a role in this process.

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Table 21 Signatory Changes

How often do you review/revise the list of authorized signatures?	Responses (N=6)	RSIC
Every six months or more frequently	0	
Annually	1	
As required due to changes in responsibilities	5	X
What does your custodian require to process a signature change?	Responses (N=6)	RSIC
Board resolution	1	
Letter from the CEO	5	
Letter signed and approved by State Treasurer	0	X

STO has required written and faxed signatures. This has created problems when key RSIC staffers are away from the office (e.g., on due diligence trips). The practice has added to staff work burden and administrative costs; RSIC states that it has one operations staff person primarily assigned to coordinating capital call funding. Although not all peer funds utilize electronic signatures to release funds, it is leading practice and becoming more commonplace. BNY Mellon has stated that its technology which allows electronic payment authorization has been available for 8-9 years and is currently used by RSIC to pay external manager fees. The Treasurer could approve the additional use of this technology to release funds for capital calls.

Table 22 Method of Authorization

How do you obtain the authorizations? Some have multiple responses.	Responses (N=6)	RSIC
Physical signatures (via fax or paper)	5	X
An electronic signature	3	

Recommendations

P3.1: Continue to allow standing instructions for the custodial bank to receive incoming funds and allow sweeping of cash to maximize income.

P3.2: Review the positions required to sign to release cash transfers with the custodial bank and revise the requirements to allow two appropriate RSIC signatories, one from investments and the other from operations.

P3.3: Instruct the custodial bank to accept signatory changes based upon a letter from the Commission Chair or the RSIC COO and CIO (or CEO if a CEO position is created).

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P3.4: STO should revise its policies to allow electronic payment authorization for release of funds to cover capital calls using the existing technology offered by BNY Mellon.

Staff Compensation Plan

Conclusion P4: The Commission revised its staff compensation plan in 2012; there has not been further discussion about reaching the overall goal of the plan, which is constrained by the Legislature's approval of RSIC's budget and incentive plan.

South Carolina statutes authorize the Commission to establish compensation for all employees. The Commission's Compensation Policy defines the purpose, goals and method for establishing salaries for all staff and performance incentive compensation (PIC) for investment staff.

RSIC's compensation consultant is a widely recognized expert in compensation plans for investment organizations. The consultant advised the Commission on the design of the current compensation policy and provides peer benchmarking data.

The compensation policy was last amended in May 2012. The Commission adopted a goal to "target total compensation at the 90th percentile of a select group of comparably sized U.S. public pension funds." Note: "A percentile is a measure used in statistics indicating the value below which a given percentage of observations in a group of observations fall. For example, the 20th percentile is the value (or score) below which 20 percent of the observations may be found. The term percentile and the related term percentile rank are often used in the reporting of scores from norm-referenced tests. For example, if a score is in the 86th percentile, it is higher than 86% of the other scores."⁸

RSIC's goal reflects the view that RSIC compensation needs to be near the top of its public fund peers in order to attract the experience and skills needed to manage a portfolio with a large allocation to alternative investments. The Commission has not taken the next step to define how this goal should be reached and over what time period.

When the current compensation goals were adopted, the consultant reported that, on an aggregate basis, RSIC's salaries were competitive with a select peer group of 20 other public pension funds; six of the peers had significant (approximately 25 percent) allocations to alternative investments.

However, the consultant also reported that approximately 48% of RSIC staff base salaries and total cash compensation levels were in the bottom quartile of the public fund peer group. Based on 2010 and 2011 peer data, RSIC's actual and maximum potential compensation appear to have been well short of the 90th percentile goal in most cases. The consultant further reported that RSIC's compensation levels were "uncompetitive" with a group of 250 private sector firms "with skill sets similar to those of RSIC staff."

⁸ <http://en.wikipedia.org/wiki/Percentile>

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Recently, the consultant compared RSIC 's 2012 actual total cash compensation and 2013 salaries to a broader group of 55 public pension funds, including smaller and significantly larger funds. RSIC staff is still reviewing this information with the consultant, but it appears that RSIC's median total cash compensation in 2012 for most position types was below the median of this peer group, as were 2013 salaries. Commissioners have not yet had the opportunity to review this information with management or the consultant.

In 2011, McLagan reported that seven of 25 public funds (26%) in its data base with assets between \$10 billion and \$40 billion included some or all of their investment staff in an incentive compensation plan. It has been challenging for RSIC and other public funds to gain and sustain legislative and public support for incentive compensation, even though the alternative is often to pay the higher cost of relying more on external management. RSIC's plan to increase the use of less expensive internal management is not likely to succeed without a strong overall compensation program that includes incentive pay for performance.

The PIC plan includes basic elements often found in those of other public investment organizations:

- Awards are based on the net returns of the total fund and quantitative performance targets.
- Longer term performance (five years) is emphasized over more recent performance (one year and three years).
- Awards gradually scale up in size as the level of outperformance increases.
- Awards are deferred or not made if the total fund has a negative return.

RSIC could benefit by from: 1) an annual review by the Compensation Committee of RSIC's implementation of the compensation policy and goals; 2) updated peer benchmarking data at least every three years; and 3) the addition of a senior level human resources manager (see Recommendation O3.1).

A larger issue is that RSIC determines compensation levels, but compensation funding is controlled by the Legislature. The Legislature effectively sets compensation levels, despite the intent for this to be delegated to the Commission. Senate and House committees must also annually approve the PIC plan. There have been problems, such as securing the last appropriation for the PIC, which raises uncertainty and potential retention and recruitment issues (see Recommendation G5.1).

Recommendations

P4.1: The Compensation Committee should conduct an annual review of RSIC's implementation of the Compensation Policy.

P4.2: The Commission should engage and independent consultation to conduct a new peer compensation study at least every three years to assess the current level of RSIC staff compensation and make revisions to the target ranges, as appropriate.

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Procurement Policy

Conclusion P5: The requirement for RSIC to utilize standard State purchasing processes to acquire investment-related services and systems has contributed to delays in building infrastructure and is not leading practice.

Although RSIC is exempt (by BCB policy) from the standard State procurement process for brokerage, investment management and advisory services, it is not exempt for investment support systems. RSIC cites multiple examples of systems procurements that have taken a year or more to complete. State procurement processes limit RSIC's ability to do the same kind of expert due diligence on complex investment system purchases as they do to hire investment managers. For more information see *Section 6 – Information Technology*.

Moreover, since the purpose of those systems is to more efficiently manage the investments (for example, by measuring risk or by performing "what if analyses" on how a managerial change would affect the overall portfolio), the State procurement policies recognize the uniqueness and importance of investment purchases on the one hand, but constrain the RSIC's ability to robustly analyze and manage them on the other.

In 2012, RSIC unsuccessfully sought an exemption from state process for investment operational and support systems. This would have maintained a competitive selection process with oversight by the IIC, Commission and external auditors. Most peer investment boards either have modified state procurement rules or are not subject to state procurement rules for investment support systems.

Due to procurement delays, funds for new systems often aren't spent by fiscal year-end. The inability to move funds across budget categories or fiscal years limits flexibility. RSIC has been unable to acquire critical investment management systems on a timely basis, which contributes to operational (and ultimately financial) risk.

The State procurement policy is a barrier to RSIC developing its investment infrastructure capabilities in a timely manner. In 2011, Deloitte & Touche concluded that the lack of adequate investment systems and support services was a high risk for the Commission. To address the situation, RSIC unsuccessfully sought authority from BCB in 2012 to exempt investment operational and support systems from the state process, which would have maintained a competitive selection process with oversight by the IIC, Commission and external auditors.

RSIC has been unable to complete the acquisition of key systems that were identified as high priority in the Deloitte & Touche report two and a half years ago, and cumbersome procurement policies and procedures appear to be a major factor. The recently completed procurement of an Investment Administrator seems to be an exception because it bundled the acquisition of multiple systems into a single procurement and proceeded on a schedule that was given priority and was processed more quickly. However, that process still limited the Commission's ability to directly engage with bidders.

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The State Treasurer disagrees with this and states instead:

“Funston should not recommend that RSIC should be exempted from procurement and budgetary restraints, given that the fund oversight is critical and that RSIC lacks investment “back office” professionals with procurement experience in specialized systems. RSIC should not be exempted from procurement and budgetary requirements...All expenditures by RSIC come out of the SCRS Trust and therefore reduce funds available to pay beneficiaries and ultimately increase the unfunded liability. The procurement code of the State is structured to instill transparency and accountability to the spending of public funds, as is appropriate with trust funds...

RSIC is already exempt from portions of the S.C. procurement code when engaging investment managers through the exemption provided by the Budget and Control Board related to the hiring of investment managers. RSIC had the ability to hire staff and purchase systems but chose not to use available resources. RSIC has a five or more year history of not using its full annual appropriation by an average of approximately \$1,000,000 per year. Legislative approval played no part in the shortfall of staffing or insufficient systems. The deliberate decision not to make use of available funds when services and staffing were crucial is a critical issue and should be added to the report. Additionally, services RSIC expressed interest in are readily available through the custodial bank agreement without procurement delays. RSIC instead has chosen to take a delayed approach for important services by issuing an RFP and the results of the RFP may lack the synergistic effect that would occur if the same or similar tools were purchased from the custodial bank. PEBA (formally under the B&CB) has successfully managed with the same legislative budget oversight for years.”⁹

In contrast to the State Treasurer’s position, and as indicated in the chart below, most peer investment boards either have modified state procurement rules or are not subject to state procurement rules for investment support systems. This prevailing practice is also endorsed by UMPERSA.

⁹ Ibid. State Treasurer’s Office response to FAS Midpoint draft report.

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Table 23 Procurement Authority

Which goods/services are subject to standard state purchasing policies and rules? (N=6)	Not subject to State purchasing requirements	Subject to standard State purchasing requirements	Subject to modified State purchasing requirements	RSIC
Investment services (e.g., investment manager contracts)	3	0	3	Not subject to State purchasing requirements
Investment consultants	3	1	2	Not subject to State purchasing requirements
Other direct investment support services (e.g., trading systems, portfolio accounting, risk management)	3	1	2	Subject to standard State purchasing requirements
Routine goods and services (e.g., furniture, computers, non-investment services)	2	3	1	Subject to standard State purchasing requirements
Comments:				
While not specifically subject to state purchasing requirements, we use state purchasing requirements as a guide. Responded: "Subject to modified State purchasing requirements".				

Recommendation P5: To facilitate timely acquisition and implementation of information systems, RSIC should develop a proposed modified procurement process for approval by the BCB or the Legislature which would allow acceptable transparency and objectivity, improve the ability to evaluate, select and implement new systems, as needed, and include documentation to allow oversight on a post-purchase audit basis (rather than imposing pre-purchase restrictions).

3. Organizational Structure

Scope and Standard for Comparison

The organization structure assessment included an evaluation for reasonableness and adequacy of RSIC's current organizational structure as it relates to roles of the commissioners, staff and other fiduciaries over the investments and operations of RSIC's responsibility to the Retirement System. The assessment also focused on ascertaining whether there is a need for clarification and/or additional specification of the respective roles and responsibilities of the Investment Commission and RSIC staff. We utilized internal interviews, review of key documents, review team experience, and the FAS public pension database for a comparison of RSIC practices with peer funds.

The assessment addressed the following specific issues:

- Assess the roles and responsibilities of key staff, including the PEBA investment accounting relationship for the investment portfolio and any other significant outside services
- Assess organizational reporting relationships, spans of control, and segregation of duties, including cash movement procedures
- Assess RSIC staff capabilities and deployment compared to other funds
 - Number of staff by functional area
 - Position descriptions
 - Level of experience, skill sets, and credentials
 - Training and education policies
- Assess the standard operating procedures manual and compare to leading and prevailing industry practices
- Assess the adequacy of reporting and disclosure from staff to IC and other stakeholders to facilitate oversight

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Summary of Organization Conclusions

O1: The organizational structure has changed to place greater emphasis on operational support and due diligence; RSIC staff is generally of high quality with strong credentials and significant industry experience.

O2: Despite recent staffing increases, however, RSIC support capabilities are heavily reliant on outside parties and continue to lag behind peers and leading practices.

O3: Lack of a dedicated internal Human Resources function has contributed to a deficit of HR policies and procedures and lack of a strong focus on organizational development.

O4: RSIC has made progress in documenting its most critical operating procedures, but has not yet adopted a standard process for recording, approving and updating them.

Findings and Recommendations for each Organization Conclusion

Quality of Operations and Support Staff

Conclusion O1: The organizational structure has changed to place greater emphasis on operational support and due diligence; RSIC staff is generally of high quality with strong credentials and significant industry experience.

RSIC is still adjusting to the significant changes in leadership, duties and organizational structure that have occurred over the last several years. Until January 2012, the organization was led by a CEO who was also CIO and who had been in that role since RSIC was created. Then, for a short period, there was an acting CEO before the Commission eliminated the CEO position and adopted the current structure under which the CIO and COO both report to the Commissioners. The COO was designated by the Commission as “agency head” solely for the purpose of discharging certain functions required by state law. The practice among state investment boards FAS surveyed is to have a chief executive officer who reports to the Board, rather than a dual reporting structure, in order to focus authority and accountability for managing the organization.

Since 2010, the number of full-time positions has grown from 19 to 42 as RSIC has sought to implement improvements in management and due diligence practices. The number of temporary employees has grown from three to ten. In 2010, investment staff and some operations staff reported to the Deputy CIO, while the COO oversaw more limited areas with four staff. Under the current structure, operations, operations due diligence and legal functions have enlarged to include 17 staff who report to the COO.

The span of supervisory responsibility for senior managers is more balanced between the CIO and COO under the current structure than it was. The number of direct reports to the deputy CIO (five) and to the COO (six) seems to be approaching the maximum level for a senior manager to provide effective oversight.

Public retirement funds have traditionally organized and supervised investment staff according to asset class (e.g., stocks, bonds, real estate, and private equity). The Commission’s investment staff is not organized strictly along asset class lines and their titles in some cases do not seem to reflect their current responsibilities. Investment staff was reorganized in anticipation that more investments would be managed internally. The internal management initiative has been slowed but the CIO concluded that the reorganized structure will still provide improvements in research and analysis capabilities that are needed now and will be even more necessary if and when internal management is expanded.

Investment reporting, performance analysis and operational due diligence functions are performed by staff who report to the COO. The reporting of performance and management fees are produced by staff that is not part of the investment team. This provides a form of independent reassurance since this information is used in the calculation of performance incentive compensation for investment staff.

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RSIC's separate operational due diligence team is a leading practice among public pension funds based on our observations.

In 2011, Deloitte & Touche told the Commission that RSIC should ideally have 53 total staff to mitigate operational and investment risk factors. At a minimum, Deloitte recommended an additional 14 staff. That number did not include additional staff for expanded internal management which staff proposed in 2012. Also, in 2011 RSIC was just beginning to implement a more extensive process for verifying and reporting external management performance fees. The equivalent of two full-time employees is currently required to perform that function which is not typically found at other funds.

At the time Deloitte made its recommendation, RSIC had 35 authorized positions. In its state budget requests for each of the next three fiscal years, RSIC sought 47 total positions, slightly less than the minimum number recommended by Deloitte. To date, the Legislature has authorized 42 positions. The five positions not approved include one for IT and four for the investment team. For FY 2015, The Commission requested the 47 FTE positions. The Senate Sub-Committee has approved RSIC's budget request but the House subcommittee has not. RSIC is unable to predict what will happen in conference between the two. However, RSIC anticipates receiving no additional positions in the FY 2015 budget that is currently before the Legislature. RSIC has supplemented its workforce by adding more temporary employees over the last several years.

Based upon our interviews and comparison to other public funds which rely almost entirely on external management, the authorized number of RSIC staff positions appears to be at a reasonable overall level for investment management. However, RSIC has a larger allocation than its peers to alternative investments that are more labor intensive to manage. Vacancies and turnover add to its staffing issues. More investment staff would likely be required to expand certain strategies, such as co-investments. Additional investment staff will be required to expand active internal management. In aggregate, the headcount of the operations support staff, as compared to the investment staff, is about the size of a typical fund. However, due to the lack of systems, the requirements on the operations and support staff often exceeds its capacity, particularly in IT, and places greater reliance on outside resources.

Current staff is generally of high quality with strong credentials and levels of experience. The six investment staff in lead positions had five or more years of experience at other public or private investment organizations before coming to RSIC and three of them had more than ten years prior experience. All have master's degrees in business administration, and most have completed the chartered financial analyst (CFA) designation. The eight staff in lead positions in operations, legal and audit also have solid professional credentials and all had ten or more years of relevant experience before coming to RSIC. They consistently received high marks from external managers (including terminated ones). The quality of staff is at least equal to other public funds.

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Recommendations

O1.1: RSIC should consider creating the position of chief executive officer who would be accountable to the Commissioners for managing the entire organization.

O1.2: Given the delay in the migration to internal management, the CIO (hopefully in conjunction with the new senior HR professional) ought to examine the way the investment team is organized today to determine if staffing is aligned with AUM, complexity and risk.

Reliance on Outside Parties

Conclusion O2: Despite recent staffing increases, RSIC support capabilities are heavily reliant upon outside parties and continue to lag behind peers and leading practices.

Despite the growth in internal staff, the RSIC remains more heavily reliant on services from outside its own organization than other investment boards. RSIC and the PEBA have agreed to assign responsibility for the investment accounting and audit functions of the retirement fund, as well as various administrative and information technology services, to the PEBA. PEBA performs investment accounting and also supplies most IT support for RSIC. This has been governed through a documented agreement (Memorandum of Understanding) with PEBA, which was most recently updated in January 2014, and appears to work well.

In addition to investment accounting, peer investment boards typically have other key internal functions such as Human Resources, Procurement and Information Technology (often supplemented with third parties). Even where these functions are performed internally by RSIC, staffing is minimal, with the exception of Legal.

Most peer investment boards have a chief financial officer responsible for accounting and financial reporting. If RSIC were to develop its own investment accounting staff, it could consider appointing a Chief Financial Officer.

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Table 24 Functions Performed

Who performs the following functions for your fund?	Responses from the Investment Board Peer Group (N=6)				
	Investment accounting	Human resources	Information technology	Procurement	Legal
Internal fund staff	6	6	5	6	3
The pension administration agency	0	0	0	0	0
Another sister state agency	0	0	0	0	0
A private third party outsourcing firm	0	0	2	0	0
State Attorney General's Office	0	0	0	0	3
Outside legal counsel	0	0	0	0	4
RSIC Response	The pension administration agency	Internal fund staff	Internal fund staff & pension administration agency	Internal fund staff	Internal fund staff & Outside legal counsel
RSIC Full-time Headcount	0	1	1	0	4

Recommendation O2: The RSIC should develop an enterprise-wide capabilities and resources assessment and determine:

- 1) What are the overall support needs and priorities?**
- 2) Where are the major resource gaps?**
- 3) Should the gaps be filled through internal and/or external resources?**

Internal Human Resource Function

Conclusion O3: Lack of a dedicated internal Human Resources function has contributed to a deficit of HR policies and procedures and lack of a strong focus on organizational development.

Primary HR functions are currently handled by senior executives and detract from their core duties and make consistent focus on HR difficult. Although position descriptions exist for each staff position, there is not a standard content template and the level of detail is inconsistent. Staff have received inconsistent messages regarding education; while policies are supportive of education, at least some staff were told that they should not go to industry conferences for cost or workload reasons.

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There have been significant changes in senior managers (CEO, CIO and COO) and their duties in recent years, and there have been frequent changes in responsibilities at all levels of the organization to fill gaps. Due to recruitment difficulties resulting from recent negative publicity for RSIC, sometimes the “best available” candidate is hired with less regard to the specific skill set; this may result in the new hire not being in the most appropriate position. Some staff have commented that these human resources processes could “be better managed.”

RSIC has had ongoing requirements for recruiting and, while a number of qualified professionals have been hired, the permanent staff is supplemented by 8 part-time interns, and there are 5 vacant full-time investment staff positions and 1 vacant administrative staff position. The lack of a senior Human Resources professional focused on filling these positions requires investment and support function executives to lead the search and recruiting process.

There are a number of potential changes which have been under consideration (e.g., expansion of internal investment management, further development of risk management) which will require careful planning for staffing, technology and budgetary requirements. In order to effectively develop RSIC’s capabilities, it will be necessary to have a longer-term plan which incorporates human resources, systems, training, and third party resources.

A number of investment, operations and management staff had worked for public investment organizations before joining RSIC. In general, staff seems to appreciate that public and private organizations have different types of accountability. However, several described the negative effect on staff morale of the ongoing controversies of the last several years. One described the current environment as “toxic”, while another mentioned a “fear of political risk”. Another observed that the two ethics investigations had been very distracting for staff and had a “deleterious effect on morale”. One manager expressed particular concern about the effect on morale and retention among more recently hired, less senior employees.

RSIC has had three different chief operating officers in less than two years. The supervisor of the IT Director has changed four times in the 28 months he has been with RSIC. The Commission would be especially affected by the further loss of a number of key individuals at this time as it seeks to complete fundamental improvements in investment strategy, operational practices and systems support.

Due to gaps in structure and staffing, several managers appear to have an unusually wide range of current responsibilities. For example, the Research Managing Director is also responsible for workouts of illiquid assets, serving as the lead on private debt and equity investments, oversight of the Tamale database and managing any other issues having to do with external managers. The Director of Operations and Due Diligence conducts and oversees operational due diligence for new investments, is responsible for RSIC’s financial and performance reporting, coordinates strategic and budget planning and is currently overseeing the procurement and management of a major, multi-component systems initiative.

The absence of a single executive who is responsible for the entire organization means that accountability for planning, priority setting, employee development, external communications and

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response to crises is diffused and unclear. That poses multiple risks for the organization in the management of its staff, interactions with stakeholders and in the implementation of investment strategies and systems.

Recommendations

O3.1: A senior human resources professional position should be created and filled to lead development of an overall HR strategy to support the organization's business plan.

O3.2: Policies and processes should be developed which ensure that the HR implications of proposed new initiatives are recognized and addressed before launch.

O3.3: RSIC should implement more thorough compensation planning and evaluations to enable recruitment and retention of highly skilled and experienced staff (see Recommendations P4.1 and P4.2).

O3.4: More formalized staff training and development plans and programs should be developed.

O3.5: RSIC should utilize succession planning, including cross-training and other actions, to develop staff for broader responsibilities.

O3.6: The Human Resources function should provide leadership for development of a multi-year (3-5 year time horizon) infrastructure business plan which considers the needs and priorities of the organization.

O3.7: RSIC should develop an internal governance process to plan and manage capability and infrastructure development.

Documentation

Conclusion O4: RSIC has made progress in documenting its most critical operating procedures, but has not yet adopted a standard process for recording, approving and updating them.

In its 2011 Strategic Assessment, Deloitte & Touche found no documentation for operational workflows. This was identified as a high risk area for RSIC, particularly because staff responsibilities were changing in significant ways. The assessment recommended that RSIC "consider documenting formal operating procedures across the organization." Among the steps Deloitte suggested:

- a. Create a cross-functional review work group to review, edit, and approve the documented policies and procedures.
- b. Define a management review and approval process for the consolidated policies and procedures manual.
- c. Store the completed policies and procedures manual in a centralized and easily accessible location.

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- d. Create a review schedule to ensure policies and procedures manual stay current.
- e. Update policies and procedures manual as needed.

If anything, the pace of organizational change has accelerated since the 2011 assessment and so has the need for well documented procedures. Since the 2011 report, RSIC has made progress in documenting its most critical operating procedures, such as daily cash management, manager fee reporting and validation, and information technology services. In 2014, RSIC is focusing on other priority procedures, including the on-boarding of new investment managers, procedures for collecting return information from strategic partnerships, preparation of various investment reports and a business continuity plan. RSIC's first priority is to create standard procedures where they do not yet exist with less focus for now on documenting procedures that are currently in place and working effectively.

RSIC has not yet adopted a standard process for reviewing, documenting and approving procedures, including criteria for determining whose approval are required and in what form. It has also not adopted a review schedule to ensure that procedures remain up-to-date. These are steps which RSIC recognizes as needed but which have been delayed due to more urgent workload.

Like many peers, RSIC does not have a standard operating procedures manual that covers all aspects of its investment and operations functions in one location. Its procedures are established in several different ways: 1) the South Carolina statutes and associated state directives, such as those related to budget, procurement and travel; 2) the Governance Policy Manual, which includes procedures for the selection of service providers; 3) an MOU that establishes procedures for accounting and IT services provided by PEBA; and 4) the Employee Handbook, which includes procedures for matters such as applying for educational expense reimbursement and responding to freedom of information requests.

It is the documentation of workflow procedures to ensure consistent and accurate execution that was of concern in 2011 and is still in progress. RSIC has created an on-line index and access to workflow procedures it has documented but more need to be completed.

Recommendation O4: RSIC should adopt a standard process for documenting, approving and updating operational procedures and should continue its effort to provide on-line access to them as they are completed.

4. Investment Administration

Scope and Standard for Comparison

We assessed the reasonableness and adequacy of RSIC's key investment administrative functions. In addition to a review of written documentation (including the Comprehensive Annual Financial Report, Deloitte due diligence assessment report, NEPC review of strategic partnerships, the report of the State Inspector General, Commission minutes, HEK reviews, the Statement of Investment Objectives and Policies, annual investment reports, investment contracts, investment files, internal investment committee(IIC) minutes, and scores of other documents), we utilized a combination of interviews with the internal staff and external service providers (seventeen external managers across the asset classes, the investment consultants, and the actuary), commissioners, review team experience, results from the CEM benchmarking process, and the FAS leading practices database to perform the assessment. The custodial bank initially declined to be interviewed by FAS and, in lieu of direct interviews, supplied answers to written questions. Ultimately, the custodial bank relationship executive did agree to discuss the banking services provided, the relationships, and communications in two interviews and was very helpful.

The assessment addressed the following specific issues:

- Assess the process for setting asset allocation and methodology for determining acceptable level of risk
 - Setting the asset allocation in light of plan liabilities and resources used, including coordination with the actuary
 - Use of various asset classes, sub-asset classes, and use of alternative investments in the portfolio
 - Consideration of risk tolerance and methodology used to determine acceptable level of risk, portfolio risk and risk budgeting
- Assess implementation strategies (active versus passive, internal versus external management) and compare to peer funds, including historical performance by asset class and style (from CEM and HEK benchmarking data)
- Assess the process for portfolio rebalancing and compare to leading and prevailing practices
- Assess the external manager selection and management process and compare to leading and prevailing practices; this included a compliance audit of RSIC's due diligence process conducted for Alternative Investments from January 1, 2013 to the beginning of the review, as described in the answers to RFP questions.

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- Due diligence process used to select investment managers
- Frequency and quality of manager monitoring
- Manager termination process
- Investment manager contracts (general terms and conditions)
- Assess the process used to ensure adherence to the defined investment decision making process
- Assess the internal control structure for investments, with emphasis on those identified as less than adequate in prior audits
- Assess RSIC investment cost management strategies and practices and compare to other public funds
 - RSIC investment costs by asset class and investment style compared to peer group (from CEM benchmarking data)
 - Use of specific cost management strategies (e.g., decreasing the number of external managers, increasing internal management, increasing passive management, forming external strategic partnerships, use of performance-based fees)
 - Process for reviewing reasonableness of investment manager fees by asset class, individual investment, and/or peer comparisons (e.g., use of an independent measuring service)
- Assess the use and effectiveness of investment consultants (general consultant, asset class consultants, specialty consultants) and compare to other funds
 - Role of consultants vis-à-vis internal staff
 - Services provided by consultants
 - Level of spending on consultant fees
 - Effectiveness of investment consultant reports (usefulness, timeliness, accuracy, etc.)
 - Process and criteria to evaluate the investment consultant's effectiveness
- Assess the use of performance benchmarks and compare to leading and prevailing practices
 - Process to establish performance metrics
 - Selection of benchmarks for each asset class/style
 - Use of peer comparisons

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- Independence, accuracy, and usefulness of return calculations and reporting
- Assess the custodian relationship and compare to leading and prevailing practices
 - Role of the state treasurer
 - Services obtained from custodian bank
 - Custodian bank contract provisions (service levels, fees, fiduciary provisions, etc.)
 - Custodian bank securities lending capabilities and programs, including fee splits, adequacy of collateral in lending programs, and third party securities lending agents
 - Reasonableness of custodian bank fees
 - Methods for monitoring and evaluating custodian bank services
- Assess the commissioners' access to information and the adequacy of supporting tools and resources

Overview and Context

The RSIC is in the midst of a major cultural evolution. It has largely moved from a “get money out the door” deal culture designed to rapidly diversify asset classes and risk exposures which existed from the creation of the modern RSIC until roughly 2011-12 to a more strategic, risk-controlled portfolio culture. Coincident with that timeline has been maturation in the RSIC’s focus on operational systems and procedures. Where operations were a sporadic focus of the Commission and staff in the past, resulting in systems that lagged the sophistication of the investment program, the need for systems and procedures sufficient for the complex investment program is now recognized.

Other major contextual factors affecting the investment program are

- The evolution in staffing, from a mere handful plus Commissioners to a professionally staffed investment office.
- The legislatively mandated 7.5% assumed return.
- The 30-year amortization rule.

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Summary of Key Investment Administration Conclusions

I1: The asset/liability matching process is disjointed and requires careful and systematic coordination.

I2: The asset allocation appears to be driven by the interactions of the funded status, the legislatively set assumed rate, and the desire to remain within the 30-year amortization band.

I3: RSIC has been simplifying the portfolio and focusing more on risk but needs to develop better capabilities and tools.

I4: RSIC had intended to move to more internal management but decided to delay the decision and build adequate infrastructure first.

I5: Based upon manager interviews and review of documents, the RSIC manager selection and due diligence processes are consistent and thorough. Documentation is thorough and appropriate.

I6: Although the RSIC manager selection and due diligence processes have significantly improved and are robust, they are slow by industry standards.

I7: The current level of reporting and monitoring is consistently noted as “top quartile”, “highest level”, or the “most” by managers.

I8: It appears there has been a “cultural change” with more emphasis on fees following the CIO change and the focus on fees from the State Treasurer.

I9: The asset allocation is a relatively high cost strategy. RSIC is pursuing several investment strategies to reduce costs.

I10: RSIC investment reporting has significantly improved over the past two years; however, some further refinements are indicated.

I11: Although disclosure of overall investment management costs by RSIC is the most complete among U.S. public pension funds, there has been limited benchmarking of external and internal investment management costs, which has led to lack of understanding about the appropriateness of RSIC costs.

I12: The role and use of strategic partnerships has significantly evolved from the earlier era, but there are still areas which could be improved.

I13: Rebalancing is consistent with the HEK and RSIC philosophy, but could use better documentation to provide assurance that it conforms to the SIOP.

I14: RSIC has handled transition management appropriately and professionally; however, there are other tools which could be examined to see if they would improve efficiency.

I15: The selection of benchmarks is appropriate and consistent with prevailing industry practice.

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I16: RSIC appears to be using its general investment consultant effectively.

I17: The RSIC custodial relationship with the Treasurer and BNY Mellon is diffused, strained and inefficient, with uncertain authorities.

I18: The current level of securities lending revenue is minimal and the future direction for securities lending is unclear.

I19: The Commissioners appear to have adequate access to information required to perform their duties; however, adherence to the policy for managing Commissioners' requests for information may need to be improved.

I20: RSIC has detailed procedures for validating management fees and pass-through expenses that provide reasonable assurance that reported fees are accurate.

I21: The RSIC/PEBA process of valuing investment assets at fiscal year-end is prevailing practice in the public pension industry.

Findings, Recommendations for Each Investment Administration Conclusion

Asset-Liability Matching Process

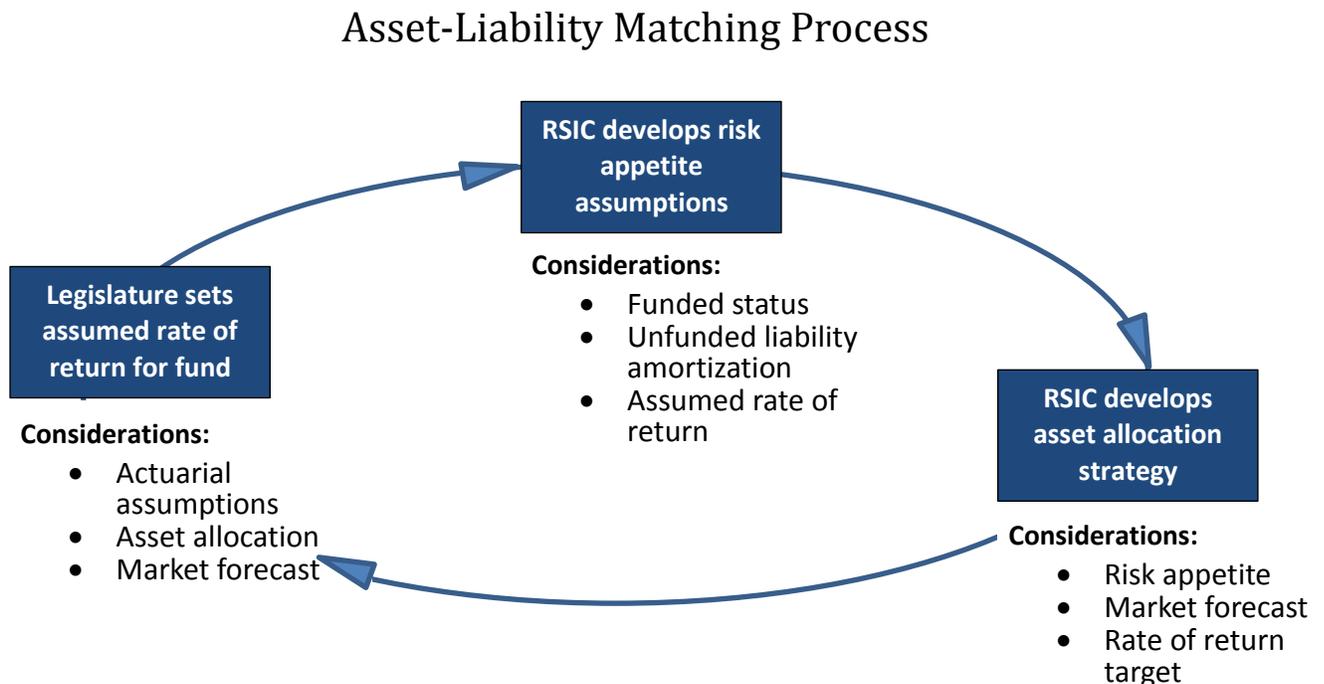
Conclusion 11: The asset-liability matching process is disjointed and requires careful and systematic coordination.

The division of responsibilities between Legislature, RSIC and PEBA is complex, with the legislature setting the assumed rate of return, PEBA being responsible for benefits administration, and the RSIC setting the asset allocation and running the investment program.

The assumed rate of return for the fund, the asset allocation strategy, amortization of unfunded liabilities, and employer and employee contribution rates are all interrelated. The setting of the 7.5% return assumption by the Legislature was done considering actuary and investment consultant input. The process by which the asset allocation strategy was developed and updated was consistent with industry practice and the assumptions and outcomes were reasonable.

However, separately PEBA engages an actuary to review assumptions, and it is required by law to do a full experience study (designed to predict the cost of benefits) every five years. Those actuarial findings must be approved by both the PEBA Board and the Budget and Control Board to become effective. Similarly, the SIOP requires the RSIC to perform an asset liability study at least every five years.

Table 25 Asset-Liability Matching Process



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There is no requirement for the Legislature to consider various inputs – including the PEBA experience study and the RSIC’s asset liability study -- when setting the assumed rate of return, though we note that the Legislature engaged its own actuarial and investment expert consultants when it last set the rate.

Recommendation I1: If the Legislature continues to set the expected rate of return, it should regularly review the process and its assumptions on a periodic basis. Ideally, that cycle should be set to take advantage of the information available from the every five year PEBA experience study and RSIC’s asset liability study.

Asset Allocation

Conclusion I2: The asset allocation appears to be driven by the interactions of the funded status, the legislatively set assumed rate, and the desire to remain within the 30-year amortization band.

Based upon numerous discussions with the Commissioners, investment staff, and the general investment consultant, we identified several critical underlying assumptions which appear to have driven the current asset allocation strategy. The risk appetite appears to be dominated by a desire to avoid significant drawdowns so as to avoid lengthening the amortization period for the unfunded liability to more than 30 years. Such a lengthening would automatically increase both the employee and employer (the State of South Carolina) contribution rate.

RSIC believes the current risk-free rate of return plus the historical equity premium is about 5-6%; thus hitting the 7.5% return target means the fund must take on different risks and be opportunistic. RSIC is determined to avoid a “big drawdown” (i.e., major capital loss) which would trigger the special increase in employer and employee contributions, which is perceived as catastrophic for employees, employers, and taxpayers.

The ongoing relatively high allocation to hedge funds and other private asset classes by RSIC is based on a belief that these asset classes are less volatile than public markets and so less likely to experience such a drawdown. If the retirement plans were 70% funded instead of the current 56% (at market valuation), investment staff at RSIC would be comfortable with taking on more public equity risk; however, at the current funded level RSIC believes it must avoid another drawdown similar to 2008-2009.

Based upon the 2014 CEM analysis, over the five years ending December 31, 2012, the RSIC asset allocation – without considering the actual managers selected (the “policy mix”) – resulted in a total return at the bottom of the peer group of 20 funds. CEM calculated the 5-year policy return for RSIC at 1.3% (the return RSIC would have earned had it passively implemented its asset allocation through benchmark portfolios), compared to 2.6% for all U.S. public funds and 2.8% for the CEM RSIC peer group. However, RSIC’s investment management actually added 1.2% of net return over the theoretical passive alternative, resulting in a 2.5% return. This return was higher than 7 of the 20 peer funds. We note that those five years largely corresponded to a bull market in U.S. equities, so funds which took more public equity exposure and risk tended to have higher total returns.

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The Commission has decided to take a long-term view and maintain the current asset allocation, which it believes has the best chance to amortize the unfunded liability over time and without major drawdowns. It states it is not trying to time the market by making changes perceived as advantageous in today's market environment but which may not be sustainable. An HEK liability study in 2013 basically supported that conclusion, and resulted in changes to the asset allocation that are more in the nature of minor tweaks rather than a major change in direction.

The Commission adopts both a Statement of Investment Objectives and Policy (SIOP) and an Annual Investment Plan (AIP), which is consistent with prevailing practice. Adopting a high level statement of investment beliefs would be a leading practice. Such a statement is a guide to inform the context for making investment decisions. Such a statement might include the Commission's beliefs about what types of risk are acceptable and where they should be taken; the relative value of strategic allocation, active management and implementation; the importance of costs; what type of culture and resources are necessary to achieve the desired results; public accountability; and time frame.

Recommendation I2: The Commission should spend more time discussing its underlying investment beliefs and ensure that the asset allocation strategy remains consistent with those beliefs (see Recommendation G10.1).

Capabilities and Tools

Conclusion I3: RSIC has been simplifying the portfolio and focusing more on risk, but needs to develop better capabilities and tools.

Portfolio streamlining over the past two years has simplified the portfolio and begun to reduce costs:

- Individual mandates have been reduced from more than 500 to about 200; the CIO says consolidation is about 90% complete.
- The hedge fund strategy is moving away from funds of funds to direct investing.
- Strategic partnerships have been reduced from 14 to 8.
- A significant amount of the public asset allocation is being moved to passive investing.

However, lack of a security-based risk management system and a portfolio management system for private investments hampers RSIC's ability to more deeply understand risk exposures. Technology constraints limit the ability to do systemic risk analysis on a manager-by-manager basis and there is limited visibility into security level holdings. Risk management estimates it has real time information on 25-30% of the portfolio on a security-level basis. An RFP for a new risk management system has been developed and responses from potential vendors are being received and will be evaluated later this year.

In addition to the technology, the Risk Management function could improve its effectiveness, as there is currently less than optimal interaction and communication between Risk Management and other

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investment staff. For example, while Risk Management is supposed to be part of the Internal Investment Committee, it only attends sporadically and is listed in the minutes under “other participants”. We do note that Risk Management reports to the Deputy CIO and that he attends all IIC meetings, but do not believe that is a full substitute for staff-to-staff interaction. We also note that a previously hired Director of Risk Management resigned, creating a temporary setback in the progress of the Risk Management program.

Planning and coordination with staff could help in developing a new risk management framework and reporting. For example, although the RFP for a new risk management system is well under way, and although Risk Management envisions a future state where it will be able to do scenario analyses and back tests, among other reports, to date Risk Management has not coordinated with the other investment officers as to what should be included in the risk reports, how they should be formatted, or how frequent they should be.

With reference to the portfolio consolidation, one area with which many funds struggle is how to consolidate private equity and/or real estate funds, since they often have contractual terms of ten years plus various extensions. Some funds have found that they can sell interests in the secondary market. However, the secondary market for private equity fund limited partnership (LP) interests is not fully developed; some interests can be sold for close to current value, while selling others requires the acceptance of a material mark-to-value loss. A similar secondary market exists with regard to hedge fund partnership interests, though that may be of less interest, since the lock-up periods are relatively shorter. To date, the RSIC has not participated in the secondary market for LP interests.

Recommendations

I3.1: As part of an overall infrastructure development plan, the RSIC should continue to prioritize a new risk management system and capability as a top priority.

I3.2: RSIC should create a Risk Management/Investment working group to design the functionality of risk reporting.

I3.3: Investment risk management should be a participating member at all IIC meetings.

I3.4: Risk Management should produce an annual plan which is reviewed and approved at the IIC; this should improve risk discipline, provide a benchmark for performance evaluation, create an opportunity for other investment officers to understand Risk Management capabilities, and improve communication.

I3.5: The RSIC should explore whether the secondary market in LP interests could help it rationalize its private equity portfolio, while keeping in mind the variable inefficiencies of that secondary market.

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Infrastructure

Conclusion I4: RSIC had intended to move to more internal management but decided to delay the decision and build an adequate infrastructure first.

A well-developed strategy to bring appropriate asset classes and management styles in-house has the potential to significantly reduce overall investment management fees. Although RSIC has contemplated this strategy, the decision to move forward has been delayed due to limitations in building the operational capabilities required to effectively manage additional assets internally.

Systems are needed prior to increasing internal management, including a better order management system, improved risk capabilities, an updated portfolio accounting system, a valuation system, and a performance calculation system. Additionally, new policies will need to be in place to support increased internal management, including:

- Adapting the compensation policies;
- Developing a counterparty risk policy; and
- Developing a more robust broker/dealer selection policy.

To ensure that RSIC is not underestimating the resources necessary to move to a robust internal management program, a detailed business plan should be developed. Additionally, we note that some of the policy needs highlighted by the delayed plan to increase internal management of assets would be beneficial to address whether or not the plan proceeds. For example, RSIC does not have a formal counterparty exposure policy. It does monitor monthly counterparty exposure reports produced by Russell, which manages the overlay portfolio and provides transition services, but has no formal policy either to inform Russell or to use as a guideline against which to judge the counterparty risk reports produced by Russell. In addition, while there is a broker/dealer selection policy, it relies primarily on the judgment of the fixed income team and does not require any periodic review or affirmation.

Recommendations

I4.1: The overall RSIC infrastructure development plan should fully consider and incorporate the staffing, systems and policy requirements to significantly increase internal asset management and manage risk prior to significantly expanding the current limited amount and types of assets managed internally.

I4.2: RSIC should adopt a formal counterparty risk policy (see Recommendation P2.1).

I4.3: RSIC should review its broker/dealer selection policy with an eye towards increasing its robustness by creating objective measures for acceptability and setting a time period for reaffirmation of the acceptable broker/dealers (see Recommendation P2.2).

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Manager Selection and Due Diligence

Conclusion 15: Based upon manager interviews and review of documents, the RSIC manager selection and due diligence processes are consistent and thorough.

RSIC has been evolving from deal-oriented investment manager sourcing and inconsistent due diligence to being more consistently focused on strategic allocation following the Deloitte review. Recent manager selection has been driven by both a desire to streamline the number of individual mandates, including reducing the number of funds of funds and strategic partnerships and searches for managers to fill out the HEK asset allocation, as well as routine opportunistic sourcing of limited partnership opportunities which typically are open for investment only during a specified fund-raising time period. RSIC has appropriately used RFPs, consultant searches and staff searches/due diligence to source investments, tailoring the methodology to the need and marketplace for the relevant investment product.

Recent RSIC due diligence is highly praised by external managers, with comments such as “right at the top”, “top quartile,” “excellent”, and “the most thorough.” That was not always the case. A few years ago the diligences appear to have been inconsistent, with some excellent due diligence reviews and some of which were cursory at best. One manager, who had been selected to manage funds for the RSIC both before and after the Deloitte report, described the difference in his experience as “night and day”. Also, following the Deloitte report, the RSIC has made a major effort to institute a robust operational due diligence program for new managers. The best RSIC operational due diligences, utilizing a separate team and process, is a leading practice. However, on site operational due diligence is not always done by dedicated operational staff due to staffing constraints, though internal operations staff does review operational due diligence documents and the investment staff generally asks operational questions in its on-site review. HEK performs operational due diligence for all potential managers, even when internal staff does perform an onsite inspection. A new position of Operational Due Diligence Officer has been created and a person has been hired to fill the position.

Table 26 Due Diligence

How do you typically conduct operational due diligence for prospective funds/managers?	Responses (N=6; multiple responses)	RSIC
Our due diligence team performs operational due diligence as part of their due diligence process	5	
We have a separate operational due diligence team which operates independently of the investment due diligence team	1	X
Our consultant performs operational due diligence on our behalf	3	
We typically do not perform operational due diligence	0	

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Although staff believes Operations can veto investments based upon concerns identified during operational due diligence, including underlying investments in strategic partnerships, there is no formal policy yet approved and there has not yet been a situation where there have been significant operational concerns on a new investment since the new operational due diligence policies and practices were put in place.

As discussed in Conclusion I3 above, risk management is a rapidly evolving capability at the RSIC. While quantitative screens and analyses generally are done during the selection process (particularly in the public asset classes) to judge the managers both on a stand-alone basis and generally to understand investment style and portfolio fit, the planned risk management system, if purchased, should allow the RSIC to perform more targeted and precise quantitative “what if” scenarios, which would be more useful in screening potential managers for portfolio fit.

HEK also performs due diligence and provides recommendations to RSIC, a prevailing practice. RSIC utilizes HEK, which has a broad set of capabilities, to perform due diligence across all asset classes. Some funds utilize investment class specialist consultants for assistance in due diligence. The HEK memorandum, as well as the investment staff memorandum and operations staff recommendation, is presented to the IIC.

RSIC assigns Commissioners to work with staff on due diligence and to accompany staff on due diligence trips. Commissioner involvement in initial due diligence is unusual; very few managers have ever seen other funds involve trustees routinely in due diligence. Only one of the peer investment boards includes trustees in due diligence, described as “Occasionally a Trustee or Investment Committee member joins in an investment due diligence.”

Table 27 Participants in Due Diligence

Who typically participates in due diligence of prospective funds/ managers? (N=6)	Investment Due Diligence	Operational Due Diligence	RSIC	
			Investment Due Diligence	Operational Due Diligence
Trustees	0	0	X	
Investment Staff	6	6	X	
Operations Staff	1	4		X
General Investment Consultant	2	1	X	X
Asset Class Consultant	3	2		

The routine use of Commissioners to perform due diligence is potentially problematic for a number of reasons. It focuses the Commissioners on routine day-to-day operational functions, rather than higher-value strategic issues. It also creates potential conflicts in a number of ways. First, it puts the

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Commission in the position of making a final hiring decision on a manager which it was part of recommending. (We note that some investment staff saw that as a positive, remarking that it creates an advocate on the Commission for the hiring.) Second, it gives an individual Commissioner effective veto power over a hiring, as many staff said they would not make a recommendation to the CIO to recommend a manager to the Commission if they knew the Commissioner assigned to due diligence opposed it, probably correctly assuming that the Commission would give deference to that Commissioner's opinion, even if the staff person thought that manager was qualified. That said, it should be reported that all managers who experienced due diligence reviews by a team which included a Commissioner found them skilled and reported that they acted professionally.

In addition to a process review, the SIG requested a compliance audit of the due diligence process conducted for alternative investments with the period of review from January 1, 2013 to the present.

The Commission formalized new due diligence guidelines in November 2012. The format requires the RSIC staff to complete a Due Diligence Report for each new investment manager. The components of the Report are:

- SC Due Diligence Team
- Historical Motions
- Key Investment Rationale
- Investment Considerations
- Portfolio and Asset Class Fit
- Strategy Description
- Firm Overview
- Ownership and Personnel Compensation
- Key Personnel
- Succession Plans
- Employee Turnover
- Products Managed, AUM, Investor Base
- Market Overview
- Performance and Risk Analytics
- Investment Process
- Investment Risk Management
- Portfolio Guidelines
- Allowable Investments and Liquidity
- Leverage
- Economic Terms
- Reference Checks
- Back Office Staffing and Systems
- Legal and Compliance
- Infrastructure
- Transparency and Reporting
- Insurance Coverage

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- Service Providers
- Trade Life Cycle Process
- Valuation Policies and Procedures
- Cash Management and Control
- Counterparty Risk Management

The Due Diligence Report also contains a checklist of the documents that were requested from the manager, a checklist of additional documents and actions that are required (New Investment Procedural Checklist,) and a checklist of items provided to the State Treasurer's Office. As a part of this examination, new investment mandates initiated during this period, plus one previously-approved investment which was funded during this period, were reviewed. Each manager's due diligence report was examined for thoroughness as was the documentation and checklists denoted in the report. Each manager has a properly completed Due Diligence Report with validating documentation, plus the documents associated with the New Investment Procedural Checklist, and documents directed to and requested by the Treasurer of State.

The investment mandates and associated documentation viewed for this examination included an opportunistic credit investment (35 documents), two secondary venture capital fund investments (45 documents), a real estate fund investment (48 documents), a private equity investment (59 documents), and a strategic real estate fund investment (54 documents).

Recommendations

I5.1: The policy of Commissioner Involvement in due diligence should be changed to limit participation to no more than occasional involvement as an observer for educational or reassurance purposes only (see Recommendation G10.3 and P1.3); Commissioners could be invited to all manager meetings held in Columbia.

I5.2: Ideally operations should perform on-site reviews of all potential new managers. If staffing makes that impractical, the RSIC should adopt a formal operational due diligence calendar so as to a) minimize the number of managers hired without such an on-site visit, and b) prioritize an on-site operational visit as soon as possible following selection.

I5.3: Operational due diligence recommendations to the IIC should require a sign off from the head of RSIC operations.

I5.4: RSIC should clarify the level of authority operations has on manager hiring and retention. Two potential options would be to give a veto to operations or, alternately, to mandate that should the CIO decide to recommend an investment despite operational concerns, an operations memorandum should go to the Commission along with the CIO's recommendation explaining why the investment should be made notwithstanding operation's concerns.

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Speed of Due Diligence

Conclusion I6: Although the RSIC manager selection and due diligence processes have significantly improved and are robust, they are slow by industry standards.

A number of managers hired by RSIC since January 2013 stated that its due diligence process is slower than virtually all other investors; in one case the entire process took two years to complete. RSIC missed the close window for one side-by-side overage (co-investment) fund that offered improved economic terms compared to the main fund (in which RSIC is invested).

Slow due diligence makes it virtually impossible to be an “anchor” investor in a partnership, which often increases the leverage to negotiate terms and conditions to a greater extent than investors who commit later in the process. The ability to perform adequate, robust due diligence in a timely manner is also key to making co-investments. Co-investments, in which the RSIC would participate in individual deals alongside a partnership in which it is already invested, are used by many investors to lower fees (co-investments generally have lower fees than the core partnerships) and to fine-tune risk exposures. However, co-investment opportunities generally have only 2-3 months available for due diligence

No one feature of the RSIC process consistently caused the delays in due diligence. Staff turnover, the change in consultants from NEPC to HEK, a process that seemed unfocused from the outside as diligence contacts went dormant for a time only to begin again, significant time in legal review and contracting, the 30-day rule (RSIC requires Commissioners be allowed 30-days to review final contract language before funding can be made), and the fact that agreements must be approved at Commission meetings which are only held quarterly and so create timing windows, were all cited. In most situations, multiple causes interacted to create the long time frame.

In several instances, the contracting process was one source of delay in completing a close, with a few managers, while citing the expertise and professionalism of outside legal counsel, also suggested that the legal process was slow because legal needed to get up to speed about the specific investments and the implications thereof, sometimes resulting in a start and stop contracting process.

The 30-day review rule is, in our experience, unique. Consistent with other findings in this report, it puts the Commission in an operational role, rather than relying on staff (in this case RSIC legal department and outside counsel) for operations and assurance, and on internal audit and any needed extraordinary post review by the Commission for reassurance. In addition, it amplifies the delays.

Recommendations

I6.1: RSIC should re-assess its due diligence practices towards identifying opportunities to streamline and reduce the cycle time of activities without impacting the thoroughness or effectiveness of the overall process. Among the possible improvements would be: weekly management report of due diligence progress at the IIC, addition of a paralegal to co-ordinate legal reviews and with outside counsel (see Recommendation L1.2), and more frequent Commission meetings (see Recommendation G12.1).

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16.2: RSIC legal staff should work with outside counsel to standardize contracting practices where possible. This should reduce delays in the contracting process (see Recommendation L2.1).

16.3: The Commission should seek alternate means of assuring and reassuring itself as to the quality of the legal review, thereby enabling it to eliminate the 30-day review period before funding.

Reporting and Monitoring

Conclusion 17: The current level of reporting and monitoring is consistently noted as “top quartile”, “highest level”, or the “most” by managers.

Since the Deloitte study and the implementation of the Tamale data base, external manager reporting has evolved and become more precise and detailed. It typically includes monthly, quarterly and annual reporting. Compliance and monitoring templates and checklists are consistently used. There is frequent communication between managers and RSIC investment staff. Notably, despite extensive requests for information from RSIC investment staff, managers remark that it is not just a “data dump,” and that they receive logical follow up questions from staff. Managers now are asked to provide detailed fee information. To quote one external manager: “They ask for more detail. Not a lot of our clients ask for (details) down to the penny on every fee: custodial, administration, auditor, etc.”

In addition to the written reports and checklists, there is a requirement for semi-annual personal contact, which may be on-site, in Columbia or by telephone. Such contact must be documented. Although there are discussions with most managers semi-annually, there is no policy requirement for on-site visits. Managers do make frequent in-person visits to Columbia.

The Tamale research management system is in place and being used effectively. One area of monitoring that could be improved is in the area of trading. The SIOP mentions trading efficiency but the RSIC does not engage any independent external trade execution measurement system or vendor.

Recommendations

17.1: RSIC should consider establishing a formal policy for frequency of site visits to external managers as part of the monitoring process. Leading practice is to make the periodicity annual, but given staff constraints and the existing semi-annual contact requirement, a biannual periodicity could be considered.

17.2: RSIC should consider how it wants to gain assurance that managerial trading is efficient. It could suggest that its external managers trading in public securities provide independent trade execution measurements, or engage a trade execution management vendor itself to “spot check” external managers.

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Emphasis on Fees and Negotiations

Conclusion 18: It appears there has been a “cultural change” with more emphasis on fees following the CIO change and the focus on fees from the State Treasurer.

There is now more focus on fee negotiations than under the previous CIO. RSIC staff is slowly reviewing all previous managers selected, including terms and conditions, and has renegotiated some contracts, as appropriate, to reduce fees. Interviews with external managers and review of documents indicate there is consistent evidence of both negotiations and fee breaks in recent mandates.

CEM’s benchmarking analysis tends to confirm the conclusions in a 2013 HEK report that the management fees RSIC pays are competitive. In fact, CEM concluded that overall, RSIC pays lower external management fees than its peers, (excluding performance fees such as carried interest which peers do not report). Nonetheless, there are several asset types for which RSIC’s management fees were noticeably more the median of the CEM peer group in 2012: high yield fixed income, international (EAFE) stocks and hedge funds which were not fund of funds.

In addition to the overall level of fees, alignment of fee philosophy with the overall investment philosophy is improving. Negotiations are now underway with at least one strategic partner to emphasize “everyday low fees” rather than a “high/low” structure of full fees on primary investments with low or no fees on co-investments. That better aligns with the current emphasis on strategic asset allocation as opposed to the previous deal-making emphasis.

Recent investment agreements appear to have been reasonably well negotiated. Multiple managers said the RSIC “beat us up” or that they had given more to the RSIC than to others. One said that it had given so much that it would not give the same terms ever again.

Cost of Asset Allocation Strategy

Conclusion 19: The asset allocation is a relatively high cost strategy. The RSIC is pursuing several investment strategies to reduce costs.

In FY 2006, the year RSIC began operations, the retirement funds were invested only in publicly traded stocks and bonds, and half of its stock investments were managed passively. This was a relatively low cost asset allocation and management strategy. RSIC’s reported costs have grown from \$29.8 million in 2006 to \$427.5 million in 2013. The increase reflects major changes in asset allocation, from no investments in alternative markets in 2006 to 38% in 2013, as the Commission has sought to diversify the portfolio and protect against the risk of a major market downturn.

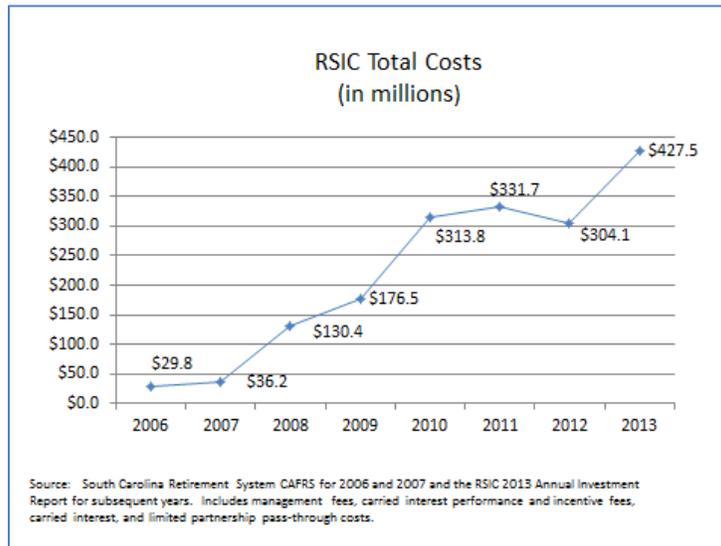
Alternative investments are high-cost strategies. Additionally, part of the reported increase may be because RSIC has made a determined effort over the last several years to gain even more transparency into performance fees and pass through costs. These expenses, which certainly have an effect on the net return to the RSIC, are often not reported as fees by other pension funds and investors, because of

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the significant amount of manual effort involved in collecting the information and because a number of pension funds consider these costs to be a form of profit sharing that is not comparable to a fixed management fee. Other funds report their returns for these investments on a “net of fees” basis, which is considered an acceptable approach under GAAP and GASB standards. Comparisons of net performance from one fund to another are identical under either fee reporting scenario.

After three years of relatively flat total costs, expenses increased by \$123.4 million in FY 2013, which RSIC attributes to an increase in performance by managers paid through performance fee structures. Over 60% of the increase was to three of the strategic partnerships that invest in alternative assets.

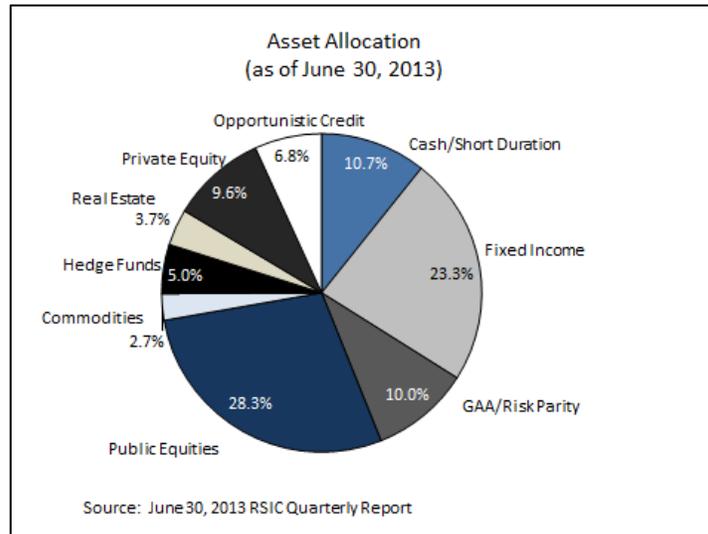
Table 28 Cost of Asset Allocation Strategy



RSIC began investing in alternative markets in 2007, later than many U.S. public pension funds. As measured by CEM Benchmarking, RSIC’s allocation to hedge funds, commodities, private equity and other real assets represented 28% of its assets compared to an average 22% for its peers in 2012. RSIC uses a broader definition of alternative assets that includes other structured assets, which adds to a total alternatives allocation of 38%. The actual asset allocation as of June 30, 2013, as reflected in the 2013 annual investment report, had 38% of its assets allocated in markets other than equities, fixed income and cash/short duration.

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Table 29 Asset Allocation as of June 30, 2013



In 2006, RSIC hired CEM to perform an analysis of the expected impact on returns and fees of the proposed new target asset allocation (at the time this target was 30 percent in alternative asset classes) which had been developed; among their assumptions:

- “We are incurring additional costs to achieve additional returns.
- The after-fee returns associated with our targeted asset classes is expected to be greater.
- We also expect to realize additional returns through alpha.
- Management fees are expected to increase from \$27.4 million actual costs or \$28.0 million policy costs, to approximately \$204.8 million, an increase of \$176.9 million.”

The Commissioners and investment staff appear to have been fully aware of the expected increase in management fees, accepting that fact for the trade-off expectation that the increase in net returns would be greater than the increase in costs. Commissioners and staff have explained that they believe this asset allocation reduces downside risk.

The actual management fees paid for its 38% allocation to assets other than fixed allocations to stocks, bonds and cash in calendar year 2012, as measured using CEM’s methodology, was \$219.6 million. As noted in the next section, RSIC’s management costs were the highest in its peer group in 2012, but normalized for the asset allocation (that is, compared to peers if they were to manage a similar mix of assets), CEM considers RSIC’s costs to be average. Still, there are a number of potential ways that the costs of managing the current asset allocation could be reduced.

As RSIC’s asset allocation has changed over the last five years, less of its investments have been managed internally or using passive strategies, which tend to be lower cost, and more have been in external active strategies, which tend to be higher cost. RSIC has reduced its reliance on funds of funds in favor of direct investments in hedge funds. However, RSIC still had more reliance on these higher cost fund of funds strategies than its peers in 2012, according to the CEM survey.

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Table 30 RSIC Management of Assets CY 2008-2012

RSIC Management of Assets						
CY 2008 to 2012						
	2008	2009	2010	2011	2012	Peers 2012
Fund of Funds	17%	17%	12%	16%	13%	4%
External Active	55%	67%	70%	74%	76%	65%
Internal Active	21%	6%	6%	4%	6%	19%
External Passive	7%	10%	11%	5%	5%	8%
Internal Passive	0%	0%	0%	0%	0%	4%
TOTAL	100%	100%	100%	100%	100%	100%

Source: CEM 2012 Investment Cost Effectiveness Analysis completed March 2014

Based upon prior research, FAS has identified the following as the most effective strategies employed by other public funds to reduce fees paid to external managers:

1. Forming strategic partnerships that concentrate business with fewer suppliers;
2. Increasing internal management /reducing external management;
3. Increasing passive management / reducing active management;
4. Reducing the number of external manager relationships; and
5. Greater use of separate accounts or co-investments in private markets.

RSIC has been pursuing three of these strategies and would like to pursue the other two if the infrastructure were capable of effectively supporting those strategies. Since its early days, RSIC has utilized strategic partnerships to diversify the portfolio, though there may not have been adequate focus on the use of such partnerships to minimize fees. Initially, RSIC’s strategy was to use strategic partnerships to deploy assets quickly, to overcome limitations of internal staff, and to take advantage of the unique knowledge of partners. Recently, in reducing the number of strategic partnerships from 14 to 8, the RSIC has focused on retaining two types of partners:

1. Opportunistic, cross asset class strategic partners; and
2. Platform strategic partners.

In addition, RSIC has used the process of reducing the number of strategic partners to renegotiate fees in some cases and to increase fee transparency. One strategic partnership was terminated primarily because of the high fee levels. Bringing additional selected asset classes and investment styles in-house under internal management was recently planned by RSIC. RSIC currently manages only cash and short duration fixed income internally. A proposed program to move additional asset classes to internal management was suggested in 2012. The intent was to move from fixed income to indexed equities, then to enhanced indexing. The plan did not anticipate active management. The focus was on fees, improving staff motivation, and alignment with a philosophy of being opportunistic and close to the market. The program projected that an annual additional internal cost of \$5 million, including 11 additional staff positions, was needed to result in fee savings of \$20-30 million annually. However, as discussed in I4, above, the implementation of the plan has been delayed due to the need to more fully develop the infrastructure, policies and procedures to support more complex internal management.

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RSIC has plans to increase passive management and reduce active management by investing over \$4 billion in global equity index funds; these new investments are expected to close in the near future. While this is expected to have little impact on management fees, it should have tax benefits and reduce counterparty risk. There may be potential for some additional savings through further use of passive strategies. For example, in 2012 RSIC invested \$2.4 billion in U.S. fixed income investments with external active management while half of its peer group managed a portion of similar investments passively at an average fee savings of 11.5 bps (basis points).

Reduction in the number of RSIC managers and mandates over the past two years is nearly completed and has resulted in approximately doubling of the average mandate size in U.S. stocks, EAFE stocks, and emerging market fixed income. This is notable regarding fees because fee structures for those asset classes generally feature “break points” which result in reduced fees for incremental assets. Across eight asset types, RSIC’s average mandates are now more comparable in size to the average of its CEM peers (larger in three and smaller in five). There may be more opportunity for consolidation. By decreasing the number of managers and increasing assets with those that remain, RSIC should be in a better position in fee negotiations, in addition to the benefits it receives in executing its investment strategy.

RSIC currently utilizes separate accounts for some private investments. Co-investments in private asset classes (e.g. private equity, real estate) are of interest to RSIC investment staff, but require additional resources to adequately support the strategy. As an interim step, RSIC might consider whether having a ready pool of asset-class specific consultants to perform underwriting due diligence on co-investments would be cost effective. That is possible, but not guaranteed, as there is a staff management cost in addition to the explicit cost of the consultants.

One methodology used successfully by peers such as the California Public Employees Retirement System (CalPERS) is to maintain a “spring-fed pool” of consultants. Those firms have been selected through an RFP process and have established contracts and pricing, but CalPERS is under no obligation to ever use them, and only chooses to use one of them if it believes such an engagement would be beneficial. Thus, the only up-front cost is the management time of conducting the proposal and contracting process. Also, as noted in I7, for public equity markets there is currently no measurement of trade execution efficiency, which may be a further opportunity to reduce net costs.

Recommendations

I9.1: RSIC staff should update the 2012 plan for expanded internal management and include a full business plan which considers all requirements (see Recommendation I4.1).

I9.2: RSIC should continue to pursue reductions in fees where it pays greater costs than its peers, taking into account potential net return and risk.

I9.3: RSIC should consider whether the use of a pool of asset-class specialist consultants to perform due diligence on co-investment opportunities would be beneficial and consistent with current asset allocation plans.

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Investment Reporting

Conclusion I10: RSIC investment reporting has significantly improved over the past two years; however, some further refinements are indicated.

For alternative investment asset classes, RSIC reports management fees, performance and incentive fees, carried interest, and limited partnership pass-through costs (such as set up organizational costs, legal costs, taxes, audit, accounting). No other U.S. public pension funds disclose all of these fees, and some do not report any, simply netting out all costs and reporting net returns. Among the investment board peer group, the most categories of fees reported by any of the funds amounts to less than half of the fees reported by RSIC. The RSIC Annual Investment Report has always included all fees, but the CAFR has not. In FY2012, the CAFR listed all fees in the investment section. In FY2013, all fees were included in the financial statement and the investment section of the CAFR.

Table 31 Types of Fees Disclosed

For alternative asset class investments, which of the following are included in external management fees that are separately broken out and reported in your audited Statement of Changes in Plan/Fiduciary Net Position/Asset within you annual CAFR?	Investment Board Survey Responses (N=6)	2013 Reported RSIC Fees (\$Mils)	2013 Reported RSIC Fees (% of Fees)
Invoiced fees	3	\$42	10%
Non-invoiced asset-based management fees that are netted out of account	4 ^{1/}	\$154	37%
Performance/incentive fees and carried interest for alternative assets	1 ^{2/}	\$182	44%
Pass-through expenses (e.g., set up organizational costs, legal costs, taxes, audit, accounting)	0	\$39	9%
^{1/} Non-invoiced private equity and real estate management fees are included for one fund. ^{2/} One peer fund has started to report incentive fees for hedge funds, but not private equity or real estate.			

The current level of manager fee disclosure by RSIC is the highest in the industry; we have identified only two other public funds in the U.S. (see chart below) which disclose performance and incentive fees for alternative investments, and none which report pass-through expenses.

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Table 32 Fee Disclosure

All as of June 30, 2013	South Carolina RSIC				Missouri SERS (MOSERS)				Missouri PSRS/PEERS			
	Assets	Alloc.	Fees	bps	Assets	Alloc.	Fees	bps	Assets	Alloc.	Fees	bps
	(\$Bils)	(%)	(\$Mils)	pbs	(\$Bils)	(%)	(\$Mils)	pbs	(\$Bils)	(%)	(\$Mils)	pbs
Global Public Equity	3.5	13.2%	22.7	65	2.0	25.0%	17.6	87	16.1	48.0%	83.4	52
Fixed Income	8.8	32.9%	9.8	11	0.8	9.5%	5.9	76	2.7	8.2%	8.0	30
Cash and Short Duration	2.5	9.5%	2.2	9	0.0	0.1%	0.0	0	4.1	12.3%	3.0	7
Commingled Funds	1.8	6.6%	13.5	77								
Private Equity/ Private Assets	1.7	6.2%	28.5	172	0.9	11.1%	26.1	292	2.3	7.0%	96.8	414
Private Debt and Opportunistic Credit	0.9	3.4%	33.8	378					0.4	1.2%	19.1	490
Hedge Funds/Alpha Pool	1.4	5.3%	37.5	265	3.0	36.7%	59.4	200	4.7	14.1%	113.4	240
Real Estate	0.6	2.2%	29.8	498	1.1	13.0%	24.9	236	2.6	7.7%	43.6	169
Inflation Indexed Bonds					0.4	4.6%	0.0	0	0.5	1.5%	0.4	8
Strategic Partnerships	5.6	21.2%	233.6	415								
Other	-0.1	-0.4%	8.3	-714								
Total	26.6	100%	419.7	158	8.1	100%	133.9	166	33.4	100%	367.7	110

Source: FAS analysis

The reporting of “Strategic Partnerships” as an asset class in the PEBA CAFR, however, is inconsistent and reduces transparency. It is our understanding that for internal reporting purposes, the mapping of investments in the strategic partnerships into asset classes has been completed. However, the strategic partnership investments are not reported externally within the appropriate asset classes for performance or fee reporting purposes.

Reporting management fees, incentive fees, carried interest, and pass-through fees as one total cost for each asset class (as opposed to breaking out each category) also makes it more difficult for stakeholders to understand how RSIC costs might compare to other funds.

The level of fee reporting undertaken by RSIC requires significant manpower due to the highly manual nature of RSIC’s reporting processes. RSIC has estimated that two full-time equivalent employees are involved in identifying, calculating and reporting alternative investment costs. The Investment Accounting Controller at a peer investment fund which reports only invoiced management fees for alternative investments told us that if her fund chose to report all the fee categories which RSIC reports she would need to hire six additional staff. In an environment of staffing limitations, RSIC fee reporting resources could potentially be utilized in other roles, such as risk management. Because RSIC is the only fund with this level of fee disclosure, it opens up RSIC to charges of being significantly higher cost

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relative to other funds. It is also possible that an overemphasis on reducing fees could result in decisions which lower overall fund returns if the balance is lost among risk, returns, and costs.

Recommendations

I10.1: RSIC fee reporting for alternative investments should be restructured to improve transparency and comparability with peer funds; management fees should be broken down into invoiced and non-invoiced management fees, performance fees and carried interest, and pass-through fees.

I10.2: Investments in strategic partnerships should be allocated to the appropriate asset classes for performance and fee reporting in the PEBA CAFR.

Disclosure of Management Costs

Conclusion I11: Although disclosure of overall investment management costs by RSIC is the most complete that FAS has identified among U.S. public pension funds, there has been limited benchmarking of external and internal investment management costs, which has led to lack of understanding about the appropriateness of RSIC's costs.

In this section we attempt to address and calibrate a controversial issue which has embroiled the Commission and contributed to dysfunctions and threaten the future ability of the Commission to perform its fiduciary duties. This is the matter of fund performance and external investment manager fees.

Since its inception, RSIC has disclosed all management fees in its Annual Investment Report (AIR) and the Comprehensive Annual Financial Report (CAFR) now published by the Public Employee Benefits Authority (PEBA). Management fees are those paid by an investment fund to the fund's investment managers for investment and portfolio management services as well as administrative services. Usually, the fee is calculated as a percentage of assets under management. Other public funds also disclose management fees.

However, the RSIC also discloses another set of fees for its alternative asset classes which are not reported by almost every other fund. These are performance fees. A performance fee is a fee that an investment fund may be charged by the investment manager that manages its assets and may be calculated many ways. For separate accounts, it often is based on the change in net realized and unrealized gains, and it can also be based on other measures, such as net income generated.¹⁰

For hedge funds and other investment funds, performance fees are generally calculated based on the increase in the fund's net asset value (or "NAV"). Performance fees are widely used by the investment managers of hedge funds, which typically charge a performance fee of 20% of the increase in the NAV of the fund in addition to the base management fee. In private equity, carried interest, or carry, is a share of the profits of an investment or investment fund that is paid to the investment manager in excess of

¹⁰ Lemke and Lins, *Regulation of Investment Advisers*, §2:10 (Thomson West, 2013 ed.)

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the amount that the manager contributes to the partnership. It is a form of performance fee that rewards the manager for enhancing performance.¹¹

RSIC and PEBA expend considerable effort to identify and calculate these performance fees, as well as non-invoiced pass-through expenses (i.e., expenses incurred within the limited partnerships such as set-up organizational costs, legal costs, taxes, audit fees, and administrator fees). In FY2013, these two categories of costs for hedge funds and private equity funds represented 53 percent of the total fees reported by RSIC across all asset classes.

We have found no other public pension funds in the U.S. which report non-invoiced pass-through expenses for their hedge fund or private equity investments, and only two which report hedge fund and private equity performance fees in their CAFRs. The combined effect over the past several years of the long-term RSIC strategy selected, which is more heavily weighted toward hedge funds, private equity, and other alternative assets than the average fund, and the expanded disclosure of manager fees, was to double the amount of fees disclosed. This has led to heated public controversy regarding RSIC's performance and fees.

To attempt to resolve these controversies, in 2014, a new investment cost effectiveness analysis study was commissioned by SIG as part of this fiduciary performance audit to gather facts that would enable an "apples to apples" comparison of RSIC's performance and fees to those of other funds. The study was conducted by CEM Benchmarking, Inc. (CEM), a global benchmarking company based in Toronto, Canada. CEM is the leading independent provider of objective and actionable benchmarking information for large pools of capital including pension funds, endowments/foundations and sovereign wealth funds. CEM created a custom peer group for RSIC which includes 21 U.S. state public pension funds ranging from \$13.8 billion to \$58.0 billion in AUM (10 larger and 10 smaller) with an average AUM of \$28.8 billion. See *Appendix F CEM Report Executive Summary*.

At the time when it began to plan for a shift into alternative assets in 2006, the Commission made the decision to fully disclose all external manager fees, including management fees, performance and incentive fees, carried interest, and limited partnership pass-through costs (such as set up organizational costs, legal costs, taxes, audit, accounting). However, this decision has not been documented or reflected in the Commission minutes. Given the controversy this has engendered, the Commission should more clearly articulate its policy decision. These fees go beyond those which were included in the CEM report, as no other funds report all performance and incentive fees and pass-through costs for alternative asset classes.

In 2013, the Commission asked HEK to prepare and present an analysis of RSIC's external management fees. This one-time HEK analysis indicated that on an asset class-by-asset class basis, the fees paid to external managers by RSIC was about average and comparable to other public funds.

According to the 2014 CEM report just completed, RSIC 5-year net return of 2.5% as of December 31, 2012 was equal to the U.S. public fund median and to the custom RSIC peer group median return of

¹¹ Lemke, Lins, Hoenig and Rube, *Hedge Funds and Other Private Funds: Regulation and Compliance*, §13:20 (Thomson West, 2013-2014 ed.).

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2.5%. The RSIC asset allocation would have returned 1.3% if invested in passive benchmark funds, as the RSIC asset allocation (the “policy mix”) has been at the bottom of the peer group of 20 funds over that 5-year period. However, through RSIC’s management, the fund achieved a 2.5% return, or 1.2% net value added, to equal median industry returns.

CEM also compared the fees which are consistently reported by peer U.S. funds (as mentioned earlier, RSIC reports significantly more fees than all other public funds). On this basis, RSIC’s management costs for CY2012 were 103.0 bps, compared to the peer average of 61.1 bps. RSIC’s management costs were highest in peer group, largely due to the heavy weighting to alternatives with their associated higher costs. However, after adjusting for fund size and asset mix, CEM found that RSIC was normal cost in 2012 (0.5 bps below the median).

CEM’s analysis determined that RSIC’s normalized management costs were the result of two largely offsetting factors. Its heavier reliance on active, external fund of funds management and overlays led to greater costs, while the overall lower fees it pays for external management, oversight and custody, and lower costs for the assets it does manage internally produced compensating savings.

Table 33 RSIC Management Fee Savings and Added Costs Compared to Peers 2012

RSIC Management Fee Savings and Added Costs Compared to Peers 2012		
	Added Cost / -Savings	
	\$000s	bps
RSIC Added Costs:		
Greater use of fund of funds	\$4,719	1.8
More external management and less lower cost passive and Internal management	79	0.0
Higher use of overlays	2,000	0.8
Total added costs	\$6,808	2.7
RSIC Savings:		
Lower external management fees	-\$6,068	-2.4
Lower internal management costs	-1,120	-0.4
Lower costs for oversight, custody and other	-894	-0.3
Total savings	\$8,082	-3.2
Net total savings	\$1,274	<u>-0.5</u>
Source: CEM 2012 Cost-Effectiveness Analysis completed March 2014		

The CEM report results for RSIC’s calendar year 2012 investment management costs were very consistent with the analysis completed in 2013 by HEK, and are also consistent with the comments FAS received from external managers during our interviews.

At the present time, RSIC does not have an ongoing source of fee benchmarking which is refreshed on a regular basis. Many leading public pension funds participate in the CEM investment cost effectiveness benchmarking on an annual basis. While the primary use of the report is to ensure external fee levels are not excessive, many funds have also found the reports useful in supporting fee negotiations and in

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evaluating the potential impact of changes in strategy, such as moving from active to passive management or bringing specific asset classes in-house, on costs.

Recommendations

I11.1: Given the controversy the decision to disclose all external manager fees has engendered, the Commission should more clearly articulate its policy decision.

I11.2: The RSIC should contract with CEM, or a similar service from another provider, on an annual basis to develop a source of “apples-to-apples” benchmarks of investment management costs for each asset class and for the entire fund, as well as to provide an additional source for returns performance benchmarking (see Recommendations G13.4 and G18.4).

Use of Strategic Partnerships

Conclusion I12: The role and use of strategic partnerships has significantly evolved, but there are still areas which could be improved.

Although the Commission approves all individual investments with new and existing managers, once a strategic partnership is approved the strategic partnership investment committee approves all investments made by the partnership itself. The RSIC CIO sits on the investment committees and has veto authority. The Commission is not involved in investment decision-making within the strategic partnerships, but does receive a transparency report detailing the investments within each strategic partnership.

Several changes have recently been instituted for RSIC governance of new investments made within strategic partnerships. The RSIC IIC and HEK now review every potential new underlying investment, which is a positive step. In addition, RSIC now has two investment officers attend quarterly partnership meetings; these institutionalizations of the review process for investments within strategic partnerships to prevent “single point of failure” types of risks are salutary. Formalizing these actions into a partnership governance document approved by the Commission would insure institutionalization beyond the current RSIC personnel.

While the vast majority of assets in the strategic partnerships are private assets or alternative strategies, there are currently traditional assets (e.g., emerging markets equities) in some of the strategic partnerships, which may not be optimal. Similarly, some partnerships hold significant amounts of cash which RSIC could sweep if it so chose. There are no guidelines for when and how much long-only, traditional assets should be in the strategic partnerships.

One rationale for the initiation of the partnership program was to enable information sharing from leading investment organizations to the RSIC. One key to that program was to inform the Commissioners of leading developments in the asset management industry and in the theory of how to

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manage assets in general and the pension fund specifically. While there have been some such programs in the past, they have not happened as frequently recently.

Recommendations

I12.1: The RSIC should formalize its policies with respect to oversight of the strategic partnerships and controls over underlying investments within RSIC, e.g., use of the IIC to vet investments, two RSIC staff participating in meetings, etc.

I12.2: RSIC should develop a guideline, rather than current situational decision making, for when and how much long-only, traditional assets should be in strategic partnerships.

I12.3: RSIC should develop a guideline regarding the appropriate level of cash to remain within strategic partnerships and for the return of any cash in excess of partnership needs.

I12.4: The Commission should take increased advantage of the information, insights and experience resident in the RSIC's strategic partners. In-person education programs in Columbia would be one possibility, either in conjunction with regularly scheduled Commission meetings or, as in the past, at special educational or strategic planning retreats in-state.

Rebalancing

Conclusion I13: Rebalancing is consistent with the HEK and RSIC philosophy, but better documentation could ensure that it conforms to the SIOP.

The SIOP says staff shall "review" rebalancing at least quarterly. In practice it is reviewed more frequently than quarterly; however, there is no formal process to guarantee or document that practice.

Currently rebalancing is an iterative process driven by CIO and Deputy CIO. They first look at whether or not the asset mix is in compliance (in or out of bounds with the approved asset class ranges). The second step considers markets and trends and determines if there are opportunities for more favorable asset deployments. The third consideration is cash flow and liquidity requirements. Finally, transaction costs related to potential changes are then considered. The external transition manager uses an overlay to rebalance or express a slight tilt.

Recommendation I13: Rebalancing policies should be revised to require a quarterly rebalancing review to be scheduled on the annual meeting calendar of the IIC or Wednesday markets meeting to ensure compliance with SIOP; in the event the CIO and staff review balancing in the interim due to market movements or otherwise, that should be reflected in the IIC minutes to demonstrate compliance.

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Manager Termination and Transition Management

Conclusion I14: RSIC has handled manager terminations and transition management appropriately and professionally; however, there are other tools available for transition management which could be examined to see if they would improve efficiency.

FAS interviewed two terminated managers and identified no issues with the termination process, which were handled appropriately and professionally. All transitions use Russell as the transition manager; Russell is also used as the overlay manager to maintain appropriate exposures. The normal transition policy is for managers to go to cash while terminating the manager. RSIC coordinates with Russell to use derivatives to maintain exposure. Russell acts only in an agency capacity and gives a transition report to RSIC.

RSIC does not independently measure transition management costs.

Recommendations

I14.1: RSIC should explore alternate transition management programs, such as manager-to-manager transitions (cherry picking) with the remaining securities sold, or principal bids. RSIC should educate itself about when each technique is most appropriate.

I14.2: RSIC should determine if it wants to independently measure transition management costs, at least on a spot check basis.

Use of Benchmarks

Conclusion I15: The selection of benchmarks is appropriate and consistent with prevailing industry practice.

Benchmarks in use by RSIC are largely standard indices, or combinations of indices, calculated by outside, respected entities (e.g., MSCI, S&P, Dow Jones-UBS). The rationale for selection of the benchmarks is logical. The benchmarks are communicated to the external managers and they generally think them appropriate.

HEK devoted an entire section of its February 2013 asset allocation study to benchmarks and selection criteria. The benchmarks were subsequently explicitly adopted by the Commission in the SIOP, with reference to the CFA criteria for benchmark selection. Returns vs. benchmarks are independently calculated and HEK also reports on performance vs. benchmark.

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Use of the General Management Consultant

Conclusion I16: RSIC appears to be using its general investment consultant effectively.

Hewitt EnnisKnupp (HEK) is being used appropriately and thoroughly for asset allocation, benchmark selection, investment advice, due diligence, monitoring, reporting, and special projects, as appropriate. HEK states clearly that it reports to the Commission and views the Commission as its client, and its actions are consistent with appropriate independence:

- HEK reviews independent calculates and reviews Plan returns.
- HEK consults with the Commission on setting of benchmarks.

RSIC staff is developing a consultant evaluation process which will be conducted and reported to the Commission annually. Both RSIC and HEK perform due diligence on new investment opportunities, with RSIC in the lead, which is appropriate and prevailing practice. HEK has adequate expertise, capability and capacity across asset classes, and RSIC relies upon HEK for a full range of investment consulting services. This minimizes the need for additional specialty consultants. However, if RSIC pursues co-investments in the future, it may want to consider specialty consultants to assist in due diligence (see Recommendation I9.3).

Although RSIC spends somewhat more on their general consultant than most peers due to HEK's broad role, RSIC spends less on consultants overall because it does not use other firms such as asset class specialists.

Recommendation I16: RSIC should complete development of an annual assessment process for the Commission to evaluate the performance of its general investment consultant and the Commission should adopt and implement the process.

Custodial Relationship

Conclusion I17: The RSIC custodial relationship with the Treasurer and BNY Mellon is diffused, strained and inefficient, with uncertain authorities.

The practice of the Treasurer serving as custodian for retirement fund assets dates from when Treasurers physically held all of a state's negotiable securities in a vault for safekeeping and collected the income stream from those securities; those securities often tended to be predominantly or only bonds.

Because retirement system investments became more complex and physical securities were transferred to book entry form, Treasurers had to acquire the services of a custody bank to serve as a sub custodian to fulfill their assigned duties of custodians. In this type of arrangement, the Treasurer may serve in an

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oversight role but often adds complexity and complications to the interaction between the retirement system and the custodian bank.

While safekeeping remains at the core of the custody relationship, the role of a global custodial bank has evolved over time to include much more than safeguarding of assets and income collection. As is the case at other retirement funds, the custodial bank is integral to most aspects of RSIC's daily investment activities, including trade settlement, performance and compliance reporting, foreign exchange, portfolio analytics, class actions claims processing, and tax support. A direct and effective relationship between the RSIC and custodial bank is essential for efficient operations and oversight. South Carolina's relationship with BNYM and its predecessor Bank of New York dates back to prior to the creation of the Commission.

When the Bank of New York and Mellon merged in 2007, the Treasurer signed a new custody agreement which remained in effect until a new contract was signed in December 2013. Approximately 60 percent of RSIC's total assets under management are considered "not-in-bank" assets, meaning they are not actually custodied at BNYM. RSIC's comparatively large not-in-bank share reflects greater allocation to limited partnerships, as well as an historical preference for commingled over separate accounts in public markets to simplify accounting for PEBA. Commingled funds may be custodied at managers' banks other than BNYM; in those cases, data for not-in-bank assets is provided to BNYM to provide a total fund picture, which is standard industry practice for not-in-bank reporting.

In December 2012, FAS conducted a survey of 15 state public retirement systems with assets of over \$50 billion. Although those systems have more assets under management than RSIC, their average (25.1%) allocation to "high touch" private market and opportunistic assets was smaller than RSIC's (35.1%). The custody services used by RSIC are similar in type, but somewhat fewer in number than is the case for these public funds. The Commission's cost for BNYM's custody services in 2012 was \$254,000 (the bank's share of securities lending revenue) which was in the lowest quartile of the CEM peer group.

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Table 34 Services Offered by Custodial Institution

Source: New York State Common Fund Survey Which of the following services offered by your custodial institution do you use? RSIC Response <input type="checkbox"/>	Number of Responses (N=15)
Portfolio performance reporting and analysis	12
Fund accounting	12
Standing instruction foreign exchange trades	10
Directly-negotiated foreign exchange trades	9
Compliance monitoring	9
Daily fund valuation	8
Class action claims processing	8
Derivatives services (trading, valuation, reporting)	7
Tax support	7
Fund exposure and structural analysis	5
Management fee calculations	3
Proxy voting	1
Asset servicing	1
Cash management	1
Transition management	1
Data management	1
Document safekeeping	1

The RSIC operations staff indicates that BNYM generally performs current functions acceptably; however, RSIC says it has not been able to get BNYM to respond satisfactorily to its need for additional services in several areas, such as compliance monitoring and private markets tracking systems, which has been a source of “great frustration”.

BNYM states it “has responded to RSIC’s request for additional services by way of RFP response and discussions held regarding specific products/services. BNYM quoted pricing in line with scope of work for services to be performed.”

Involvement of the State Treasurer’s Office and PEBA in the custody relationship adds complexity and uncertainty about the boundaries of authority. The current structure is unique among the state investment boards FAS surveyed and limits RSIC’s ability to obtain and manage the increased level of services it needs from its custodian to support a complex portfolio. Lack of control over the custodial bank relationship appears to be a major factor in RSIC’s decision to contract for a data administrator

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(which RSIC will manage) rather than utilize the custodial bank's services (which the Treasurer manages).

BNYM believes it "is and has been ready and available to service RSIC ... and has been able to service a number of the most sophisticated public investment commissions in the country regardless of interactions with other state agencies."

The recent custodial bank selection process started in December 2011 with the issuance of an RFP. An expert consultant was involved in the process. RSIC participated in developing the requirements for the RFP and was a member of selection committee (which also included PEBA and STO). The committee recommended in the summer of 2012 that BNYM be retained as custodian. RSIC indicates that BNYM's cost proposal was significantly lower than the closest competitor and the selection of BNYM avoided the added transition cost to move to another bank.

However, the process was ultimately complicated by the contentious litigation between the State and BNYM over securities lending losses in the retirement funds and state funds and protracted settlement negotiations. The final terms of the custody contract were negotiated by STO without RSIC involvement beyond legal staff review of contract language; the contract between STO and BNYM was not signed until December 2013. The contract also includes other state funds for which STO is custodian; all the funds may benefit from economies of scale. The new contract results in no fundamental changes to the respective roles of STO, PEBA and RSIC in custody.

Although the Treasurer asserts that the STO was in contact with RSIC attorneys throughout the negotiating process, the RSIC Chief Legal Officer identified only two rather minor issues where STO's General Counsel contacted RSIC Legal during the period May 2013 - December 2013 and asked for input regarding the new custody contract. It appears that RSIC was consulted on minor issues of legal language and terms in the contract, but not on substantive questions of potential changes to services or products to be obtained from BNY Mellon.

Although the RFP requested a proposal for a five- year contract, the final contract is for ten years. (BNYM indicates that it has other clients with ten-year contracts as well as contracts that include no fixed termination date.) In the RFP, the State could terminate the contract in whole or in part "for convenience" at any time but the custodial bank would have been required to provide a one-year notice. The contract provides that either party may terminate for convenience, subject to a pre-termination resolution process extending up to 90 days and a process for determining compensation the bank may be owed.

The new contract includes a split between base price services BNYM will provide and "a la carte" ancillary services RSIC can purchase at added cost from BNYM or another provider. The base price of \$260,000 is essentially what BNYM was paid by the retirement funds for custody in CY 2012. This amount is low compared to what CEM peers paid in 2012 and is less than the fee quote in BNYM's initial RFP response. The base price includes domestic assets but only up to \$200 million in global assets and the first 1,000 transactions in global developed markets, after which additional amounts will be charged depending upon the country and trade volume. RSIC has not reached those limits but states it is

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concerned about potential additional costs to the retirement funds in the future as it expands its global holdings. This concern could lead RSIC to rely more on commingled accounts that are not custodied at BNYM for global assets.

BNYM states “customers’ reliance on commingled funds versus separately managed global accounts to minimize global custody fees, transaction fees, registration costs, stamp duties, appointment of local market representation, etc. is commonplace amongst institutional investors.”

BNYM’s share of securities lending revenue was its sole source of compensation for 2012 custody costs. The revenue BNYM receives from lending has dropped considerably since 2008, as has RSIC’s. If RSIC lends securities through BNYM in the future, BNYM would receive 10% of that revenue in addition to the base custody fee and other ancillary fees.

The base price includes an annual credit of \$150,000 which the STO may use to acquire training from BNYM for employees of the STO, RSIC or PEBA. It also includes provisions for credits against the base fee and ancillary services should RSIC decide to pay an additional cost to use a platform affiliated with BNYM to provide pricing, compliance and position-level risk monitoring for hedge fund investments. RSIC is not inclined to use that platform for several reasons, including the fact that the vendor is not willing to be a fiduciary for the managed account platform.

Under the new BNYM sub-custody contract, additional services such as compliance monitoring, daily fund valuation, fund exposure and structural analysis and managed funds platform are available to the RSIC at a pre-negotiated contract rate. The cost of the entire list of those services exceeds \$1.5 million annually, excluding the costs of the managed funds platform which would depend on the amount of assets RSIC put on the platform. RSIC did not have the ability to directly negotiate with the custodial bank regarding the services it would receive under the contract, the service standards to be met, or the costs it would incur.

The new contract contains no provision for a service level agreement between BNYM and RSIC, nor is there a defined process for managing the relationship between BNYM and RSIC which includes performance evaluation and feedback. BNY Mellon states “There is nothing preventing RSIC from monitoring the service they receive from BNY Mellon. BNY Mellon has governance tools in place to set expectations and to monitor service levels. It is common practice for the servicing teams to meet with our clients with regular frequency to discuss operational matters and strategic goals.”

However, the STO has recently hired a Custody Officer to facilitate communications and service delivery. The Treasurer has stated that:

“The Custody Officer will act as the STO’s liaison to the custodial bank in order to ensure that RSIC, PEBA, and STO are provided the quality of services.

The Custody Officer’s duties include, but are not limited to, developing and maintaining effective relationships with all internal and external stakeholders, with focused coordination of functions among the State Treasurer, RSIC, PEBA, and the custodial bank; overseeing service

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provider relationships and holding service providers accountable for agreed upon service levels; and ensuring that proper internal controls are created and maintained and that all applicable parties comply with applicable state and federal regulations and contractual obligations.

The addition of a Custody Officer further demonstrates the STO's commitment to improve the custodial relationship for RSIC, PEBA, and STO."

While it may improve communication, this approach still seems to leave BNYM ultimately accountable to the STO rather than to the RSIC for the services RSIC receives.

Primarily due to dissatisfaction with the protracted custody contracting process and its perceived inability to participate in the process, in December 2013 RSIC issued an Administrator RFP for new systems which includes performance, data support and compliance services, some of which could have been obtained from BNYM (although a trade order management system is not offered by BNYM).

The administrator contract was concluded in March 2014 and is between RSIC and the selected turnkey vendor. The contract was concluded by RSIC and gives control over the relationship to RSIC. This course of action will likely eventually shrink BNYM's role to "custody only" (i.e., no general ledger or performance reporting). The RFP capped the cost of these services at \$1.2 million, which is roughly equivalent to the cost of all the ancillary services available under the new BNYM contract, though there are differences between the two in services included and providers.

BNYM recently assigned a new relationship executive to the STO contract in October 2013. STO states it had been dissatisfied with the prior relationship executive and requested a change in fall 2013. The new relationship executive has not been able to successfully develop a relationship with senior RSIC staff due to lack of interest on the part of RSIC.

The Treasurer has a difference of opinion in a number of areas regarding the relationship with BNY Mellon and the contracting process. His response to the Midpoint FAS report included the following:

"RSIC is incorrect in stating the agreement did not meet its needs. RSIC and PEBA named representatives to serve on the procurement advisory panel. In fact, after the panel was set, RSIC's CIO, Hershel Harper, asked also to be included on the panel, and STO agreed. Representatives from RSIC and PEBA who served on the procurement advisory panel participated in the "Request for Proposal," "Reviewing of Proposal Responses," "Selection of Firms for Site Visits," "Site Visits," and the "Scoring of Selected Firms."

RSIC and PEBA were both involved in the drafting of STO's RFP for custodial and securities lending services which outlined services and needs for all parties. RSIC and PEBA representatives served on the procurement advisory panel and both had access to all of the bank's responses to the STO's RFP. Clearly, both RSIC and PEBA were deeply involved in the choice of a custodial bank as well as services needed. In the summer of 2012, the procurement advisory panel recommended that STO retain the BNY as the State's custodial bank.

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Throughout the negotiating process, the STO contacted RSIC attorneys for specific items and corresponding language in the agreement. The custodian agreement was finalized and signed December 30, 2013. Communication with RSIC was inclusive during the entire BNYM agreement negotiation process.

The report states that because of dissatisfaction with the contracting process, RSIC was forced to issue an RFP. This statement is incorrect as RSIC chose to ignore available funds for over five years that should have been used to implement critical services. In September/October 2013, two years after the STO issued an RFP for custodial services, RSIC created a RFP for an Administrator. The Administrator RFP was published during the same time period the custodian agreement was finalized, but years after RSIC could have taken action. The contracting process had nothing to do with services RSIC neglected to seek, leaving the system at risk for many, many years.”

In summary, while there was a joint STO-RSIC-PEBA evaluation of the proposals submitted in response to the custody/securities lending RFP, RSIC states that the record is quite clear that both (a) the March 2013 settlement and (b) the apparent, multi-month negotiation of the new custody agreement were handled by STO without any meaningful involvement by RSIC. Based upon both interviews and emails provided by RSIC, this appears to be an accurate statement.

Recommendation I17: The Legislature should consider four potential options to significantly improve the ability of the RSIC to obtain services from and work with its custodial bank; each option is described in Table 35 below, and the associated pros and cons are described in Table 36.

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Table 35 Custodial Options

Option	Description
Status Quo: Custodian: Treasurer Relationship: Treasurer	<ul style="list-style-type: none"> • No significant changes • The Treasurer remains the custodian • STO implements its new Custody Officer role • RSIC proceeds to implement its investment administrator role • This structure is unique to South Carolina among U.S. state investment boards with an independent investment staff
Option 1: Improved Status Quo Custodian: Treasurer Relationship: RSIC	<ul style="list-style-type: none"> • The Treasurer remains the custodian • The Treasurer delegates authority to RSIC to conduct custodial bank selection, negotiate the contract, and manage the contract and relationship for the retirement funds • Authorization processes are streamlined to not require STO signatures and utilize electronic payment authorization • Service level agreement and performance feedback are implemented by RSIC • The internal accounting system is updated (not related to custodian) • Similar to Washington State Investment Board (WSIB) structure
Option 2: RSIC Custody Relationship Custodian: Treasurer Relationship: RSIC	<ul style="list-style-type: none"> • The Treasurer retains the title of Custodian • Legislative change provides for delegation of authority to RSIC to conduct custodial bank selection, negotiate the contract, and manage the contract and relationship for the retirement funds • Similar to the Illinois State Board of Investments (ISBI) and New Mexico ERB structure
Option 3: PEBA as Custodian Custodian: PEBA Relationship: RSIC	<ul style="list-style-type: none"> • Legislative change provides for: <ul style="list-style-type: none"> – PEBA to become the custodian of record – RSIC to contract with its own custodial bank and manage the custodial bank relationship for the retirement funds • Similar to the Minnesota State Board of Investments (SBI) structure
Option 4: RSIC as Custodian Custodian: RSIC Relationship: RSIC	<ul style="list-style-type: none"> • Legislative change provides for RSIC to become the custodian of record and to contract with its own custodial bank and manage the custodial bank relationship for the retirement funds • Similar to Florida SBA, Massachusetts PRIM, West Virginia IMB, and SWIB structure

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Table 36 Pros and Cons of Custodial Options

Option	Pros	Cons
Status Quo: Custodian: Treasurer Relationship: Treasurer	<ul style="list-style-type: none"> • Treasurer provides another layer of assurance • Custody Officer might improve bank responsiveness to RSIC • Economies of scale for custodial bank contract 	<ul style="list-style-type: none"> • Remaining conflicts with Treasurer’s multiple roles • Continued operational inefficiencies and costs • Dysfunction could continue • May not improve responsiveness of custodial bank to RSIC
Option 1: Improved Status Quo Custodian: Treasurer Relationship: RSIC	<ul style="list-style-type: none"> • Treasurer provides another layer of assurance • Improved responsiveness to RSIC’s needs 	<ul style="list-style-type: none"> • Remaining conflicts with Treasurer’s multiple roles • If STO does not fully delegate authorities to RSIC, dysfunction could continue
Option 2: RSIC Custody Relationship Custodian: Treasurer Relationship: RSIC	<ul style="list-style-type: none"> • Custodial bank would be accountable to RSIC for services it provides RSIC • Continues to provide another layer of assurance 	<ul style="list-style-type: none"> • Remaining conflicts with Treasurer’s multiple roles • Potential loss of economies of scale with separate contract • Potential costs to change contract
Option 3: PEBA as Custodian Custodian: PEBA Relationship: RSIC	<ul style="list-style-type: none"> • Custodial bank would be accountable to RSIC for services it provides RSIC • Continues to provides another layer of assurance • Removes conflict of Treasurer’s multiple roles 	<ul style="list-style-type: none"> • Potential loss of economies of scale with separate contract • Potential costs to change contract
Option 4: RSIC as Custodian Custodian: RSIC Relationship: RSIC	<ul style="list-style-type: none"> • Custodial bank would be accountable to RSIC for services it provides RSIC • Resolves conflict of Treasurer’s multiple roles 	<ul style="list-style-type: none"> • Loss of a second layer of assurance • Potential loss of economies of scale with separate contract • Potential costs to change contract

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Securities Lending

Conclusion I18: The current level of securities lending revenue is minimal and the future direction for securities lending is unclear.

RSIC and 86% of its CEM peers lend securities to generate additional income. A principal reason securities are borrowed is to cover short positions. Borrowers are required to pledge cash or approved securities as collateral for loaned securities. Income is generated from the investment of the pledged cash or, if securities are pledged, fees the borrowers pay for the use of the loaned securities.

RSIC's lending program is managed under an agreement between the Treasurer and BNYM, the sole lending agent for the Fund. The 85%/15% split of lending income between RSIC and BNYM in 2012 was near the 86%/14% average for its CEM peer group. The Treasurer announced in January, 2014 that RSIC's split would increase to 90%/10% if it chooses to continue to lend under a new agreement with BNYM. However, that agreement has not been signed yet and RSIC has not seen it. As they add new managers in separate accounts custodied at BNYM, RSIC is not currently permitting them to be lent because of "the complete lack of clarity" in what's happening with the lending agreement and lack of RSIC control of the relationship.

Pension funds are typically indemnified by the lender in case of borrower default, but not for losses in cash collateral reinvestments. Many pension funds experienced lack of liquidity and the majority of funds in a FAS 2012 survey suffered losses in their cash collateral pool as credit markets collapsed in 2008.

Following over \$223 million of unrealized lending losses in 2008-09, RSIC substantially curtailed lending and limited collateral reinvestment to overnight repurchase agreements. The losses led to protracted and recently settled litigation between the State and BNYM. RSIC was not a party to the lawsuit or settlement negotiations. After legal settlement and other recoveries, RSIC had \$165 million in realized losses, of which all but \$50 million has been distributed.

Much more conservative collateral reinvestments and less favorable market conditions have resulted in a significant reduction in RSIC's lending revenues. The losses now realized from 2008-09 are more than double the income which the Fund realized over this nine-year period.

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Table 37 Securities Lending Revenues

Securities Lending Revenues			
Fiscal Years 2005 -2013			
Fiscal Year	Total	RSIC	BNYM
2013	2,512,800	2,195,400	317,400
2012	1,387,000	1,179,000	208,000
2011	1,344,700	1,143,100	201,600
2010	4,349,300	3,697,000	652,300
2009	22,761,900	19,870,000	2,891,900
2008	29,441,500	24,492,500	4,948,900
2007	10,576,000	8,991,100	1,584,900
2006	9,040,600	7,688,400	1,352,200
2005	5,075,600	4,060,700	1,014,900

Source: September 26, 2013 report from the CIO to the Commission.

Average lending income as a percent of stock and bond holdings fell in the CEM peer group after 2008. However, RSIC's (1.2%) was the lowest in the CEM peer group in 2012 and well below the average (4.9%). To increase lending revenue, the RSIC states it has sought STO approval to somewhat widen collateral reinvestment guidelines to a still conservative 2A-7 money market type constraint, but has not received a response from the STO. The Treasurer's Office states that it did not receive such a request and has not been unresponsive. The Treasurer further states that, "STO considers the establishment of collateral reinvestment guidelines to be an investment decision that is RSIC's alone to make. Securities lending is an investment decision. If at any time, STO receives a request from RSIC to change the collateral reinvestment guidelines, including under the new securities lending contract being finalized now, STO would review the request and work with the custodial bank to effectuate RSIC's investment decision."

Seven of 15 participants in a 2012 FAS survey of public funds with assets over \$50 billion bundled their custody costs with the custodian's role in lending. That was also the case for South Carolina prior to the new custody contract negotiated and signed by the Treasurer in December 2013. The cost of RSIC'S custody services is now determined independently of whether RSIC continues to lend through BNYM.

Although lending has been traditionally seen as a way to pay for custody services, the losses incurred in 2008-09 suggest that the decision about whether and how to lend is fundamentally an investment decision. During the Commission's discussion of the custody RFP in 2012, the CIO expressed reservations about continuing participation in lending based on rewards and risk, but stated that a key factor was who should be the contracting party for lending.

In February 2013, HEK provided an analysis to the Commission of potential future risks and benefits of lending as well as different ways to participate in the lending market. Later in 2013, the CIO outlined a plan to determine the future direction of the program.

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An option discussed in HEK and CIO comments to the Commission would be to lend through one or more parties other than BNYM. In a 2013 FAS survey of 13 public funds with assets between \$7 and \$14 billion, three of the ten who lend do so through a third party. Based on information provided in response to the custody RFP, RSIC anticipates that it could achieve the program control it desires and increase its share of lending revenue through a third party lending arrangement.

The Treasurer's position is that RSIC lacks the authority to enter into securities lending arrangements, citing SC Code Section 11-9-660(B) which he asserts gives that authority solely to the Treasurer. However, that section only applies to the Treasurer's investment authority for "funds of the State." SC Code Ann. Section 16-315(G) grants exclusive authority for investment of retirement fund assets to RSIC, which appears to include the lending of those assets. In addition, the Legislature explicitly moved the BCB's and Treasurer's authority to invest retirement system funds to the RSIC when it was established. (S.C. Code Ann. s. 9-16-315(G) provides, "The RSIC is established to invest the funds of the retirement system. All of the powers and duties of the State Budget and Control Board as investor in equity securities and the State Treasurer's function of investing in fixed income securities are transferred to and devolved upon the RSIC.") Since the BCB had been engaged in securities lending of retirement system assets prior to the transfer, it appears that "all" of those powers and duties were moved to RSIC.

The future of the securities lending market is likely to be affected by a number of federal and international regulatory changes that are in process to reduce the risk of systemic failure in global banking. They include provisions to reduce counterparty credit risk and increase capital ratios and liquidity. Some observers anticipate that they could result in a contraction in the lending market.

The Commission needs to complete its review of lending and determine its future direction. If lending continues, it should be guided by a policy approved by the Commissioners which defines objectives and risk tolerance and establishes guidelines for the program. It should be accompanied by robust compliance monitoring by the lender and RSIC as well as benchmarking against the broader lending market. A periodic report should be provided to management and the Commissioners that includes key measures of program activity and risk.

Recommendations

I18.1: The Commission should determine the future of securities lending based on assessment of the potential investment benefits and risks of different approaches to participating in the lending market.

I18.2: RSIC will need to develop new policies and practices if it chooses to continue securities lending through BNYM or another third party; a new policy should include a statement of lending objectives, risk tolerance and guidelines approved by the Commission.

I18.3: The RSIC securities lending agent should be required to provide quarterly reporting to management and the Commission regarding program activity, including amounts on loan, borrower concentration, return and risk.

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I18.4: RSIC should obtain an annual benchmarking of its activities against lending activity across the industry.

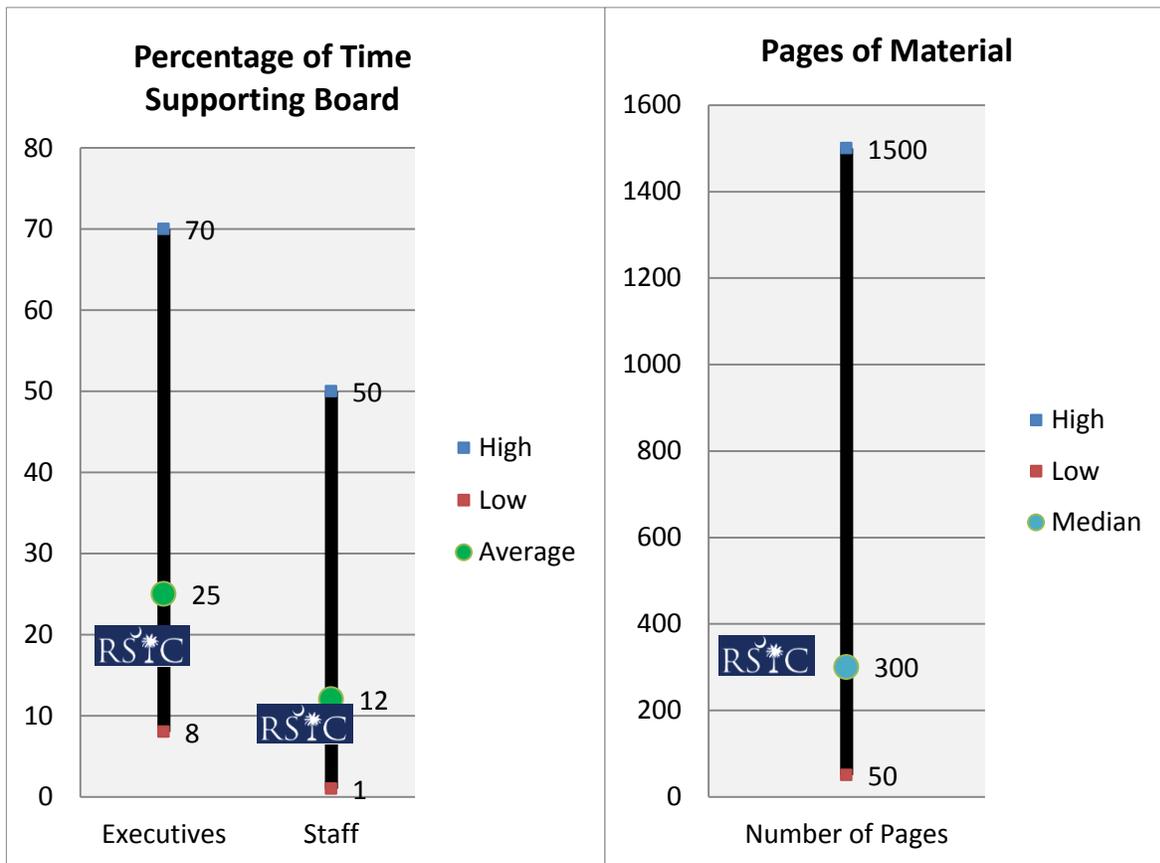
I18.5: If RSIC decides to significantly grow securities lending, it should implement enhanced and more automated compliance functions, including compliance reporting from the lender(s) and periodic review by RSIC's compliance officer.

Commissioners Access to Information

Conclusion I19: The Commissioners appear to have adequate access to information required to perform their duties; however, adherence to the policy for managing Commissioners' requests for information may need to be improved.

The percentage of time spent by executives and staff supporting the Commission is consistent with the peer group. Similarly, the number of pages of material provided to the Commission for each meeting is also consistent with the peer group. (Source: CalPERS Governance Survey).

Table 38 Access to Information



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The use of an on-line portal, which is used by RSIC to provide information to the Commissioners, has become prevailing practice among public pension funds. An important feature of a commission portal is that all Commissioners have immediate access to the same data at all times. RSIC provides access to all transaction-related documents on the portal, which is much more than most other funds provide to their trustees.

Although most Commissioners have expressed satisfaction with the information they are provided by RSIC, the Treasurer has indicated a desire to receive several additional reports, such as monthly reports from Russell and risk reports from Goldman Sachs. RSIC has responded that, “the Goldman Sachs risk reports have been recently provided to all Commissioners via Watchdox. Additionally, it was our understanding that Russell had provided the Treasurer his request directly. If this isn’t the case, we are happy to provide them to all Commissioners going forward.”

In addition, as stated earlier the Treasurer continues to believe *“the genesis of the problematic relationship between the RSIC and STO is the intentional withholding of information that is due to me as a fiduciary. Even though you both (FAS and SIG) have opined on this I want to state as plainly as possible that to this very day I am routinely denied access to important, and in fact necessary information, that I need to perform my duties. I have outstanding requests that have been ignored, or dismissed for over 6 months. Most of these requests would take a few moments of a junior staffer’s time to forward the information, yet, they regularly breach their fiduciary responsibility and deny me the access I am due by law and custom.*

Trust cannot be earned under these circumstances, and it is unreasonable to believe that good can come out of the willful and premeditated RSIC policies that are illegal and unethical.”¹²

This comment is further evidence of the ongoing nature of the dysfunctional relationship. It reinforces the earlier finding by SIG that such requests from the Treasurer may be *“slanted, self-serving, and having a bias towards fault finding”¹³* rather than a desire to improve the investment program or to provide oversight. As a result, every such request to the RSIC is treated by them as a potentially litigious situation which causes delays in coordinating the RSIC response since it cannot be handled routinely by a junior staffer.

Most other funds FAS has worked with have developed a protocol and process for formally handling any request by a trustee for additional information from the fund staff. There are several reasons this is a leading practice:

- Direct interactions by an individual trustee with investment staff can provide an opportunity for undue influence and, at a minimum, the appearance of impropriety
- Requests made directly to staff members may not be addressed to the appropriate person with the best expertise, or even with the correct answer

¹² Ibid. Email from Curtis Loftis, April 17, 2014 to R. Funston (FAS) and P. Maley (SIG).

¹³ Ibid. Review of “Red Flag” Indicators of Potential Wrongdoing at the Retirement System Investment Commission. July 2013 p. 4.

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- If unchecked, some trustees can unwittingly submit requests which require significant staff workload and present conflicts with other important duties
- It may at times be necessary to prioritize information requests to manage staff workload

Typically, an effective trustee request-handling process has the following characteristics:

1. A single person or office who receives the information requests
2. As opportunity for discussion among the trustees about the request and its priority
3. A transparent list of all requests which is made available to all trustees
4. A single person or office who assigns follow-up responsibility to fund staff and is responsible for ensuring all response commitments are honored
5. Distribution of responses to all requests to all trustees

The current RSIC policy on Commissioner-to-Management communications is contained in the Governance Policy Manual in ***Policy VII: Communications***, which states:

(C) Commission Member Communication with the Management

- (1) Commission members should direct questions regarding any aspect of the South Carolina Retirement System Investment Commission (“RSIC”) operations to the Chief Investment Officer (“CIO”), COO, or the appropriate designated staff member.
- (2) Requests for information that require significant expenditure of RSIC staff time or use of external resources should be:
 - (a) Directed to the CIO or COO;
 - (b) Consistent with the role of the Commission (*See Commission Roles and Responsibilities Policy*); and
 - (c) Formally requested and approved at a Commission or committee meeting.
- (3) Individual Commission members will share information pertinent to the RSIC with the CIO and/or COO in a timely manner. The CIO and COO will similarly share information with the Commission pertinent to the Commission in a timely manner.
- (4) The CIO and COO will ensure that information that has been requested by the Commission or a Commission member is made available to the Commission members as appropriate, and in a timely and complete manner.

The policy as stated appears consistent with leading practice and, if followed, should result in an effective process for Commissioners to submit requests and receive responses and for RSIC executives and staff to manage the process and be responsive to Commissioners’ requests. Regarding (2)(c), the policy should be implemented with a presumption that all requests will be fulfilled unless, on an exception basis, the COO or CIO reasonably determines that the request is inappropriate due to

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workload or other reasons, brings it to the Commission's attention, and proposes the request be considered by the Commission.

Commissioner access to relevant information is important to implementation of their fiduciary responsibilities. However, fiduciaries must also be cognizant of the impact that overbroad, excessive or inappropriate information requests can have on the ability of the organization to efficiently and effectively perform its primary responsibilities, especially when extra staff resources are not available.

Recommendation I19: RSIC should ensure that its policy pertaining to Commissioner requests for information from the RSIC staff is followed. This would include timely fulfillment of routine requests, a transparent process for determining the priority of requests which require approval at Commission meetings, and all responses being made available to all Commissioners through the portal.

Validation of Management Fees and Pass-Through Expenses

Conclusion I20: The RSIC has detailed procedures for validating management fees and pass-through expenses that provide reasonable assurance that reported fees are accurate.

Within the RSIC, the Operations section is responsible for collecting, validating and aggregating fees and expense information to the contract. The investment team is responsible for analyzing the fee and expense information to determine if the amount paid is reasonable for the value received. The RSIC reports management fees and pass-through expenses. The RSIC also reports performance fees/carried interest as of the financial reporting date. Performance fees and carried interest are earned to date by the general manager, but can be affected by future events and are usually not paid until a future date.

Management fees may be directly invoiced to the Fund and are paid by PEBA after validation of the amount. Alternatively, private investment managers may make capital calls of investors and deduct fees and expenses from the proceeds or may make net distributions to investors after deducting fees and expenses. The alternative manager may also take the fees and expenses directly from the investment funds and report the net asset value (NAV) to investors. There is not a standard process to report any of these fees collections to investors.

The RSIC requests management expense fees from the investment managers through a template. Managers do not always use the template and may choose to report in their own format. The RSIC requests much more information than most investors and some managers have difficulty in understanding and complying with the RSIC request.

RSIC has created a detailed Fee Validation Procedure for management fees (and a separate Fee Validation Procedure for managers whose fees are being calculated for the first time) that includes the invoiced fees; non-invoiced management fees (deducted from capital calls or distributions, or a reduction of NAV); performance fees/carried interest; and additional expenses. A multiple page spreadsheet is used to gather the information from the manager for each mandate, recalculate the manager fees according to the contractual agreement, and then compare and reconcile the RSIC

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calculation with the information from the manager. Changes in various types of fees that are outside of set parameters are reviewed. Annotations are made to document resolutions of issues and provide guidance for the next reconciliation. Multiple calculations for a manager must then be aggregated and reported.

The current process is complex and time-consuming. RISC staff described the time and work involved in management fee validation to involve the following:

“The fee validation and aggregation process has required that we hire at least three dedicated resources to manage the process. We have typically staffed the process with a combination of full time and temporary resources. This creates difficulty as well because private equity and hedge fund contracts are not simple and staffing the validation project with resources that do not have experience in such contracts can create a significant learning curve.

With improvements in the fee reviews, the average time for completion per fund now requires approximately 13 hours each. This is because the review of many private market investments involves email exchanges and calls with the manager which can take days or weeks to finally resolve. With approximately 200 non-invoiced funds, 227 in all last fiscal year, this means that a four person team needs about five months to complete a full review. “

The 2013 manager fees and expenses were validated at the end of the fiscal year. Fees and expenses are now being reconciled and validated quarterly.

We also reviewed the procedures for validating management fees and expenses and found them to be thorough. The completed June 30, 2013 templates from a sample fourteen managers, some of who had multiple mandates, were reviewed.

The flow of information, calculations and reconciliations was tracked through each spreadsheet. The manager fees and expenses reviewed matched to the fees reported in the Comprehensive Annual Financial Report.

Valuation of Investment Assets

Conclusion I21: The RSIC/PEBA process of valuing investment assets at fiscal year-end is prevailing practice in the public pension industry.

Valuation of investment is a joint responsibility between PEBA and the RSIC. A memorandum of understanding between PEBA and RSIC, most recently revised as of January 2014, provides that the PEBA staff will provide investment accounting and financial reporting services for the RSIC investments.

A Valuation Team comprised of both PEBA and RISC representatives meets quarterly to discuss any changes or issues with the values of Fund investments. Minutes of the quarterly meeting are recorded were reviewed for FY2013.

Manager statements, custodian-manager reconciliations, and reports are received monthly by PEBA which is responsible for ensuring that the PEBA general ledger and custodial bank are in agreement and

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any reconciling differences are resolved. Since PEBA receives the monthly statements, they also review the reported asset values during the year for substantive value changes and work with RSIC to confirm the values.

RSIC is responsible for on-going due diligence over investment managers and for compliance monitoring. The on-going monitoring of investment managers is discussed elsewhere in this report. We note that RSIC did not have an automatic compliance monitoring system as of June 30, 2013, but did require managers to self-report compliance for FY2013. There was a 100% return rate by the managers and the compliance reports were discussed by the Valuation Team. Compliance reports are now being requested quarterly.

The valuation policy for investments is stated on page 44 in the 2013 PEBA CAFR and is in accordance with generally accepted accounting principles in the United States. Securities traded on public exchanges are priced at fair value by the custodial bank. Alternative investments are valued based on the most recent financial information available for the underlying companies and reported by the investment managers at their fiscal year end, which is adjusted for subsequent cash flow movements through the end of the fiscal year for PEBA.

Audited financial statements are received from managers who have assets not held by the custodian. Last year all 86 financial statements were received. Both PEBA and RSIC staff review these audited statements.

RSIC does a semi-annual review of the not-in-bank managers' statements. The year-end review includes reconciliation with each manager's audited financial statements. Any differences outside of a tolerance of $\pm 5\%$ are researched and reconciled.

PEBA rolls forward the balances from the not-in-bank manager's fiscal year-end report (usually Dec. 31) to the PEBA fiscal year end of June 30. This entails taking cash movements (distributions and contributions) into consideration for the ending balance. The resulting value is compared to the manager's June 30 statement, the custodial bank values and the PEBA general ledger system. Any differences are reviewed and reconciled.

Both RSIC and PEBA perform a detailed review of the information on the values of alternative investments held in the portfolio at year end. A meeting of the Valuation Team is held at the point that PEBA must start the process of finalizing the financial statements. Each alternative investment mandate has the June 30 value documented. Any outstanding issues are discussed and resolved.

Auditing practices require that management (PEBA and RSIC) take responsibility for the investment values reported in the financial statements. Management is expected to have sufficient oversight of the investment process so as to have a basis on which to base an opinion on the investment values. Both management at RSIC and PEBA sign a representation letter taking responsibility for the investment values, activities and information provided to the auditor.

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The auditor performs testing, analysis, and reviews on the information in management's financial statements in order to opine on whether those statements fairly present, in all material respects, the status of the Fund on the measurement day and the activities that occurred during the year. The auditor's opinion on PEBA's FY2013 was unqualified.

The process is rigorous and extensive. Sufficient information is received to have assurance that the values reported on the financial statements are reasonable approximations of the actual fair value.

5. Legal Compliance

Scope and Standard for Comparison

The legal compliance assessment included an evaluation for reasonableness and adequacy of RSIC's legal compliance with existing laws and statutes governing the RSIC and the Retirement System. This was linked to many of the activities in Category 1: Governance, which reviewed applicable laws and regulations and also utilized internal interviews and document reviews.

The review addressed the following specific issues:

- Review the use of internal legal counsel and compare to other funds
 - Role of internal counsel
 - Level of staffing
- Review the use of outside legal counsel
 - Role of external counsel in investment and due diligence processes
 - Other roles for external counsel
 - Use of fiduciary counsel
 - Cost and contracting approaches for external counsel
- Assess board and staff compliance with plan documents, for example:
 - Commission and committee operations
 - Roles, delegations and decision making
 - Transparency
 - Ethics and conflict of interest
 - Contracts
 - Trust and custody
 - Risk reporting
 - Compensation
 - Internal audits

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- Documentation management
- Other RSIC policies
- Assess compliance with “prohibited transactions” requirement

Summary of Legal Compliance Conclusions

L1: Internal legal staff and outside counsel are both qualified and capable, but there are opportunities to improve efficiency.

L2: Development of standard clauses could improve consistency of investment agreements and enhance the bargaining position of legal counsel in negotiating contract terms.

L3: The contracting process has resulted in investment agreements with generally reasonable and appropriate terms; however, procedures for obtaining Commission approvals are cumbersome and could be streamlined to avoid delay in closing transactions.

L4: Compliance with RSIC policies appears to be satisfactory, with several areas for potential improvement.

L5: The outside counsel pool is due to be refreshed through an RFP, once the legal counsel selection and contracting process has been streamlined.

Findings and Recommendations for each Legal Compliance Conclusion

Qualifications and Capabilities

Conclusion L1: Internal legal staff and outside counsel are both qualified and capable, but there are opportunities to improve efficiency.

Based on our experience in working with other public pension funds, the size and qualifications of RSIC's legal staff are appropriate for the workload, which reflects RSIC's commitments to privately negotiated investment transactions and use of outside counsel. Because legal staffing requirements are highly dependent upon the complexity of investment transactions and amount of other legal services needed at a particular fund, comparisons across peers based solely on asset size are less relevant. Qualifications and experience of RSIC's outside legal counsel are also appropriate for the investment work they are handling.

Comments from external investment counterparties indicate that responsiveness in the documentation process has generally been adequate. Nevertheless, on a few occasions, delays were cited as frustrating.

Internal legal staff and outside counsel first become involved in the diligence process after the transaction is approved by Commissioners. In addition, further delay in legal diligence can result from the need to obtain deal-by-deal approval of outside counsel from the Attorney General. While this is not unusual at public pension funds, it discourages development of a team approach to due diligence that takes full advantage of available legal expertise. Earlier involvement of internal or outside legal counsel could enhance efficiency by ensuring up front that transaction counterparties are aware of and will agree to comply with RSIC's legal requirements. To the extent that questions with respect to legal terms or investment structure arise in the investment due diligence process, internal or outside legal counsel should be assigned to address those questions immediately rather than waiting until the investment is approved.

Addition of a paralegal would be consistent with peer practices and would help to improve tracking and timeliness of the document negotiation process.

Recommendations

L1.1: RSIC's procedure for use of legal counsel should be revised to assign inside or outside counsel to each investment transaction during the final due diligence process prior to approval of the Commissioners, as needed.

L1.2: RSIC should add a paralegal to the legal staff to provide administrative support and assist in document control.

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Investment Agreements

Conclusion L2: Development of standard clauses could improve consistency of investment agreements and enhance the bargaining position of outside legal counsel in negotiating contract terms.

The quality and experience of outside counsel firms utilized by the RSIC is appropriate. However, outside counsel firms have each developed their own RSIC contract clauses. A review of a sample of RSIC's recent investment contracts indicates that statutorily-required terms are addressed in the relevant legal documents. Legal documents also generally include provisions addressing RSIC preferred terms. However, there is some variation in the standard contract clauses used by different outside counsel firms and in the extent to which negotiations over different provisions is prioritized.

The following examples are illustrative of cases in which a consistent process with outside counsel using standard contract clauses could help ensure that all priority items are covered and assist in generating more consistent language in RSIC's investment contracts.

- RSIC typically requests a representation that no personnel of the General Partner or Manager have made prohibited political contributions in South Carolina. We found significant variation in the language through which this issue was addressed. In certain instances, assurance was obtained only indirectly via reference to compliance with the Federal Investment Advisers Act, while in other agreements reference was made directly to the applicable South Carolina statute. We consider the latter approach as more likely to convey clear compliance expectations to the counterparty.
- RSIC requires specialized fee reporting for operational purposes. In the majority of cases, RSIC's required fee reporting was addressed via an exhibit to an agreement side letter setting forth general reporting requirements. In one instance, however, we were advised that fee reporting obligations were indirectly obtained through reliance on another investor's negotiated side letter, as part of the Most Favored Nations ("MFN") process, rather than directly through a standard provision in RSIC's side letter. Preferred practice is that any required special reporting should be addressed directly via RSIC's standard side letter, and the MFN election to bootstrap on another investor's side letter should not be relied upon to obtain required terms.
- General Partners are considered fiduciaries to the funds they serve under Delaware law (the state of formation for most private funds). However, Delaware law permits the General Partner's fiduciary duties to be reduced by provisions in the partnership agreement. Leading practice includes negotiation to obtain an affirmative recognition by General Partners of their status as a fiduciary under a public pension fund's state law standards or negotiation of acceptable terms for any modification of that duty in the fund's legal documents. In one older transaction that we reviewed, an explicit reference to RSIC's state law fiduciary duty standard was not included, leaving RSIC to rely by default on Delaware partnership law.

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The results of our investment documentation review are summarized in Appendix G Investment Manager Agreement Compliance Summary.

Development and consistent use of standard contract clause requests in side letters, along with delivery of those standard contract clauses to transaction counterparties as early in the process as practical, would facilitate negotiation of more consistent and favorable contract terms. Early identification of required terms for transaction counterparties should also lead to improved efficiencies. The investment due diligence process could be halted early if the counterparty is unable or not willing to agree to RSIC's required terms. For example, deal-breaker terms may include statutorily-required provisions, such as public records disclosures and limitations on indemnification.

Recommendations

L2.1: RSIC should establish a standard side letter and contract clauses to improve bargaining leverage and increase contract consistency, and internal counsel should work with investment staff and outside lawyers on prioritization of the “asks.”

L.2.2: RSIC should identify investment terms that are deal-breakers and provide those terms to investment counterparties early in the investment due diligence process.

Commission Approvals

Conclusion L3: The contracting process has resulted in investment agreements with generally reasonable and appropriate terms; however, procedures for obtaining Commission post-approval closing authorizations are cumbersome and could be streamlined to avoid delay in closing transactions.

Our document reviews and counterparty interviews confirmed that RSIC's investment due diligence and document negotiation procedures are reasonable and consistent with peer practices. However, a few transaction counterparties indicated that RSIC has been slower in closing on investments than other investors. In one instance involving an older investment, the entire process took more than a year to complete. In another instance, RSIC missed the close window for a side-by-side overage (co-investment) fund that offered favorable economic terms compared to the main fund (in which RSIC invested).

Slow due diligence makes it virtually impossible for RSIC to be an “anchor” investor and to have the leverage enjoyed by early investors to negotiate terms and conditions to a greater extent than investors who commit later in the process. None of RSIC's peers require a 30-day post-approval document review period. This requirement appears unique to RSIC and, in some cases, may add delays or result in RSIC having to pass up investment opportunities.

We also note that RSIC's use of Watchdox for posting relevant investment materials for review by Commissioners prior to closing is a leading practice. However, while this added transparency for

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Commissioners is appropriate, it runs the risk of interjecting individual Commissioners into negotiation of the legal documents. Active participation in transaction legal diligence by individual Commissioners is also, in our experience, unique and could be seen as undermining the full Commission's ability to serve its independent fiduciary oversight role, raising potential co-fiduciary liability concerns if undue influence were involved.

Quarterly meetings of the Commissioners, since the Commission retains final approval authority over alternative investment transactions, may also result in delays to investment transactions—if an investment is not ready to be presented at a meeting, it will have to wait until the next quarterly meeting. This may affect RSIC's ability to take advantage of otherwise favorable investment opportunities in instances where opportunities are time-sensitive.

The Legal Sufficiency Certificate, implemented in June 2013, is provided by internal legal counsel at the conclusion of the contract negotiation process and start of the 30-day Commissioner review period. It provides confirmation that legal compliance and due diligence items have been completed and the investment documentation is ready for closing in accordance with material terms that were presented to and approved by the Commission.

The Legal Sufficiency Certificate should confirm that the final negotiated documents are consistent with delegated authority under the Statement of Investment Objectives and Policies, as well as all material terms of the Commission's approval. It does not appear that the current form of Legal Sufficiency Certificate fully covers all of these items. The form of the Certificate should be reviewed to ensure it offers comfort on all material closing conditions, is specific as to what items should be included and that the Commissioners are satisfied they can rely on it. (One of the Commissioners expressed reservations that the Certificate was insufficient in the scope of its coverage and level of assurance.)

Some peer funds assign responsibility to outside counsel for confirming and documenting that final documentation complies with all material requirements. It might also be that staff signatories in addition to legal counsel should be added to the Certificate, if Commissioners want assurance on material investment terms. However, in considering revisions to the Certificate, Commissioners should recognize that deal terms may change (typically for the better and often in non-material ways) during final document negotiations. It is unrealistic to expect otherwise and adoption of a no-changes rule could undermine ability to negotiate improved terms.

Recommendations

L3.1: RSIC should consider eliminating the 30-day review period and instead rely on an appropriately documented Legal Sufficiency Certificate to confirm that all legal compliance and due diligence is complete. Alternatively, RSIC could shorten the Commission review period and add a provision to the Governance Policy Manual clarifying the purpose for this review period and confirming that it does not delegate Commission authority to individual Commissioners or revoke authority otherwise delegated to the CIO or COO.

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L3.2: RSIC could require more frequent Commission meetings to consider investments. (See also Recommendation G12.1.) Alternatively, the Commission could consider delegating greater authority for approval of alternative investments to the CIO or Internal Investment Committee.

L3.3: The Legal Sufficiency Certificate should include confirmation that documentation for each investment is consistent with material terms approved by the Commission and with authority delegated to staff by the Commissioners in the Statement of Investment Objectives and Policies.

Policy Compliance

Conclusion L4: Compliance with RSIC policies appears to be satisfactory, with several areas for potential improvement.

The Sourcing and Conflict Disclosure Form, adopted in November 2012 and now required of Commissioners and staff for new investment approvals, as well as the Annual Manager Compliance Certificate (adopted July 2013), Code of Ethics, Annual Code of Ethics Acknowledgment and Personal Trading Policy (adopted December 2013), are consistent with leading peer policies and appropriately implement prohibited transaction requirements.

- Compliance review procedures are in place and appear to be functioning well.
- Annual compliance questionnaires and certifications, implemented in July 2013, were received from all staff, managers and the RSIC consultant for 2013.
- No violations were identified during 2013.

One area where greater compliance coordination could be considered is in regard to seeking periodic confirmation from the State Ethics Commission, or through an independent audit, that RSIC Statements of Economic Interests has have been audited and cross-checked with RSIC investment transactions and Sourcing and Conflict Disclosure Forms to proactively identify potential code of conduct compliance issues. In particular, external reassurance could be sought that staff and Commissioners have not obtained a benefit for themselves, their family members or their business associates from sourcing investments or otherwise acting on RSIC matters. This practice has been adopted by a number of public pension funds. Sourcing information is relevant to implementation of co-fiduciary monitoring obligations, so timely disclosure to all Commissioners is important.

In addition, RSIC should consider extending coverage of the Sourcing and Conflict Disclosure Form to Commission approval of consultants and professional service providers exempted from State procurement processes (referred to as Named Service Providers), as the same compliance issues are present as for Commission investment approvals. An explicit statement could also be added to the Sourcing and Conflict Disclosure Form advising that certifications contained in the form are subject to external audit for compliance with Ethics Code, Standards of Conduct and other legal requirements.

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While RSIC has initiated development of a Sudan divestment policy, it has not yet been adopted and should be finalized. (See *Section 2 Policy Review and Development* for further discussion of this Conclusion.)

Although the governance policy manual directs the RSIC to implement an enterprise risk management program (ERM), the ERM program and Director of ERM position were only recently approved by the Commission at its March 13, 2014 meeting, and implementation is targeted for July 1, 2014. (See *Section 1 Governance* for further discussion of this Conclusion.)

Recommendations

L4.1: The Audit Committee should approach the State Ethics Commission and establish an independent audit process for regular confirmation that RSIC Statements of Economic Interests have been reviewed.

L4.2: Consideration should be given to extending coverage of the Sourcing and Conflict Disclosure Form to Commission approval of consultants and professional service providers exempted from State procurement processes.

L4.3: The Sudan divestment policy should be completed and approved by the Commission (See also Recommendation P2.7).

L4.4: The Enterprise Risk Management (ERM) program planning should be completed and the new function launched as soon as practical. (See also Recommendation G13.2.)

Use of Outside Counsel

Conclusion L5: The outside counsel pool is due to be refreshed through an RFP, once the contracting legal counsel selection and contracting process has been streamlined.

The outside counsel approval process used by the Attorney General is cumbersome and falls short of leading practices at benchmark peers. As illustrated in the table below, most benchmark peers do not require approval of the Attorney General for each engagement of outside counsel. The current approval process can add to delays in completing RSIC legal due diligence.

Given the level of experience and expertise with institutional investment transactions that RSIC's internal legal staff has demonstrated, we believe it is fully capable of prudently selecting, contracting, monitoring and evaluating outside counsel on RSIC investment matters. RSIC's legal fees and use of outside counsel were found to be consistent with peer practices. Periodic approval by the Attorney General of a pool of qualified law firms, with use of a pre-approved form of engagement contract and billing procedures and regular reporting on firm retentions and billings, would meet peer standards and achieve an equivalent level of Attorney General oversight without unnecessarily delaying transaction closings.

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Table 39 Approval of Outside Counsel

Who must approve engagement of outside counsel? (N=6; Some multiple responses)	For each contract	For a pool of approved law firms	RSIC
Fund Chief Legal Counsel	1	1	
Fund CEO			
Board	1	1	
Attorney General	2	1	X

Table 40 Approval of Legal Fees

Does the Attorney General or other outside approval authority require approval of legal fees?	Responses (N=6)	RSIC
Yes	3	X
No Outside Approvals Required	3	
Comments:		
Just for contingent fee agreements. Responded: "Yes".		
There is a preapproved list of law firms approved by the Department of Justice/Attorney General. We can use firms from the list as necessary.		

The outside counsel service provider relationship has not been refreshed in more than six years (since the last RFP market test). In our experience, most peers refresh their pool of outside counsel at least every five years.

It is important to recognize that negotiation of institutional investment transaction legal documents requires outside counsel that is experienced in such sophisticated transactions, including expertise with international transactions. In any revision of the RSIC outside counsel approval process, the standards applied for selection and compensation of law firms should ensure that RSIC can retain counsel with appropriate experience that will match the qualifications of counsel used by peer funds and contract counterparties. RSIC would be put at a bargaining disadvantage and exposed to increased fiduciary liability risk if it were not able to engage the same caliber of investment legal counsel as its investment peers.

As is shown in the below table, a majority of RSIC's benchmark peers engage outside fiduciary counsel. The RSIC does not currently utilize independent fiduciary counsel but regularly encounters issues on which independent fiduciary advice would be beneficial. We understand that RSIC recently attempted to engage fiduciary counsel but could not obtain approval from the Attorney General to pay competitive rates. As with investment legal counsel, public pension fund fiduciary law is a specialized field and

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requires familiarity with peer practices. The process for selection and approval of RSIC fiduciary counsel should ensure that counsel with appropriate experience and independence, comparable to fiduciary counsel used by peer funds, can be retained.

Table 41 Use of Outside Counsel

Source: New York State Common Fund Survey Do you engage outside fiduciary counsel?	Responses (N=15)	RSIC
Yes	8	
No	5	X
Sometimes	2	
Comments:		
No standing contract for external fiduciary counsel. Retention of counsel would require approval of the South Carolina Attorney General.		

Recommendations

L5.1: Outside counsel should be refreshed, since it has been more than six years since the last RFP market test.

L5.2: The process for approval of outside counsel by the Attorney General could be streamlined through development of a pre-approved pool of qualified investment counsel, with agreed engagement contract form and budget standards, and requirements for regular reporting to the Attorney General and Commissioners.

L5.3: Consideration should be given to engagement of qualified, independent fiduciary counsel.

6. Information Technology

Scope and Standard for Comparison

The review included an evaluation for reasonableness and adequacy of RSIC's information technology systems and availability of tools and resources for RSIC commissioners, staff and fiduciaries to effectively administer the assets and funds of the Retirement System. The review addressed the following specific issues:

- Adequacy of investment, risk management, accounting and compliance systems, tools and resources
- Investment systems
- Risk management systems
- Accounting systems
- Compliance systems
- Other tools and resources

Summary of information Technology Conclusions

IT1: Critical investment support systems are missing or inadequate.

IT2: RSIC has insufficient internal IT staff to support its requirements.

IT3: RSIC lacks a project governance process, guided by an overall business plan and IT strategy.

IT4: RSIC needs greater autonomy in selecting and managing its systems.

Findings and Recommendations for each Information Technology Conclusion

Investment Support Systems

Conclusion IT1: Critical investment support systems are missing or inadequate.

The shift from investing only in publicly traded stocks and bonds to a portfolio with substantial exposure to private markets and structured investments greatly increased RSIC's need for robust and integrated information systems. However, RSIC continues to lack critical systems necessary to support management of trading, risk, performance and compliance. A lagging systems infrastructure poses major operational risks and prevents RSIC from increasing internal management of assets – a step that could expand RSIC's investment capabilities and reduce costs.

RSIC's 2009 Strategic Plan identified strengthening information technology (IT) as a major goal but did not provide a blueprint for identifying and addressing systems needs. In its 2011 Strategic Assessment, Deloitte & Touche identified data management, reporting and technology as a high risk area for the Commission. Among other findings, the report raised concern about systems limitations for private markets and assets held within strategic partnerships (which together are approximately 40% of total assets). These are still areas which need to be addressed, which RSIC anticipates will be resolved through a recently signed contract with an investment systems administrator.

To a great extent, RSIC relies on information and tools accessible through its custodial bank (BNY Mellon). Over 60% of its assets are actually custodied at other banks. BNYM gathers and reports certain information about "not-in-bank" assets. However, RSIC does not have systems that provide a fully integrated view of the whole portfolio down to the individual security level. That is a major obstacle in managing performance, risk and compliance.

Commissioners, management and staff expressed concerns about the weaknesses in RSIC's information systems. One manager remarked that "not having the systems we need is crippling." Another summed up the situation in alternative investments this way: "Any system would be better than what we have now."

RSIC has made some improvements, recently implementing the Tamale system for document storage and contract management. This system is adding value in due diligence and monitoring investment managers. A staff member is assigned full time to managing the system, an indication of the resource challenges RSIC will face as it seeks to implement other major systems improvements in the near future.

RSIC has pursued other IT improvements but states that progress has been slowed by a strained relationship with the custodial bank, state procurement processes and the constraints of the state budget process. The lack of internal staff to manage and implement new initiatives will continue to be a major obstacle, even if RSIC relies on off-the-shelf applications installed and managed by vendors.

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Based on our interviews with staff and Commissioners, these appear to be the most critical system needs:

- **Private equity markets.** An asset management system for private equity investments that provides historical information on partnerships, has general partner information available, looks at vintage years, provides IRRs from inception, provides net of fees and other expenses as well as performance fees/carried interest, and tracks commitments.
- **Hedge Fund oversight.** A system to provide oversight and risk monitoring of hedge fund investments including position-level risk and performance analytics and performance attribution.
- **Risk management.** A security-based risk management system which would provide position level transparency as well as risk and performance analytics across the total portfolio. In September 2013, RSIC issued an RFP for a risk management system.
- **Compliance.** An automated system for monitoring on a daily basis the compliance of internal investments and external managers with investment policies and manager contracts and to ensure that the total portfolio is in compliance with Commission policies and directives. To date, RSIC has been unsuccessful in its effort to procure such a system through BNYM.
- **Trade order management.** A system which provides timely, efficient and transparent trade execution, has real-time market information, allows management of broker commissions, and provides audit and control mechanisms.
- **Data warehouse.** A system which contains essential information about the whole investment portfolio, down to the security level, that can seamlessly feed other systems for analysis.

Internal accounting. The current system (QED) is provided through a contract between the Treasurer and the vendor and PEBA provides connectivity. The current version is outdated, requiring workarounds according to PEBA and RSIC. However, the STO had not been made aware of concerns about the current system.

A properly functioning internal accounting system is required before substantial internal investing can be implemented. Primarily due to dissatisfaction with BNYM's responsiveness to its system needs, and because the custody contract is not managed by the Commission, RSIC issued an Investment Administrator RFP in December 2013 to meet its system needs through a "turnkey" vendor and include these components:

- Order Management System
- General Ledger feeds
- Data Warehouse for all assets (including look through to underlying holdings of commingled funds whenever possible)

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- Automated data feeds to a risk system (RSIC intends to complete the risk system procurement shortly)
- Private markets system to provide look through to private market assets
- Compliance functionality
- Performance reporting, including daily performance estimates
- Fee Validation

RSIC also wants the Investment Administrator to eventually provide accounting information to PEBA, which will further shrink the role of the custodian.

In March 2014, an agreement was reached with a vendor to provide all of the services specified in the RFP within the \$1.2 million annual budget for the initiative. RSIC will be its largest client. RSIC is seeking an increased budget appropriation from the Legislature to ensure it has sufficient funds to pay the costs in the next fiscal year and thereafter.

Management considers implementation of the Investment Administrator capabilities to be the Commission's highest priority initiative. Implementation discussions were beginning with the vendor at the time we were completing our review. If successful, this initiative could greatly enhance system capabilities; however, the scope and complexity will require a substantial initial and ongoing commitment of vendor resources and internal resources that will make it challenging to implement.

Recommendations

IT1.1: Guided by an overall business and IT plan, RSIC should complete the acquisition of systems to:

- **Track commitments and provide return calculations for private market investments**
- **Provide security-based risk management that includes position level transparency and risk and performance analytics**
- **Monitor compliance of investments with investment policies and contracts**
- **Automate trade order management**
- **Warehouse data for the whole investment portfolio in order to seamlessly feed other systems for analysis**

IT1.2: The QED internal accounting system provided by vendor contract with the State Treasurer's Office should be upgraded or replaced.

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IT Staffing

Conclusion IT2: RSIC has insufficient internal IT staff to support its requirements.

The insufficient number of IT staff is a substantial risk to the organization. Information technology has only one full-time employee—the IT Director—and two interns. At this minimal level, no one is dedicated to project planning, prioritization and management. The help desk is staffed by the interns, which creates continuity problems when they leave. Vacation coverage is an issue.

Investment staff relies primarily on the custodian’s systems, Bloomberg, internet services and Excel worksheets to track and manage internal and external portfolios. IT does not have the staff to develop applications to support the investment process.

Through an MOU that was modified and renewed in January, 2014, PEBA continues to host RSIC’s servers and provide email, other office applications, internet access and help desk services. However, PEBA staff is not sufficient in number or trained to support specialized investment systems.

Until the director was hired in 2012, RSIC had no permanent IT staff. In its 2011 assessment, Deloitte & Touche recommended that RSIC consider creating an internal IT function, beginning with the hiring of a director, followed by an applications manager and an infrastructure specialist. These would be the first steps toward providing all IT services internally.

RSIC concluded that moving IT support over from PEBA is too big an undertaking at present. If the number of PEBA IT staff which move to RSIC is sufficient only to continue the services PEBA currently provides, overall management of IT services may improve but the resource gap in IT may not decrease much.

RSIC plans to implement major systems enhancements through the Investment Administrator RFP. While this initiative is to be vendor led and supplied, it is unlikely to be successful without substantial ongoing involvement from IT, operations and investment staff. The current lack of adequate IT staff is a significant risk to the project.

Further, as RSIC seeks to acquire the infrastructure to expand internal management of assets, it may need additional portfolio management tools and specialized investment applications. The expansion is planned to begin with internal passive management, which would have less systems requirements. However, subsequent extension into more active internal management is likely to further increase the need for IT staff and the need for expertise in investment trading and management systems.

RSIC recognizes that IT staffing is inadequate but must look to the state budget process for authorization and funding to improve the situation. Its FY 2015 budget request that is currently before the Legislature includes one additional IT position which has not been approved. A longer-term IT staffing plan to more fully address IT needs is necessary. Additional authority and management flexibility to implement a staffing plan also seems desirable.

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Recommendation IT2: Guided by a business plan for the whole organization, RSIC should seek the number and types of additional IT staff needed to adequately support its expanding systems infrastructure (see Recommendation O3.6).

IT Governance

Conclusion IT3: RSIC lacks a project governance process, guided by an overall business plan and IT strategy.

The Commission's most recent strategic plan, adopted in 2009, included a goal to strengthen information technology resources with six initiatives:

- Establish internal control of information technology infrastructure and systems
- Create system redundancy and stability
- Establish internal control of information technology infrastructure and systems
- Formalize disaster recovery and business continuity plan
- Assess and improve system security
- Hire internal information technology staff

While some progress has been made, for the most part, the initiatives have not been completed. The 2009 plan did not define IT's role in supporting RSIC's evolving investment strategy and due diligence processes. In its 2011 Strategic Assessment, Deloitte & Touche recommended that the Commission consider:

“...undergoing an in-depth assessment of its technology platforms and data management framework. This assessment should include a current state inventory of the applications and Excel spreadsheets used across the business, the definition of firm wide technology requirements, and determination of a plan for addressing the Commission's needs from a technology perspective going forward.”

The Investment Administrator contract signed in March 2014 reflects management's goal to address critical systems needs in a swift and comprehensive way. The components reflect input from work teams across the organization. However, the full in-depth assessment recommended in 2011 still seems prudent. RSIC might benefit from the advice of a firm which specializes in evaluations of IT and operations systems for investment organizations.

The role and resource needs for IT should be guided by an overall business plan for the organization. Among other things, it should address which investment and support functions are best performed internally and which are better outsourced. That choice is heavily influenced now by state budget and procurement constraints. By providing more management and budget authority to RSIC, the State could enable the Commission to make more optimal and timely IT decisions that could improve services and reduce risk.

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As RSIC seeks to make major systems enhancements through the Investment Administrator, it lacks a formal, ongoing governance process that includes investment, operations and IT staff to set priorities, monitor progress and ensure coordination of effort across the organization. A formal project management team with wide representation that meets on a regular basis to address those topics is something RSIC should consider.

Recommendations

IT3.1: Guided by a business plan for the whole organization, RSIC should develop a strategic IT plan with clearly defined objectives, a full assessment of the current state of its systems and a timetable for completing needed improvements (see Recommendation O3.6).

IT3.2: RSIC should establish a project governance process with representation from across the organization to determine IT priorities and monitor progress of initiatives, and to assure resources are appropriately targeted and that issues are addressed promptly.

Systems Procurement

Conclusion IT4: RSIC needs greater autonomy in selecting and managing its systems.

RSIC identified several recent cases in which the state procurement process or other contracting constraints have contributed to delays and other issues in acquiring critical systems:

- **Client relationship management system:** It took over 16 months to obtain this system due to a protest by a losing bidder.
- **Risk system:** RSIC started working with the state procurement process in February 2013 and is just now getting close to selection.
- **Private market system:** RSIC attempted to obtain this system through the custodian for over a year. However, the custody contract is with the Treasurer, not RSIC. The Commission then issued an RFP in September, 2013.
- **Investment administrator:** In March 2014, the procurement process was completed for a systems administrator RFP issued in December 2013. RSIC indicates that due diligence for this complex initiative was inhibited by its lack of authority to have follow-up visits or direct calls with respondent(s) to ask questions (steps RSIC typically takes in selecting investment managers).

RSIC and the retirement funds would benefit from the authority to use a modified procurement process to select investment systems that includes appropriate accountability. Options are discussed in *Section 2 Policy Review and Development* of this report.

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In our survey of other state investment boards, RSIC is unusual in the extent to which it relies on another agency (PEBA) for IT services. RSIC has taken steps to better define and facilitate coordination with PEBA's information technology team. It is understandable that RSIC concluded that it is dealing with too many other issues to pursue a move of PEBA's staff to RSIC management now.

However, as the organization continues to grow and seeks to add more internal management, RSIC should continue to assess whether it would be better served by having all IT support under its direct management. PEBA and RSIC have different systems priorities due to the different nature of their respective businesses. Portfolio management and trading organizations necessarily have much lower tolerance for system outages and have need for much lower time to recovery than non-financial entities. For example, the current MOU includes a two-hour response time to a high priority, mission-critical IT problem, which could be inadequate for RSIC in some situations.

Recommendations

IT4.1: RSIC should be authorized to procure investment systems under a modified procurement process that includes appropriate accountability (See Recommendation P5).

IT4.2: RSIC should continue to pursue the eventual move of IT support from PEBA to RSIC.

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Appendix B RSIC Improvements Timeline

Since the issuance of the Deloitte report (September 2011), the following is a list of improvements that have been implemented:

- Recruited additional employees in positions that previously did not exist such as; Director of Reporting, Senior Legal Officer, Senior Risk Management Officer, Operational Due Diligence
- An Audit Committee of the RSIC Commission was established in June of 2011
- Formal Memorandum of Understanding (MOU) was established between PEBA and RSIC (October 2011) and updated (January 2014)
- Adopted new Performance Incentive Compensation (PIC) Plan (May 2012)
- Created and implemented placement agent policy (September 2012)
- An Internal Audit and Compliance Department was established (September 2012)
- Completed year long search for new Investment Consultant (September 2012)
- Formal initial due diligence guidelines were adopted and implemented (November 2012)
- Formal management representation letter provided to PEBA and external auditor annually (November 2012)
- Formal on-going due diligence guidelines were adopted and implemented, including semi-annual and audited financial statement review (January 2013)
- A research management/contact management database program was purchased and implemented (February 2013)
- Formal Joint Valuation policies were adopted between PEBA and RSIC (March 2013)
- An operational due diligence program was established and implemented, which requires review of operations of all new investments (April 2013)
- Revised Governance Policies were adopted by the Commission (May 2013)
- Implemented formal legal sufficiency letter to accompany every new investment funding (June 2013)
- Implemented annual compliance questionnaire and certification from external managers (July 2013)

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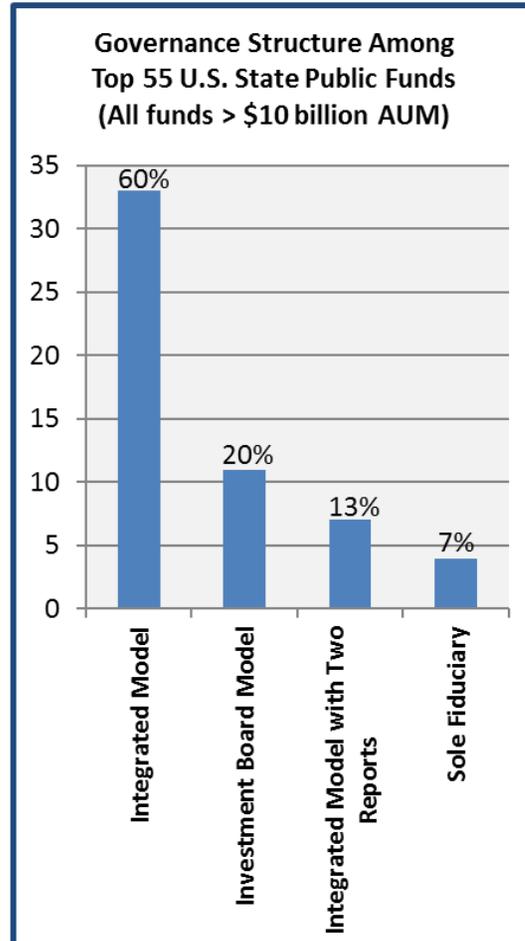
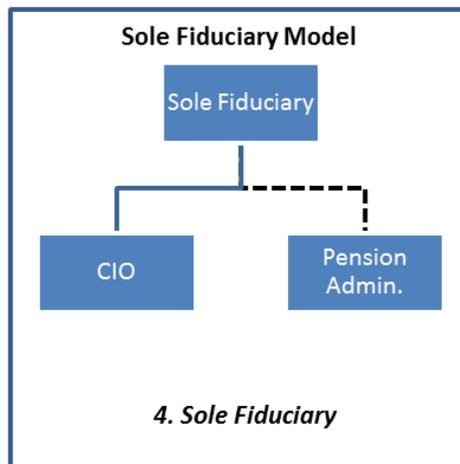
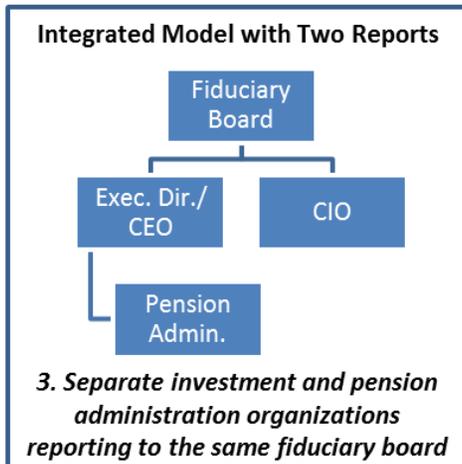
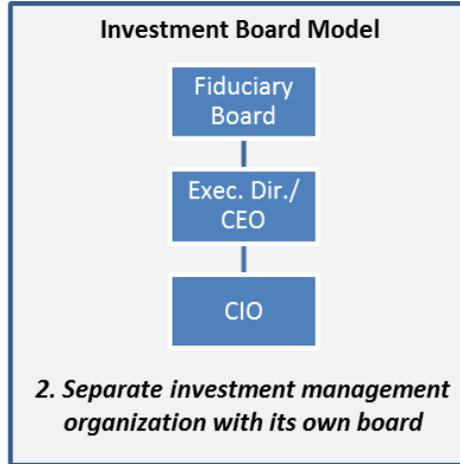
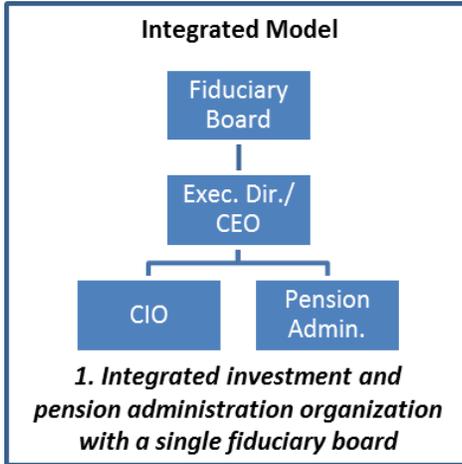
- Implemented a Non-Disclosure Agreement (NDA) with the STO (September 2013)
- Implemented a technology solution to provide for document sharing with the Treasurer's staff and Commissioners (September 2013)
- Improved fee validation procedures and collection process by moving to quarterly process - (October 2013)
 - Disclosed investment fees by manager in the 2012 CAFR
 - All fees were published in the 2013 audited financial statement
- Employee Compliance Policies have been established, including Code of Ethics Acknowledgement, Personal Trading Policy, Gifts and Conflict of Interest Policy and Whistleblower Policy (December 2013)

In process improvements:

- Risk RFP in final stages.
- Administrator selected after RFP process. Implementation to commence immediately with target completion of July 1, 2014.
- Development of Enterprise Risk Management Function, with direct reporting to Audit Committee, approved by Commission at March 2014 Commission meeting.

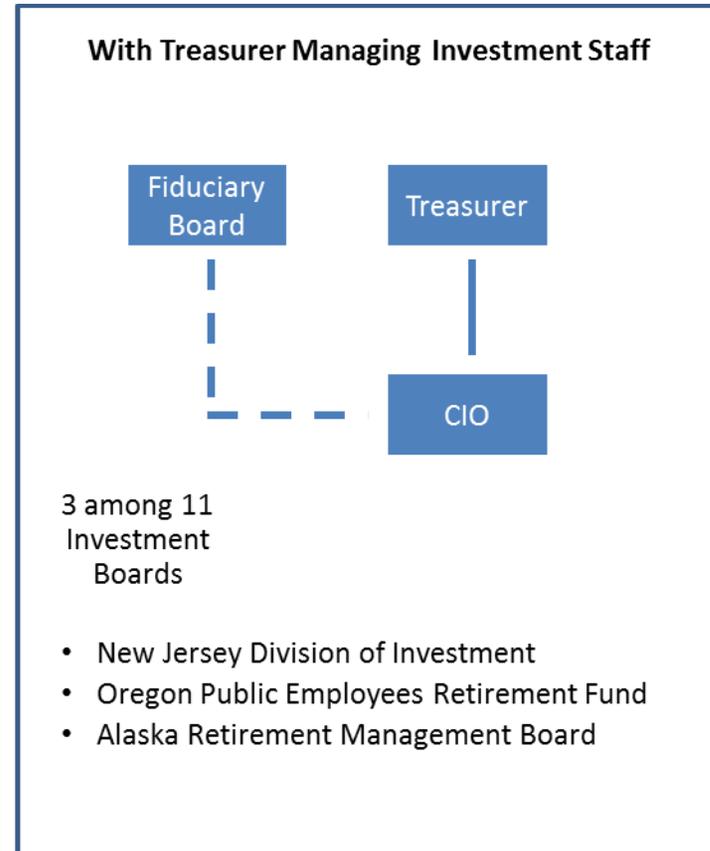
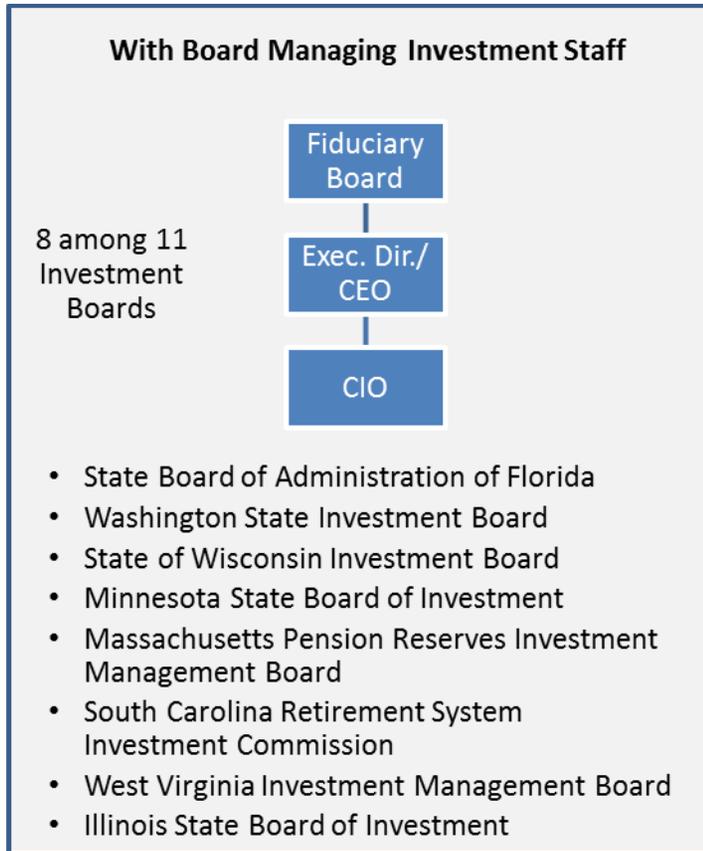
Appendix C Fund Governance Models

- There are four basic public pension fund governance models employed by U.S. state public pension plans, with variations on each.
- The South Carolina RSIC is an example of one of the eleven funds utilizing the **Investment Board Model** (although currently as a variation with COO and CIO direct reports).



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- Eight of the 11 investment board funds have a structure similar to South Carolina, with the trustee board overseeing an independent investment staff.
- Three have the CIO and investment staff reporting to the Treasurer as an Investment Department.



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- Even among the eight comparable investment boards there are differences in board composition, custodian selection, use of advisory boards, and executive reporting relationships.
- RSIC is unique among this group in two respects:
 - Two operating executives reporting to the Board
 - The Treasurer selects the custodial bank.

	Number of Board Members	Ex officio Board Members	Investment Advisory Board	Custodian of Record	Custodial Bank Selection	Board Direct Reports	Current AUM \$Billions	Non-Pension Assets
State Board of Administration of Florida (SBA)	3	1. Governor 2. Chief Financial Officer 3. Attorney General	Yes	Board	ED/CIO	1. ED/CIO 2. Internal Audit	\$168	18%
Washington State Investment Board (WSIB)	15	1. Treasurer 2. Dir. of Dept. of Ret. Sys. 3. Dir. of Dept. of Labor & Industries	No, but 5 non-voting expert board members	Treasurer	Staff Recommends to Treasurer	1. ED	\$95	19%
State of Wisconsin Investment Board (SWIB)	9	1. Sec. of Dept. of Administration	No	Board	Board	1. ED 2. Internal Audit	\$91	0%
Minnesota State Board of Investment (SBI)	4	1. Governor 2. State Auditor 3. Secretary of State 4. Attorney General	Yes	Pension Administration Board	Board	1. ED	\$69	15%
Massachusetts Pension Reserves Investment Management Board (PRIM)	9	1. Governor 2. Treasurer	Yes	Treasurer	Board	1. ED/CIO	\$57	0%
South Carolina Retirement System Investment Commission (RSIC)	7	1. Treasurer 2. Dir. of Public Employee Benefit Authority	No	Treasurer	Treasurer	1. COO 2. CIO 3. Internal Audit	\$27	0%
West Virginia Investment Management Board (WVIMB)	13	1. Governor 2. State Auditor 3. Treasurer	No	Board	Board	1. CEO 2. Internal Audit	\$16	8%
Illinois State Board of Investment (ISBI)	9	1. Treasurer 2. Comptroller 3. Senator 4. Judge	No	Treasurer	Board	1. ED	\$13	0%

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The peer investment boards generally reflect one of two models:

1. *Expert Advisory Board*: An ex officio lay board with an expert advisory board
2. *Lay Oversight Board*: A board with several expert members combined with active member and retiree representation

The current RSIC model is somewhat unique in that it is an expert oversight board.

Expert Advisory Board Model			
	Florida SBA	Minn. SBI	Mass. PRIM
Ex Officio Members	Gov., CFO, AG	Gov., AG, Sec., Auditor	Gov., Treas.
# of Trustees	3	4	9
Member Representation	None	None	5
# of Investment Adv. Council Members	9	17	9
Other Advisory Committees	Audit	None	Real Estate/ Timber, Admin & Audit, Comp.
Investment Manager Selection	Exec. Dir./CIO & Investment Staff	Board	Board
Appointee Expertise Qualifications	No appointees	No appointees	Investment or Financial Management (one appointee)
<ul style="list-style-type: none"> • State Board of Administration of Florida • Massachusetts Pension Reserves Investment Management Board • Minnesota State Board of Investment 			

Lay Oversight Board Model			
	SWIB	WSIB	ISBI
Ex Officio Members	Sec. of Dept. of Administration	Treasurer, Ret. Sys. Dir., Labor & Industries Dir.	Treas., Comptr., Senator, Judge
# of Trustees	9	15	9
Member Representation	2	5	None
Investment Committee	Committee of the Whole	Private Mkts., Public Markets	Investment Policy Comm.
Other Board Committees	None	Audit, Administrative	Audit, Executive, Emerging Mgr.
Investment Manager Selection	Internal Investment Committee	Board	Board
Appointee Expertise Qualifications	Financial or investment experience (5 appointees)	None (Investments for 5 non-voting members only)	None
<ul style="list-style-type: none"> • State of Wisconsin Investment Board (SWIB) • Washington State Investment Board • Illinois State Board of Investment 			

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Appendix D List of Documents Reviewed

- Investment management contracts: 98 files from 7 investments
- Investment agreement review master checklist compliance: 29 files from 7 investments
- Investment reports and correspondence: 18 files
- Quarterly reviews of the investment program: 11 files
- Internal RSIC meeting minutes: 55 files
- Documents relating to hiring external managers for past 2 years: 42 files
- Strategic partnership and manager termination memos: 14 files
- External manager monitoring documents: 5 files
- Management fee and valuation and due diligence document testing: 265 files from 5 investments
- PEBA Comprehensive Annual Financial Reports: 4 files
- RSIC internal policy, procedure and charter documents: 45 files
- Special external reviews: 13 files
- General consultant reports: 8 files
- Internal audit reports: 4 files
- State Auditor reports: 1 file
- RSIC legal structure: 1 file
- Actuarial reports: 1 file
- Compliance documents and reports: 8 files
- Risk reports: 8 files
- External provider RFPs and contracts: 14 files
- Attorney general approval documents: 8 files
- Human resources and training documents: 20 files
- RSIC plans and proposals: 15 files
- Information technology documents: 3 files
- Litigation-related documents: 4 files

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Appendix E Interviews Conducted by FAS for Fiduciary Performance Audit

Retirement System Investment Commission

- All seven current Commissioners and one former Commissioner

Investment Staff

- Chief Investment Officer
- Deputy Chief Investment Officer
- Manager Research Managing Director
- Strategic Partnerships Director
- Internal Asset Management Managing Director
- Senior Investment Officer
- Senior Risk Management Officer
- Senior Risk Management Officer

Operations Staff

- Chief Operating Officer
- Director of Operations and Operational Due Diligence
- Director of IT
- Chief Legal Officer
- Director of Investment Reporting and Performance
- Administrative Manager
- Public Information Officer
- Legal and Policy Counsel
- Senior Legal Counsel

Internal Audit and Compliance Staff

- Director of Internal Audit & Compliance
- Internal Audit & Compliance Officer

Public Employee Benefit Authority Staff

- Interim Executive Director
- Director of Retirement Systems Finance
- Investment Accounting Manager

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State Treasurer's Office Staff

- Chief of Staff
- General Counsel

External Investment Managers

- Apollo Global Management
- Blackrock
- Bridgewater Associates
- Brookfield Asset Management
- GMO
- Goldman Sachs Asset Management
- Golub Capital
- Industry Ventures
- Johnston Asset Management
- Lighthouse Partners
- Oaktree Capital Management
- Putnam Investments
- Russell Investments
- SJC Direct Lending
- Strategos Capital Management
- TA Associates
- Warburg Pincus

Other External Service Providers

- Custodial Bank: Bank of New York Mellon
- PEBA External Auditor: CliftonLarsonAllen
- PEBA Actuary: Gabriel Roeder Smith
- General Investment Consultant: Hewitt EnnisKnupp

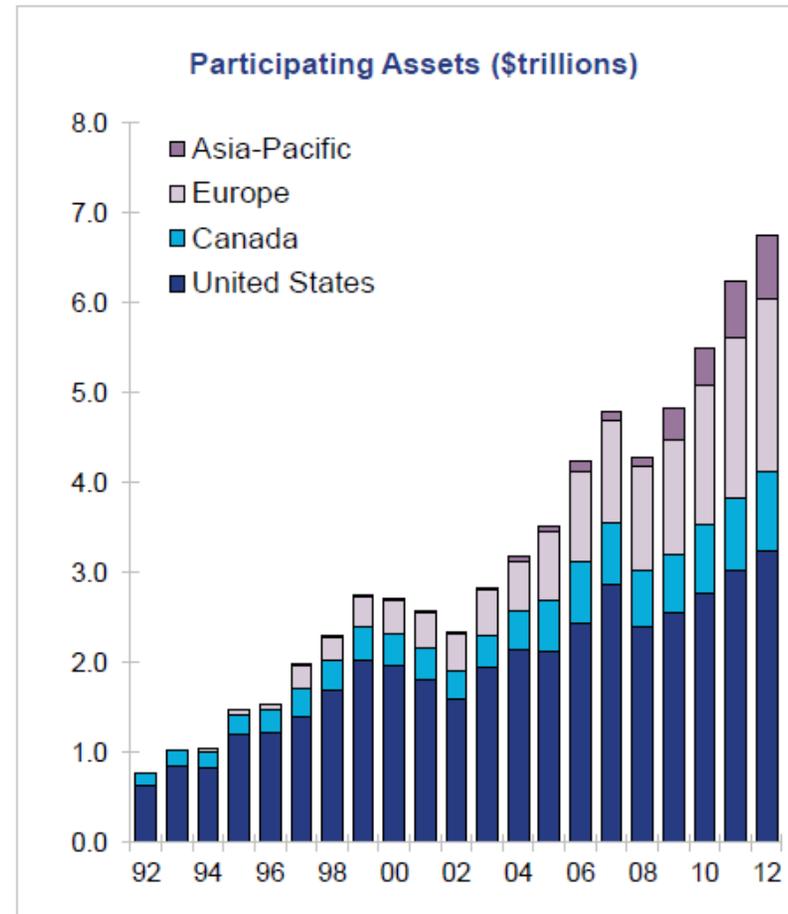
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Appendix F CEM Report Executive Summary, Methodology, Quality Control and Contracting Process

This benchmarking report compares your 2012 calendar year-end cost and return performance to CEM's extensive pension database.

- 196 U.S. pension funds participate. The median U.S. fund had assets of \$5.7 billion and the average U.S. fund had assets of \$16.5 billion. Total participating U.S. assets were \$3.2 trillion.
- 87 Canadian funds participate with assets totaling \$875 billion.
- 79 European funds participate with aggregate assets of \$1.9 trillion. Included are funds from the Netherlands, Norway, Sweden, Finland, Ireland, Denmark and the U.K.
- 11 Asia-Pacific funds participate with aggregate assets of \$700 billion. Included are funds from Australia, New Zealand, China and South Korea.

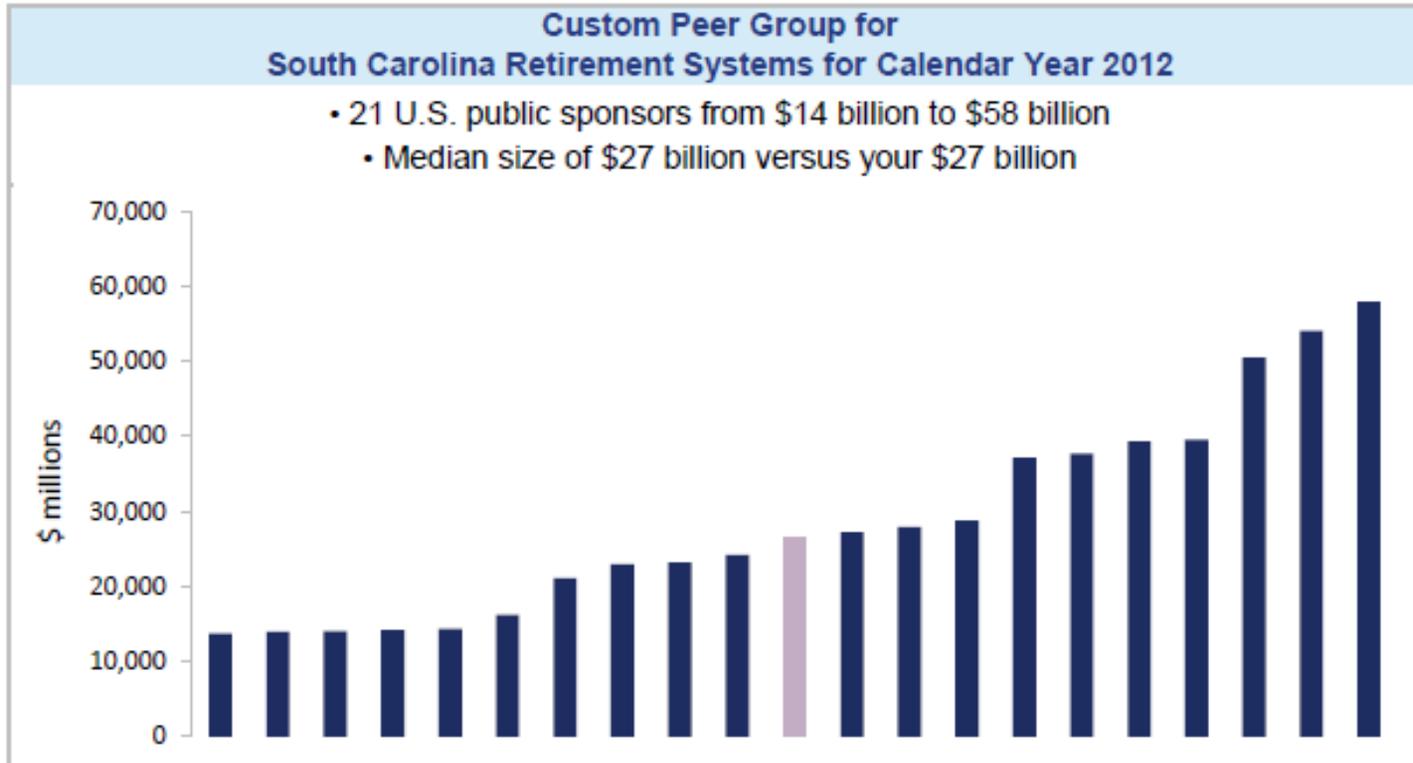
The most meaningful comparisons for your returns and value added are to the U.S. Public universe which consists of 65 funds.



South Carolina Retirement Systems

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 Executive Summary - Page 1

The most valuable comparisons for cost performance are to your custom peer group because size impacts costs.



To preserve client confidentiality, given potential access to documents as permitted by the Freedom of Information Act, we do not disclose your peers' names in this document.

What gets measured gets managed, so it is critical that you measure and compare the right things:

1. Policy Return	How did the impact of your policy mix decision compare to other funds?
2. Net Value Added	Are your implementation decisions (i.e., the amount of active versus passive management) adding value?
3. Costs	Are your costs reasonable? Costs matter and can be managed.
4. Cost Effectiveness	Net implementation value added versus excess cost. Does paying more get you more?

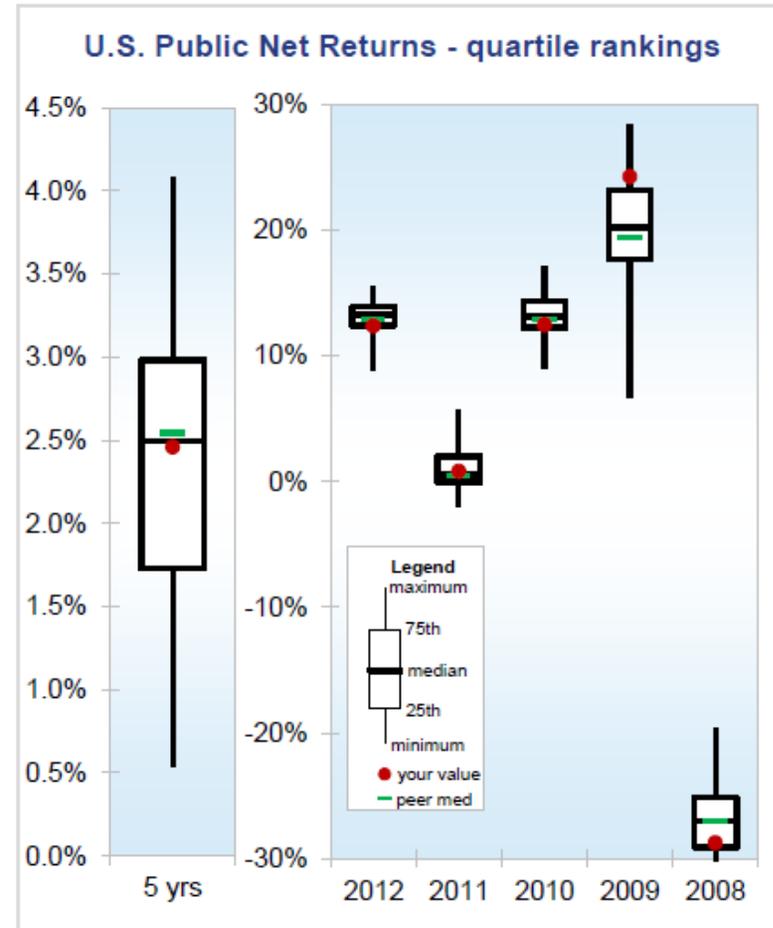
Your 5-year net return of 2.5% was equal to the U.S. Public median of 2.5%.

Returns, by themselves, provide little insight into the reasons behind relative performance. Therefore, we separate total return into its more meaningful components: policy return, cost and value added.

	Your 5-yr
Net Total Fund Return	2.5%
- Policy Return	1.3%
= Net Value Added	1.2%

This approach enables you to understand the contribution from both policy mix decisions (which tend to be the board's responsibility) and implementation decisions (which tend to be management's responsibility).

The median 5-year net return of your peers was 2.5%.



1. Policy Return

Your 5-year policy return of 1.3% was below the U.S. Public median of 2.6%

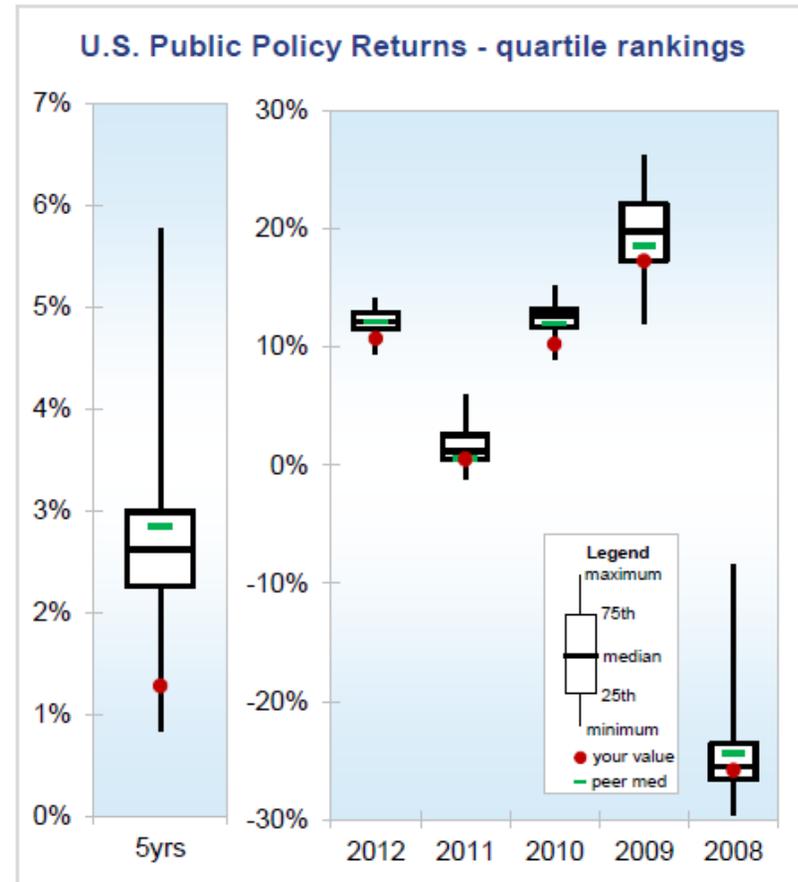
Your policy return is the return you could have earned passively by indexing your investments according to your policy mix.

Having a higher or lower relative policy return is not necessarily good or bad. Your policy return reflects your investment policy, which should reflect your:

- Long term capital market expectations
- Liabilities
- Appetite for risk

Each of these three factors is different across funds. Therefore, it is not surprising that policy returns often vary widely between funds.

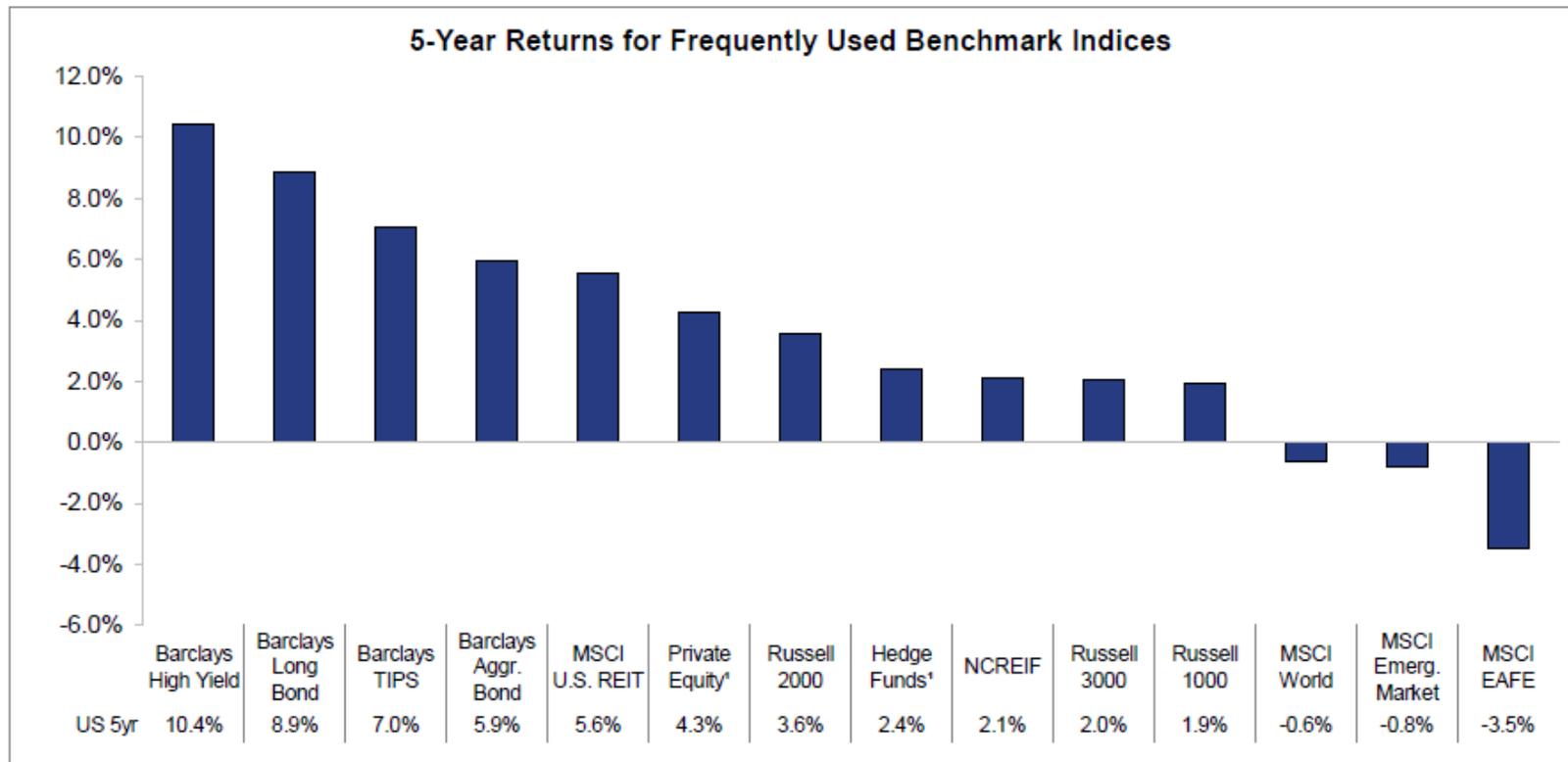
The median 5-year policy return of your peers was 2.8%.



To enable fairer comparisons throughout this entire report, the policy returns of all participants in the U.S. Public universe were adjusted to reflect your benchmarks for private equity. In 2012, the adjustment reduced the average U.S. Public policy return by -0.86%.

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Differences in policy returns are caused by differences in benchmarks and policy mix. The two best performing asset classes for the 5 years ending 2012 were high yield bonds and long bonds.



1. The private equity and hedge fund benchmark returns reflect the average benchmark of all U.S. participants.

Your 5-year policy return was below the U.S. Public median primarily because of:

- The negative impact of your higher weight in one of the poorer performing asset classes of the past 5 years: Cash (your 7% 5-year average weight versus a U.S. average of 1%).
- The negative impact of the timing of changes in your policy mix. For example your 41.8% weight to stocks in 2008 when they performed poorly was reduced to 30% in 2009 when stocks rebounded.

5-Year Average Policy Mix			
	Your Fund	Peer Avg.	U.S. Public Avg.
U.S. Stock	16%	27%	28%
EAFE Stock	10%	6%	7%
Emerging Market Stock	7%	1%	2%
ACWIXUS Stock	0%	11%	9%
Other Stock	<u>0%</u>	<u>4%</u>	<u>6%</u>
Total Stock	32%	50%	52%
U.S. Bonds	12%	21%	21%
High Yield Bonds	3%	2%	2%
Fixed Income - Emerging	4%	1%	0%
Global Bonds	6%	2%	2%
Cash	7%	1%	1%
Other Fixed Income	<u>0%</u>	<u>4%</u>	<u>3%</u>
Total Fixed Income	32%	30%	29%
Global TAA	9%	1%	1%
Hedge Funds ¹	5%	3%	3%
Commodities	2%	0%	1%
Other Real Assets ²	4%	8%	8%
Private Equity	14%	8%	7%
Total	100%	100%	100%

¹ Does not include Absolute Return hedge fund investments used in Portable Alpha implementation.

² Real assets includes natural resources and infrastructure.

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Your policy asset mix has changed over the past 5 years. At the end of 2012 your policy mix compared to your peers and the U.S. Public as follows:

Policy Mix	2008	2012		
Asset Class	Your Fund	Your Fund	Peer Avg.	U.S. Public Avg.
U.S. Stock	23%	14%	24%	25%
EAFE Stock	15%	8%	6%	7%
Emerging Market Stock	4%	8%	2%	2%
ACWixUS Stock	0%	0%	11%	9%
Other Stock	<u>0%</u>	<u>0%</u>	<u>6%</u>	<u>7%</u>
Total Stock	42%	30%	49%	49%
U.S. Bonds	19%	12%	20%	19%
High Yield Bonds	2%	6%	2%	2%
Fixed Income - Emerging	3%	6%	1%	1%
Global Bonds	17%	1%	1%	2%
Cash	0%	7%	1%	1%
Other Fixed Income	<u>0%</u>	<u>0%</u>	<u>3%</u>	<u>3%</u>
Total Fixed Income	41%	32%	29%	28%
Global TAA	7%	10%	1%	1%
Hedge Funds ¹	6%	5%	3%	4%
Commodities	0%	3%	1%	1%
Other Real Assets ²	0%	3%	9%	9%
Private Equity	4%	17%	9%	8%
Total	100%	100%	100%	100%

¹ Does not include Absolute Return hedge fund investments used in Portable Alpha implementation.

² Real assets includes natural resources and infrastructure.

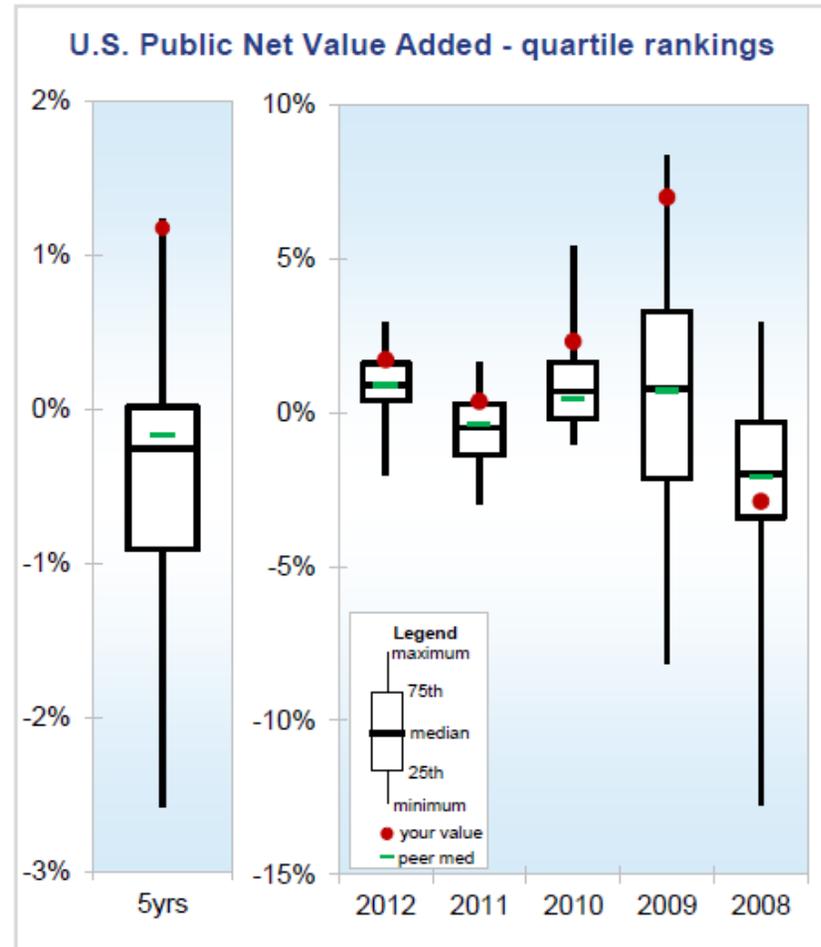
2. Net Value Added

Net value added is the component of total return from active management. Your 5-year net value added was 1.2%.

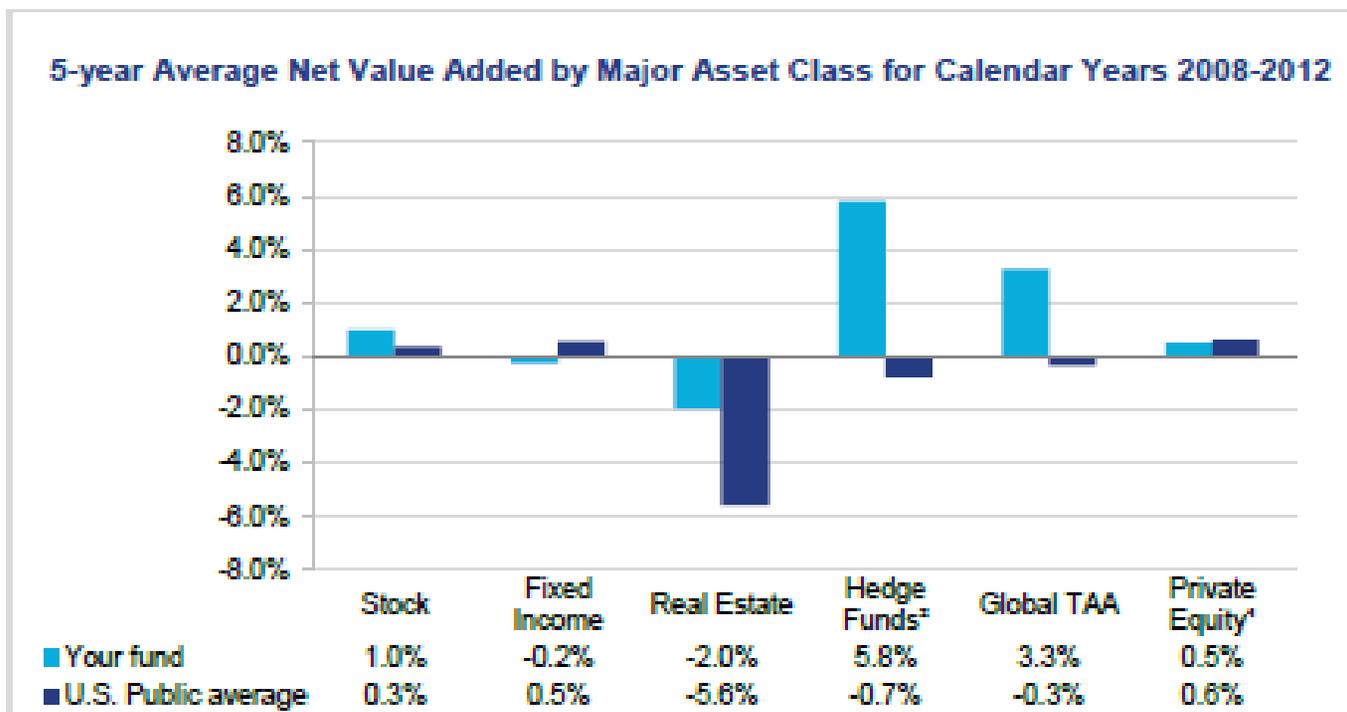
Net value added equals total return minus policy return minus costs.

South Carolina Retirement Systems			
Year	Net Return	Policy Return	Net Value Added
2012	12.4%	10.7%	1.7%
2011	0.8%	0.5%	0.4%
2010	12.5%	10.2%	2.3%
2009	24.3%	17.3%	7.0%
2008	(28.7)%	(25.8)%	(2.9)%
5-year	2.5%	1.3%	1.2%

Your net value added was impacted by your above-average benchmark return for private equity (your 5.0% versus a 5-year U.S. Public average of 3.9%). If you had used the U.S. Public average benchmark, your 5-year net value added would have been approximately 0.4% higher.



You had positive 5-year net value added in Stock, Hedge Funds, Global TAA and Private Equity.



1. Private equity value added is net whereas the other asset classes are gross. To enable fairer value added comparisons, the private equity benchmarks of all U.S. participants were set to equal your benchmarks. It is also useful to compare total returns. Your 5-year return of 5.5% for private equity was above the U.S. average of 4.5%.

2. Comparisons of value added for hedge funds must be interpreted with caution because the types of investments and benchmarks can be extremely varied. It may be more useful to compare total returns. Your 5-year return of 2.9% for hedge funds was above the U.S. average of 1.9%.

3. Costs

Your total investment management of \$263.5 million per this report reconcile to your annual report as follows:

South Carolina Retirement Systems	\$ millions
Investment cost per annual report - June 2013	427.5
- Costs according to CEM definitions - Dec 2012	<u>263.5</u>
= Difference to be reconciled	164.0
CEM adds costs for:	
Private equity fund of funds: embedded fees ¹	-9.3
Hedge funds fund of funds: embedded fees ¹	-48.5
Difference between contractual fee and actual fees ²	<u>-16.7</u>
Total costs added	-74.5
CEM excludes:	
Private asset and hedge fund performance fees ³	181.7
Partnership operating expenses	38.9
Timing difference between 6 months ending Dec 2012 and June 2013	17.9
Net difference	164.0

1. To allow costs comparisons between the different styles of hedge funds and private assets, CEM adds the manager fees of the underlying managers in fund of funds arrangements.

2. In order to avoid the inconsistent treatment of rebates by different funds, CEM compares private equity costs based on the management fees implied in each limited partnership contract.

3. CEM excludes private asset and hedge fund performance fees from benchmarking because only a limited number of participants are currently able to provide this data.

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3. Costs

Your asset management costs in 2012 were \$263.5 million or 103.0 basis points.

Your Investment Management Costs (\$000s) for Calendar Year 2012								
	Internal		External Passive		External Active		Total	Total Asset Class Cost in bps
	Passive	Active	Fees	Monitoring & Other	Base Fees	Perform. Fees ² & Other		
U.S. Stock - Broad/All					10,201	313	10,514	55.1bp
Stock - EAFE					903	42	945	67.3bp
Stock - Emerging			48		7,441	298	7,786	46.1bp
Fixed Income - U.S.		56			4,100	409	4,565	18.0bp
Fixed Income - Emerging			223		1,747	117	2,087	36.8bp
Fixed Income - Global					3,586	159	3,745	27.5bp
Fixed Income - High Yield					6,648	217	6,865	63.0bp
Cash		306			2,310	221	2,836	12.7bp
Global TAA					11,167	410	11,577	44.8bp
Hedge Funds - Direct					35,507	278	35,785	204.9bp
Hedge Funds - Fund of Funds					71,222 ¹	443	71,664	212.6bp
Commodities					2,520	41	2,561	188.3bp
Real Estate		23					23	1.5bp
Real Estate - LPs					16,663 ²	117	16,780	124.9bp
Diversified Private Equity	88				29,963 ²	218	30,269	145.6bp
Diversified Priv. Eq.- Fund of Funds					14,407 ¹	48	14,455	255.4bp
Private Debt Limited Partnerships	2				36,204 ²	294	36,500	128.4bp
Overlay Programs					1,437		1,437	3.6bp
Total investment management costs							260,397	101.8bp

Your Oversight, Custodial and Other Asset Related Costs ⁴ (\$000s)		
Oversight of the fund	1,039	0.4bp
Trustee & custodial	254	0.1bp
Consulting and performance measurement	452	0.2bp
Audit	397	0.2bp
Other (legal)	951	0.4bp
Total oversight, custodial & other costs	3,093	1.2bp

Total asset management costs	263,490	103.0bp
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Notes

¹ Includes default for fees paid to underlying partnerships in fund of funds. The default for Hedge Funds was 144bps. The default for Diversified Private Equity was 165bps.

² Cost derived from the partnership level detail you provided. Costs are based on partnership contract terms.

³ Total cost excludes carry/performance fees for real estate, infrastructure, hedge funds, private equity and overlays. Performance fees are included for the public market asset classes.

⁴ Excludes non-investment costs, such as PBGC premiums and preparing checks for retirees.

Your total cost of 103.0 bps was above the U.S. Public median of 57.1 bps.

Differences in total cost are often caused by two factors that are often outside of management's control:

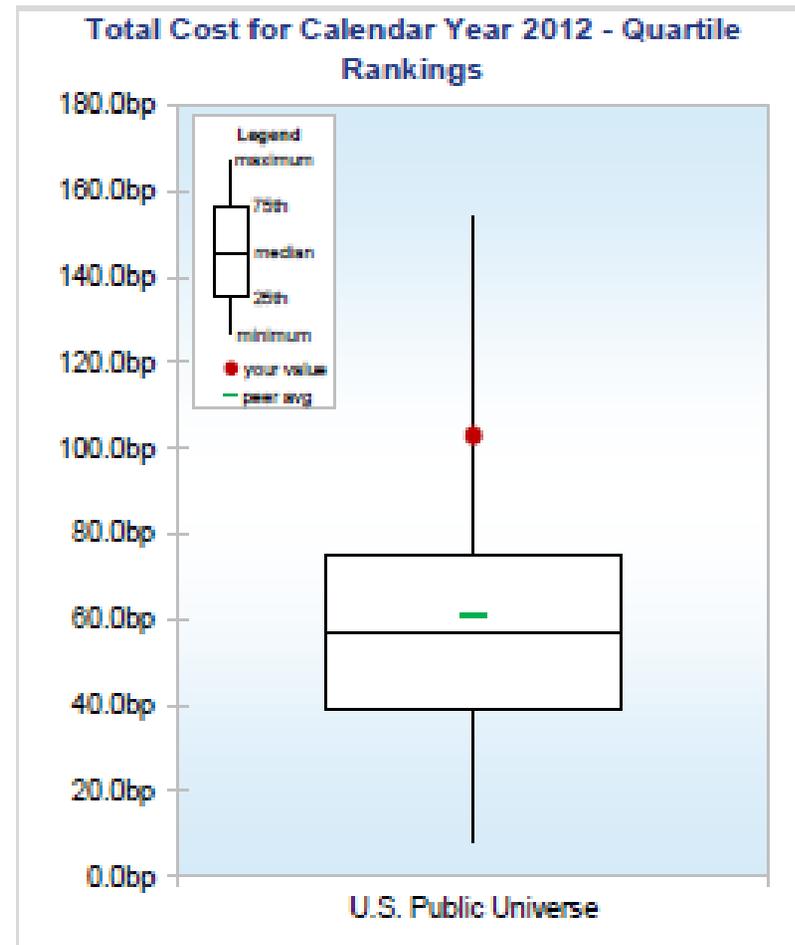
- asset mix and
- fund size.

Asset mix is set by policy and may include assets that are higher cost than traditional investments, such as private equity, real estate or hedge funds. The total cost of fees will be higher than peers with a policy asset mix that does not include higher cost assets. Therefore, policy asset mix is a major driver of total cost.

Fund size is also a major driver of cost because funds with a larger size are often able to negotiate lower costs.

A total cost comparison to peers which is not adjusted for asset mix and fund size may not be an appropriate measure because of these factors. Used out of context, a total cost comparison could be misleading.

In order to provide plan sponsors with accurate feedback regarding reasonability of costs, CEM must take policy asset mix and overall fund size into consideration. Therefore, to assess whether your costs are high or low given your unique asset mix and size, CEM calculates a benchmark cost for your fund and provides an assessment of the reasonability of your costs for your given policy asset mix and overall fund size. This analysis is shown on the following page.



Benchmark cost analysis suggests that, after adjusting for fund size and asset mix, your fund was normal cost in 2012.

Your benchmark cost is an estimate of what your cost would be given your actual asset mix and the median costs that your peers pay for similar services. It represents the cost your peers would incur if they had your actual asset mix.

	\$000s	basis points
Your actual cost	263,490	103.0 bp
Your benchmark cost	<u>264,764</u>	<u>103.5 bp</u>
Your excess cost	(1,274)	(0.5) bp

Your total cost of 103.0 bp was close to your benchmark cost of 103.5 bp. Thus, your cost savings was 0.5 bp.

Your fund was normal cost because your higher cost implementation style was offset by paying less for similar services.

	Explanation of Your Cost Status for Calendar Year 2012	
	Excess Cost/ (Savings)	
	\$000s	bps
1. Higher cost implementation style	6,808	2.7
2. Paying more or (less) than your peers for similar	(8,082)	(3.2)
Total savings in 2012	(1,274)	(0.5)

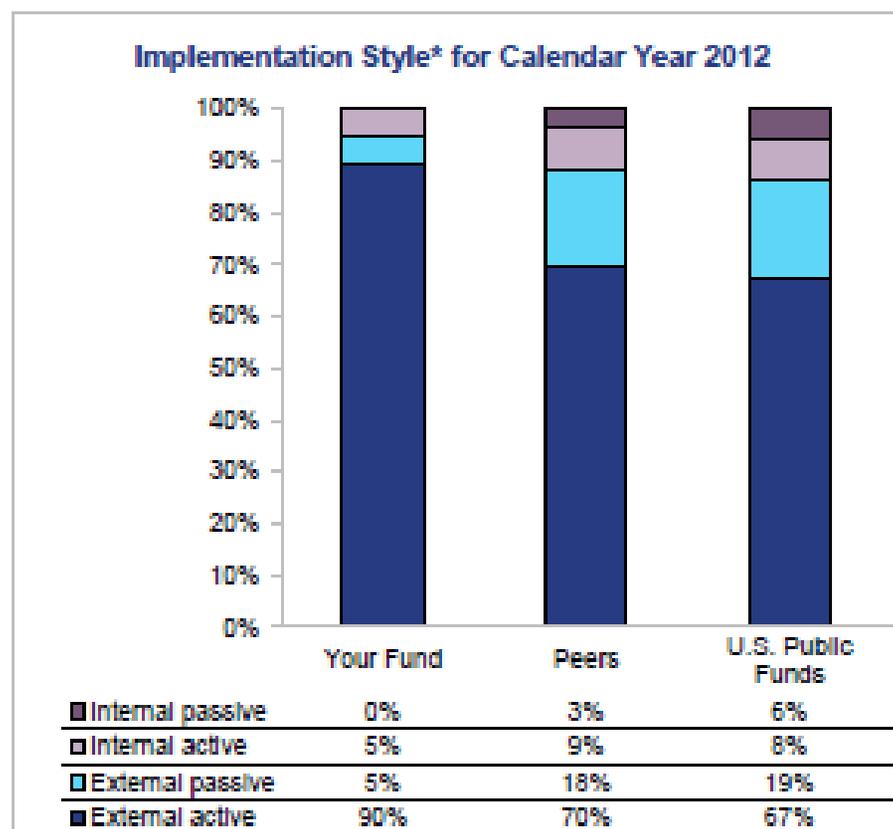
These reasons are examined in detail in the following pages.

Differences in cost performance are often caused by differences in implementation style.

Implementation style is defined as the way in which your fund implements asset allocation. It includes internal, external, active, passive and fund of funds styles.

The greatest cost impact is usually caused by differences in the use of:

- External active management because it tends to be much more expensive than internal or passive management. You used more external active management than your peers (your 90% versus 70% for your peers).
- Within external active holdings, fund of funds usage because it is more expensive than direct fund investment. You had more in fund of funds. Your 31% of hedge funds, real estate and private equity in fund of funds compared to 19% for your peers.



* The graph above does not take into consideration the impact of derivatives.

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Differences in implementation style cost you 2.7 bp relative to your peers.

Cost Impact of Differences in Implementation Style for Calendar Year 2012						
Asset class	Your avg holdings in \$mils	% External Active			Cost ^{1,2} premium	Cost/ (Savings) in \$000s
		You	Peer average	More/ (less)		
U.S. Stock - Broad/All	1,910	100.0%	53.5%	46.5%	45.6 bp	4,042
Stock - EAFE	141	100.0%	53.8%	46.2%	38.3 bp	248
Stock - Emerging	1,688	93.5%	80.8%	12.7%	53.2 bp	1,135
Fixed Income - U.S.	2,537	93.4%	66.4%	27.0%	13.8 bp	944
Fixed Income - Emerging	567	73.6%	95.2%	(21.6%)	28.3 bp	(346)
Fixed Income - Global	1,363	100.0%	100.0%	0.0%		0
Fixed Income - High Yield	1,090	100.0%	99.1%	0.9%	Insufficient	0
Global TAA	2,584	100.0%	100.0%	0.0%		0
Hedge funds	5,118	100.0%	100.0%	0.0%		0
<i>of which Fund of Funds represent:</i>		65.9%	42.3%	23.6%	72.5 bp	8,770
Commodities	136	100.0%	100.0%	0.0%		0
Real Estate ex-REITs	1,495	89.9%	96.8%	(6.9%)	63.2 bp	(654)
<i>of which Ltd Partnerships represent:</i>		100.0%	38.0%	62.0%	42.1 bp	3,507
Diversified Private Equity	3,231	81.9%	98.9%	(17.0%)	166.0 bp	(9,121)
<i>of which Fund of Funds represent:</i>		21.4%	21.7%	(0.3%)	65.0 bp	(56)
Private Debt Limited Partnerships	2,842	99.6%	98.9%	0.7%	166.0 bp	323
<i>of which Fund of Funds represent:</i>		0.0%	21.7%	(21.7%)	65.0 bp	(3,994)
Total		89.6%	69.7%	19.9%		4,798
External active style Impact in bps						0.0 bp
Style impact related to fund of funds in bps						1.8 bp
Impact of differences in the use of lower cost styles ³						0.0 bp
Cost from your higher use of portfolio level overlays						0.8 bp
Total style impact						2.7 bp

1. The cost premium is the additional cost of external active management relative to the average of other lower cost implementation styles - internal passive, internal active and external passive.

2. A cost premium listed as 'insufficient' indicates that there was not enough peer data to calculate the premium.

3. The 'Impact of differences in the use of lower cost styles' quantifies the net impact of your relative use of internal passive, internal active and external passive management.

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The style impact of differences in the use of overlays cost you 0.8 bps.

Style impact of using more/(fewer) overlays for Calendar Year 2012						
	Your avg total holdings (\$mils)	Overlay notional amounts as a % of avg total holdings			Median cost as a % of notional	Cost/ (Savings) Impact in \$000s
		Your Fund	Peer Average	More/ (Less)		
Internal Overlays						
Passive Beta - Hedge	25,587	0.0%	0.0%	(0.0%)	2.4 bp	(2)
Duration - Hedge	25,587	0.0%	0.1%	(0.1%)	0.8 bp	(2)
External Overlays						
Currency - Hedge	25,587	0.0%	0.5%	(0.5%)	2.6 bp	(36)
Currency - Discretionary	25,587	0.0%	0.4%	(0.4%)	18.2 bp	(148)
Passive Beta - Hedge	25,587	15.5%	1.4%	14.1%	6.1 bp	2,212
Long/Short - Discretionary	25,587	0.0%	0.2%	(0.2%)	4.7 bp	(23)
Net impact					0.8 bp	2,000

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The net impact of differences in external investment management costs saved 2.4 bps.

Impact of Paying More/(Less) for External Investment Management for Calendar Year 2012					
	Your avg holdings in \$mils	Cost in bps			Cost/ (Savings) in \$000s
		Your Fund	Peer median	More/ (Less)	
U.S. Stock - Broad/All - Active	1,910	55.1	46.7	8.4	1,606
Stock - EAFE - Active	141	67.3	40.3	27.0	380
Stock - Emerging - Passive	111	4.4	11.9	(7.5)	(83)
Stock - Emerging - Active	1,577	49.1	65.0	(16.0)	(2,521)
Fixed Income - U.S. - Active	2,370	19.0	16.1	2.9	694
Fixed Income - Emerging - Passive	150	14.9	Insufficient		
Fixed Income - Emerging - Active	417	44.7	43.2	1.5	61
Fixed Income - Global - Active	1,363	27.5	27.5	0.0	0
Fixed Income - High Yield - Active	1,090	63.0	44.2	18.8	2,050
Global TAA - Active	2,584	44.8	64.7*	(19.9)	(5,131)
Hedge Funds - Active	1,746	204.9	143.8	61.1	10,678
Hedge Funds - Fund of Fund	3,372	212.6	216.3	(3.8)	(1,272)
Commodities - Active	136	188.3	142.5	45.8	623
Real Estate ex-REITs - Limited Partnership	1,344	124.9	119.4	5.5	733
Diversified Private Equity - Active	2,079	145.1	165.0	(19.9)	(4,128)
Diversified Private Equity - Fund of Fund	566	255.4	230.0	25.4	1,439
Private Debt Limited Partnerships - Active	2,830	129.0	165.0	(36.0)	(10,196)
Derivatives/Overlays - Passive Beta	3,973	3.6	6.1*	(2.5)	(1,000)
Total external investment management impact				(2.4) bp	(6,068)

*Insufficient indicates insufficient peer and universe data to do meaningful comparisons.

*Universe median used as peer data was insufficient.

The net impact of differences in internal and co-investment management costs rounds to 0.4 bps.

Impact of Paying More/(Less) for Internal Investment Management for Calendar Year 2012					
	Your avg holdings in \$mils	Cost in bps			Cost/ (Savings) in \$000s
		Your Fund	Peer median	More/ (Less)	
Fixed Income - U.S. - Active	167	3.3	2.9	0.4	7
Real Estate ex-REITs - Co-investments	152	1.5	30.2	(28.6)	(434)
Diversified Private Equity - Co-Investments	585	1.5	13.1	(11.6)	(679)
Private Debt Limited Partnerships - Co-Investments	12	1.5	13.1	(11.6)	(14)
Total internal and co-investment management impact				(0.4) bp	(1,120)

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The net impact of differences in oversight, custodial & other costs rounds to 0.3 bps.

Impact of Differences in Oversight, Custodial & Other Costs for Calendar Year 2012					
	Your avg holdings in \$mils	Cost in bps			Cost/ (Savings) in \$000s
		Your Fund	Peer median	More/ (Less)	
Oversight*	25,587	0.4	0.8	(0.4)	(916)
Custodial / trustee	25,587	0.1	0.2	(0.1)	(358)
Consulting / performance measurement	25,587	0.2	0.4	(0.2)	(610)
Audit	25,587	0.2	0.0	0.1	281
Other (legal)	25,587	0.4	0.1	0.3	709
Total impact				(0.3) bp	(894)

* Oversight of the fund includes staff salaries, direct expenses (travel, fees paid to directors, director's insurance, etc.) and related unallocated overhead pertaining to overseeing the fund assets. Include the costs of executives and their staff responsible for the total fund or responsible for overseeing multiple asset categories (for example, CEO, CIO office, Board of Director/Investment Committee etc.). Staff responsible for overseeing a single asset class category (i.e. private assets, stock, etc.) have their costs included with that asset category.

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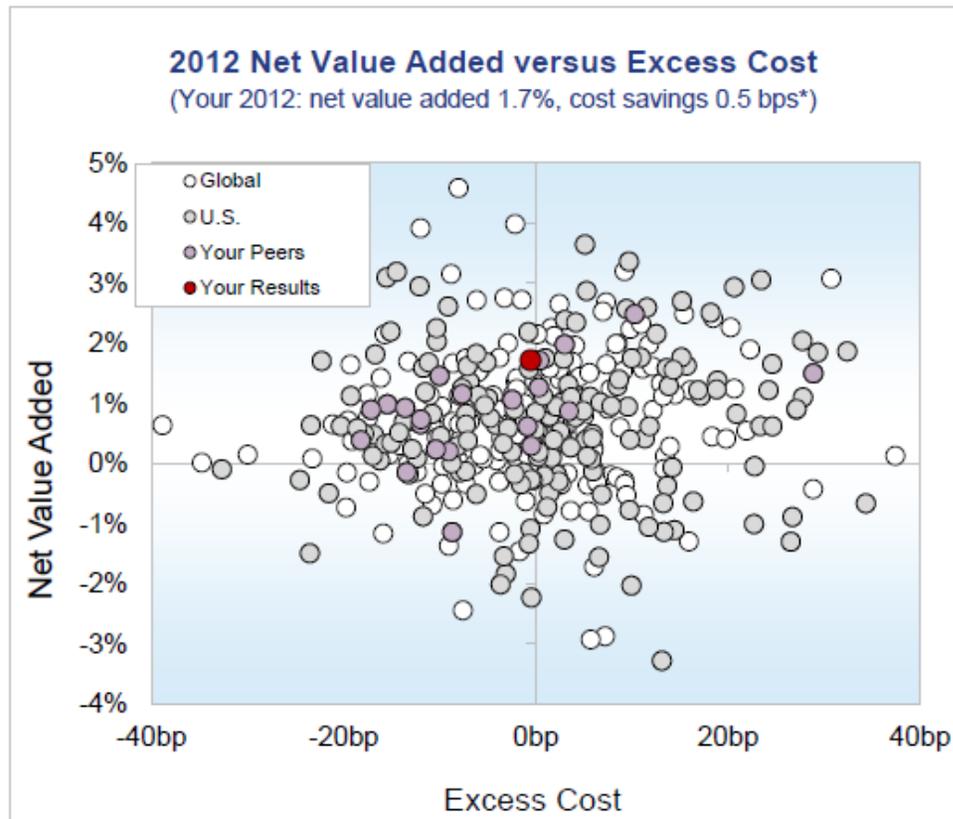
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In summary, your fund was normal cost because your higher cost implementation style was offset by paying less for similar services.

Explanation of Your Cost Status for Calendar Year 2012		
	Excess Cost/ (Savings)	
	\$000s	bps
1. Higher cost implementation style		
• Greater use of fund of funds	4,719	1.8
• More external active management and less lower cost passive and internal management	79	0.0
• Higher use of overlays	2,000	0.8
• Other style differences	<u>9</u>	<u>0.0</u>
	6,808	2.7
2. Paying more or (less) than your peers for similar services		
• External investment management costs	(8,088)	(2.4)
• Internal investment management costs	(1,120)	(0.4)
• Oversight, custodial & other costs	<u>(894)</u>	<u>(0.3)</u>
	(8,082)	(3.2)
Total excess cost/(savings)	(1,274)	(0.5)

4. Cost Effectiveness

Your fund had 2012 net value added of 1.7% and cost savings of 0.5 bps.



In summary:

1. Policy Return

Your 5-year policy return was 1.3%. This compares to the U.S. Public median of 2.6% and the peer median of 2.8%.

2. Value Added

Your 5-year net value added was 1.2%. This was above the U.S. Public median of -0.3% and above the peer median of -0.2%.

3. Costs

Your actual cost of 103.0 bps was close to your benchmark cost of 103.5 bps. This suggests that your fund was normal cost. Your fund was normal cost because your higher cost implementation style was offset by paying less for similar services.

4. Cost Effectiveness

Your fund had 2012 net value added of 1.7% and cost savings of 0.5 bps on the cost effectiveness chart

CEM Methodology and Quality Control, CEM's Independence and Contracting Process

CEM Methodology

CEM Benchmarking: Proved Methodology and Quality Data.



CEM Benchmarking has over 20 years' experience in benchmarking pension costs. Over this time CEM has developed a methodology that effectively identifies and quantifies factors that drive total costs and compares costs and cost components across peers and universes. Strategies and approaches vary from fund to fund for good underlying reasons such as different liabilities and risk appetites. The CEM report contains quantitative analysis that aims to break out factors in order to help management gain a better understanding of their costs and whether those costs appear reasonable given the fund's approach and the peer group and universe data.

The CEM database is known as the leading global database for quality cost information of large funds. Academics often use the data (under strict confidentiality restrictions) because of the size, length, detail and quality of the database. CEM collects data from funds via an annual voluntary survey, evaluates the data, accepts or rejects the responses, performs tolerance checks, applies CEM methodology to ensure consistency, and makes a decision if the data will be used in the CEM database and in a CEM report. All responses are handled by qualified analysts who work with survey participants to ensure quality.

Data quality is important to CEM as our clients need to trust the message the analysis is providing. Where funds cannot provide all data requested, CEM may offer to apply certain default numbers as proxies. These are calculated using the verified data in the database and the appropriate peers or universe. These are footnoted in the report. CEM methodology is outlined in detail throughout the report.

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One of the major challenges in cost collection and comparison in the industry is the lack of standardization in measuring and disclosing costs in private asset classes. CEM's methodology is based on 20 years of collaboration with funds around the world to collect as much quality cost data as is available from funds. CEM methodology is aimed at providing the greatest level of detailed analysis based on consistent quality data in the database. Where the industry or many in the industry do not provide quality data or similar levels of granularity, CEM may not include this data in the analysis.

Alan Torrance
Partner,
CEM Benchmarking Inc.

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Answers to Questions Raised by the State Treasurer's Office about the CEM Methodology

On March 27, 2014 the State Treasurer's Office raised the following questions:

Q1. The policy allocation rate and the policy benchmark rates of return are components of the policy return. On page 7, CEM presents the average 5 year allocation policy allocation rate for the RSIC along with the average policy allocation rate for the peer group CEM used in this report and the U.S. public average policy allocation rate. Please provide the 5 year average rate of return for each policy asset class benchmark presented on page 12 for

- a. the custom peer group that CEM used for this report, and
- b. the U.S. public average.

A1. CEM Section 4, Implementation Value Added – page 15 provides this information

Q2. Please provide the 5 year actual average allocations by market values and by exposure for the custom peer group and for the U.S. public average by the same asset classes listed on page 8 for both the custom peer group and the U.S. public average.

A2. CEM Section 4, Implementation Value Added - page 12 provides the five-year average market value of actual holdings for RSIC, peers and the U.S public average. CEM's survey does not collect this information by exposure.

Note that CEM collects information based on actual positions because it is actual positions that tend to drive investment costs.

Q3. The RSIC stays within policy benchmark ranges by means of classifying investments through exposure rather than by market value. For example, at 06/30/13, the RSIC held physical equity with a market value of \$3.5 billion, or about 13.4% of the total portfolio but through derivatives (and perhaps hedge funds); HEK reported the public allocation as 28% in the FY 2013 CAFR. Please explain whether the 5 year actual average allocations provided in response to #2 are by way of exposure or market value.

A3. The five-year asset allocations provided in response to question 2 are based on market value.

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Q4. On page 3, CEM asks, "How did the impact of your policy mix decision compare to other funds?"

a. What is CEM's answer to that question?

A4. CEM Section 4, Implementation Value Added – page 7 indicates that the 1.3% return of RSIC’s policy mix for the five-year period was the lowest in its peer group. However, the Executive Summary – page 5 states “Having a higher or lower relative policy return is not necessarily good or bad. Your policy return reflects your investment policy, which should reflect your: long-term capital market expectations; liabilities; appetite for risk. Each of these three factors is different across funds. Therefore, it is not surprising that policy returns often vary widely between funds.”

Q5. According to CEM, the U.S. public median 5 year policy return of 2.6% was double RSIC's 5 year policy return of 1.3%. Are these rates the annualized 5 year rates? That is, is the difference 1.3% a year for each of the five years?

A5. The 2.6% U.S. public median return and 1.3% policy return are not the sum of the one-year returns divided by five. They are an average annual geometric return which takes into account the compounding effect of investment returns over time.

If you started with the beginning asset value at January 1, 2008 and multiplied that by 1.3% each year, you would get to the end of 2012 total market value ONLY if we took into account contributions and withdrawals to the fund and any compounding effects.

Q6. CEM presents the difference (1.2%) between the policy benchmark (1.3%) from the RSIC's return rate (2.5%) as "net value added". However, value was added only if the asset class benchmarks that make up the RSIC's policy benchmark were appropriate. How did CEM determine that the asset class benchmarks were appropriate?

A6. CEM does not determine whether a fund’s benchmarks are appropriate. That is determined by the benchmark setting process the survey participants use. For RSIC, it is the Commission in consultation with HEK.

RSIC’s 2012 benchmarks and benchmark returns for each asset class are shown on CEM Section 4, Implementation Value Added- page 17. CEM Section 4, Implementation Value Added –page 15 shows the average five-year benchmark returns for each RSIC asset class compared to peers’. CEM Section 4, Implementation Value Added– pp. 18-23 shows the most frequently used benchmarks by asset type in 2012 for the peer group and the universe of U.S. pension funds. In each asset class, a variety of different market indices or custom benchmarks are used, which may reflect differences in the types of investments survey participants have within a particular asset type (particularly for an asset class like hedge funds).

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Q7. Does the result of CEM's Net Value Added Calculation represent an endorsement of the appropriateness of the asset class benchmarks that make up the RSIC's policy benchmark?

A7. No

Q8. On pages 5, CEM cites the U.S. public median 5 year policy return as 2.6%. On page 4, CEM cites the ~~average~~ **median** U.S. public 5 year net return as 2.5. Does this mean that during the period of time that the RSIC added 1.2% in value each year, the median fund added -0.1% each year?

A8. This does not work because medians are not additive. The median fund of the policy return data set is not the same fund as the median fund of the net return data set and neither is likely to be the same fund as the median fund of the net value added data set.

Q9. Do the difference between the median net added value and the RSIC's net added value suggest that the RSIC's management made much better implementation decisions than the median fund?

A9. Not necessarily. Having a higher net value added simply means that RSIC outperformed its weighted average benchmark more than the median fund did during this period. Evaluating implementation decisions needs to take into account risk, liabilities, allowable investment universe, investment style, location and other intangibles.

Q10. On page ~~19~~ **9**, CEM states the following:

Your net value added was impacted by your above-average benchmark return for private equity (your 5.0% versus a 5-year U.S. Public average of 3.9%). If you had used the U.S. Public average benchmark, your 5-year net value added would have been approximately 0.4% higher.

On page 28 of HEK's 12/31/12 performance report, HEK places the private equity 5 year rate of return at 6.8% and private equity's benchmark rate of return at 3.8%. On page 6 of the CEM draft report, CEM indicates the private equity average benchmark for all U.S participants is 4.3%. The U.S. public average benchmark is higher than the policy benchmark, so how could the net value added be higher if the RSIC had used the average benchmark.

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A10. In CEM Executive Summary - page 6, the benchmark return of 4.3% for PE is for all US participants. The benchmark return of 3.9% on page 9 is for public US participants.

Q11. The 5 year U.S. public average benchmark return for private equity is cited as 3.9% on page 9 and as 4.3% on page 6. Please explain this difference.

A11. In CEM Executive Summary - page 6, the private equity benchmark return of 4.3% for PE is for all US participants. The benchmark return of 3.9% on page 9 is for public US participants.

Q12. Are the high cash allocation and the negative impact of timing changes in the policy mix the two biggest reasons that the RSIC's lagged the U.S. Public Average policy mix by 1.3%?

A12. CEM Implementation Value Added – Page 7 shows that the median policy return for the U.S. Public Universe was 2.6% compared to 1.3% for RSIC. Executive Summary – Page 7 states that RSIC's five-year policy return was lower primarily because of the two factors cited in the question.

Q13. Rather than totally excluding performance fees "because only a limited number of participants are currently able to provide this data", why didn't CEM compare RSIC costs with plans that did provide the data? Or impute performance or carried interest fees to the other plans.

A13. Not enough of RSIC's peers provided performance fees/carried interest on private market and estimating these is difficult. RSIC's size-based public funds peer group was chosen to get good cost comparisons across all asset classes and styles.

Q14. Why does CEM exclude \$38 million in "partnership operating expenses?"

A14. CEM excluded those costs because it didn't have sufficient comparable peer data to benchmark them.

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Q15. CEM presents its adjusted fee amounts for each asset class on page 12. The only fee rate that appears is the rate for the total portfolio. Please state the AUM by the asset classes listed on page 12 so that the rates by asset class can be calculated.

A15. The AUM for each asset class shown on CEM Executive Summary– page 17 is found in CEM Appendix pp. 4 and 5. CEM will add a cost in basis points column to this page.

Q16. Some of the tables and graphs have clearly stated beginning and ending dates. Please label all graphs and tables with the dates.

A16. CEM will include additional labels.

Q17. On page 13, CEM states that "Fund size is also a major driver of costs because funds with a larger size are often able to negotiate lower costs." How does the RSIC's fund size compare rank in comparison to other public plans? Does the size of the fund prevent the RSIC from being able to

A17. CEM's U.S. Public Fund universe has 65 funds in it. The average size is \$32.990 billion. The median size is \$14.01 billion. CEM cannot comment on RSIC's ability to negotiate lower fees as CEM only collects costs at the asset class level not by mandate.

Q18. Please state the components of the CEM's calculated 31% (page ~~18~~ 16) total for hedge funds, real estate, and private equity?

A18. CEM Implementation Value Added –p. 12 provides this breakdown:

Real Estate	3.5%
Hedge Funds	6.9%
Hedge Funds Fund of Funds	11.0%
Diversified Private Equity	7.2%
Diversified PE Fund of Funds	<u>1.6%</u>
	30.2%

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Q19. What plans were used as peers for the RSIC in CEM's report?

A19. CEM, Executive Summary—page 2 states “To preserve client confidentiality, given potential access to documents as permitted by the Freedom of Information Act, we do not disclose your peers’ names in this document.” As stated on that page, the 21 funds in the peer group are all U.S. public funds ranging in size from \$14 billion to \$58 billion. Half are larger and half are smaller than RSIC at \$27 billion.

Q20. Does CEM use the same U.S. public median rates of return for comparison in all reports that CEM has issued for the 5 year period ending December 31, 2012?

A20. No. The universe of funds (and thus the medians) is based on amount of data collected at the time the report was run. Thus, RSIC’s CEM 2012 universe of funds is larger than for a report run earlier in the year. Not all funds use the public universe, some include corporate, use an international universe or a North American Universe.

Q21. Why was a calendar year used instead of a fiscal year?

A21. Other clients report their information to CEM on a calendar year basis.

Q22. Please insure that all tables, graphs, conclusions, etc., that are based on exposure or actual asset class are identified as to which.

A22. CEM will label that graphs throughout the report are based on market values or policy weights

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On April 4, 2014 the State Treasurer's Office raised a second set of questions regarding CEM. Below are those response to those questions.

Q1. Please explain CEM's fee adjustments on page 11.

A1. Page 11 of the Executive Summary identifies the difference between the \$427.5 million of total costs reported in the FY 2013 CAFR and the \$263.5 million of RSIC costs that CEM benchmarked for calendar year 2012 (the latest period for which CEM has peer data). Some of the difference is due to difference in time periods. The largest difference is the exclusion of private asset and hedge fund performance fees which RSIC reports but peers do not. CEM adds costs to amounts reported by RSIC and other participants to improve the consistency of reporting for private equity and hedge funds.

Q2. It appears that CEM is adding "embedded fees", which are referenced in footnote 1 as "the manager fees of the underlying fund of funds arrangements." Doesn't the RSIC claim to have reported these fees?

A2. CEM includes fees paid to the fund of fund manager and fees paid to the underlying partnerships in fund of fund arrangements. CEM used the manager fees reported by RSIC and a proxy for the underlying fees. That is described in Note 1 in the Executive Summary - Page 12. CEM indicates that it always counts both fees levels in its report.

Q3. Has CEM calculated the difference between the RSIC's contractual fees and actual fees for private equity?

A3. Yes, the difference between RSIC's contractual fees and actual fees for partnerships is shown on page 11 of the Executive Summary. RSIC provided the actual fee data, but CEM prefers to use contractual fees for consistency in comparisons among the peer group. The differences by type are private equity \$9.285 mil, real estate \$1.527 mil and private debt \$5.89 mil. Only the sum is shown on page 11.

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Q4. The following statement is from page 5 of the CEM report:

"To enable fairer comparisons throughout this entire report, the policy returns of all participants in the U.S. Public universe were adjusted to reflect your benchmarks for private equity. In 2012, the adjustment reduced the average U.S. Public policy return by -0.86%."

If CEM had not made this adjustment, would the U.S. median policy be 3.46%? (2.6% + 0.86%)

A. 4. The adjusted U.S. Public policy return median for 2012 was 12.16%. The raw U.S. Public policy return median was 13.02%. This adjustment can go either way depending on whether the client's benchmarks are higher or lower than the typical fund's private equity benchmark:

In 2011, the adjustment increased the average U.S. Public policy return by 0.28%

In 2010, the adjustment reduced the average U.S. Public policy return by 0.07%.

In 2009, the adjustment reduced the average U.S. Public policy return by 1.02%.

In 2008, the adjustment increased the average U.S. Public policy return by 0.64%.

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CEM Quality Control

1. CEM survey data is self-reported, however, participants complete a standard worksheet that includes detailed instructions and definitions of what to report and how to categorize it. CEM collects and evaluates the data, accepts or rejects the responses, performs tolerance checks, applies the CEM methodology to ensure consistency, and makes a decision if the data will be used in the CEM database and in a CEM report. All responses are handled by qualified analysts who work with survey participants to ensure quality.
2. Having reported thousands of numbers to a thousand funds, CEM reports that the feedback from clients and participants is that it is the most accurate and expansive cost database they have seen. This alone suggests the data quality is solid. The analyst who worked on the South Carolina data is a Senior Analyst with CEM, he has been with CEM since August 2006 and is a qualified Chartered Financial Analyst (CFA).
3. Data quality is very important to CEM as its clients need to trust the message the analysis is providing. Where funds cannot provide all data requested, CEM may offer to apply certain default numbers as proxies. These are calculated using the verified data in the database and the appropriate peers or universe. These are footnoted in the report. The CEM methodology is outlined in detail throughout the report.
4. For example, for RSIC and other participants, CEM added a standard cost factor for embedded fees for private market and hedge fund of fund arrangements to provide more meaningful cost comparisons. For direct investments in private equity partnerships, RSIC provided actual cost information but CEM chose to re-calculate costs based the terms of the individual contracts. The contractual fee is CEM's standard basis for benchmarking partnership costs.
5. Data evaluation and tolerance checks: The CEM database contains performance and cost information on more than 1,000 pension and sovereign wealth funds from around the globe (over the history of 22 years). These funds invest globally and, in most cases, the same markets. CEM conducts tolerance checks and data evaluation to compare any survey results to what is

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considered reasonable given the cost numbers CEM has for the same asset classes (or sub asset classes) in the same country over the same time period.

6. Where there are numbers that do not look right the CEM analyst will ask for an explanation. If that explanation is solid and justifies the numbers (against CEM's experience and the database numbers) CEM will accept the numbers (for example a low volatility hedge fund that is the only hedge fund. As one example, CEM originally questioned whether RSIC's reported custody cost number was accurate because it was quite low compared to the rest of the peer group. The process for South Carolina involved a lot of time and discussion to arrive at the treatment of certain costs. The discussion is consistent with CEM methodology and all cost inclusions and exclusions have been reconciled as per CEM methodology and noted in the report. In the experience of FAS team members who have themselves been involved in completing the CEM survey, and our observation of other funds, it is common, particularly for a first time participant, to go through several iterations of the worksheet before the CEM report is considered final.
7. On page 11 of the Executive Summary, CEM does a comparison of RSIC's costs reported in FY 2013 CAFR with the costs benchmarked in its report to account for the difference between the two.
8. While the CEM report describes RSIC's overall costs as "normal", it also identifies a number of areas in which RSIC is more reliant on active external management than its peers, at greater cost (Executive Summary-page 17). The report further identifies several asset classes for which RSIC appears to be paying higher management fees than its peers (Executive Summary-page 19). These are described in the FAS report as potential areas for RSIC to pursue cost savings.
9. Some funds have a formally documented procedure as to how the CEM survey is to be completed and reconciliation performed between the CAFR and the survey. RSIC might consider doing the same. FAS can provide an example procedure from another fund we recently benchmarked.

Although not a part of CEM's quality control process, FAS did compare HEK's 2013 management fee report to CEM's. Overall, both reach the same basic conclusion: RSIC's management fees are about average. By asset class, both reports conclude that RSIC's GTAA fees are low, fixed income average, private debt low, real assets a bit high, direct private equity low, hedge funds higher than

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average and emerging market stocks low to average. HEK concluded that RSIC's US stock fees are average, CEM found them to be a bit above the median.

CEM's report drills further into the component parts of each asset class than did HEK's February 2013 report, and HEK's data was taken from multiple different sources while CEM's is all taken from the same peer group. From CEM's report it is easier to see the cost impact of paying fees for a particular asset type that are higher or lower than the peer average. Hedge fund costs stand out as an area where RSIC appears to be paying more.

CEM's Independence and the Contracting Process

The CEM study was commissioned by the State Inspector General's Office to address public controversy about the Commission's fiduciary oversight role regarding fund's performance and fees. FAS was asked by SIG to subcontract with CEM to complete the study as part of the fiduciary performance audit. The CEM study, like the FAS study would be paid from the Retirement System's funds. The State Treasurer's Office has subsequently raised questions about the independence of CEM if it is paid by the RSIC.

An email from STO on 3/25/2014 stated: "RSIC paid approximately \$30,000 for the CEM report. Can Funston share the reasoning or history for the subsidy? Was the CEM report not a part of the fiduciary audit? Is it odd for entity being the audited to pay for an independent report?" This question may suggest that CEM's independence is somehow compromised by the fact that the funds are ultimately coming from RSIC even though they only provided data and verified its accuracy.

Our response is shown below:

"This view is contrary to the entire notion of external audit. The overwhelming majority of organizations who retain independent advisors and auditors pay them directly without compromising the integrity of their reports. The fact that this review was under the auspices of the SIG creates an even greater degree of independence. As with the Fiduciary Performance Review, which is paid for by the retirement trust fund, the CEM report is being paid through the trust fund and you have made it abundantly clear to us and CEM that SIG not the RSIC, STO or PEBA is the client.

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CEM, as a premier provider of independent performance and cost studies, is typically engaged directly by its pension fund clients, who rely upon their reports as one form of independent reassurance. As noted above, in this case, their independence is even greater as they were engaged by FAS through SIG. Our credibility and that of CEM as independent providers of benchmarking and audit services demand the highest levels of integrity and independence.

Similarly, on other fiduciary audit engagements, FAS is typically engaged directly by our pension fund clients. This is our first experience being engaged by an Inspector General or any other oversight body and we have appreciated your efforts to prevent the stakeholders from attempting to exert undue influence. The \$30,000 CEM fee is the standard annual fee for participation in its investment benchmarking survey. (Note: a separate invoice will be submitted by FAS for the final CEM report and there is no mark-up by FAS for coordinating this report.)”

The question may further suggest that Funston Advisory Services somehow received a “subsidy” from RSIC which again might be interpreted as reducing our independence. Again, our response is shown below: “..., the CEM study was identified as one option among a number of other options in the original FAS response to your request for proposal which included a flat, all inclusive fee requirement to address all matters within scope. As part of the negotiations process, we agreed to take out a number of options and related fees to focus exclusively on the matters within scope to bring our total cost to within the \$700,000 budget. These included, for example, the elimination of an expert advisory panel, a study of the asset/liability matching process and a significant reduction of the review of IT systems given the RSIC’s current stage of development as well as the elimination of the CEM study. This reduction in our fees from our initial proposal did not anticipate our subsequent involvement in the CEM study.

Subsequently, we understand the SIG decided, given the controversy surrounding performance and fees, to commission the CEM report through FAS rather than directly with CEM. Thus, CEM is under contract to FAS for the RSIC Investment Cost Effectiveness Analysis. The CEM study was always identified by FAS as an option. We could have completed our core responsibilities for the Fiduciary Performance Audit without it. Our involvement in coordinating the collection of data has involved a considerable amount of extra, unbudgeted effort.

By agreeing to coordinate CEM’s work without additional compensation, we (FAS) have, in effect, subsidized the RSIC.”

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Appendix G Powers Reserved Analysis

In a prior assignment for the Oregon Investment Council in early 2012, FAS performed a benchmarking analysis of legislation and policies affecting powers reserved. We compared 66 authorities and organized them into 9 major areas of responsibility:

1. Set mission
2. Set /approve board governance
3. Set / approve fund policies and processes
4. Select, evaluate, compensate, terminate executive management
5. Set enterprise strategy and budgets
6. Set investment strategies and enterprise risk policy framework
7. Promote effective stakeholder relations and advocate for beneficial change
8. Oversee ongoing investment performance
9. Oversee effectiveness of enterprise risk management including ethics and enterprise policy compliance

The benchmarking study included seven participants.

- Three sole fiduciaries (Connecticut, Michigan and North Carolina).
- Four investment boards (Alberta Investment Management Company (AIMCo), Oregon Investment Council (OIC), Washington State Investment Board (WSIB), and State of Wisconsin Investment Board (SWIB)).

For this analysis of the RSIC we have included three of the four investment boards for comparison (AIMCo, WSIB and SWIB). Oregon does not have a comparable structure, as the Treasury Department Investment Management Division manages the pension fund (legislation is currently pending to change this). AIMCo is an interesting comparison because they made a transition from sole fiduciary to investment board structure, similar to South Carolina, in 2008.

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1. Set mission RSIC’s authorities are consistent with the peer investment boards

Powers Reserved	Investment Board			
<i>1. Set mission</i>	AIMCo	WSIB	SWIB	RSIC
1.1 Set and approve mission and vision	Board	Board/ CEO	Board	Commission
1.2 Approve organization performance metrics and oversee overall organization performance	Board	Board/ CEO	CEO/ Board	Commission

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2. **Set / approve board governance** Peer investment boards typically have some responsibilities which the Commission does not have:

- The South Carolina legislature retains responsibility for approving the commissioner election calendar and approving regulations relating to agency
- The governor is responsible for board disciplinary actions.

Powers Reserved	Investment Board			
2. Set / approve board governance	AIMCo	WSIB	SWIB	RSIC
2.1 Conduct and oversee periodic board self assessment of effectiveness, policies governing board conduct, and utilization of board resources, time, and processes	Board	Board	Board	Chair & Commission
2.2 Approve board committee roles and charters including creating and disbanding standing and ad hoc as appropriate	Board	Board	Board	Commission
2.3 Approve board governance principles and policies	Board	Board	Board	Commission
2.4 Approve board member election calendar	Board	N/A	NA	Legislature
2.5 Approve board self-development education program and budget	Board	Board	Board	Commission w/ COO
2.6 Oversee board processes and organizational accountability	Board	Board	CEO/Board	Commission
2.7 Conduct an annual review of powers reserved, delegations and committee charters, and update, as appropriate	Board	Board	Board	Commission/ Legal
2.8 Discipline if a member fails to meet board standards of conduct	Board	Board	Government Accountability Board	Governor
2.9 Set the board (committee) agendas by identifying, articulating, prioritizing and scheduling matters and reports the board will regularly address	Board	Board/ CEO	CEO/ Board	Commission Chair/ Committee Chair
2.10 Approve information to be delivered to the board, including benchmarks which trigger board review	Board	CEO	Board	CIO or COO
2.11 Approve board delegations to executive and/or third parties (excluding investments)	Board	Board	Legislature/ Board	Commission
2.12 Approve and adopt regulations relating to agency	Board	Board	Legislature	Legislature
2.13 Conduct election of board president and vice president	Board	Board	Governor	Commission
2.14 Oversee the process of board member and board direct reports disclosure statements and compliance	Board	External Auditor	Board audit committee	Int. Audit & Compl./ State Ethics Comm.

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3. Set / approve fund policies and procedures. In contrast to all three peer funds, the RSIC is not responsible for its own external audit.

Powers Reserved	Investment Board			
<i>3. Set / approve fund policies and procedures</i>	AIMCo	WSIB	SWIB	RSIC
3.1 Evaluate and select non-investment consultants	Board	CEO	Board	Commission for Named Providers
3.2 Approve major litigation	Board	Board	Board	Commission
3.3 Approve accounting policies	Board	CEO/ CFO	Board/ CEO	PEBA
3.4 Approve financial reports and oversee controls over financial reporting and processes	Board	Board/ Audit Committee	Board Audit Committee	Commission for AIP/ PEBA for CAFR
3.5 Approve, as required, external and internal audits	Board	Board/ Audit Committee	Board Audit Committee	Ext – PEBA/ Int. – Audit Committee
3.6 Select and approve the external auditor	Board	Board	Board	State Auditor's Office

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4. **Select, evaluate, compensate, and terminate executive management.** RSIC's authorities are consistent with the peer investment boards and are the responsibility of the Commission or delegated to the executive.

Powers Reserved	Investment Board			
<i>4. Select, evaluate, compensate, terminate executive management</i>	AIMCo	WSIB	SWIB	RSIC
4.1 Conduct goal setting and evaluation and set compensation for the CEO and /or CIO	Board	Board	Board	Commission
4.2 Oversee setting of salary ranges, salary, and bonus schedule according to the established Compensation Policies and Procedures	Board	Board	Board	Commission*
4.3 Conduct long-term succession planning for the CEO and CIO	Board	Board/ CEO	Board/ CEO	Commission
4.4 Conduct hiring/firing of the CEO/ CIO	Board	Board/ CEO	Board	Commission
4.5 Approve and oversee senior executive long-term succession planning	Board	CEO	CEO	Commission
4.6 Approve human resource executive compensation policies	Board	Board	Board	Commission
4.7 Hire, fire and discipline other executives	Board	CEO	CEO	COO & CIO

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5. Set Enterprise Strategy and Budgets. RSIC’s authorities are consistent with the peer investment boards with a critical exception than the legislature retains budget and resource allocation authority; two of the three peer investment boards have the authority to set their own budget and headcount.

Powers Reserved	Investment Board			
<i>5. Set enterprise strategy and budgets</i>	AIMCo	WSIB	SWIB	RSIC
5.1 Approve enterprise-wide budgets and resource allocations and oversee budget process	Board	Legislature	Board	Legislature
5.2 Create investment holding company(ies)	Board	Board	Board	NA
5.3 Approve business plans and oversee business planning process	Board	CEO	CEO	Commission
5.4 Set overall organization strategy, oversee strategic planning process, and approve strategic plans	Board	Board/ CEO	Board	Commission

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6. Set investment strategies and enterprise risk management framework. The South Carolina legislature sets the expected rate of return; this is delegated to the board at two of the three peers. The Commission delegates asset class strategies and construction to the CIO; the peer fund boards retain this responsibility. Benchmarks are recommended by the CIO and the general consultant but are approved by the Commission.

Powers Reserved	Investment Board			
<i>6. Set investment strategies and enterprise risk management framework</i>	AIMCo	WSIB	SWIB	RSIC
6.1 Approve enterprise risk policies framework and oversee effectiveness of enterprise risk management	Board	Board/ CEO	Board/ CEO	Commission
6.2 Set risk policies	Board	Board	Board/CIO	Commission
6.3 Approve strategic asset allocation (including active risk budget for each trust for which the Board has fiduciary responsibility); approve the total fund policy benchmark for each trust	PERF Board	Board	Board	Commission
6.4 Approve and oversee asset class strategic plans, portfolio construction guidelines, and benchmarks	Board	Board	Board	CIO*
6.5 Set the expected rate of return	Board	Legislature	Board	Legislature
6.6 Set investment beliefs to guide investing strategies	Board	Board	CEO	Commission
6.7 Set investment risk appetite and tolerances	Board	Board	Board	Commission
6.8 Approve risk appetite and strategy (excluding investment risk)	Board	Board	CEO	Commission

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7. Promote effective stakeholder relations and advocate for beneficial change, the South Carolina RSIC responsibilities are consistent with the peer investment boards. The Commission is less involved in legislative policies than the other investment boards.

Powers Reserved	Investment Board			
<i>7. Promote effective stakeholder relations and advocate for beneficial change</i>	AIMCo	WSIB	SWIB	RSIC
7.1 Oversee stakeholder relations	Board	CEO	CEO	COO
7.2 Approve overall communications strategy	Board	CEO	Board/ CEO	Commission/COO
7.3 Set legislative priorities and approve legislative policy and legislative positions	Board	Board/CEO	Board/ CEO	COO & CIO

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8. *Oversee ongoing investment performance.* RSIC’s authorities are consistent with the peer investment boards.

Powers Reserved	Investment Board			
8. <i>Oversee ongoing investment performance</i>	AIMCo	WSIB	SWIB	RSIC
8.1 Oversee investment performance	Board	Board/ CEO	Board/ CIO	Commission & CIO
8.2 Oversee fund liquidity management, including ensuring that the fund has sufficient liquid assets to respond to market conditions and meet investment obligations (e.g. capital calls, collateral calls).	Board	CEO	CIO	CIO
8.3 Oversee financial soundness of the overall system, including annual review of unfunded liability, overall pension soundness and sustainability, health programs, and any other programs offered	PERF Board	State Actuary	PERF Board	PEBA Trustees & Legislature
8.4 Conduct selection and oversee performance of board consultants who provide investment-related expertise to the board	Board	Board/ CEO	Board	Commission
8.5 Oversee selection process and performance of investment partners, managers and consultants, including addressing diversity policies and objectives	Board	Board/CEO	Board/CIO	Commission/ CIO
8.6 Approve major investment-related litigation	Board	Board	Board	Commission & State AG
8.7 Oversee cost effectiveness of the investment program	Board	CEO	Board/ CIO	Commission
8.8 Oversee operations and cost effectiveness	Board	CEO	Board/ CEO	CIO and COO
8.9 Oversee cash management to ensure sufficient cash is available to pay benefits and operating expenses	Board	CEO	CIO/ PERF Board	PEBA with CIO
8.10 Oversee interaction of cash management and liquidity management processes	Board	CEO	CIO	CIO
8.11 Oversee Investment Office risk management processes, including investment risk management, investment policy compliance monitoring, and operating risk management	Board	CEO	Board	CIO/ Risk Team & Compliance
8.12 Oversee investment office risk assessment and control environment	Board	CEO	N/A	CIO

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9. *Oversee effectiveness of enterprise risk management including ethics and enterprise policy compliance.* RSIC’s authorities are consistent with the peer investment boards, although the Commission has delegated somewhat more to staff than the peer funds. RSIC does not have a diversity program or an ESG program for its investments.

Powers Reserved	Investment Board			
<i>9. Oversee effectiveness of enterprise risk management including ethics and enterprise policy compliance</i>	AIMCo	WSIB	SWIB	RSIC
9.1 Oversee all enterprise diversity programs	Board	NA	CEO	NA
9.2 Oversee enterprise program and policy compliance	Board	CEO	Board	Internal Audit & Compliance
9.3 Oversee privacy and security compliance	Board	CEO	CEO	Legal & IT/ COO
9.4 Oversee review of alleged breaches of Code of Ethics by board or executives	Board	CEO/ Internal and External Auditors	Government Accountability Board	Commission w/ Legal/Others
9.5 Oversee service provider compliance (including harmonizing conflict of interest policies)	Board	CEO/ COO	CEO	COO and CIO
9.6 Oversee business continuity and disaster recovery	Board	CEO/ COO	Board	Commission/IT/ COO
9.7 Approve contracting policies and oversee effective management of service provider contracts	Board	CEO/ COO	Board	Commission/ COO/ CIO
9.8 Approve and oversee compliance with investment policies	Board	CEO/ COO	Board/CIO	Consultant, Int Audit & Compl, CIO
9.9 Oversee environmental, social and governance (ESG) program	Board	CEO	Board	NA
9.10 Oversee whistleblower and hotline processes	Board	CEO/ Internal Auditor	Internal Auditor	Int Audit & Compl, Audit Comm, IG

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Appendix H Fiduciary Duty and Governance Structure Analysis

Number of Fiduciaries Blurs Authority and Accountability

The South Carolina Retirement System has four separate named fiduciaries with overlapping authority. The sources of these overlapping authorities are the following statutory provisions.

- Budget and Control Board ("BCB")/ Department of Administration or State Fiscal Accountability Authority (effective July 2015)
 - Named Trustee (S.C. Code Ann. § 9-1-1310)
 - Fiduciary status as Trustee
- Treasurer
 - Custodian of the funds (S.C. Code Ann. § 9-1-1320)
 - "Other fiduciary" in role as custodian (S.C. AG Op. November 16, 2011)
 - However, the custodian has a ministerial role only, with no investment authority (S.C. AG Op. November 16, 2011)
 - Commissioner on RSIC (S.C. Code Ann. § 9-16-315)
 - Member of BCB (S.C. Code Ann. § 1-11-10)
- Retirement System Investment Commission (RSIC)
 - Vested with exclusive investment authority (S.C. Code Ann. § 9-16-20)
- Public Employee Benefit Authority (PEBA)
 - Named Trustee (S.C. Code Ann. § 9-1-1310)
 - Executive Director is non-voting Commissioner on RSIC (S.C. Code Ann. § 9-16-315)

In addition, the legislature has reserved certain fiduciary powers for itself that result in a mismatch between RSIC's statutorily designated fiduciary duties and the authority needed to implement those responsibilities. For example, the legislature's authority to control budget and staffing for the RSIC (*see, e.g.*, S.C. Code Ann. §2-7-60) and set the assumed rate of return for retirement system investments (S.C. Code Ann. § 9-16-335) are key powers that affect implementation of RSIC's investment duties.

Other State entities that exercise powers oversight powers in regard to implementation of RSIC's investment authority include the Attorney General (retention of outside legal counsel); Comptroller General (accounts payable and payroll audits); State Auditor (external audit); and Inspector General (annual fiduciary performance review). While these are not identified as fiduciaries, they do exercise monitoring and oversight functions that influence implementation of RSIC's responsibilities.

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Multiple Fiduciary Roles and Statutory Ambiguity Creates Potential for Conflict

These authority and responsibility mismatches, as well as the overlaps and ambiguity around duties statutorily allocated amongst the Retirement System's fiduciaries, create the potential for conflicts and uncertainty as to which fiduciary has what authority and responsibility under what circumstances. The overlaps transcend personalities of current incumbents and present inherent issues in regard to who has accountability for shared responsibilities. This potential for conflicts is demonstrated most acutely by the multiple statutory roles assigned to the South Carolina State Treasurer.

Custodian. The South Carolina State Treasurer is statutorily designated as the custodian of Retirement System Funds. (S.C. Code Ann. § 9-1-1320 provides, "The State Treasurer shall be the custodian of the funds of the System."). The South Carolina Attorney General has opined that the Treasurer's duties as custodian are purely ministerial and, as such, the Treasurer has no authority regarding the investment of retirement funds. (S.C. AG Op. November 16, 2011 at 12.)

All of the Treasurer's previous authority for investment of retirement funds in fixed income investments was transferred to the RSIC when it was created. (S.C. Code Ann § 9-16-315(G) says, "All of the powers and duties of the State Budget and Control Board as investor in equity securities and the State Treasurer's function of investing in fixed income instruments are transferred to and devolved upon the Retirement System Investment Commission.") The Attorney General noted that the Treasurer plays a role in investment functions only as a member of the Commission, not as Treasurer. (S.C. AG Op. November 16, 2011 at 12.) Consequently, the Treasurer, as custodian, appears to have only ministerial functions regarding the Retirement System assets, and his duties "encompass disbursement of the funds upon instruction and protection of those funds as a bailee." (*Id.* at 12.)

Nevertheless, the Attorney General also noted that, when the Treasurer is acting as custodian, he is acting in a fiduciary capacity.¹⁴ (2011 WL 6120331) In the opinion, the Attorney General "deem[s] the Treasurer, as custodian of the retirement funds, even though he acts in a ministerial capacity, to be an "other fiduciary" as described in section 9-16-40(3), with the fiduciary duties appertaining thereto." (S.C. AG Op. November 16, 2011.) However, this conclusion seems to be at odds with prevailing authority elsewhere. There is a line of recent cases holding that a custodian which has ministerial responsibilities for custody, record keeping, disbursement of funds and reporting is not a fiduciary unless granted additional discretion and control over the assets.¹⁵ Furthermore, where a custodian is granted such additional discretionary authority and becomes a fiduciary, its fiduciary status is limited to

¹⁴ In the opinion, the Attorney General cites to a few dated cases for the position that the custodian is also a fiduciary. (See *e.g.*, County Comm'rs. v. Winnsboro Nat. Bank, 7 S.C. 78 (1876); Whitebeck v. Estate of Ramsay, 74 Ill. App. 524 (1896); Olin Mathieson Chem. Corp. v. Planters Corp., 236 S.E.2d 326 (S.C. 1960).) While these cases may remain good law, there have been recent decisions in this area. (La. Municipal Police Employees' Retirement System v. JPMorgan Chase & Co., 2013 WL 3357173 at 13 (S.D.N.Y.); see also Matkin v. Fidelity National Bank, 2002 WL 32060182 (D.S.C.); Burwell v. S.C. National Bank, 340 S.E.2d 786 (S.C. 1986)).

¹⁵ See, *e.g.*, In re Mushroom Transportation Company, Inc., 382 F.3d 325 (3rd Cir. 2004); Beddall v. State Street Bank and Trust Company, 137 F.3d 12 (1st Cir. 1998); La. Municipal Police Employees' Retirement System v. JPMorgan Chase & Co., 2013 WL 3357173 at 13 (S.D.N.Y.); Matkin v. Fidelity National Bank, 2002 WL 32060182 (D.S.C.); Burwell v. S.C. National Bank, 340 S.E.2d 786 (S.C. 1986).

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the scope of that discretionary authority and does not convert the custodian into a general fiduciary for all of its duties.

For example, the Third Circuit Federal Court of Appeals held in *In re Mushroom Transportation Company, Inc.* (382 F.3d 325 (3rd Cir. 2004)) that "ERISA does *not* consider as a fiduciary an entity such as a bank when it does no more than receive deposits from a benefit fund on which the fund can draw checks." (Pages 346 – 347.) Accordingly, because Continental Bank (which was custodian for Mushroom Transportation, Inc.'s pension fund assets) did nothing more than "serve as holder of assets placed there," it was not a fiduciary. (Page 347.) Though the *Mushroom* case concerned fiduciary duties under ERISA, its guidance is instructive here because the fiduciary duty standards written into the South Carolina Statutes are patterned after those in ERISA, which governs private pension funds.

In a similar case, *Beddall v. State Street Bank and Trust Company* (137 F.3d 12 (1st Cir. 1998)), the Court found that a custodial bank did not become a pension fund fiduciary under ERISA by virtue of being authorized to "perform administrative and ministerial functions in respect to those investments which, like real estate, are held within a so-called Investment Manager Account. Without more, mechanical administrative responsibilities (such as retaining the assets and keeping a record of their value) are insufficient to ground a claim of fiduciary status." (Par. 45.) In addition, "such details as checking whether [the investment manager's] instructions are in a writing signed by an authorized person and issuing periodic reports to [the plan's administrative committee] about the fund's status . . . does not transform the bank into a fiduciary vis-à-vis the affected assets." (Par. 48.) The Court also held, "Because one's fiduciary responsibility under ERISA is directly and solely attributable to his possession or exercise of discretionary authority, fiduciary liability arises in specific increments correlated to the vesting or performance of particular fiduciary functions in service of the plan, not in broad, general terms." (Par. 23.)

While this analysis is not intended to be a legal opinion on whether the Treasurer (as custodian for the retirement funds) serves in that capacity as a fiduciary, it is difficult to reconcile the recent line of legal authority referenced above with the Attorney General's application of nineteenth and early twentieth century court decisions relating to a completely different scope of custodial relationship than what exists today. The resulting confusion over roles and responsibilities held by the Treasurer as custodian, and how that authority relates to responsibilities of other statutorily designated fiduciaries, is an inherent source for potential conflict and disagreement. Lack of role clarity also creates increased risks of fiduciary liability exposure when conflicts of interpretation arise.

Fiduciary Duty Standard. This analysis cannot resolve questions around interpretation of South Carolina's statutory governance scheme for fiduciary responsibilities relating to the retirement systems. That can only be resolved by the courts or legislature. One thing that is clear is the statutory fiduciary duty standard in section 9-16-40 of the South Carolina Code, which applies to all Retirement System fiduciaries:

"A trustee, commission member, or other fiduciary shall discharge duties with respect to a retirement system:

- (1) solely in the interest of the retirement systems, participants, and beneficiaries;
- (2) for the exclusive purpose of providing benefits to participants and beneficiaries and paying reasonable expenses of administering the system;

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- (3) with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose;
- (4) impartially, taking into account any differing interests of participants and beneficiaries;
- (5) incurring only costs that are appropriate and reasonable; and
- (6) in accordance with a good faith interpretation of this chapter."

Given the Attorney General's advice that the Treasurer is a fiduciary when acting as custodian, it followed that the Treasurer is not only responsible for safekeeping of the retirement funds but also has a duty to preserve the funds and resist disbursements of the funds that have no basis in law. Exactly how this separate fiduciary duty interacts with the RSIC's exclusive authority to make investment decisions is unclear. This has been a source of confusion and conflict between the RSIC and Treasurer. What might have been viewed as separation of powers has created a fragmentation of authority situation, with confusion over what authority the Treasurer, as custodian, holds in relation to the exclusive investment powers granted to the RSIC.

Treasurer's Duties as a Commissioner. As noted above, the Treasurer is also a member of the RSIC and, as such, shares investment authority over the Retirement System funds with the other Commissioners. (S.C. Code Ann. § 9-16-315(A)). As a Commissioner, the Treasurer is subject to the fiduciary standard of care described above. The Treasurer is faced with the challenge of resolving potentially conflicting fiduciary duties between his role as one of several Commissioners on the RSIC and his separate fiduciary obligations as Treasurer. While the Treasurer is obligated to implement duly-adopted investment decisions of the RSIC, under the Attorney General's opinion, he might also have the potential to block them when exercising separate fiduciary duties as Treasurer. The existence of such separate veto power appears to be inconsistent with the exclusive statutory grant of investment authority to RSIC. (See the further discussion below of this apparent veto authority.)

Duty of Loyalty. Pursuant to the duty of loyalty, a fiduciary is strictly prohibited from entering into transactions that involve or create a conflict between those fiduciary duties and personal interests of the fiduciary or that place a fiduciary in a position in which it is reasonably foreseeable that a conflict of fiduciary and personal interests may arise in the future. (See the Restatement Third of Trusts § 78.) The Treasurer, as an elected official with separate duties from his role as a Commissioner on the RSIC, has duties to all citizens of South Carolina. This creates a potential conflict with his duty of loyalty to retirement system beneficiaries, which presents fundamental challenges.

Furthermore, case law suggests that a fiduciary could unintentionally violate the duty of loyalty even while subjectively acting in good faith, based on his individual view of what fiduciary responsibilities required. (See *e.g.*, Fletcher Cyclopedia of the Law of Corporations § 837.60 (2010 Ed.); In Re Mony Group, Inc. Shareholder Lit., 853 A.2d 661 (Del. Ch. 2004); Esophs Creek Value Lp v. Hauf, 913 A.2d 593 (Del. Ch. 2006)). For example, the Delaware Court of the Chancery has noted that the fiduciary duty of loyalty imposes an affirmative obligation to protect and advance the interests of the corporation and that a fiduciary may not engage in conduct that is adverse to the interests of the corporation. (Shocking Technologies, Inc. v. Michael, 2010 WL 4482838 (Del. Ch. 2012)). Though this Delaware case concerns fiduciaries of a corporation rather than a retirement system, the facts of the case are fairly analogous. A single fiduciary acted on his own to interfere with the actions of the Board

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and the interests of the corporation. Thus, the issue before the Delaware Court was whether a fiduciary could violate his fiduciary duty of loyalty by subverting the decisions of the board as a whole, even though acting in good faith.

The Delaware Court ultimately held that, while an aspect of good faith is encompassed in the duty of loyalty, it would be difficult to reconcile disloyal conduct with its likely "foreseeable (and intended)" consequences of causing serious harm to the corporation with the fiduciary duty of loyalty. That is, fiduciaries can unintentionally violate the duty of loyalty even while claiming to act in subjective good faith.

Consequently, it could be that even when the Treasurer is acting in good faith, pursuant to the Treasurer's fiduciary duties as custodian or a member of the BCB, the Treasurer could unintentionally violate the duty of loyalty to Retirement System beneficiaries in his role as an RSIC Commissioner. It seems that the increased risks of fiduciary liability that result from the Treasurer being placed in multiple fiduciary roles with potentially conflicting obligations merit further consideration by policymakers.

Apparent Veto Authority. Pursuant to the common law of trusts, where the terms of the trust (or, in this instance, the statute) provide that, in administration of the trust, a trustee must take certain actions if so directed by another person, it is ordinarily the trustee's duty to comply with the direction; the trustee would ordinarily be liable for a loss resulting from failure to do so. (See the Restatement 3rd Trusts § 75.) When the statutes vest exclusive investment authority in the RSIC, this seems to preclude subsequent exercise of a *de facto* veto by one of the Commissioners, regardless of the role in which that fiduciary is acting. However, the Attorney General's opinion muddies the waters by advising that the Treasurer, as custodian of the retirement funds, is also an "other fiduciary," with the fiduciary duties appertaining thereto.

This apparent dual fiduciary status of the Treasurer is confusing and problematic. By having the ability to refuse to fund investments the Treasurer objects to (in good faith) in his role as custodian, the Treasurer could be seen as exercising veto power over investment decisions already made with his participation as a fiduciary Commissioner at the RSIC. The existence of such veto authority is inherently inconsistent with the statutory grant of exclusive investment authority to the RSIC. Use of such a veto could create risk that the Treasurer might be found to be in breach of his duties as a fiduciary at the RSIC, if losses were incurred as a result of his good faith exercise of separate statutorily-created fiduciary duties as custodian. Increased liability risk is the natural result of such multiple overlapping and ambiguous statutory fiduciary duties.

Master and Servant. Case law in South Carolina sets forth the rule that a public officer cannot hold the "dual position of master and servant" because such a dual role would lead to "constant conflict between self-interest and integrity". See *e.g.* McMahan v. Jones, 77 S.E. 1022, 1023 (S.C. 1913). As clarified by the Attorney General, where one office is subordinate to another and subject in some degree to the other's supervisory power, a conflict of interest may exist that prevents an individual from holding dual office. See *e.g.*, S.C. AG Op. October 22, 2007. The Treasurer is likely a public officer because the office of Treasurer is established by the constitution. See Sanders v. Belue, 58 S.E.2d 762 (S.C. 1907). Therefore, allegations could be made that the Treasurer cannot be both master and servant, as this dual status could lead to a conflict of interest. Because the Treasurer is a Commissioner

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on the RSIC (the "master") and the RSIC instructs the Treasurer in his role as custodian (the "servant") to release funds, there is potential that the Treasurer could be found to have been improperly required to serve as both master and servant. (The Treasurer's membership on the BCB could also be seen as raising similar questions.)

Budget and Control Board. The Treasurer's third fiduciary role for the retirement system is as a member of the BCB. As further discussed below, the BCB appears to hold legal title to the retirement system's funds and appears to have both statutory and common law fiduciary responsibilities as a Trustee. For example, under common law trust principles, trustees are obligated to administer the trust in good faith, with prudence, and in accordance with their other fiduciary duties. (*See e.g.*, Restatement Third of Trusts § 70). The duty of prudence requires a trustee to exercise reasonable care, which, in turn, includes a duty to monitor the trust and fellow trustees. (*See e.g.*, Restatement Third of Trusts § 77). Failure to monitor the trust and fellow trustees can, in some instances, lead to co-fiduciary liability. (*See generally*, Restatement Third of Trusts § 81). Consequently, as a member of the BCB, the common law of trusts appears to give the Treasurer and BCB some degree of ambiguous monitoring for the retirement system, which could expose the Treasurer and/or BCB to liability.

Adding to the potential for conflict is the confusion surrounding the role of BCB (whose powers are soon to be transferred to the Department of Administration and State Fiscal Accountability Authority) as co-trustee. The BCB, or its successor, is statutorily designated as a co-trustee of the retirement system. (S.C. Code Ann. § 9-1-1310 now provides, "The South Carolina Public Employee Benefit Authority and the State Budget and Control Board, or its successor, are co-trustees of the retirement system . . . in performing the functions imposed on them by law in the governance of the Retirement System."). The BCB, however, has very limited statutorily-identified duties for the Retirement System.^[1] Rather, nearly all duties were divided between the RSIC and the PEBA when they were created. (S.C. Code § 9-16-315 (G) says, "All of the powers and duties of the State Budget and Control Board as investor in equity securities and the State Treasurer's function of investing in fixed income instruments are transferred to and devolved upon the Retirement System Investment Commission." Furthermore, S.C. Code Ann. § 9-4-10(H) provides that, "Effective July 1, 2012, the following offices, divisions, or components of the State Budget and Control Board are transferred to, and incorporated into, an administrative agency of state government to be known as the South Carolina Public Employee Benefit Authority: (1) Employee Insurance Program; and (2) the Retirement Division.")

^[1] In addition to retaining a designation as trustee, it appears as though the BCB also retains approval authority over all policy determinations of the PEBA. (S.C. Code Ann. § 9-4-45 says, "(A) Policy determinations made by the South Carolina Public Benefit Authority are subject to approval by the State Budget and Control Board or its successor, evidenced by a majority vote of the board. (B) For purposes of this section, policy determination means a determination by law required to be made by the South Carolina Public Benefit Authority in its administration of the Employee Insurance Program relating to coverage changes and premium increases and in its administration of the Retirement Division, actuarial assumptions governing the retirement system and adjustments in employer and employee contributions.") The statute refers to policy determinations of the "Public Benefit Authority" rather than the PEBA, but it seems that these are the same entity. For example, the statute specifically references policy determinations with regard to the Employee Insurance Program and the Retirement Division, which are the two divisions specifically transferred from the BCB to the PEBA. Consequently, it appears that the BCB retains some statutory authority related to the Retirement Systems and the RSIC in that the BCB must approve any PEBA policy determination with regard to actuarial assumptions, which may impact the RSIC's investment strategy.

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Nevertheless, case law suggests that the BCB, as a named trustee, holds legal title to retirement fund assets. See Hamiter v. Retirement System of the South Carolina Budget & Control Board, 484 SE.2d 586 (S.C. 1997). While *Hamiter* was decided prior to the formation of the PEBA, the case may still be good law, as the court held that the BCB holds legal title to the assets because the BCB was statutorily designated as a trustee, which designation still remains. This further confuses the extent of authority and responsibility held by the BCB as a co-trustee.

Transfer of BCB Functions. Recent South Carolina legislation (Act 121) eliminates the BCB effective July 2015 and transfers its Retirement System oversight functions to the Department of Administration or State Fiscal Accountability Authority. However, the statute designating BCB as co-trustee (S.C. Code Ann. § 9-1-1310) was not amended as part of this bill.^[2] Section 2A and 18A of Act 121 contain ambiguous and potentially conflicting language on allocation of BCB powers to the Department of Administration and State Fiscal Accountability Authority. These two Sections of the Act could be read as contradictory and become the source of future conflict regarding the exercise of Retirement System oversight functions. If the overlapping co-trustee structure is maintained, we recommend that clarity be provided on whether the SFAA or DOA will become co-trustee of the Retirement System when the BCB is abolished.

PEBA Relationship to RSIC. A final level of ambiguity exists in the allocation of retirement system management and administration responsibilities between the PEBA and the RSIC. For example, the RSIC and the PEBA have agreed to assign responsibility for the accounting and audit functions of the Retirement System to the PEBA. (See Article II of the Memorandum of Understanding dated January 15, 2014.) However, it is not clear that PEBA has been statutorily granted this authority, as the RSIC has exclusive authority over the management of the Retirement System assets. (See S.C. Code Ann. § 9-16-20.) On the other hand, accounting and audit functions may be more akin to administration of the Retirement System, which is the statutory responsibility of the PEBA under S.C. Code Ann. § 9-4-30.

Either way, RSIC and PEBA have worked out a resolution of this ambiguity through the Memorandum of Understanding. If PEBA does not have clear statutory responsibility for accounting and audit functions, RSIC does have the ability to delegate this responsibility to PEBA under RSIC's delegation authority in S.C. Code Ann. § 9-16-30. Nevertheless, this illustrates another level of ambiguity in assignment of fiduciary authority and responsibility amongst the various entities with fiduciary duties. If personalities and agendas were to change at the two agencies, this ambiguity in assignment of authority and responsibility could also generate conflicts.

Conclusion

The statutory allocation of fiduciary authority and responsibilities amongst designated trustees and other entities with fiduciary duties is duplicative and confusing. The current structure presents inherent

^[2] Section 2.A of Act 121, on July 1, 2015, transfers all functions, powers, duties, responsibilities, and authority of the BCB related to executive functions, except as otherwise provided by law, to the Department of Administration. However, Section 18.A of the Act (which establishes the State Fiscal Accountability Authority) also gives the SFAA authority to decide any matters that would have previously been referred to the BCB for decision, where the procedure for the decision is not specifically provided for by general law. While we were advised that legislative intent was to transfer BCB Retirement System functions to the SFAA, these two Act Sections could be read as contradictory and become the source of future conflict regarding the exercise of Retirement System oversight functions.

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implementation challenges and increased liability risks. It has resulted in conflicts between fiduciaries and has arguably added to retirement system costs, resulted in foregone investment opportunities and added to enterprise-level risk exposures (which are discussed in the body of this report). Legislative review and rationalization of the statutory structure for allocation of fiduciary authority and responsibilities is needed to resolve these issues.

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Appendix I Policy Review

SECURITIES LITIGATION						
Issue	RSIC	Fund 1	Fund 2	Fund 5	Fund 8	Fund 12
Monitoring new or potential securities litigation	Internal staff is responsible for monitoring and initial evaluation of potential securities litigation. No stated dollar threshold.	Substantially the same position. Loss threshold is \$10 million.	May move for lead plaintiff status if losses exceed \$5 million or other opportunities to enhance value or deter conduct.	Monitoring done by Fund 5 counsel, which may hire a support service to aid in such monitoring. Loss threshold is \$10 million.	Substantially the same position. Loss threshold is \$20 million.	Substantially the same position. Loss threshold is \$15 million.
Enhanced evaluation	Generally referred to outside securities litigation counsel for further evaluation	If threshold exceeded, will evaluate. Staff recommendation is reviewed by executive director.	If seeking lead plaintiff status is appropriate, the case is referred to outside counsel for evaluation and recommendation.	Outside consultant shall submit a report and recommendation to allow sufficient time to take legal action.	If after approved by certain staff, chief legal counsel will retain outside counsel to further evaluate. Action requires unanimous approval of certain staff or Board. Board approval required to initiate or join any action exceeding \$50 million.	Evaluation counsel reviews various documents and data, such as disclosures and trading data, and recommends a course of action.
Securities Litigation Committee or	Requires quarterly reports to the	An informal group composed of the general counsels	Subcommittee on Corporate Governance shall	Not addressed.	Not addressed.	Committee reviews evaluation

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SECURITIES LITIGATION						
Issue	RSIC	Fund 1	Fund 2	Fund 5	Fund 8	Fund 12
Board Role	Commission from legal counsel on claims and recoveries collected	of the state retirement systems meets to discuss outstanding and proposed litigation. Not binding on fund.	determine whether to seek lead plaintiff status.			counsel's recommendation and prepares a recommendation for the Comptroller.
Selection of litigation counsel	The securities litigation policy lacks clarity as to final approval role of the Commission vs. General Counsel and role of Attorney General in approving litigation counsel.	Not addressed.	If determination is made to seek lead plaintiff status, fund will solicit bids for lead class counsel.	Counsel finalizes agreement with litigation counsel, which must be approved by state agencies.	Not addressed.	May retain the law firm who notified the Fund of the potential action without seeking other proposals. Alternatively, a competitive bid process may be used.

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PLACEMENT AGENT						
Issue	RSIC	Fund 2	Fund 5	Fund 8	Fund 11	Fund 12
General policy	Does not prohibit, but requires disclosure of the use of a placement agent.	External managers using placement agents must agree to comply with the policy.	External managers cannot cause the Board to bear any placement agent fee or expense.	Cannot use placement agents to find investments, but can work with them if contacted regarding potential investment.	All investment decisions must be made solely on the basis of the investment and not undue influence.	Fund generally prohibited from working with an outside investment manager that is using the services of a placement agent.
Direct and Indirect Investments provide disclosure letter	Requires disclosure letter with due diligence report from direct and indirect investment managers. Required before consideration for investment unless exigent circumstances.	Included; distinguishes between placement agent fees, gifts and campaign contributions.	Included; must provide before consideration for retention.	Not addressed.	Included; external parties must provide written disclosure of the use of placement agents.	Investment Managers with direct investments must provide disclosure letter.
Review process/Internal Controls	CIO and internal staff review disclosure letters and determine if sufficient, referring questions to legal; prohibits voting before receipt of letter, unless exigent circumstances.	Not addressed.	Not addressed.	Institutional controls in place to ensure full reporting of potential conflicts of interest and no personal benefit.	Not addressed.	Disclosure review process in place to review letters, notification of a party acting as placement agent in an investment transaction; includes internal controls at closing to ensure disclosures made.
Option to terminate/remedies	Not addressed	Not addressed.	Includes a remedies process.	Not addressed.	Not addressed.	Option to terminate if fails to comply, or misstatement or omission.

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PLACEMENT AGENT						
Issue	RSIC	Fund 2	Fund 5	Fund 8	Fund 11	Fund 12
Notification process	Provides that the Investment Manager will be notified of the policy as soon as practicable after begin due diligence review.	Not addressed.	Not addressed.	Not addressed.	Not addressed.	Includes a process for notifying potential investees of policy.
*Policies include a list of items to include in the disclosure letter.						

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BOARD ETHICS						
Issue	RSIC	Fund 2	Fund 9	Fund 10	Fund 11	Fund 12
Application of Policy	Within Governance Manual. Applies to Commissioners.	Applies to Board members and staff	Not Addressed	Applies to Members of the Board, officers, employees and designated independent contractors.	Applies to all employees of the system.	The Policy applies to the officers and employees, investment managers and consultants.
Prohibited Transactions	Includes description of statutory prohibitions.	Includes an explanation that staff cannot receive consideration or favors.	Includes a description of conflicts of interest and requires disclosure of same.	Included.	Included.	Includes a list of prohibited transactions.
Political Contributions	Included with reference to statutory requirement.	Included based on statutory requirements.	Not Addressed	Not Addressed	Not addressed.	Includes restrictions on political contributions.
Advisory Council and Committees	Includes general committee guidelines.	Not Addressed	Not Addressed	Not Addressed	Not addressed.	Includes a list and guidelines for committees.
Transparency and Financial Reporting	Not addressed.	Not Addressed	Generally included.	Not Addressed	Included.	Includes rules and requirements applicable to reviewing books and records, audits, and internet publications.
Breach of Fiduciary Duty and Enforcement	Provides a process for enforcement and indemnification.	Not Addressed	Not Addressed	Included.	Included.	Provides a process for enforcing fiduciary obligations.
Gifts and Benefits	Governed by statute; addressed in policy and Staff Gifts Policy.	Not Addressed	Includes guidelines on allowable gifts.	Included.	Included.	Not Addressed; covered by Public Officers Law
Media Relations	Communications policy provides guidelines on referencing to designated	Includes a prohibition on writing or making any statement to the media purporting to represent the fund's	Not Addressed	Included.	Not Addressed	Not Addressed

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BOARD ETHICS						
Issue	RSIC	Fund 2	Fund 9	Fund 10	Fund 11	Fund 12
	spokesperson.	position.				
Nepotism	Addressed by Ethics Act & Regulations	Not Addressed	Not Addressed	Not Addressed	Includes a policy on nepotism.	Not Addressed
Personal use of resources	Included within general statutory requirements.	Not Addressed	Not Addressed	Not Addressed	Includes a prohibition on use of fund resources and personnel time for personal reasons.	Not Addressed

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EMPLOYEE ETHICS						
Issue	RSIC	Fund 2	Fund 9	Fund 10	Fund 11	Fund 12
Application of Policy	Code of Ethics and accompanying policies apply to RSIC Staff.	Applies to Board members and staff	Not Addressed	Applies to Members of the Board, officers, employees and designated independent contractors.	Applies to all employees of the system.	The Policy applies to the Comptroller, the officers and employees of the Office of the State Comptroller, investment managers and consultants.
Prohibited Transactions	References statutory requirements with regard to conflicts of interest; does not detail all statutory requirements.	Includes an explanation that staff cannot receive consideration or favors.	Includes a description of conflicts of interest and requires disclosure of same.	Included.	Included.	Includes a list of prohibited transactions.
Political Contributions	Not directly addressed; generally restricted by statute.	Included based on statutory requirements.	Not Addressed	Not Addressed	Not addressed.	Includes restrictions on political contributions.
Transparency and Financial Reporting	Includes description of forms and reporting process.	Not Addressed	Generally included.	Not Addressed	Included.	Included.
Gifts and Benefits	Includes guidelines on allowable gifts.	Not Addressed	Includes guidelines on allowable gifts.	Included.	Included.	Not Addressed; covered by Public Officers Law
Media Relations	Not addressed herein. Covered in separate communications policy.	Includes a prohibition on writing or making any statement to the media purporting to represent the fund's position.	Not Addressed	Included.	Not Addressed	Not Addressed
Personal use of resources	Generally addressed; also covered in Employee Handbook.	Not Addressed	Not Addressed	Not Addressed	Includes a prohibition on use of fund resources and personnel time for personal reasons.	Not Addressed

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INSIDER TRADING									
Issue	RSIC	Fund 1	Fund 2	Fund 3	Fund 4	Fund 6	Fund 9	Fund 11	Fund 12
Applicability	This Policy applies to RSIC staff.	The Policy applies to employees with access concerning investment assets and activities, as well as related parties.	The Policy applies to Board members and staff, including investment consultants and contractors.	The Policy applies to employees, the Treasurer, immediate family members, and tipees of those individuals.	The Policy applies to members of the Board, all officers, and designated employees.	The Policy applies to any person with access to non-public information about trading or holdings of the Fund.	The Policy applies to employees of the Board and Board members.	The Policy applies to employees and contractors in the investment division.	The Policy applies to employees.
Receipt of policy	Code of Ethics requires certification of receipt and compliance.	Includes a compliance statement.	Included.	Not addressed.	Includes twice-yearly certification of compliance.	Included.	Not addressed.	Included.	All covered employees must annually certify compliance with the Policy.
Description of Applicable Accounts and Assets	Utilizes a restricted list	Includes a description of which accounts and assets are covered by the Policy.	Not addressed.	Includes reference to personal transactions restricted list and fund restricted list.	Included.	Not addressed.	Included.	Not addressed.	Not addressed.
Pre-clearance	Notes that if in-house actively managed program adopted, preclearance will be required.	Certain personal investment transactions require pre-clearance through the Fund. The Fund has an automated system for most transactions.	Not addressed.	Included.	Not addressed.	Not addressed.	Not addressed.	Not addressed.	Not addressed.
*Generally, policies include a statement of restriction, require confidentiality, enforcement and termination provisions, and definitions of terms.									

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WHISTLEBLOWER POLICY						
Issue	RSIC	Fund 5	Fund 6	Fund 8	Fund 9	Fund 12
General	Whistleblower policy applicable to RSIC employees, pursuant to Audit Committee charter.	Fund 5 is subject to a statutory whistleblower policy applicable to all state employees.	Includes a statement of the policy's purpose and Fund's commitment to integrity.	Fund 8 is subject to a statutory whistleblower policy applicable to all state employees.	Fund 9 is subject to a statutory whistleblower policy applicable to all state employees.	No standalone whistleblower policy; rather, guidelines regarding internal investigations are contained in directives to the director.
Responsibilities	Details responsibilities of the supervisor/director, Audit Committee and OIG in investigating reports.	The state inspector general is responsible for receiving and investigating complaints.	Details procedures for how employees shall report improper activity. Identifies the agency responsible for investigating allegations and who shall review the reports.	A governmental unit receiving information must within 30 days determine whether further investigation is warranted.	Responsibility for investigating complaints lies with an auditor. The statute requires that the auditor examine various factors to determine whether additional investigation is warranted.	Determine whether allegations of improper activity warrant further investigation and report on the findings of such investigations.
Protection	Employees making reports in good faith are protected from retaliation.	Statute provides that employees may not be discharged or discriminated against for reporting improper government action.	Provides that employees who file a report shall be protected as required by statute.	Prohibits retaliatory action by an appointing authority or supervisor against a reporting employee.	Identity of whistleblower shall remain confidential unless whistleblower consents to disclosure.	Officers and employees acting in good faith are not subject to retaliatory dismissal, discipline or other adverse personnel action.
Safeguards	Provides three mechanisms for reporting suspected wrongdoing via a supervisor, Audit Committee or OIG.	Not included.	Notes that allegations shall be handled in a confidential manner.	Employer may take appropriate action against an employee who knowingly makes false statements.	Employees must make a reasonable attempt to ascertain the correctness of information supplied. Employees may be subject to penalties for knowingly supplying false information.	Employee that is subject to investigation notified, who then has a right to representation. Final findings reported to general counsel and director.

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COMMITTEE CHARTERS							
Issue	RSIC	Fund 1	Fund 2	Fund 5	Fund 9	Fund 10	Fund 12
Purpose and scope of authority.	Each charter specifies the authority and responsibilities of the Audit and Compensation Committees, and Internal Investment Committee.	Each charter specifies the purpose of the committee and the authority of the committee. The authority may include authorization to retain outside experts.	Each charter defines the authority of the committee and the matters for which the committee is responsible.	Fund 5 has a single policy defining the role of each committee and its reporting responsibilities. The policy restricts the power of the Board to delegate certain duties.	Each charter provides a broad statement of the purpose of the committee. With certain exceptions, the committees are restricted in their ability to act.	Each policy defines the authority and responsibility of the committee.	This section generally defines the role of the committee, who it will report to and the extent of its authority.
Composition	Defines the members and/or size of the committees. Works in conjunction with general Committees policy included in the Governance Manual.	Not addressed	The charters define the number of members on the committees. Several policies also define how members are appointed to the committee.	The policy does not define the composition of each committee. Rather, discretion is given to the Board chairman as to composition of each committee.	Not addressed	The policies provide a position description for the chair of the committee but do not otherwise discuss the makeup of the committee.	Defines the size of the committee and the qualifications of those on the committee.
Meetings	Provides how often and in what manner the committees will meet.	Not addressed	The charters provide for how often committees are to meet and whether meetings can be called at the discretion of the committee chair or the Board chair.	Not addressed	Not addressed	There is no specific requirement regarding meetings of the committees.	Provides how often and in what manner the committees shall meet.
Minutes	Requires regular reports to the Commission, but does not require the committees, particularly the IIC, to share minutes of meetings with the Commission.	Not addressed	Not addressed	Not addressed	Not addressed	Not addressed	Requires committees to keep minutes to record all actions taken.

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COMMITTEE CHARTERS							
Issue	RSIC	Fund 1	Fund 2	Fund 5	Fund 9	Fund 10	Fund 12
Responsibilities	Each charter outlines primary and detailed responsibilities of the committee.	Each charter provides the responsibilities of the respective committee, including expectations with regards to making recommendations and reports to the Board.	The charters define the specific responsibilities of each committee and note what actions the committees may take.	The policy defines the responsibilities of each committee and the areas in which the committee is to make recommendations.	The charters provide a detailed list of duties and responsibilities of each committee. The charters generally require the committees to report findings to the Board.	The policy defines the responsibilities of each committee and the areas in which the committee is to make recommendations.	The committee charters provide that the committees are to perform various roles and make various recommendations to Fund personnel.

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Appendix J Investment Manager Agreement Compliance Summary

	Fund A	Fund B	Fund C	Fund D	Fund E	Fund F
Part I: Due diligence/Required approvals						
1. Commissioner/staff sourcing disclosure forms (governed by S.C. Code § 9-16-360)	X	X	X	X	X	NA
2. RSIC staff due diligence report & recommendation	X	X	X	X	X	X
a. Required documents checklist	X	NA	NA	X	X	NA
b. New investment procedural checklist	X	NA	NA	X	X	NA
c. STO required information checklist	X	NA	NA	X	X	NA
3. Investment consultant report	X	X	X	X	X	X
4. Internal Investment Committee recommendation (IIC minutes)	X	X	X	X	X	X
5. Internal Audit & Compliance completeness review	X	NA	NA	X	X	NA
6. Certification of legal sufficiency	X	X	X	X	X	X
7. Closing certification of RSIC Counsel & compliance with 30-day Commissioner review period?	NA	NA	NA	X	X	X
8. Voucher and funding directive?	NA	NA	NA	X	X	X
9. Fully executed investment agreements (IMA/LPA/LLC Operating Agreement/Subscription Agreement/ Side letter, as applicable)?	X	X	X	X	X	X
Part II: Key Documentation						
10. Ethics/standards of conduct compliance	X	X	X	X	X	X
11. Most favored nations clause	X	X	X	X	X	X
12. Recognition of fiduciary status	X	X	X	N ^{1b}	X	X
13. Valuation policies and reporting by manager	X	X	X	X	X	NA
14. Manager to provide information such that RSIC can comply with ongoing due diligence requirements (Quarterly, Semi-annual and Annual reporting)	X	X	X	X	X	X
15. Custody of assets (identification of service provider)	X	X	NA	X	X	X

¹⁶ Not specifically addressed, but General Partner is a fiduciary under Delaware law.

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	Fund A	Fund B	Fund C	Fund D	Fund E	Fund F
16. Notice of future wrongdoing/investigations by governmental authorities/lawsuits	X	X	X	X	X	X
17. Transfers (GP will not unreasonably withhold consent to a transfer to an affiliate)	X	X	X	X	X	X
18. RSIC is subject to the SC FOIA	X	X	X	X	X	X
19. Sovereign immunity	X	X	X	X	X	X
20. Venue/jurisdiction (limited to SC)/no waiver of jury trial	X	X	X	X	X	X
21. Indemnification (limited by SC law)	X	X	X	X	X	X
22. Placement Agent Disclosure Letter compliance	X	X	X	X	X	NA
23. Web-based reporting (side letter controls to the extent web end-use agreements conflict with confidentiality)	X	NA	NA	X	X	NA
24. No political contributions	X	X	X	X	X	N ¹⁷
25. Compliance with fee reporting	X	X	X	X	X	NA
26. Compliance with anti-money laundering laws and Patriot act	X	X	X	X	X	X
27. Compliance with Sudan divestment policy (Note: SC Code § 9-16-55(A)(6) exempts certain structures, e.g., limited partnerships and commingled funds.)	NA	NA	NA	NA	NA	X
Part III: Consistency of documents with Commission approval						
28. Correct fund	X	X	X	X	X	X
29. Management fees/Carried interest	X	X	X	X	X	X
30. Distribution waterfall (Preferred return/Hurdle rate)	X	X	X	X	X	NA
31. Investment strategy/guidelines	X	X	X	X	X	X
32. Personnel (e.g., key persons)	X	X	X	X	X	X
33. Investment period	X	X	X	X	X	NA
34. Term of agreement	X	X	X	X	X	NA
35. Commitment amount not in excess of that authorized by Commission	X	X	X	X	X	NA

¹⁷ Not specifically addressed, but IMA requires Manager to comply with the Investment Advisors Act and other applicable law, and, thus is broadly covered.

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Appendix K Scope of Work

1. Governance

The review will include an evaluation for reasonableness and adequacy of RSIC's governance in terms of fiduciary and staff roles, responsibilities, policies, procedures, and statutory requirements, which will address, at a minimum, the following specific issues:

- A. Review of applicable laws, policies and procedures (to include Investment Commission governance manuals, policies and procedures)
- B. Investment Commission charter – roles and responsibilities of commissioners; identification of fiduciaries and/or the existence of “de facto” fiduciaries; fiduciary education; meeting protocols; and strategic planning and implementation process
- C. Role of the internal audit department and adequacy of audit plans
- D. Role of Audit Committee in policy compliance, and scope of Audit Committee charter
- E. Role of the Investment Commission in the annual external financial audit for the Retirement System
- F. Indemnification/use of fiduciary liability insurance
- G. Board, COO, and CIO evaluation processes and criteria, and level of delegation of authority to COO and CIO (roles and responsibilities)
- H. Investment Commission communication policy
- I. Review the investment decision-making process (Internal Investment Committee and Investment Commission)

2. Policy review and Development

The review will include an evaluation for reasonableness and adequacy of RSIC's existing policies and policy development to determine whether RSIC's policies, procedures, practices and functionalities were properly documented, implemented, and reflective of the Investment Commission's established investment goals, risk tolerances and governance. The review will address, at a minimum, the following specific issues:

- A. Ethics Policy and enforcement for identifying, disclosing, reporting, and mitigating conflicts of interest (to include, travel/gift policy, and expense reimbursement policy)
- B. Investment policy (Annual Investment Plan and Statement of Investment Objectives and Policy)
- C. Investment funding process
- D. Staff compensation policy
- E. Securities litigation policy
- F. Risk Management Policy
- G. Whistleblower Policy
- H. Procurement policy

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3. Organizational Structure

The review will include an evaluation for reasonableness and adequacy of RSIC's current organizational structure as it relates to roles of the commissioners, staff and other fiduciaries over the investments and operations of RSIC's responsibility to the Retirement System. The review also focused on ascertaining whether there is a need for clarification and/or additional specification of the respective roles and responsibilities of the Investment Commission and RSIC staff. The review will address, at a minimum, the following specific issues:

- A. Roles and responsibilities of key staff, including PEBA investment accounting relationship for the investment portfolio
- B. Staff position description review
- C. Staffing by functional area compared to peers
- D. Type, skill sets, and credentials of staff
- E. Training of staff and education policies
- F. Standard operating procedures manual
- G. Reporting lines, spans of control, and segregation of duties, including cash movement procedures
- H. Adequacy of reporting and disclosure from staff to IC and other stakeholders to facilitate oversight

4. Investment Administration

The review will include an evaluation for reasonableness and adequacy of RSIC's key investment administration functions; investment management structure; asset allocation strategy and process; due diligence, and internal controls in RSIC's investment of Retirement System funds. The review will address, at a minimum, the following specific issues:

- A. Process for setting asset allocation in light of plan liabilities and resources used; use of various asset classes, sub-asset classes, and use of alternative investments in the portfolio
- B. Implementation strategies (active versus passive, and internal versus external management)
- C. Methodology used to determine acceptable level of risk, portfolio risk and risk budgeting
- D. Process for portfolio rebalancing
- E. Due diligence process used to select investment managers, frequency and quality of manager monitoring, and investment manager contracts (general terms and conditions), to include internal controls identified as less than adequate in prior audits
- F. Investment manager contracts
- G. Investment cost management strategies
- H. Process for reviewing reasonableness of investment manager fees by asset class, individual investment, and/or peer comparisons
- I. Internal control structure for investments
- J. Use of investment consultants
- K. Investment consultant reports (usefulness, timeliness, accuracy, etc.)
- L. Process and criteria to evaluate the investment consultant's effectiveness
- M. Process to establish performance metrics, benchmarks for each asset class/style, use of peer comparisons
- N. Independence, accuracy, and usefulness of return calculations and reporting

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- O. Custodian bank contracts (service levels, fees, fiduciary provisions, etc.)
- P. Custodian bank securities lending capabilities and programs, including fee splits, adequacy of collateral in lending programs, and third party securities lending agents
- Q. Reasonableness of custodian bank fees
- R. Methods for monitoring and evaluating custodian bank services
- S. Commissioners access to information
- T. Adequacy of tools and resources, other than IT related
- U. Process used to ensure adherence to investment decision making process

5. Legal Compliance

The review will include an evaluation for reasonableness and adequacy of RSIC's legal compliance with existing laws and statutes governing the RSIC and the Retirement System. The review will address, at a minimum, the following specific issues:

- A. Use of internal legal counsel
- B. Role of legal counsel, in investment and due diligence processes
- C. Board and staff compliance with plan documents
- D. Compliance with "prohibited transactions" requirement

6. IT Systems

The review will include an evaluation for reasonableness and adequacy of RSIC's information technology systems and availability of tools and resources for RSIC commissioners, staff and fiduciaries to effectively administer the assets and funds of the Retirement System. The review will address, at a minimum, the following specific issues:

- A. Adequacy of investment, risk management, accounting and compliance systems, tools and resources
- B. Investment systems
- C. Risk management systems
- D. Accounting systems
- E. Compliance systems
- F. Other tools and resources

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Appendix L Fiduciary Audit Team

The Funston Advisory Services (FAS) team brings a combination of experience and expertise which will apply an external perspective of leading and prevailing practices and identify improvement opportunities for the RSIC.

- The team includes recognized experts in public pension governance, investments, operations and accounting.
- The legal team from Reinhart Law has applied its significant experience assisting major public pension funds in governance and fiduciary policies and issues.
- Information technology expertise was provided by Cutter Associates, a leading IT and operations consultant to asset managers.
- CEM, the pension industry standard for cost and returns benchmarking, has compared RSIC's costs and returns to their peer database to establish the best "fact set" on RSIC performance and costs.
- A custom benchmarking survey covering a range of topics was completed for this review with a peer group of all public pension investment boards in the U.S. with their own investment staff managing at least \$10 billion.

FAS has completed four similar assignments for other major public pension funds (CalPERS, Oregon Investment Council, New York State Common Retirement Fund, School Employees' Retirement System of Ohio) over the past three years and has utilized its extensive database of leading and prevailing practices in public pension fund governance, policies and operations.

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Appendix M Glossary of Terms

AC	Audit Committee
AG	Attorney General
AIP	Annual Investment Plan
BCB	Budget and Control Board
BNYM	Bank of New York Mellon
bps	Basis points
CAFR	Comprehensive Annual Financial Report
CEM	Cost Effectiveness Management Inc.
CIO	Chief Investment Officer
COO	Chief Operating Officer
FAS	Funston Advisory Services LLC
GPM	Governance Policy Manual
HEK	Hewitt EnnisKnupp
IACD	Internal Audit and Compliance Department
IIC	Internal Investment Committee
ISBI	Illinois State Board of Investment
NMERB	New Mexico Educational Retirement Board
PRIM	Massachusetts Pension Reserves Investment Mgmt. Board
OSIG	Office of the State Inspector General
PEBA	Public Employees Benefits Administration
PIC	Performance Incentive Compensation
PIO	Public Information Officer
RSIC	Retirement System Investment Commission
SBA	State Board of Administration of Florida
SBI	Minnesota State Board of Investment (SBI)
SIOF	Statement of Investment Objectives and Policies
STO	State Treasurer's Office
SWIB	State of Wisconsin Investment Board
WSIB	Washington State Investment Board
WVMB	West Virginia Investment Management Board

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Appendix N Response from Retirement System Investment Commission



April 11, 2014

**Mr. Patrick J. Maley, Inspector General
South Carolina Office of the Inspector General
111 Executive Center Drive, Suite 204
Columbia, SC 29210**

**Re: Fiduciary Performance Audit of the South Carolina Retirement System
Investment Commission (Funston Advisory Services, LLC)**

Dear Mr. Maley:

We commend the Office of the Inspector General (“OIG”) for the professionalism, civility and efficiency with which OIG and Funston Advisory Services, LLC (“FAS”) have conducted this fiduciary performance audit. The OIG and FAS have done an admirable job of quickly grasping a great deal of complicated investment, legal and other information. They showed respect and courtesy towards the members of the Commission and Retirement System Investment Commission (“RSIC”) staff during this entire process. We are deeply appreciative of your efforts, and think OIG and FAS have provided a thoughtful road map for how we may all “move forward.”

We believe that this report reemphasizes to our stakeholders both the importance of the work that the Commission does and the dedication with which the Commission and its professional staff carry out their responsibilities to the SCRS trust funds.

We are pleased that yet another independent expert has determined that no indicators of malfeasance or misfeasance exist with regard to the Commission’s current policies and practices. We also are very gratified with the finding by FAS that, “Investment fee transparency, policies and controls have improved significantly; disclosure of total external management fees is the most complete in the industry.” We trust that the record on these two matters is now clear and final.

FAS’ report also serves as yet another reminder that the working relationship between RSIC and STO must improve. We reiterate our commitment and willingness to tackle this issue. We hope that the Treasurer and staff of the STO will join us in this effort.

We appreciate the observations and recommendations made by FAS regarding areas for potential improvement. Like others before it -- the OIG in 2013 and the Senate Finance Committee’s

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Special Subcommittee to Review the Investment of State Retirement Funds on April 1, 2014 -- FAS noted that "RSIC has already implemented many improvement initiatives over the past two years" and listed 13 examples of such initiatives in its Executive Summary. The Commission values this acknowledgment by an independent industry expert of the significant progress that we have made in recent years regarding processes and procedures, including the documentation of due diligence and validation of fees. We realize that further improvements and enhancements need to be made.

It is also important for us to provide all stakeholders of the South Carolina Retirement System trust funds with RSIC management's candid perspective on some of the challenges that must be faced along the way. Full implementation of the recommendations made by FAS will only be possible if there is both a significant commitment of time and resources by the Commissioners and RSIC staff, and a similarly significant commitment on the part of the Legislative and Executive Branches. There are a number of recommendations made by FAS which the Commission is able to – and will – address with existing delegations of authority and resources. There are, however, a good number of instances where the Legislative and Executive Branches alone hold the power to implement FAS' recommended solutions by changing existing delegations of authority and/or permitting the expenditure of additional trust funds by the Commission.

The FAS report serves as a useful reminder that the Commission is still a young, evolving organization in a very dynamic, ever-changing business. As such, we intend to continue to review important operational aspects of our business and seek worthwhile process improvements. Indeed, the Commission has created an Ad Hoc Planning Committee whose charge includes a review of FAS' recommendations. The Planning Committee has already held an initial meeting and will continue to work with RSIC senior management to review, prioritize and implement recommendations made by FAS along with other strategic initiatives determined by the Commission.

On behalf of the entire Commission and its staff, please accept our thanks for a job well done.

Sincerely,



W. Greg Ryberg
Chief Operating Officer



Hershel Harper, Jr., CFA
Chief Investment Officer

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Appendix O Responses from State Treasurer's Office

At the request of the Treasurer's Office we are also including STO response from March 10 to the March 3, 2014 Status Report as well as the response to the Draft Final Report.

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THE HONORABLE CURTIS M. LOFTIS, JR.
State Treasurer

March 18, 2014

Mr. Rick Funston
Managing Partner
Funston Advisory Services LLC
591 Rudgate Road
Bloomfield Hills, MI 48304

Dear Mr. Funston:

This letter is in response to the request for an opinion of the State Treasurer's Office (STO) regarding the March 3, 2014 draft of the "Fiduciary Performance Audit of the South Carolina Retirement System Investment Commission." The fiduciary audit of the Retirement System Investment Commission (RSIC) is being conducted by Funston Advisory Services, LLC, pursuant to State law.

STO renders its opinion based on specific factors and related laws and statutes. The following factors should also serve as the foundation of the recommendations of the fiduciary audit. RSIC is responsible for investment decisions affecting the South Carolina Retirement Systems (SCRS), which include five defined benefit public pension plans. In addition to RSIC and its Chief Investment Officer, the fiduciaries to SCRS and its plan participants and beneficiaries are the State Treasurer, the Budget and Control Board, and the Public Employee Benefit Authority.

By law, the State Treasurer is a fiduciary to SCRS in three roles: as statutory custodian of all of SCRS' funds, as a voting member of RSIC, and as a voting member of the Budget and Control Board.¹ The STO has focused its review of the "Fiduciary Performance Audit of the South Carolina Retirement System Investment Commission" primarily on the portions of the draft report that address the three fiduciary roles that the State Treasurer has regarding SCRS.

¹ The State Treasurer has a unique role regarding the SCRS. First, the State Treasurer serves as custodian of the funds in the SCRS. S.C. Code Ann. §9-1-1320. In this role, he serves as an "other fiduciary" with respect to the SCRS pursuant to S.C. Code Ann. §9-16-40. Op. Att'y Gen, p. 12 (Nov. 16, 2011). Second, the State Treasurer serves ex-officio as a member of the seven-member RSIC and is therefore a fiduciary to SCRS. S.C. Code Ann. §9-16-315(A)(2). The RSIC is responsible for investing the assets of the SCRS, hiring staff, and establishing investment objectives. See S. C. Code Ann. §§ 9-16-50, 9-16-315(G), 9-16-330(A). As a member of the RSIC, the State Treasurer is also a fiduciary. S.C. Code Ann. § 9-16-10(4)(c). Third, the State Treasurer serves as a member of the Budget and Control Board which is a trustee of SCRS.

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STO asks that the following amendments be made to the March 3, 2014 draft report before it is issued in its final form. Many of these items in this memo were shared during the interview Funston conducted with two STO staff. Amendments are listed below. Detailed notes clarifying each amendment follow the list.

STO recommends the following revisions or additions:

1. Funston should either remove references to the Treasurer's "conflicting fiduciary duties" or make a clear finding of such a conflict, providing a full and detailed explanation of any named conflict.
2. Funston should not recommend that RSIC or PEBA be named custodian or be named in charge of the custodial activities. Naming RSIC or PEBA as custodian or head of custodial activities violates the integrity of the control environment by creating a lack of segregation of duties. Alternatively, if Funston does not alter its draft recommendations on custodial activities, it should choose to add a fifth alternative under which the STO remains the statutory custodian of SCRS' funds.
3. Funston should not recommend that RSIC or PEBA take over custodial duties because recommending such a change in the fiduciary structure violates the principles of segregation of duties and greatly increases the risk to the State, its taxpayers who may be called upon to make up for any shortfall or losses, and the plan's participants and beneficiaries.
4. Funston should name which entity holds responsibility for investment valuations or clarify if and where any joint responsibility exists. Funston should also specify to the type of audit to which it is referring.
5. Funston's report should clearly state that RSIC directly caused much of the lack of trust and confidence between STO and RSIC because the RSIC refused, and in some cases, continues to refuse, access to information required by the STO. Such trust and confidence can be rebuilt only when RSIC has consistently demonstrated that it has reversed course from the causes of the lack of trust and confidence.
6. Funston should not recommend that RSIC should be exempted from procurement and budgetary restraints, given that the fund oversight is critical and that RSIC lacks investment "back office" professionals with procurement experience in specialized systems.
7. Funston should revise page 68. "RSIC indicates that negotiations for the new BNYM custody agreement did not meet its needs and because of dissatisfaction with the contracting process, RSIC was forced to issue an RFP". RSIC and PEBA were both involved in the drafting of STO's RFP for custodial and securities lending services, which outlined services and needs for all parties.

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8. Funston should revise pages 69 and 71 based on detailed notes on pages 10 and 11. Improved communication and proper sharing of information, make options 1-4 unnecessary and in compliance with existing law and proper separation of duties.
9. The report should reflect that, outside of daily work processing, RSIC has been unresponsive to BNYM. In addition, with respect to the statement, "BNYM will not take corrections of BNYM records from statement directly from PEBA. Corrections must be sent to RSIC to forward onto BNYM."
10. Funston should clarify the roles regarding securities lending. State law does not give RSIC the authority to enter into Securities Lending Agreements².
11. Funston should amend the statement, "The initial direction was to rapidly diversify what had been a traditional stocks and bonds portfolio to improve long-term returns," as it does not reflect the fact that a legislative mandate to rapidly diversify without proper "back office" operations never existed.
12. Funston should amend the statement, "RSIC lacks automated systems in a number of key areas" to reflect the fact that RSIC has had numerous opportunities and resources to secure automated systems and has failed to do so. Funston should also amend, "The RSIC custodial relationship with the Treasurer and BNYM is cumbersome, strained..."; as the statement above does not include efforts by both STO and BNYM to accommodate RSIC. In addition, Funston should add "the deliberate decision to not make use of available funds when critical services were needed should be added to the report".
13. Funston should remove the statement(s) 3.2, "whereas overall, STO is hindering the operations of RSIC," as it is false and offers no proof of hindrance. The report should be corrected as the signature process has not resulted in the loss of interest earnings. Funston should clearly state that signed fax directives are a requirement of BNYM (not STO) and should be noted in the report.
14. The STO is concerned about the reasonableness of the peer size mentioned in the report. In order to appropriately comment, the STO had hoped to respond based on a review of the CEM report. On March 3, 2014, the STO requested Funston provide the report. Funston agreed to provide the CEM report, but stated it is still being reviewed and is not ready for distribution. The STO stands ready to provide a response as soon as the CEM is received. Sampling of peers is not the optimal way to determine best practices. Many

² "It is important to note that S.C. Code Ann. § 11-9-660(B) expressly grants the State Treasurer (and ONLY the State Treasurer) authority to "contract to lend securities invested pursuant to this section" which covers "all funds of the State." See also S.C. Code Ann. § 9-1-1320 which makes the State Treasurer custodian of the funds in the SCRS. State law does not grant RSIC any authority to enter into securities lending arrangements."

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plans “evolved” to their present structure and would no doubt be organized differently if allowed.

15. The STO has questions regarding the manager fees mentioned in the report. In order to appropriately comment, the STO had hoped to respond based on a review of the CEM report. On March 3, 2014, the STO requested Funston provide the report. Funston agreed to provide the CEM report, but stated it is still being reviewed and is not ready for distribution. The STO stands ready to provide a response as soon as the CEM is received.
16. Funston should include specific implementation dates in the report as they are an important part of accurately reflecting when changes or improvements take place.

Detailed notes explicating above amendments are as follows:

1. Preliminary Overall Recommendations, Conflicting Fiduciary Duties, page 26

Under the recommendation to “[a]lign fiduciary duties and responsibilities,” Funston notes, “The Legislature should resolve the Treasurer’s conflicting fiduciary duties.” Funston has not provided evidence to conclude that the State Treasurer’s fiduciary duties conflict, how they conflict, or to what extent they conflict. Funston should either remove references to the Treasurer’s “conflicting fiduciary duties” or make a clear finding of such a conflict and provide a full explanation of any such conflict. Proper segregation of duties entails separating the following three functions: authorizing investments and cash disbursements (performed by RSIC and to some degree PEBA), performing the accounting for SCRS (done by PEBA), and having custody of the assets of SCRS (done by STO). The Treasurer’s fiduciary duties are entrusted to him as an elected representative of the people, including retirees. This representation explains his triple fiduciary responsibilities. The people’s presence, in the person of the State Treasurer, creates no conflict.

2. Preliminary Overall Recommendations, Improving the Custodian Relationships, page 27

Funston provides four alternatives “to improve the RSIC relationship with the custodial bank which are based on peer investment board policies and procedures.” STO has several comments about this recommendation.

- a. The main goal should not be “to improve RSIC’s relationship.” The goal should be to achieve what is best for the plan’s participants and beneficiaries by improving the overall control environment surrounding SCRS. Having STO as the custodian of SCRS’ assets provides a needed control by ensuring proper segregation of duties.

RSIC is an important part of SCRS because sound investment decisions are crucial, but RSIC is only one part of SCRS. Making RSIC operations easier is a

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valid goal, but ease of operations should not deter the implementation of good segregation of duties in functions that require the highest level of proper oversight and regulation. Again, proper segregation of duties divides the following three functions: authorizing investments and cash disbursements (performed by RSIC and to some degree PEBA), performing the accounting for SCRS (done by PEBA), and having custody of the assets of SCRS (done by STO) is critical.

The SEC has recognized the increased risk incurred when an investment adviser (e.g., RSIC) also has custody of the assets that it manages. In response to such frauds perpetrated by Madoff and others, the SEC extended rules related to the Investment Advisers Act of 1940 to impose additional controls on investment advisers who also have custody of clients' assets. Here, custody includes anyone who has control of the assets or can authorize that the assets be disbursed or otherwise transferred to another. Therefore, if RSIC is given custody, as more than one of the recommendations states, the assets of the SCRS would be in a position of high risk, as recognized by the SEC, because its investment adviser would also have custody of its assets. Therefore, RSIC should not have custody of SCRS' assets because it also authorizes SCRS' investment transactions.

Even though the SEC imposed additional controls on private investment advisers, those controls do not prevent fraud from occurring and are not applicable to public pension plans. STO believes that the control environment for a public pension plan should be even stronger than the controls the SEC has imposed on private investment advisers and accordingly, that SCRS should have a separate custodian.

Under each of the four alternatives, either RSIC or PEBA would be the custodian or be in charge of custodial activities. STO does not believe a recommendation that RSIC or PEBA be the custodian or in charge of the custodial activities is prudent because this actually harms the control environment by creating a lack of segregation of duties. Should the four alternatives remain as recommendations, a fifth alternative should be included whereby the STO remains the statutory custodian of SCRS' funds.

It is indisputable that the involvement of the State Treasurer, and STO as a whole, serving as a custodian of SCRS' assets and as a member of RSIC has resulted in RSIC making many needed and significant improvements to its operations and control environment. With this level of success, it is unconscionable to remove the State Treasurer as custodian of SCRS funds.

- b. STO believes that the alternatives should not be selected merely because another public pension plan operates in a certain manner. Just because another public pension is working with a custodial bank in a certain manner does not mean that the practice provides the proper level of safekeeping of pension assets or proper segregation of duties.

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- c. In addition to segregation of duties problem, Alternative # 1 is flawed because it suggests that STO, who is the statutory custodian, should abdicate all of its custodial responsibilities and give all of its custodial responsibility to RSIC. First, this is not the will of the General Assembly pursuant to Section 9-1-1320. Second, as a fiduciary, STO cannot abdicate its responsibilities.
- d. In addition to being obstacles to the segregation of duties, Alternatives # 2 and 3 are flawed because they suggest that the General Assembly shall give all custodial responsibilities to RSIC but make STO or PEBA the custodian of record. STO believes that appointing STO or PEBA as custodian of record while allowing RSIC to contract with its own custodial bank and manage its own custodial banking relationship provides no benefit or protection to SCRS or its plan participants or beneficiaries and misrepresents the custodial relationship.
- e. Alternative # 4 is flawed because it clearly violates the principles of segregation of duties. Here, RSIC would authorize investment transactions while also maintaining custody of the SCRS' assets. A person or entity serving in both capacities creates high risk. The participants and beneficiaries of a public pension plan deserve a better internal control environment.

The STO is dedicated to creating a seamless custodial relationship with RSIC and PEBA, while also ensuring that proper controls are in place to protect the assets of SCRS. The STO has recently hired a full time, well qualified individual to serve as its Custody Officer. The Custody Officer will act as the STO's liaison to the custodial bank in order to ensure that RSIC, PEBA, and STO are provided the quality of services. The Custody Officer's duties include, but are not limited to, developing and maintaining effective relationships with all internal and external stakeholders, with focused coordination of functions among the State Treasurer, RSIC, PEBA, and the custodial bank; overseeing service provider relationships and holding service providers accountable for agreed upon service levels; and ensuring that proper internal controls are created and maintained and that all applicable parties comply with applicable state and federal regulations and contractual obligations. The addition of a Custody Officer further demonstrates the STO's commitment to improve the custodial relationship for RSIC, PEBA, and STO.

3. Fiduciary Duties and Authorities, Conflicting Fiduciary Duties, pages 58-60, and 63

STO disagrees with the Funston conclusion that the "existing fiduciary structure is unduly complex and misaligned in regard to the roles, responsibilities and authorities of the various fiduciaries." Any perceived problems with the fiduciary structure were caused by RSIC's failure, and continued failure, to share information with a co-fiduciary and RSIC's failure to make needed improvements to its operational controls in a timely manner. Again, if the State Treasurer had not asked tough questions and dutifully continued to seek necessary information, RSIC would not have made the significant and overdue recent improvements that Funston has noted during the audit. These questions

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and requests are being transformed into an allegation of problems with the fiduciary structure, when in fact the current fiduciary structure allowed – and demanded – that the State Treasurer ask these questions and request certain information.

Additionally, Funston has concluded that the State Treasurer has conflicting fiduciary roles. This is a false assumption. First, the State Treasurer is a fiduciary in three roles. In two of those roles – a member of RSIC and a member of the Budget & Control Board – he is one of numerous voting members. He has no control over these two fiduciary boards and possesses only one vote on each board. Such an arrangement does not create a conflict among his fiduciary roles. In fact, his overall perspective of SCRS by looking at it from three different perspectives makes him more valuable to SCRS and its plan participants and beneficiaries. Most importantly, he is the people’s elected representation in these positions.

Finally, changing the fiduciary structure by giving RSIC or PEBA custodial duties violates the principles of segregation of duties and greatly increases the risk to the State, and its taxpayers who may be forced to make up any shortfall or losses and the plan’s participants and beneficiaries.

4. Preliminary Overall Recommendations, Investment Valuations, page 24

Funston recommends that the “Commission should have an annual external audit of fund valuations” Funston should clarify this recommendation. An external auditor already performs an annual financial audit of SCRS, which includes investment valuations. Although STO has expressed concerns about these valuations, and continues to have questions of whether “management” has complied with its responsibilities regarding these investment valuations, STO believes that Funston should make clear whether it is referencing this financial audit or some other type of audit. If Funston is referencing some other type of audit, please specify.

Also there is a conflict about who should take responsibility for the investment valuations. Funston’s draft report implies that RSIC has responsibility for investment valuations because Funston has recommended that RSIC should have an audit of valuations. RSIC’s responsibility of investment valuations was also noted by Deloitte in one of its reports to RSIC. However, PEBA has taken the role of “management” of SCRS and, therefore, has taken responsibility for SCRS’ financial statements, which includes investment valuations. The STO believes that PEBA has taken this responsibility for the financial statements without proper attestations by RSIC leadership that the financial and investment information conveyed to PEBA is “full and complete”. Funston should make clear which entity has responsibility for investment valuations or if joint responsibility exists.

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5. Improving Assurance & Independent Reassurance to Build Trust and Confidence, pages 29-39 and 81

Funston concludes that “[t]o be successful, the executives and staff need the trust and support of the fiduciaries, the beneficiaries and other key stakeholders.” This is an admirable goal, but the report does not clearly state the behaviors that led to the lack of trust and confidence in RSIC that certain fiduciaries have experienced. Funston’s report should clearly state that RSIC directly caused much of the lack of trust and confidence between STO and RSIC and that such trust and confidence can be rebuilt only when RSIC has consistently demonstrated that it has reversed course from the causes of the lack of trust and confidence and provides requested information in a timely manner.

First, until September 10, 2013, RSIC improperly imposed a cloak of secrecy on its activities by preventing the State Treasurer or the State Treasurer’s Office staff from seeing various investment-related information. RSIC often refused to provide requested information to STO staff. Finally, the Inspector General apparently convinced RSIC that its policy of secrecy was wrong. Shortly after the Inspector General’s July 2013 report found that RSIC was, “inappropriately restricting information access to the STO”. It wasn’t until September 10, 2012, RSIC finally allowed certain members of STO’s staff to have access to documents. RSIC’s cloak of secrecy was the major cause of any lack of trust and confidence that exists between STO and RSIC. Second, RSIC has known since about 2007 that it needed to implement many necessary internal controls, yet it failed to do so. STO does not believe that it is a coincidence that RSIC began to make some of the necessary improvements to its operations and controls only after the current State Treasurer took office in 2011 and began to ask critical questions. These questions and his requests were often met with resistance by RSIC. Nevertheless, overdue improvements were finally made in specific important areas. RSIC’s failure to provide documents in a timely manner, its failure to make necessary improvements to its systems that manage and monitor investments, and its negative response to the State Treasurer’s questions and requests were major causes of any lack of trust and confidence. Even now, RSIC continues to deny the State Treasurer information, such as the standard and ordinary monthly reports from Russell, the Risk reports from Goldman Sachs, etc. The continued refusal to provide information should be noted in the report.

The South Carolina Attorney General stated in an April 12, 2012 opinion that co-fiduciaries have a duty to share information with each other and to keep each other fully informed. RSIC’s failure to do so spurred a lack of trust and confidence. The process will take time, but as RSIC shares information with STO and continues the process of implementing necessary operational controls, trust and confidence will be restored.

6. Building Capabilities, Infrastructure planning, pages 24, 26, 40 – 42 and 54

RSIC should not be exempted from procurement and budgetary requirements.

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All expenditures by RSIC come out of the SCRS Trust and therefore reduce funds available to pay beneficiaries and ultimately increase the unfunded liability. The procurement code of the State is structured to instill transparency and accountability to the spending of public funds, as is appropriate with trust funds.

RSIC is already exempt from portions of the S.C. procurement code when engaging investment managers through the exemption provided by the Budget and Control Board related to the hiring of investment managers.

RSIC had the ability to hire staff and purchase systems but chose not to use available resources. RSIC has a five or more year history of not using its full annual appropriation by an average of approximately \$1,000,000 per year. Legislative approval played no part in the shortfall of staffing or insufficient systems. The deliberate decision not to make use of available funds when services and staffing were crucial is a critical issue and should be added to the report. Additionally, services RSIC expressed interest in are readily available through the custodial bank agreement without procurement delays. RSIC instead has chosen to take a delayed approach for important services by issuing an RFP, and the results of the RFP may lack the synergistic effect that would occur if the same or similar tools were purchased from the custodial bank. PEBA (formally under the B&CB) has successfully managed with the same legislative budget oversight for years.

7. Conclusions on the RSIC custodial relationship with the Treasurer and BNYM, Primarily due to dissatisfaction with the contracting process and the lack of responsiveness to RSIC's needs, RSIC has issued an Administrator RFP, page 68

RSIC is incorrect in stating the agreement did not meet its needs. RSIC and PEBA named representatives to serve on the procurement advisory panel. In fact, after the panel was set, RSIC's CIO, Hershel Harper, asked also to be included on the panel, and STO agreed. Representatives from RSIC and PEBA who served on the procurement advisory panel participated in the "Request for Proposal," "Reviewing of Proposal Responses," "Selection of Firms for Site Visits," "Site Visits," and the "Scoring of Selected Firms." RSIC and PEBA were both involved in the drafting of STO's RFP for custodial and securities lending services which outlined services and needs for all parties. RSIC and PEBA representatives served on the procurement advisory panel and both had access to all of the bank's responses to the STO's RFP. Clearly, both RSIC and PEBA were deeply involved in the choice of a custodial bank as well as services needed. In the summer of 2012, the procurement advisory panel recommended that STO retain the BNY as the State's custodial bank.

Throughout the negotiating process, the STO contacted RSIC attorneys for specific items and corresponding language in the agreement. The custodian agreement was finalized and signed December 30, 2013. Communication with RSIC was inclusive during the entire BNYM agreement negotiation process.

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The report states that because of dissatisfaction with the contracting process, RSIC was forced to issue an RFP. This statement is incorrect as RSIC chose to ignore available funds for over five years that should have been used to implement critical services. In September/October 2013, two years after the STO issued an RFP for custodial services, RSIC created a RFP for an Administrator. The Administrator RFP was published during the same time period the custodian agreement was finalized, but years after RSIC could have taken action. The contracting process had nothing to do with services RSIC neglected to seek, leaving the system at risk for many, many years.

The report states there is an “absence of a service level agreement or a defined process to manage the relationship between BNYM and RSIC”. The STO has recently hired a Custody Officer that will serve as the STO’s liaison between RSIC, PEBA to ensure BNYM continues to provide quality services dictated in the custody agreement. Performance evaluation is the responsibility of the RSIC. There is nothing contractually or by way of policy of the STO that would preclude the RSIC from initiating/requesting such governance tools. The Custody Officer, however, will seek input from the STO, PEBA and RSIC regarding performance as it relates to service levels in the custody agreement.

The report should be amended to accurately reflect that the agreement included RSIC’s requested needs and services, as well as inclusion of the custody agreement negotiations when necessary.

8. Treasurer’s Role as Custodian, pages 69-71

First, the State Treasurer serves as custodian of the funds of the Retirement System. See S.C. Code Ann. §9-16-1320 (“The Treasurer shall be custodian of the funds of the System {i.e., the Retirements System}”).... Second, State law provides that “[a]ll payments from such funds shall be made by him [i.e., the State Treasurer] only upon vouchers signed by two persons designated by the Board”).

“Authorizations” are clear, and the processes are consistent. STO’s recently hired Custody Officer is addressing this review of authorization signers. In addition, the Custody Officer will be working with BNYM on a best practice review. Account level, transaction items, letters of direction, access to data, etc. are also being reviewed. The Custody Officer will act as STO’s liaison to the custodial bank in order to ensure that RSIC, PEBA, and STO are provided the quality of services as dictated in the custody agreement. One of the focuses will be the coordination of functions among the State Treasurer, RSIC, PEBA, and the custodial bank; overseeing service provider relationships and holding BNYM accountable for agreed upon service levels; and ensuring that proper internal controls are created and maintained and that all applicable parties comply with applicable state and federal regulations and contractual obligations.

The report notes signature approval process requirements to instruct the custodial bank to execute transactions. The request to execute transactions requires two signatures from

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RSIC (not four). Funston should know that in 2007, the then State Treasurer abdicated his fiduciary responsibility as custodian by allowing RSIC to deal directly with the custodial bank. In 2012, the current State Treasurer as a fiduciary and elected representative of the people, wanted to have more knowledge of the transactions going through the custodial account. The State Treasurer merely sought to have RSIC send its instructions to execute transactions to STO before the instructions went to the custodial bank. The change in 2012, added internal controls whereby the STO reviewed the instructions and then directed the custodial bank to execute the transactions. This was a major step in allowing the State Treasurer to fulfill his fiduciary duties to preserve the trust and to safeguard SCRS' assets.

The report states "electronic signatures are not permitted" with respect to the BNYM at this time. While BNYM currently does not permit electronic signatures, the State Treasurer's Office Custody Officer will be reviewing procedures/processes that are currently in place while ensuring that internal controls and compliance are adhered to. Every opportunity to improve efficiencies will be reviewed. Again, open communication and contribution from both RSIC and PEBA are imperative to a successful relationship. Improved communication and proper sharing of information makes options 1 – 4 unnecessary and is in compliance with existing law and proper separation of duties.

9. Custodial relationship "strained", page 70 and 122

The report should reflect that outside of daily work processing, RSIC has been unresponsive to BNYM. If RSIC would engage in dialogue with BNYM, the "strained" relationship could be remedied. Example: The new Relationship Executive has made multiple attempts to meet with the RSIC since November. To date, the RSIC has not agreed to such a meeting.

STO is not aware of the relationship between PEBA and BNYM as being "difficult" nor has STO put constraints on PEBA. PEBA works virtually every day with BNYM. By all known accounts, it is the opposite of difficult. Again, both RSIC and PEBA representatives participated on the procurement advisory panel that supported retaining BNYM as the State's custodial bank.

Both PEBA and RSIC representatives also had full access to the BNYM's responses and to the BNYM's staff during visits in Columbia, New York, and Boston. With respect to the statement, "BNYM will not take corrections of BNYM records from statement directly from PEBA. Corrections must be sent to RSIC to forward on to BNYM." Please refer to the previous statement in #3. Remember that changing the fiduciary structure by giving RSIC or PEBA custodial duties violates the principles of segregation of duties and greatly increases the risk to the State, its taxpayers who may be forced to make up any shortfall or losses, and the plan's participants and beneficiaries.

The STO cannot enforce "happiness" concerning RSIC and the custody arrangements with BNYM. However, the STO can and does require that the important business of safekeeping the assets is professional, prudent and efficient.

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10. Securities Lending, pages 123 - 124

The report states “In the credit market collapse of 2008-09, many state pension funds incurred lending losses. In South Carolina, such losses resulted in the STO filing a complaint in state court asserting claims against BNYM relating to the Securities Lending Agreement, dated March 24, 2000, and BNYM’s actions relating to funds in the Treasurer’s Collateral Reinvestment Account.” Significantly, the South Carolina Attorney General became a party plaintiff in the litigation representing the interests of the State and actively pursued the litigation as the Chief Legal Officer of the State. On the other hand, RSIC knowingly and willfully declined to be a party plaintiff in the litigation.

Despite RSIC’s unwillingness to join the litigation in name, RSIC was kept abreast of the litigation and the ensuing settlement negotiations from the outset, as evidenced by the ongoing efforts of STO’s legal team, as well as RSIC’s legal team, specifically, Ms. Dori Ditty and Mr. Robert Feinstein of RSIC. Both continually assisted the STO’s office throughout all depositions, negotiations, and litigations. In fact, Ms. Ditty was at every scheduled meeting regarding the litigation between the state and BNYM and played a critical role over the last 1.5 years. As the attorneys for RSIC were at every meeting, Funston should remove these statements.

RSIC has not sought approval to widen collateral reinvestment guidelines. In fact, Hershel Harper, RSIC’s CIO, has been expressing doubt as to whether RSIC should engage in securities lending at all, as noted in the minutes of the Investment Commission’s meetings. The STO has not been unresponsive, and the report should be corrected.

STO considers the establishment of collateral reinvestment guidelines to be an investment decision that is RSIC’s alone to make. Securities Lending is an investment decision. If at any time, STO receives a request from RSIC to change the collateral reinvestment guidelines, including under the new securities lending contract being finalized now, STO would review the request and work with the custodial bank to effectuate RSIC’s investment decision.

“RSIC has not been a party to those negotiations.” The securities lending contract with BNYM is in its final negotiating stages. First, RSIC is not a party to the current or proposed securities lending contract because it is not authorized to be a party under State law. Section 11-9-660(B) expressly grants the State Treasurer (and ONLY the State Treasurer) authority to “contract to lend securities invested pursuant to this section” which covers “all funds of the State.” The State law does not give RSIC the authority to enter into securities arrangement. STO is merely negotiating a contract based on terms and information from its RFP and BNYM’s responses. As stated in #7, RSIC personnel participated in the procurement advisory panel, had input into the development of the RFP, noted services necessary to be included in the RFP, selection of firms, site visits, etc.

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The contents of the contract will not be materially different from the terms and information that RSIC has had access to since approximately 2000. BNYM has been and will continue to be in dialogue with both RSIC and STO regarding the future directions of the lending program.

The STO considers the recent disinformation disseminated by the RSIC concerning the BNYM settlement a breach of RSIC fiduciary responsibilities and evidence of why the STO should remain custodians of the funds.

11. Rapid Diversification, page 11-12

The report notes “rapid diversification” but does not mention the decision to deliberately neglect the office operations, putting its entire system at risk. There was never a legislative mandate to rapidly diversify without proper “back office” operations and this information should be added to the report. Diversification, along with the exercise of other fiduciary duties such as managing risk and income, the delegation of duties and the duty to monitor, etc., by the Commission, were to be exercised in a prudent fashion. The term “rapidly” (or any other synonym) was never used. The language used in the statute concerning diversification is “cut and paste” from the Uniform Prudent Investor Act, and is in multiple state statutes.

The desire to rapidly diversify occurred in connection with adoption of Act 153 of 2005. The asset allocation mandate was approved in December 2006, reducing the Portfolio's long-only US equity exposure. The intention was to decrease the number of and/or reduce the allocation to long-only US equity managers and reallocate those assets to other investment alternatives.

In 2007 and into 2008, at the time the portfolio was being rapidly transitioned to broader asset classes, the STO was concerned that Commission resources were not sufficient to adequately manage the risks of a dramatically more sophisticated portfolio. Significant reliance was placed on NEPC, the investment consultant, which described its role as investment policy development and review; portfolio structure development; asset allocation review; service provider searches; investment manager due diligence, and monthly and quarterly investment performance analysis. Internal controls were at best compromised, if not deficient, during this phase of RSIC's history and have continued to be compromised until very recently. Audit and compliance functions were not established or well-developed.

Under the administrations of Treasurers Ravenel and Chellis, the STO expressed concerns about the pace of diversification, absence of documented plans of due diligence, risk implications of derivatives and alternative investments in the absence of a developed RSIC staff, and key man risk. These concerns were largely ignored by RSIC, and the Treasurers did not perform the necessary follow-up.

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The provisions of the Act addressing diversification remained relatively unchanged from prior enactments – a directive to diversify the investments of the retirement system unless a reasonable determination, because of special circumstances, is made that it is clearly prudent not to do so. NEPC’s letter dated November 7, 2007 and included in the 2007 Annual Investment Report stated that “in order to achieve a more timely and efficient allocation across newly-approved asset classes, the Commission employed, at NEPC’s recommendation, a beta overlay manager.” This allowed the Commission to quickly implement portions of the newly approved asset allocation with the Russell Overlay Program.

Accordingly, the Commission appeared to be following guidance of the CIO through the AIP process, developed at least in part in reliance on advice of the investment consultant, rather than express legislative intent. We believe that this distinction is important.

The decision to rapidly diversify did not need to be implemented immediately as the Portfolio’s exposure to long-only US equity may be synthetically reallocated to new asset classes until such time as new managers are identified with the use of Russell “Overlay Program. Funston should remove the statement, “The initial direction was to rapidly diversify what had been a traditional stocks and bonds portfolio to improve long-term returns,” as it is false.

Unquestionably, a number of factors contributed to the decline in the funded ratio, and this phenomenon has been of particular significance to the Office of State Treasurer since it has potential implications on the State’s AAA credit rating. Throughout the last decade, the funded ratio has declined continuously, prompting inclusion of that fact in all of the State’s rating reports, and particularly by comparison to its AAA rated peers.

Act 278 enacted a number of pension reforms to promote stability to the retirement systems funds. The rating services continue to express interest in the progress of these reforms, improvement in the funded status, and the concentration of the portfolio in alternative investments, which has been described recently by one analyst as “quite high.”

RSIC has changed the definition of alternative investment, and this unique definition has “reduced significantly” the amount of investment considered to be alternative.

12. Infrastructure and Custodian, page 43, 64 and 70

The report states RSIC lacks automated systems in a number of key areas. RSIC has had ample opportunities to research and implement systems in all areas. Again, RSIC has a long history of not using its full annual appropriation by an average of approximately \$1,000,000 per year. The deliberate decision to not make use of available funds when critical services were needed should be added to the report.

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The report states QED is out of date. The report should add that neither PEBA nor RSIC have ever expressed dissatisfaction with QED to the STO. The annual contract, in which all three organizations participate, was recently renewed. The STO will coordinate with PEBA and RSIC to determine what needs or improvements can be implemented. The report should be corrected as it incorrectly states "QED is provided by BNYM". QED is a stand-alone system and under a separate contract. It is neither associated with, nor provided by, the BNYM. Funston should remove or revise this statement.

The report states, "The RSIC custodial relationship with the Treasurer and BNYM is cumbersome, strained and inefficient, and has caused the RSIC to look elsewhere for related services". This is not an accurate assessment of the relationship and evidenced by the record.

BNYM has made available to RSIC automated products such as "Private i" providing much needed look-through capabilities and many others. RSIC, until recently, repeatedly expressed interest in Private i, and other services. It important to note, services included in the agreement were based on input from RSIC during the RFP and site visit process. The services RSIC expressed interest in are readily available through the BNYM agreement without need of an RFP processed should be noted in the Funston report.

More importantly, RSIC waited for years, disregarding the recommendations of consultants and external auditors, before determining critical services were needed and just recently started looking elsewhere for services. RSIC is doing so to distance themselves from the Treasurer's dealings with BNYM. RSIC's desire to be its own custodian and thereby shedding prudent safeguards consistent with the STO as statutory custodian, is the primary reason for RSIC distance themselves from the Treasurer's dealings with BNYM.

The report also states BNYM has not responded to the need for additional services. BNYM senior management has reached out to RSIC senior management on multiple occasions; however RSIC has not responded. BNYM works with both PEBA and RSIC on virtually a daily basis. Neither BNYM nor STO is aware of any frustration for additional services by RSIC and would welcome the opportunity to clarify any misunderstandings. Funston should rephrase or eliminate this statement.

Funston should also reword the statement, "RSIC lacks automated systems in a number of key areas" to include RSIC's inability or unwillingness to procure by choice.

13. Hindering Operations and Signature, page 101

STO has never intentionally hindered operations, refused to move money, or restricted any authorization signatures or their levels. The STO only requires two signatures from RSIC, a practice consistent with the movement of money by many investment managers.

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The STO is unaware of any loss of RSIC interest earnings. This was discussed at an Investment Commission meeting and it was noted that at no time has the signature protocol ever caused a failure in processing. The report should be corrected as the process has not resulted in the loss of interest earnings.

The STO is unaware of any requested changes to authorization levels since the procedures were put in place. The report should reflect the STO has not received authorization level changes from RSIC since the procedural change.

The report incorrectly states "STO has refused to allow requested changes to authorization signatures." STO has an established protocol for adding authorized signatures. STO has established a form that is completed and submitted to STO. Upon STO's review, STO then forwards the request to BNYM, and the authorization is completed. BNYM is not authorized to add/delete signature authorizations without the approval of the holder of the custodial agreement: STO. RSIC has been made aware of the procedure/protocol. STO has been extremely accommodating in ensuring that requests follow the established protocol. Last fall, RSIC attempted to add Mr. Ryberg as an authorized signature. The initial letter did not follow protocol, but Ms. Clarissa Adams (current STO chief-of-staff) responded stating, "In the interest of time, we have drafted the letter for you following the format outlined on March 15, 2013." The letter adding Mr. Ryberg to the signature list with maximum authority has yet to be returned. As soon as Mr. Ryberg signs and submits the letter to the STO, signature authorization will be executed. Clearly, STO was not impeding the process. Instead, STO was aiding RSIC by expediting the process.

Signed fax directives are a requirement of BNYM (not STO) and should be noted in the report.

Funston should remove the entire section of 3.2, whereas overall, "STO is hindering the operations of RSIC," as it is false or requires clarification.

14. Peer sample size, page 145 and page 160

The STO has questions regarding the peer sample size. Sampling of peers is not the optimal way to determine a best practice. Many plans "evolved" to their present structures and would no doubt be organized differently if allowed to be reviewed and restructured.

In order to appropriately comment, the STO had hoped to respond based on a review of the CEM report. On March 3, 2014, the STO requested Funston provide the report. Funston agreed to provide the CEM report, but stated it is still being reviewed and is not ready for distribution. The STO stands ready to provide a response as soon as the CEM is received.

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15. Manager fees, page 22, 35, 37 and page 156

The STO has questions regarding the manager fees mentioned in the report as fees paid by RSIC are the highest in the country. A comparison of fees should also include a comparison of returns due to the relationship between fees and earnings.

In order to appropriately comment, the STO had hoped to respond based on a review of the CEM report. On March 3, 2014, the STO requested Funston provide the report. Funston agreed to provide the CEM report, but stated it is still being reviewed and is not ready for distribution. The STO stands ready to provide a response as soon as the CEM is received.

16. Implementation dates, page 23

Changes or improvements are noted throughout the report but implementation dates are not provided. Dates are an important part of accurately reflecting when changes or improvements took place. A few examples include:

- "...strategies that should result in lower costs" (page 23). Funston should note in the report, when changes were made to lower costs.
- "A review by HEK of each new investment was recently added to the decision-making process" (page 97). The date the review was added should be noted.
- "The use of live streaming video, video recordings on website is leading practice" (page 98). The date the live video as well as the date video recordings were placed on the website should be noted.
- "External manager reporting has evolved" (page 114). The time line of detailed reporting should be listed.
- "...more focus on fee negotiations" (page 115). The date fee negotiations should be noted.
- "HEK now review every new potential underlying investment" (page 117). The date HEK began reviewing new underlying investments should be noted.

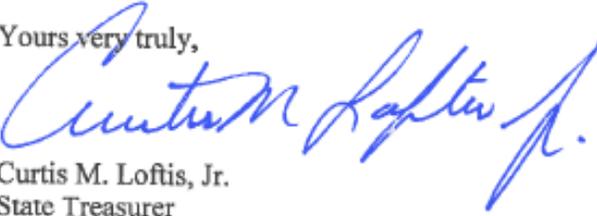
STO's opinions regarding the March 3, 2014 draft of the "Fiduciary Performance Audit of the South Carolina Retirement System investment Commission" as detailed above are based on the laws and statutes that have been put in place to safeguard the assets of the State retirees as well as the citizens of South Carolina. These laws were adopted after much consideration of maintaining the segregation of duties and the integrity of a control environment. They should not be changed carelessly or frivolously simply because one entity finds them laborious or inconvenient. Please consider the importance of the laws and the consequences of changing them when making your final recommendations.

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If the audit team would need further clarification please contact me directly at 803-734-2016 or Clarissa Adams at 803-734-2522. Thank you for the opportunity to respond.

Yours very truly,

A handwritten signature in blue ink, reading "Curtis M. Loftis, Jr.", written in a cursive style.

Curtis M. Loftis, Jr.
State Treasurer

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The Treasurer's Office response from April 12, 2014 to the April 3, 2014 Draft Final Report is included below. The FAS responses to the Treasurer's letter follow separately.

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THE HONORABLE CURTIS M. LOFTIS, JR.
State Treasurer

April 14, 2014

Mr. Rick Funston
Managing Partner
Funston Advisory Services LLC
591 Rudgate Road
Bloomfield Hills, MI 48304

Dear Mr. Funston:

This letter is in response to the request for an opinion of the State Treasurer's Office (STO) regarding the March 26, 2014 draft final report of the "Fiduciary Performance Audit of the South Carolina Retirement System Investment Commission." The fiduciary audit of the Retirement System Investment Commission (RSIC) is being conducted by Funston Advisory Services, LLC, pursuant to State law.

Again, STO re-emphasizes that its opinions are based on specific factors that are grounded in State laws and statutes. These laws and statutes should serve as the foundation of the recommendations of any fiduciary audit, but they are regrettably not the basis for this report. Instead, Funston has recommended a change to current law and one that could potentially put the system at risk. Under current laws and statutes, South Carolina is one of few states that hold a AAA credit rating. The system of checks and balances that was carefully molded, debated, and implemented by the state legislature has been critical to maintaining the highest rating and should not be ignored.

By law, the State Treasurer is a fiduciary to SCRS in three roles: as statutory custodian of all of SCRS' funds, as a voting member of RSIC, and as a voting member of the Budget and Control Board.¹ The STO has focused its review of the "Fiduciary Performance Audit of the South

¹ As the elected representative of the people, the Treasurer serves in three capacities. First, the State Treasurer is custodian of the funds in the SCRS. S.C. Code Ann. §9-1-1320. In this role, he serves as an "other fiduciary" with respect to the SCRS pursuant to S.C. Code Ann. §9-16-40. Op. Att'y Gen, p. 12 (Nov. 16, 2011). Second, the State Treasurer is an ex-officio member of the seven-member RSIC and is therefore a fiduciary to SCRS. S.C. Code Ann. §9-16-315(A)(2). The RSIC is responsible for investing the assets of the SCRS, hiring staff, and establishing investment objectives. See S. C. Code Ann. §§ 9-16-50, 9-16-315(G), 9-16-330(A). As a member of the RSIC, the State Treasurer is also a fiduciary. S.C. Code Ann. § 9-16-10(4)(c). Third, the State Treasurer serves as a member of the Budget and Control Board which is a trustee of SCRS.

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Carolina Retirement System Investment Commission” primarily on the portions of the draft report that address the three fiduciary roles that the State Treasurer has regarding SCRS.

STO respectfully asks that the following amendments be made to the March 26, 2014 draft final report before it is issued in its final form. Many of these items in this memo were previously shared during the interview Funston conducted with two STO staff, in Emails from the State Treasurer, in a letter dated March 18, 2014, and in a conference call requested by Funston with STO on March 20, 2014. Amendments are listed below. Detailed notes clarifying each amendment follow the list.

STO recommends revisions or additions in the following areas:

1. Executive Summary;
2. Governance;
3. Policy Review and Development;
4. Organizational Structure;
5. Investment Administration;
6. Legal Compliance; and
7. Information Technology.

Detailed notes explicating above amendments by section are as follows:

1. **Executive Summary**

Overall Conclusions #2 pg 8 The report states “...disclosure of external management fees is the most complete in the industry.” The sentence is not accurate as other funds such as Texas Teachers Retirement System of Texas and Washington State Department of Retirement Systems have provided documentation indicating all expenses for these retirement funds were disclosed. The sentence should state “...disclosure of external management fees is one of the most complete in the industry.”

CEM Report The audit should reflect that the CEM report is flawed. The audit should also include this information within the Executive Summary because of the significance of the inaccurate conclusions. CEM’s conclusion that the RSIC has added value by paying reduced fees comes only after CEM first reduces the RSIC’s fees by \$168 million or 38%. By reducing or simply carving out a material portion of the fees, any comparisons or outcomes are skewed. Even after the reduction, CEM’s adjusted expense rate for the RSIC is 80% higher than CEM’s median rate for U.S. plans. [1] Most plans paid significantly less in total fees and yet performed significantly higher. CEM never identifies the reasons that the RSIC pays the highest fee rates even though those reasons are easily identifiable in the report: namely, the RSIC’s high allocations to expensive asset classes such as Hedge Fund of Funds and Private Debt Limited Partnerships. The excess fees paid by the RSIC represent assets that could have been compounding interest over time.

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Conflict of Interest pg. 11 The STO requests that this paragraph be revised to reflect and include the *actual* language set forth in the SC State Ethics Commission Order, dated February 6, 2014. The present wording dismisses the fact that while there was “no evidence of an actual violation” or wrongdoing, “an appearance of impropriety does exist.” The present wording not only gives a cursory explanation of the finding, it also makes light of the ruling by essentially stating the order is the result of a “spate of continuing public confrontations” between the STO and RSIC. Such a trivialization is misleading, and minimizes the Ethics Commission’s ruling. Therefore, we request that the report reference the actual language of the ruling and remove any reference to “public confrontations.”

Limited Resources pg. 13 The report states, “Due to limited resources, the Commissioners became very involved in investing operations such as due diligence.” The sentence is false since sufficient resources were available, yet Commissioners made the decision to ignore due diligence and back office procedures. This has been substantiated in a number of audit reports as audit findings. The STO requests that the sentence instead read, “Commissioners chose to ignore back office operations and due diligence even while investing \$8 Billion in one year.”

2. Governance

G1: Fiduciary Authority Fiduciary responsibilities currently reside with B&CB. Fiduciary responsibilities could be with the future State Fiscal Accountability Authority or Department of Administration; SFAA is not mentioned in the report.

G3: Selection of the custodial bank by the Treasurer never resulted in significant delays, costs or duplication of effort, nor were there delays due to “lack of management” by BNYM. As previously stated, services such as Private i were available to RCIS and could have been purchased. Funds were readily available. More importantly, RSIC waited for years, disregarding the recommendations of consultants and external auditors, before determining critical services needed. RSIC recently made the decision to issue an RFP and not use BNYM resources that are readily available. As a reminder, BNYM works with both RSIC and PEBA daily and is unaware of any dissatisfaction or “lack of management.”

3. Policy Review and Development

P3.3: The report states, “Instruct the custodial bank to accept signatory changes based upon a letter from the Commission Chair or the RSIC COO and CIO (or CEO if the CEO position is created).”

By law, the State Treasurer is a fiduciary to SCRS in three roles: as statutory custodian of all of SCRS’ funds, as a voting member of RSIC, and as a voting member of the Budget and Control Board. As such the State Treasurer is ultimately responsible for the custodial bank: overseeing service provider relationships and holding service providers accountable for agreed upon service levels; ensuring that proper internal controls are

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created and maintained; and ensuring that all applicable parties comply with applicable state and federal regulations and contractual obligations.

STO has an established protocol for adding authorized signatures and has established a form that is completed and submitted to STO. Upon STO's review, STO then forwards the request to BNYM, and the authorization is completed. First, BNYM is not authorized to add/delete signature authorizations without the approval of the holder of the custodial agreement: STO. Second, RSIC has been made and is fully aware of the procedure/protocol. The procedure is simple and straightforward. Failure to follow the procedure can only be attributed to an unwillingness to work within the established protocol.

Currently the Custody officer is reviewing all signatures and levels required for both STO and RSIC. If RSIC believes that inappropriate individuals are currently in place to execute transactions on behalf of RSIC, RSIC should communicate and correspond with the STO through the proper protocol that has been established. Failure to follow the procedures can only be due to an unwillingness to work within established protocol.

P3.4: The report states, "Develop the capabilities to allow electronic signatures with the custodial bank to authorize cash transfers" with respect to the BNYM at this time.

BNYM does not permit electronic signatures at this time. However, the State Treasurer's Office Custody Officer will be reviewing procedures/processes for improvements while ensuring that internal controls and compliance directives are being adhered to.

Every opportunity to improve efficiencies will be reviewed, such as the opportunity to streamline this process via workbench. Note, it is imperative that internal controls and compliance issues are addressed prior to any implementation. Again, open communication and contribution from both RSIC and PEBA are crucial to a successful relationship.

The STO is dedicated to creating a seamless custodial relationship with RSIC and PEBA, while also ensuring that proper controls are in place to protect the assets of SCRS.

4. Organizational Structure
N/A

5. Investment Administration

The STO has a number of issues with CEM's methods and conclusions.

RSIC's investment performance has been poor in comparison to other plans, and RSIC's fee rates are higher than any other large plan. Rather than addressing these issues and offering solutions or suggestions, CEM concluded that the RSIC has "added value," both through investment performance and by paying less in fees than it could have paid.

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However, the RSIC's fee rate is more than double the average fee rate. No plan of \$10 billion or more has a higher fee rate than RSIC. The performance of RSIC offers no justification for the fees paid.

The main reason for RSIC's outrageous fee rate is easily identifiable: RSIC's high alternative allocation is composed of asset classes that charge high fees. Data presented in the appendix of the CEM report indicates that RSIC's allocation to both Hedge Funds and Hedge Fund of Funds are far beyond the median of both CEM's peer group and CEM's U.S. Universe². According to CEM, RSIC's 11% allocation to Hedge Fund of Funds is the highest in its peer group³. Not only is the RSIC's Hedge Fund of Funds the highest allocation in its peer group, but according to CEM, the RSIC has highest allocation to Hedge Fund of Funds in dollars in CEM's entire U.S. universe⁴. CEM's universe includes funds many times the size of RSIC.

CEM did not include the performance fees of hedge funds in its peer cost analysis because "only a limited number of participants are currently able to provide this data."⁵ A table in the Appendix explains why only a limited number of participants currently provide this data: for both peer group and the CEM's U.S. Universe, the median allocation to both Hedge Funds and Hedge Fund of Funds is zero.⁶

Rather than identifying the Hedge Fund of Fund allocation as a cause of RSIC's higher fees, CEM cites RSIC's fees to Hedge Fund of Funds as a source of what CEM claims to be "added value." This was because the RSIC's Hedge Fund of Funds fee rate of 212.6 bps was lower than the median funds fee rate of 216.3 bps. RSIC's excessive Hedge Fund of Funds allocation resulted in more added value through CEM's calculation of "added value"⁷.

CEM data also indicates that RSIC has lower allocations of asset classes that have lower fees. For example, RSIC has the very lowest allocation of equity holdings in its peer group. In CEM's U.S. universe, the allocation percentage is less than half the 25th percentile allocation⁸. According to CEM data, the net value added by equity was much greater than net value added by hedge funds between 1991 and 2012. Hedge funds had negative value added during that period.

RSIC's high fee rate is a primary reason for RSIC's below average investment performance. Moreover, the contract for investment fees provides no discount for economy of scale or the significant amount of funds invested.

² Appendix to CEM Report, pages 10, 15, and 24.

³ Appendix to CEM Report, page 24.

⁴ Appendix to CEM Report, page 24.

⁵ CEM Executive Summary, page 11.

⁶ According to page 24 of the Appendix, the RSIC held \$3371.3 million in Hedge Fund of Funds and the U.S. Universe average Hedge Fund of Funds allocation was \$196.9 million.

⁷ CEM Executive Summary, page 19.

⁸ CEM Report, Section 2, page 5

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RSIC's peer rankings contrast with the CEM conclusion that RSIC has added 1.2% in value because RSIC outperformed the policy benchmark. According to CEM, the policy benchmark return of RSIC was one of the lowest, and that in itself indicates a problem, namely a problem with the asset allocation mix.

The CEM report also includes data that strongly suggests that RSIC policy benchmark is not valid. The CEM average hedge fund benchmark of 2.4% is more than 5.0% higher than the RSIC policy benchmark of -2.90%. RSIC's 5 year hedge fund return rate of 2.4% was positive in comparison to its hedge fund policy benchmark. RSIC hedge fund performance was not positive in comparison to CEM's "average benchmark for all U.S. participants."

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L3.1: STO agrees that shortening the review period may be beneficial, but only if the Investment Commission can rely on an appropriately documented Legal Sufficiency Certificate verifying that the material terms presented to the Commission are accurately set forth in the agreements. First, it is important to note that these reviews have proven useful, as materials errors have been identified. Second, there is no substitute for accountability. Requiring a licensed attorney to attest, in writing, that the 14 terms listed on the investment summary chart presented to the Commission are accurately reflected in the agreements and comply with the governing guidelines provides not only accountability, but also the active oversight the investments warrant. Lastly, irrespective of the foregoing, we believe the current 30-day review period should remain in place until at least December 31, 2014, which would allow time for the IC legal staff and the STO to become acquainted with the newly enacted protocols.

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IT 4.1/P5: The report states RSIC is not exempt from investment support systems and outlines a perceived inconvenience by RSIC when services and funds to purchase them have been available for many years. Most recently, the RSIC issued an Administrator RFP in mid-December 2013 and issued the contract with a vendor on March 2014 with an annual fee of \$1.2 million for five years. The targeted conversion date is July 1, 2014.

Again, we state that the Legislative approval and procurement rules played no part in the shortfall of staffing or insufficient systems. The deliberate decision to ignore available funds for crucial services and staffing presents a critical problem. The table shows estimated quarterly expenditures, outlining a projected lapse of almost \$2 million for the current fiscal year.

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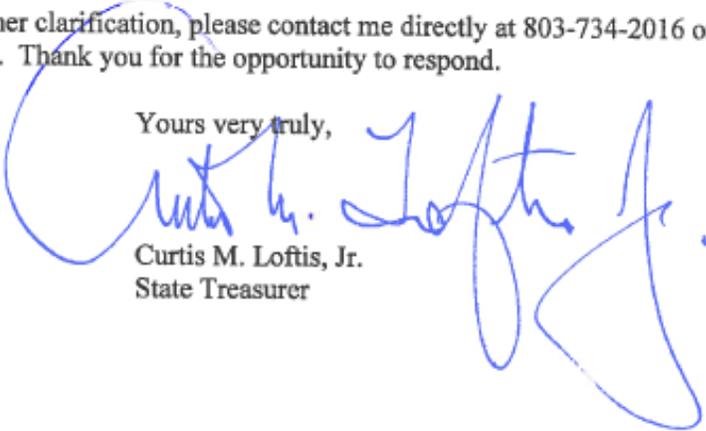
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In closing, it is the STO opinion that the recommendations of the final report should reflect thoughtful consideration of the importance and ultimate purpose of laws currently in place, as well as the possible detrimental consequences of changing them. Current laws and statutes were put in place to safeguard the assets of the State retirees, as well as the citizens of South Carolina. These laws were adopted after much consideration of how best to maintain the segregation of duties and the integrity of a control environment; therefore, they should not be changed carelessly or frivolously or simply because one entity finds them laborious or inconvenient.

The STO appreciates the opportunity to respond to the report. This is the second document submitted as a response. The STO would appreciate if both letters from the STO were included as an exhibit to the final report (today and March 18, 2014 incorporated 13 major bullet points of concern).

If the audit team requires further clarification, please contact me directly at 803-734-2016 or Clarissa Adams at 803-734-2522. Thank you for the opportunity to respond.

Yours very truly,


Curtis M. Loftis, Jr.
State Treasurer

CMLjr/afw

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FAS responses to the Treasurer's letter

April 12, 2014

Mr. Rick Funston
Managing Partner
Funston Advisory Services LLC
591 Rudgate Road
Bloomfield Hills, MI 48304

Dear Mr. Funston:

This letter is in response to the request for an opinion of the State Treasurer's Office (STO) regarding the March 26, 2014 draft final report of the "Fiduciary Performance Audit of the South Carolina Retirement System Investment Commission." The fiduciary audit of the Retirement System Investment Commission (RSIC) is being conducted by Funston Advisory Services, LLC, pursuant to State law.

Again, STO re-emphasizes that its opinions are based on specific factors that are grounded in State laws and statutes. These laws and statutes should serve as the foundation of the recommendations of any fiduciary audit, but they are regrettably not the basis for this report. Instead, Funston has recommended a change to current law and one that could potentially put the system at risk. Under current laws and statutes, South Carolina is one of few states that hold a AAA credit rating. The system of checks and balances that was carefully molded, debated, and implemented by the state legislature has been critical to maintaining the highest rating and should not be ignored.

FAS Response:

While it would be possible to perform a fiduciary audit starting from the presumption that current law is the best possible and immutable, that was not the charge to Funston Advisory Services LLC by the State Inspector General. Instead, we were specifically asked to review the current legal framework, as well as the policies and procedures, so as to provide an expert, outside focus on issues that can only be resolved by the State Legislature.

We agree that the ultimate decision with regard to the legal framework is and should be the State Legislature. We trust that the Legislature will seriously consider the issues raised and then make an informed decision as to which, if any, changes to make to the legal framework. We also note that the State Legislature has twice legislated major changes in the way the State of South Carolina manages its pension funds in recent memory.

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We appreciate the valuable input provided by the STO throughout the process of our fiduciary performance audit even though we may not always agree.

By law, the State Treasurer is a fiduciary to SCRS in three roles: as statutory custodian of all of SCRS' funds, as a voting member of RSIC, and as a voting member of the Budget and Control Board.¹⁸ The STO has focused its review of the "Fiduciary Performance Audit of the South Carolina Retirement System Investment Commission" primarily on the portions of the draft report that address the three fiduciary roles that the State Treasurer has regarding SCRS.

STO respectfully asks that the following amendments be made to the March 26, 2014 draft final report before it is issued in its final form. Many of these items in this memo were previously shared during the interview Funston conducted with two STO staff, in Emails from the State Treasurer, in a letter dated March 18, 2014, and in a conference call requested by Funston with STO on March 20, 2014. Amendments are listed below. Detailed notes clarifying each amendment follow the list.

STO recommends revisions or additions in the following areas:

1. Executive Summary;
2. Governance;
3. Policy Review and Development;
4. Organizational Structure;
5. Investment Administration;
6. Legal Compliance; and
7. Information Technology.

Detailed notes explicating above amendments by section are as follows:

1. Executive Summary

Overall Conclusions #2 pg 8 The report states "...disclosure of external management fees is the most complete in the industry." The sentence is not accurate as other funds such as Texas Teachers Retirement System of Texas and Washington State Department of Retirement Systems have provided documentation indicating all expenses for these retirement funds were disclosed. The sentence should state "...disclosure of external management fees is one of the most complete in the industry."

¹⁸. As the elected representative of the people, the Treasurer serves in three capacities. First, the State Treasurer is custodian of the funds in the SCRS. S.C. Code Ann. §9-1-1320. In this role, he serves as an "other fiduciary" with respect to the SCRS pursuant to S.C. Code Ann. §9-16-40. Op. Att'y Gen, p. 12 (Nov. 16, 2011). Second, the State Treasurer is an ex-officio member of the seven-member RSIC and is therefore a fiduciary to SCRS. S.C. Code Ann. §9-16-315(A)(2). The RSIC is responsible for investing the assets of the SCRS, hiring staff, and establishing investment objectives. See S. C. Code Ann. §§ 9-16-50, 9-16-315(G), 9-16-330(A). As a member of the RSIC, the State Treasurer is also a fiduciary. S.C. Code Ann. § 9-16-10(4)(c). Third, the State Treasurer serves as a member of the Budget and Control Board which is a trustee of SCRS.

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FAS Response:

Teacher Retirement System of Texas (TRS) discloses performance fees and carried interest by manager in its annual CAFR. However, TRS does not disclose pass-through expenses in its limited partnerships; for RSIC, these expenses totaled \$39 million in FY2013, or 9% of reported manager fees.

In direct communication between FAS and Washington State Investment Board (WSIB) staff, WSIB indicated that they do not disclose performance fees, carried interest, or pass-through fees for alternative investments and that it would require at least 6 additional staff to do so. They also expressed a point of view that WSIB does not consider carried interest or performance fees to be “external manager fees,” but rather a form of profit sharing.

Finally, RSIC's disclosure goes further than either TRS or WSIB by breaking out the fee to each manager into billed vs. netted amounts.

We applaud STO's recognition of the completeness of RSIC's manager fee disclosure, and it is our sincere hope that it will no longer be used against the RSIC when drawing comparisons to the level of fees paid by other funds. Unfortunately, this seems unlikely given the following request from STO regarding the CEM report and again regarding Investment Administration.

CEM Report The audit should reflect that the CEM report is flawed. The audit should also include this information within the Executive Summary because of the significance of the inaccurate conclusions. CEM's conclusion that the RSIC has added value by paying reduced fees comes only after CEM first reduces the RSIC's fees by \$168 million or 38%. By reducing or simply carving out a material portion of the fees, any comparisons or outcomes are skewed. Even after the reduction, CEM's adjusted expense rate for the RSIC is 80% higher than CEM's median rate for U.S. plans. [1] Most plans paid significantly less in total fees and yet performed significantly higher. CEM never identifies the reasons that the RSIC pays the highest fee rates even though those reasons are easily identifiable in the report: namely, the RSIC's high allocations to expensive asset classes such as Hedge Fund of Funds and Private Debt Limited Partnerships. The excess fees paid by the RSIC represent assets that could have been compounding interest over time.

FAS Response:

Two basic sets of decisions determine the costs that RSIC and its peers pay. The first, and most important, is asset allocation—the mix of public market and alternative assets a Fund chooses to invest in. We agree that the RSIC pays higher costs because of its higher asset allocation to alternatives. This issue has never been in dispute.

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CEM does not evaluate whether a fund chose a “better” or “worse” asset allocation than its peers because that choice depends on the time frame under consideration and each fund’s market expectations, liabilities and risk tolerance.

The second set of decisions is how a fund implements its chosen asset allocation (external versus internal management, active versus passive management and the fees negotiated for each type of management). CEM concludes that RSIC pays about the same overall management costs as peers of similar size pay for the same asset mix. (Note: CEM’s report makes it clear that this conclusion excludes private equity carried interest and hedge fund performance fees because only a limited number of survey participants are currently able to provide this data for benchmarking).

In other words, “apples to apples” RSIC is not overpaying for its asset allocation. Whether the asset allocation is appropriate is the responsibility of the RSIC. This was the decision of Legislature when it conferred all investment authority in the Commission.

(Note: The STO comment that CEM found RSIC added value only after CEM excluded \$168 million in fees is incorrect. CEM concluded that RSIC added value by earning a five-year return of 2.5% compared to the 1.3% return it would have earned by passively investing in the policy asset allocation approved by the Commission. No fees were excluded. The 2.5% return is net of all fees (management and performance) RSIC paid.)

Conflict of Interest pg. 11 The STO requests that this paragraph be revised to reflect and include the *actual* language set forth in the SC State Ethics Commission Order, dated February 6, 2014. The present wording dismisses the fact that while there was “no evidence of an actual violation” or wrongdoing, “an appearance of impropriety does exist.” The present wording not only gives a cursory explanation of the finding, it also makes light of the ruling by essentially stating the order is the result of a “spate of continuing public confrontations” between the STO and RSIC. Such a trivialization is misleading, and minimizes the Ethics Commission’s ruling. Therefore, we request that the report reference the actual language of the ruling and remove any reference to “public confrontations.”

FAS Response:

We agree that it is critical that the Commission should avoid even the perception of impropriety. We have strengthened our recommendations accordingly. However, public confrontations between the RSIC and STO are a fact and are not confined to allegations of impropriety. The report reads “Such allegations, in addition to the spate of continuing public confrontations, only serve to erode the RSIC’s reputation.”

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Limited Resources pg. 13 The report states, “Due to limited resources, the Commissioners became very involved in investing operations such as due diligence.” The sentence is false since sufficient resources were available, yet Commissioners made the decision to ignore due diligence and back office procedures. This has been substantiated in a number of audit reports as audit findings. The STO requests that the sentence instead read, “Commissioners chose to ignore back office operations and due diligence even while investing \$8 Billion in one year.”

FAS Response:

STO has taken this statement is taken out of context. The entire paragraph is shown below:

“Accordingly, the initial strategy adopted by the Commissioners, in consultation with their general investment consultant, CIO and external managers, was to diversify a traditional stocks and bonds portfolio to improve long-term returns and better manage total fund risk. They also chose to do so rapidly.

Numerous past practices were examined in this fiduciary performance audit to better understand the context, evolution and maturation of the RSIC. Unfortunately, infrastructure did not keep pace with investment strategies (e.g., private equity, strategic partnerships, etc.) as initial back office and risk management procedures and support systems were often weak, manual and ad hoc. Due to limited resources, the Commissioners also became very involved in investment operations such as due diligence. Many of these legacy weaknesses have since been identified and have been or are being addressed by the Commission. During the past two years, RSIC’s processes have evolved to become much more robust and systematic.” pp. 7-8 FAS Final Report.”

In addition, we recognize these weaknesses as shown below from p. 11 Executive Summary:

“For the past three years, the Treasurer has raised legitimate concerns about the effectiveness of the strategy and its costs as well as the lack of infrastructure to support such a strategy. He has also raised legitimate questions about the RSIC’s sense of urgency in improving staffing, systems and controls, and the RSIC has responded with many improvements, especially in the last two years as noted above. See also *Appendix B RSIC Improvements Timeline.*”

2. Governance

G1: Fiduciary Authority Fiduciary responsibilities currently reside with B&CB. Fiduciary responsibilities could be with the future State Fiscal Accountability Authority or Department of Administration; SFAA is not mentioned in the report.

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FAS Response:

We agree. The role of the State Fiscal Accountability Authority has now been addressed throughout the main body of our report.

G3: Selection of the custodial bank by the Treasurer never resulted in significant delays, costs or duplication of effort, nor were there delays due to “lack of management” by BNYM. As previously stated, services such as Private i were available to RCIS and could have been purchased. Funds were readily available. More importantly, RSIC waited for years, disregarding the recommendations of consultants and external auditors, before determining critical services needed. RSIC recently made the decision to issue an RFP and not use BNYM resources that are readily available. As a reminder, BNYM works with both RSIC and PEBA daily and is unaware of any dissatisfaction or “lack of management.”

FAS Response:

We respectfully disagree. In our opinion, the principal impediment to an effective relationship with the Custodial Bank has been the involvement of the STO. See our report. Of course, a fiduciary performance audit can only review what existed at the time of the review. We note that the STO has stated that it is now “dedicated to creating a seamless custodial relationship with RSIC and PEBA, while also ensuring that proper controls are in place to protect the assets of SCRS”. We also note that at least one positive change, ceasing to require signatures to allow money to be deposited into the SCRS accounts, has occurred since we asked questions about it during our field work.

3. Policy Review and Development

P3.3: The report states, “Instruct the custodial bank to accept signatory changes based upon a letter from the Commission Chair or the RSIC COO and CIO (or CEO if the CEO position is created).

By law, the State Treasurer is a fiduciary to SCRS in three roles: as statutory custodian of all of SCRS’ funds, as a voting member of RSIC, and as a voting member of the Budget and Control Board. As such the State Treasurer is ultimately responsible for the custodial bank: overseeing service provider relationships and holding service providers accountable for agreed upon service levels; ensuring that proper internal controls are created and maintained; and ensuring that all applicable parties comply with applicable state and federal regulations and contractual obligations.

STO has an established protocol for adding authorized signatures and has established a form that is completed and submitted to STO. Upon STO’s review, STO then forwards the request to BNYM, and the authorization is completed. First, BNYM is not authorized to add/delete

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signature authorizations without the approval of the holder of the custodial agreement: STO. Second, RSIC has been made and is fully aware of the procedure/protocol. The procedure is simple and straightforward. Failure to follow the procedure can only be attributed to an unwillingness to work within the established protocol.

Currently the Custody officer is reviewing all signatures and levels required for both STO and RSIC. If RSIC believes that inappropriate individuals are currently in place to execute transactions on behalf of RSIC, RSIC should communicate and correspond with the STO through the proper protocol that has been established. Failure to follow the procedures can only be due to an unwillingness to work within established protocol.

P3.4: The report states, “Develop the capabilities to allow electronic signatures with the custodial bank to authorize cash transfers” with respect to the BNYM at this time.

BNYM does not permit electronic signatures at this time. However, the State Treasurer’s Office Custody Officer will be reviewing procedures/processes for improvements while ensuring that internal controls and compliance directives are being adhered to.

Every opportunity to improve efficiencies will be reviewed, such as the opportunity to streamline this process via workbench. Note, it is imperative that internal controls and compliance issues are addressed prior to any implementation. Again, open communication and contribution from both RSIC and PEBA are crucial to a successful relationship.

The STO is dedicated to creating a seamless custodial relationship with RSIC and PEBA, while also ensuring that proper controls are in place to protect the assets of SCRS.

FAS Response:

We respectfully disagree regarding both points.

The Treasurer, in his role as Custodian, has the ability to delegate authorities to other appropriate parties. It is entirely within his authority to instruct the custodial bank to accept signatory changes based upon a letter from the Commission Chair or the RSIC COO and CIO.

BNY Mellon has indicated that an electronic authorization process already exists and is in use by RSIC for payment of management fees. The process has existed for nearly a decade and is used to authorize payment of capital calls by many other clients. We do note that there could be a semantic issue: BNY Mellon calls the mechanism electronic authorizations rather than electronic signatures.

4. Organizational Structure

N/A

5. Investment Administration

The STO has a number of issues with CEM's methods and conclusions.

RSIC's investment performance has been poor in comparison to other plans, and RSIC's fee rates are higher than any other large plan. Rather than addressing these issues and offering solutions or suggestions, CEM concluded that the RSIC has "added value," both through investment performance and by paying less in fees than it could have paid.

However, the RSIC's fee rate is more than double the average fee rate. No plan of \$10 billion or more has a higher fee rate than RSIC. The performance of RSIC offers no justification for the fees paid.

The main reason for RSIC's outrageous fee rate is easily identifiable: RSIC's high alternative allocation is composed of asset classes that charge high fees. Data presented in the appendix of the CEM report indicates that RSIC's allocation to both Hedge Funds and Hedge Fund of Funds are far beyond the median of both CEM's peer group and CEM's U.S. Universe¹⁹. According to CEM, RSIC's 11% allocation to Hedge Fund of Funds is the highest in its peer group²⁰. Not only is the RSIC's Hedge Fund of Funds the highest allocation in its peer group, but according to CEM, the RSIC has highest allocation to Hedge Fund of Funds in dollars in CEM's entire U.S. universe²¹. CEM's universe includes funds many times the size of RSIC.

CEM did not include the performance fees of hedge funds in its peer cost analysis because "only a limited number of participants are currently able to provide this data."²² A table in the Appendix explains why only a limited number of participants currently provide this data: for both peer group and the CEM's U.S. Universe, the median allocation to both Hedge Funds and Hedge Fund of Funds is zero.²³

Rather than identifying the Hedge Fund of Fund allocation as a cause of RSIC's higher fees, CEM cites RSIC's fees to Hedge Fund of Funds as a source of what CEM claims to be "added value." This was because the RSIC's Hedge Fund of Funds fee rate of 212.6 bps was lower than the median funds fee rate of 216.3 bps. RSIC's excessive Hedge Fund of Funds allocation resulted in more added value through CEM's calculation of "added value"²⁴.

CEM data also indicates that RSIC has lower allocations of asset classes that have lower fees. For example, RSIC has the very lowest allocation of equity holdings in its peer group. In CEM's U.S. universe, the allocation percentage is less than half the 25th percentile allocation²⁵. According to CEM data, the net value added by equity was much greater than net value added by hedge funds between 1991 and 2012. Hedge funds had negative value added during that period.

¹⁹ Appendix to CEM Report, pages 10, 15, and 24.

²⁰ Appendix to CEM Report, page 24.

²¹ Appendix to CEM Report, page 24.

²² CEM Executive Summary, page 11.

²³ According to page 24 of the Appendix, the RSIC held \$3371.3 million in Hedge Fund of Funds and the U.S. Universe average Hedge Fund of Funds allocation was \$196.9 million.

²⁴ CEM Executive Summary, page 19.

²⁵ CEM Report, Section 2, page 5

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RSIC's high fee rate is a primary reason for RSIC's below average investment performance. Moreover, the contract for investment fees provides no discount for economy of scale or the significant amount of funds invested.

RSIC's peer rankings contrast with the CEM conclusion that RSIC has added 1.2% in value because RSIC outperformed the policy benchmark. According to CEM, the policy benchmark return of RSIC was one of the lowest, and that in itself indicates a problem, namely a problem with the asset allocation mix.

The CEM report also includes data that strongly suggests that RSIC policy benchmark is not valid. The CEM average hedge fund benchmark of 2.4% is more than 5.0% higher than the RSIC policy benchmark of -2.90%. RSIC's 5 year hedge fund return rate of 2.4% was positive in comparison to its hedge fund policy benchmark. RSIC hedge fund performance was not positive in comparison to CEM's "average benchmark for all U.S. participants."

FAS Response:

A number of the comments under this point once again relate to RSIC's high cost asset allocation and the low return it produced over the last five years, which is noted in CEM's report and the FAS report. There is no disagreement about that. The purpose of CEM's report was not to evaluate whether the Commission should be more invested in lower cost asset classes, but rather to determine how the costs it pays for each asset class compares to the costs its peers pay for those same types of assets.

Please also see our responses to cost analysis issues in our response to the comments under 1. Executive Summary, in the main FAS report as well as in the CEM and FAS responses to the twenty-six questions raised by STO contained in the Appendices.

What the Commission needs to decide, in conjunction with its asset allocation consultant, is whether its higher cost asset allocation is likely to produce risk adjusted net returns in the future that are likely to meet the fund's liabilities. This decision is within the exclusive authority of the Commission.

6. Legal Compliance

L3.1: STO agrees that shortening the review period may be beneficial, but only if the Investment Commission can rely on an appropriately documented Legal Sufficiency Certificate verifying that the material terms presented to the Commission are accurately set forth in the agreements. First, it is important to note that these reviews have proven useful, as materials errors have been identified. Second, there is no substitute for accountability. Requiring a licensed attorney to attest, in writing, that the 14 terms listed on the investment summary chart

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FAS Response:

We agree.

7. Information Technology/Policy Review and Development

IT 4.1/P5: The report states RSIC is not exempt from investment support systems and outlines a perceived inconvenience by RSIC when services and funds to purchase them have been available for many years. Most recently, the RSIC issued an Administrator RFP in mid-December 2013 and issued the contract with a vendor on March 2014 with an annual fee of \$1.2 million for five years. The targeted conversion date is July 1, 2014.

Again, we state that the Legislative approval and procurement rules played no part in the shortfall of staffing or insufficient systems. The deliberate decision to ignore available funds for crucial services and staffing presents a critical problem. The table shows estimated quarterly expenditures, outlining a projected lapse of almost \$2 million for the current fiscal year.

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2014 Approved Authorization	<u>13,021,374.00</u>			
Estimated Lapsed Funds	<u>1,837,495.00</u>			

FAS Response:

We agree there may have been delays attributable to RSIC. Recommendation G5.2 specifically addresses this issue.

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In closing, it is the STO opinion that the recommendations of the final report should reflect thoughtful consideration of the importance and ultimate purpose of laws currently in place, as well as the possible detrimental consequences of changing them. Current laws and statutes were put in place to safeguard the assets of the State retirees, as well as the citizens of South Carolina. These laws were adopted after much consideration of how best to maintain the segregation of duties and the integrity of a control environment; therefore, they should not be changed carelessly or frivolously or simply because one entity finds them laborious or inconvenient.

FAS Response:

We agree. None of the report's recommendations were made frivolously. As noted above, it was the SIG's mandate to retain an independent auditor to make recommendations in the best interests of the plan beneficiaries and the citizens of the State of South Carolina including recommendations for legislative reform. Where the laws blur authority, responsibility and accountability, we have noted that fact, provided explanations and legal analysis, and made thoughtful recommendations. Now, it is up to the Legislature to determine how best to safeguard the assets of the State retirees and the citizens of South Carolina.

The fiduciary performance audit report also makes more than 120 recommendations for improvement that involve the Commission, RSIC operations, the State Treasurer's Office, the Budget and Control Board and its successor organizations and the Legislature. The STO's comments in this letter acknowledge its focus mainly on the areas of the report that affect the three fiduciary roles of Treasurer. The limited focus of the STO's response does not acknowledge the totality of the fiduciary performance audit's findings, conclusions and recommendations.

The STO appreciates the opportunity to respond to the report. This is the second document submitted as a response. The STO would appreciate if both letters from the STO were included as an exhibit to the final report (today and March 18, 2014 incorporated 13 major bullet points of concern).

FAS Response:

We have included both letters from the STO including our responses to those letters in Appendices F and O respectively.

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If the audit team requires further clarification, please contact me directly at 803-734-2016 or Clarissa Adams at 803-734-2522. Thank you for the opportunity to respond.

Yours very truly,

Curtis M. Loftis, Jr.
State Treasurer

CMLjr/afw

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Appendix P Response from the Public Employee Benefit Authority



April 11, 2014

Rick Funston
Funston Advisory Services, LLC

Dear Mr. Funston:

We appreciate the opportunity to review and provide comments to the draft final report on the Fiduciary Performance Audit of the South Carolina Retirement System Investment Commission (RSIC).

Funston's review of the RSIC's operations and relationships with other fiduciaries of the Retirement Systems appears to have been extremely thorough and we were impressed with the experience and judgment utilized to form your assessments. The recommendations provided in the draft final report are extensive and each will need to be closely evaluated by all parties impacted and prioritized with the ultimate best interest of efficiencies and effectiveness of administering the trust fund in mind.

We feel that many weaknesses were appropriately recognized and while some of the recommendations may be fairly easily implemented, others will require support and action by the state legislature will be much more difficult to achieve. Again, Funston's efforts are greatly appreciated and a quality work product has been provided. Thank you for allowing the SC Public Employee Benefit Authority to be a part of your engagement and we look forward to continuing to implement improvements for the Retirement Systems.

Sincerely,



Travis J. Turner, CPA
Interim Executive Director

Street Address:
202 Arbor Lake Drive
Columbia, South Carolina 29223

www.retirement.sc.gov
803-737-6800
800-868-9002 (within S.C. only)

Mailing Address:
Post Office Box 11960
Columbia, South Carolina 29211-1960

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Appendix Q Recommendations ranked in order of Priority, Difficulty and Responsibility

Category	Funston Recommendation	Critical vs Important vs Necessary	Difficult vs Medium vs Easy to Accomplish	Commission involvement needed	Outside cooperation needed	If yes, who?
G1	The Legislature should better align Retirement System governance authority with assignment of obligations and clarify what fiduciary responsibilities, if any, still reside with the BCB and, subsequently, the Department of Administration and the State Fiscal Accountability Authority.	Critical	Difficult	N	Y	Legislature
G2	The Legislature should resolve the Treasurer’s conflicting fiduciary duties (alternatives are discussed in I17).	Critical	Difficult	N	Y	Legislature
G3	The Legislature should delegate selection of the custodial bank and management of the relationship to the RSIC (alternatives are further discussed in I17).	Critical	Difficult	N	Y	Legislature
G5,1	The Legislature should delegate authority for operating budget, staffing and all compensation approval to the Commission.	Critical	Difficult	N	Y	Legislature
G13.2	Develop and implement an Enterprise Risk Program, as called for in the Governance Policy Manual and approved at the March 13, 2014 Commission meeting, and ensure the necessary tools are acquired to support effective risk management and oversight.	Critical	Difficult	N	N	
G10.2	In addition to an annual review of the asset allocation, throughout the year the Commission should review and discuss asset class strategies with the investment staff and provide oversight.	Critical	Medium	Y	N	
G10.1	The Commission should work with its general investment consultant and develop a set of investment beliefs to provide a basis for strategic management of the investment portfolio.	Critical	Medium	Y	Y	HEK
G13.4	An independent third party expert firm should regularly benchmark fund returns and costs (see Recommendations G18.4 and I11.2).	Critical	Medium	N	N	
G4	The Legislature should revise legislation to allow the Commission to designate a single direct operating report with the title of either Chief Executive Officer (CEO) or Executive Director, and not require that the Chief Investment Officer (CIO) report directly to the Commission.	Critical	Medium	Y	Y	Legislature

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Category	Funston Recommendation	Critical vs Important vs Necessary	Difficult vs Medium vs Easy to Accomplish	Commission involvement needed	Outside cooperation needed	If yes, who?
G8.2	The Legislature should consider adding one or three additional voting members to the Commission to increase diversity, increase beneficiary representation and reduce the potential for tie votes (making the PEBA representative a voting Commissioner could be an option, but would require an exemption from the prohibition for a state employee).	Critical	Medium	N	Y	Legislature
G8.1	The Legislature should revise the Commissioner’s qualification requirements to achieve a more diverse composition of members, including some commissioners with a broader business experience beyond investments which is not as reliant on professional certifications when there is significant practical experience.	Critical	Medium	N	Y	Legislature
G16.4	The CIO should consider whether to mandate annual plans by asset class and/or functional area. If so, the plans should be presented to the IIC to facilitate dissemination and cross-silo knowledge sharing.	Critical	Medium	N	N	
G10.3	The Commission should shift its emphasis from a focus on advising on specific investments and participating in due diligence to providing oversight and strategic guidance to staff. This would include eliminating the assignment of asset classes to individual Commissioners and, as a general rule, preclude Commissioner’s involvement in investment due diligence except as observers for either overseeing staff processes or for Commissioners’ education and training purposes.	Critical	Easy	Y	N	
G13.3	Add responsibility for Enterprise Risk Management to the Audit Committee charter; consider changing the name to the Audit and Enterprise Risk Committee.	Critical	Easy	Y (Audit Committee)	N	
G15.1	As part of a shift in emphasis by the Commission to enterprise oversight, the Compensation Committee charter should be expanded to include oversight of human resources and infrastructure and to provide guidance to staff on human resources and capability development.	Critical	Easy	Y	N	
G5.2	RSIC should review its annual budget planning process to ensure that it is using existing allocations to full advantage and that requests for increased resources are based on a realistic assessment of staff and systems the organization can assimilate during the next budget period. The Commission should conduct a mid-year review of year-to-date and projected expenses compared to budgeted amounts.	Critical	Easy	N	N	

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G6	The Commission should have an annual external financial audit or an agreed upon procedures review of fund valuations, procedures and/or controls, consistent with other investment boards; either the Commission or a state agency (e.g., the State Auditor) could select the external firm.	Important	Medium	N	Y	Legislature (for budget purposes), State Auditors Office, PEBA
G18.2	RSIC should develop a communications plan which identifies each key stakeholder group, considers what information is important for each stakeholder to know, and identifies responsibility for maintaining stakeholder communications.	Important	Medium	N	N	
G18.4	RSIC should conduct a periodic benchmarking of its returns and costs by an independent expert to provide added assurance to stakeholders about the facts of its performance compared to peers (see Recommendation G13.4).	Important	Medium	N	N	
G7	Decision-making within strategic partnerships should be assessed in the context of how all RSIC investment decisions are made and adjusted accordingly, if appropriate (see Recommendation I12.1).	Important	Easy	N	N	
G16.3	The CIO should routinely invite other investment, operations and legal staff to attend IIC meetings as visitors so as to facilitate dissemination of information across functional silos.	Important	Easy	N	N	
G12.1	The Commission should plan more frequent meetings, at least bi-monthly, and develop standing agenda items annually and for each meeting (e.g., asset allocation, investment beliefs, specific asset class reviews, infrastructure business plan review, etc.) (see also Recommendation I6.1).	Important	Easy	Y	N	
G15.2	The Compensation Committee should change its name to Human Resources and Compensation to reflect the new focus.	Important	Easy	Y	N	
G16.1	The role of the Internal Investment Committee (IIC) should be clarified.	Important	Easy	N	N	
G12.2	The revised protocol for the agenda setting process should be formally adopted by the Commission and incorporated into the Governance Manual.	Important	Easy	Y	N	

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G18.3	In the communications plan, RSIC should consider an initiative to draw greater national attention to the need for all public pension funds to disclose costs in a consistent way and for investment managers to provide the level of reporting necessary to accomplish that objective.	Necessary	Difficult	N	N	
G12.3	Improve the effectiveness of Commission self-assessments by providing evaluations of individual Commissioners, utilizing peer-to-peer and upward evaluations (from RSIC staff), and providing individualized feedback and personalized improvement goals.	Necessary	Medium	Y	N	
G19	RISC should confer with PEBA to determine whether legislative action is needed to ensure that a funding mechanism is in place for the State's indemnity and defense obligations that are not covered by insurance.	Necessary	Medium	N	Y	PEBA
G9	The Legislature should consider imposing term limits for Commissioners.	Necessary	Medium	N	Y	Legislature
G13.1	The Audit Committee should review and approve the Internal Audit Charter.	Necessary	Easy	Y (Audit Committee)	N	
G14	The Commission should adopt a mid-year review process for its direct reports to provide guidance and interim feedback.	Necessary	Easy	Y	N	
G16.2	If the named member of the IIC is not available (due either to being out of the office, on vacation, or the position being vacant), the next ranking staffer with similar responsibilities should attend IIC meetings to ensure appropriate participation.	Necessary	Easy	N	N	
G18.1	RSIC's communications policy should be reviewed and revised, as appropriate, to address who is responsible for proactively speaking out on behalf of the RSIC and any policies which might be necessary to develop key messages.	Necessary	Easy	Y	N	
G12.4	Develop an overall continuing education plan for Commissioners, including an on-going education budget for the Commission and plans for individual Commissioners.	Necessary	Easy	Y	N	
I17	The Legislature should consider four potential options to significantly improve the ability of the RSIC to obtain services from and work with its custodial bank (see Recommendations G2 and G3).	Critical	Difficult	Y	Y	Legislature

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Category	Funston Recommendation	Critical vs Important vs Necessary	Difficult vs Medium vs Easy to Accomplish	Commission involvement needed	Outside cooperation needed	If yes, who?
I4.1	The overall RSIC infrastructure development plan should fully consider and incorporate the staffing, systems and policy requirements to significantly increase internal asset management and manage risk prior to significantly expanding the current limited amount and types of assets managed internally.	Critical	Difficult	Y	N	Dependent on investments
I18.2	RSIC will need to develop new policies and practices if it chooses to continue securities lending through BNYM or another third party; a new policy should include a statement of lending objectives, risk tolerance and guidelines approved by the Commission.	Critical	Medium	Y	N	
I2	The Commission should spend more time discussing its underlying investment beliefs and ensure that the asset allocation strategy remains consistent with those beliefs (see Recommendation G10.1).	Critical	Medium	Y	N	
I3.2	RSIC should create a Risk Management/Investment working group to design the functionality of risk reporting.	Critical	Medium	N	N	
I3.4	Risk Management should produce an annual plan which is reviewed and approved at the IIC; this should improve risk discipline, provide a benchmark for performance evaluation, create an opportunity for other investment officers to understand Risk Management capabilities, and improve communication.	Critical	Medium	N	N	
I6.3	The Commission should seek alternate means of assuring and reassuring itself as to the quality of the legal review, thereby enabling it to eliminate the 30-day review period before funding.	Critical	Medium	Y	N	
I9.1	RSIC staff should update the 2012 plan for expanded internal management and include a full business plan which considers all requirements (see Recommendation I4.1).	Critical	Medium	N	N	
I9.2	RSIC should continue to pursue reductions in fees where it pays greater costs than its peers, taking into account potential net return and risk.	Critical	Medium	N	N	
I1	If the Legislature continues to set the expected rate of return, it should regularly review the process and its assumptions on a periodic basis. Ideally, that cycle should be set to take advantage of the information available from the every five year PEBA experience study and RSIC's asset liability study.	Critical	Medium	N	Y	Legislature

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I11.2	The RSIC should contract with CEM, or a similar service from another provider, on an annual basis to develop a source of “apples-to-apples” benchmarks of investment management costs for each asset class and for the entire fund, as well as to provide an additional source for returns performance benchmarking (see Recommendations G13.4 and G18.4).	Critical	Medium	N	N	
I3.1	As part of an overall infrastructure development plan, the RSIC should continue to prioritize a new risk management system and capability as a top priority.	Critical	Easy	N	N	
I3.3	Investment Risk Management should be a participating member at all IIC meetings.	Critical	Easy	N	N	
I10.1	RSIC fee reporting for alternative investments should be restructured to improve transparency and comparability with peer funds; management fees should be broken down into invoiced and non-invoiced management fees, performance fees and carried interest, and pass-through fees.	Critical	Easy	N	Y	PEBA
I10.2	Investments in strategic partnerships should be allocated to the appropriate asset classes for performance and fee reporting in the PEBA CAFR.	Critical	Easy	N	Y	PEBA
I5.1	The policy of Commissioner Involvement in due diligence should be changed to limit participation to no more than occasional involvement as an observer for educational or reassurance purposes only; Commissioners could be invited to all manager meetings held in Columbia (see Recommendations G10.3 and P1.3).	Critical	Easy	N	N	
I18.1	The Commission should determine the future of securities lending based on assessment of the potential investment benefits and risks of different approaches to participating in the lending market.	Important	Medium	Y	N	
I18.5	If RSIC decides to significantly grow securities lending, it should implement enhanced and more automated compliance functions, including compliance reporting from the lender(s) and periodic review by RSIC's compliance officer.	Important	Medium	N	N	

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16.1	RSIC should re-assess its due diligence practices towards identifying opportunities to streamline and reduce the cycle time of activities without impacting the thoroughness or effectiveness of the overall process. Among the possible improvements would be: weekly management report of due diligence progress at the IIC, addition of a paralegal to co-ordinate legal reviews and with outside counsel (see Recommendation L1.2), and more frequent Commission meetings (see Recommendation G12.1).	Important	Medium	N	N	
13.5	The RSIC should explore whether the secondary market in LP interests could help it rationalize its private equity portfolio, while keeping in mind the variable inefficiencies of that secondary market.	Important	Medium	N	N	
15.2	Ideally operations should perform on-site reviews of all potential new managers. If staffing makes that impractical, the RSIC should adopt a formal operational due diligence calendar so as to a) minimize the number of managers hired without such an on-site visit, and b) prioritize an on-site operational visit as soon as possible following selection.	Important	Medium	N	N	
17.1	RSIC should consider establishing a formal policy for frequency of site visits to external managers as part of the monitoring process. Leading practice is to make the periodicity annual, but given staff constraints and the existing semi-annual contact requirement, a biannual periodicity could be considered.	Important	Medium	N	N	
119	RSIC should ensure that its policy pertaining to Commissioner requests for information from the RSIC staff is followed. This would include timely fulfillment of routine requests, a transparent process for determining the priority of requests which require approval at Commission meetings, and all responses being made available to all Commissioners through the portal.	Important	Easy			
16.2	RSIC legal staff should work with outside counsel to standardize contracting practices where possible. This should reduce delays in the contracting process (see Recommendation L2.1).	Important	Medium	N	N	
114.1	RSIC should explore alternate transition management programs, such as manager-to-manager transitions (cherry picking) with the remaining securities sold, or principal bids. RSIC should educate itself about when each technique is most appropriate.	Necessary	Medium	N	N	

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I14.2	RSIC should determine if it wants to independently measure transition management costs, at least on a spot check basis.	Necessary	Medium	N	N	
I7.2	RSIC should consider how it wants to gain assurance that managerial trading is efficient. It could suggest that its external managers trading in public securities provide independent trade execution measurements, or engage a trade execution management vendor itself to “spot check” external managers.	Necessary	Medium	N	N	
I9.3	RSIC should consider whether the use of a pool of asset-class specialist consultants to perform due diligence on co-investment opportunities would be beneficial and consistent with current asset allocation plans.	Necessary	Medium	N	N	
I12.1	The RSIC should formalize its policies with respect to oversight of the strategic partnerships and controls over underlying investments within RSIC, e.g., use of the IIC to vet investments, two RSIC staff participating in meetings, etc. (see Recommendation G7).	Important	Easy	N	N	
I12.2	RSIC should develop a guideline, rather than current situational decision making, for when and how much long-only, traditional assets should be in strategic partnerships.	Important	Easy	N	N	
I12.3	RSIC should develop a guideline regarding the appropriate level of cash to remain within strategic partnerships and for the return of any cash in excess of partnership needs.	Important	Easy	N	N	
I13	Rebalancing policies should be revised to require a quarterly rebalancing review to be scheduled on the annual meeting calendar of the IIC or Wednesday markets meeting to ensure compliance with SIOP; in the event the CIO and staff review balancing in the interim due to market movements or otherwise, that should be reflected in the IIC minutes to demonstrate compliance.	Important	Easy	N	N	
I18.3	The RSIC securities lending agent should be required to provide quarterly reporting to management and the Commission regarding program activity, including amounts on loan, borrower concentration, return and risk.	Important	Easy	N	N	
I18.4	RSIC should obtain an annual benchmarking of its activities against lending activity across the industry.	Important	Easy	N	N	
I4.2	The RSIC should adopt a formal counterparty risk policy (see Recommendation P2.1).	Important	Easy	N	N	

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Category	Funston Recommendation	Critical vs Important vs Necessary	Difficult vs Medium vs Easy to Accomplish	Commission involvement needed	Outside cooperation needed	If yes, who?
I4.3	RSIC should review its broker/dealer selection policy with an eye towards increasing its robustness by creating objective measures for acceptability and setting a time period for reaffirmation of the acceptable broker/dealers (see Recommendation P2.2).	Important	Easy	N	N	
I5.4	RSIC should clarify the level of authority operations has on manager hiring and retention. Two potential options would be to give a veto to operations or, alternately, to mandate that should the CIO decide to recommend an investment despite operational concerns, an operations memorandum should go to the Commission along with the CIO's recommendations explaining why the investment should be made notwithstanding operation's concerns.	Important	Easy	N	N	
I11.1	Given the controversy the decision to disclose all external manager fees has engendered, the Commission should more clearly articulate its policy decision.	Necessary	Easy	Y	N	
I12.4	The Commission should take increased advantage of the information, insights and experience resident in the RSIC's strategic partners. In-person education programs in Columbia would be one possibility, either in conjunction with regularly scheduled Commission meetings or, as in the past, at special educational or strategic planning retreats in-state.	Necessary	Easy	N	N	
I16	RSIC should complete development of an annual assessment process for the Commission to evaluate the performance of its general investment consultant and the Commission should adopt and implement the process.	Necessary	Easy	Y	N	
I5.3	Operational due diligence recommendations to the IIC should require a sign off from the head of RSIC operations.	Necessary	Easy	N	N	
L4.4	The Enterprise Risk Management (ERM) program planning should be completed and the new function launched as soon as practical. (See also Recommendation G13.2).	Critical	Difficult	N	N	

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L3.1	RSIC should consider eliminating the 30-day review period and instead rely on an appropriately documented Legal Sufficiency Certificate to confirm that all legal compliance and due diligence is complete. Alternatively, RSIC could shorten the Commission review period and add a provision to the Governance Policy Manual clarifying the purpose for this review period and confirming that it does not delegate Commission authority to individual Commissioners or revoke authority otherwise delegated to the CIO or COO.	Critical	Easy	Y	N	
L5.2	The process for approval of outside counsel by the Attorney General could be streamlined through development of a pre-approved pool of qualified investment counsel, with agreed engagement contract form and budget standards, and requirements for regular reporting to the Attorney General and Commissioners.	Important	Difficult	Y	Y	AG
L5.3	Consideration should be given to engagement of qualified, independent fiduciary counsel.	Important	Difficult	N	Y	AG
L1.1	RSIC's procedure for use of legal counsel should be revised to assign inside or outside counsel to each investment transaction during the final due diligence process prior to approval of the Commissioners, as needed.	Important	Medium	N	N	
L1.2	RSIC should add a paralegal to the legal staff to provide administrative support and assist in document control (see Recommendation I6.1).	Important	Medium	N	N	
L3.3	The Legal Sufficiency Certificate should include confirmation that documentation for each investment is consistent with material terms approved by the Commission and with authority delegated to staff by the Commissioners in the Statement of Investment Objectives and Policies.	Important	Medium	N	N	
L3.2	RSIC could require more frequent Commission meetings to consider investments. (See also Recommendation G12.1). Alternatively, the Commission could consider delegating greater authority for approval of alternative investments to the CIO or Internal Investment Committee.	Important	Easy	Y	N	
L4.2	Consideration should be given to extending coverage of the Sourcing and Conflict Disclosure Form to Commission approval of consultants and professional service providers exempted from State procurement processes.	Important	Easy	Y	N	

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L4.3	The Sudan divestment policy should be completed and approved by the Commission (See also Recommendation P2.7).	Important	Easy	Y	N	
L2.1	RSIC should establish a standard side letter and contract clauses to improve bargaining leverage and increase contract consistency, and internal counsel should work with investment staff and outside lawyers on prioritization of the “asks” (see Recommendation I6.2).	Important	Easy	N	N	
L2.2	RSIC should identify investment terms that are deal-breakers and provide those terms to investment counterparties early in the investment due diligence process.	Important	Easy	N	N	
L5.1	Outside counsel should be refreshed, since it has been more than six years since the last RFP market test.	Necessary	Medium	N	Y	AG
L4.1	The Audit Committee should approach the State Ethics Commission to establish a process for regular confirmation that RSIC Statements of Economic Interests have been audited.	Necessary	Easy	N	N	
O3.3	RSIC should implement more thorough compensation planning and evaluations to enable recruitment and retention of highly skilled and experienced staff (see Recommendation P4.1).	Critical	Difficult	N	N	
O2	The RSIC should develop an enterprise-wide capabilities and resources assessment and determine: 1) What are the overall support needs and priorities? 2) Where are the major resource gaps? 3) Should the gaps be filled through internal and/or external resources?	Critical	Medium	N	N	
O3.1	A senior human resources professional position should be created and filled to lead development of an overall HR strategy to support the organization’s business plan.	Critical	Medium	Y	N	
O3.2	Policies and processes should be developed which ensure that the HR implications of proposed new initiatives are recognized and addressed before launch.	Critical	Medium	Y	N	
O3.6	The Human Resources function should provide leadership for development of a multi-year (3-5 year time horizon) infrastructure business plan which considers the needs	Critical	Medium	N	N	

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	and priorities of the organization.					
O1.1	RSIC should consider creating the position of chief executive officer who would be accountable to the Commissioners for managing the entire organization.	Critical	Easy	Y	N	
O1.2	Given the delay in the migration to internal management, the CIO (hopefully in conjunction with the new senior HR professional) ought to examine the way the investment team is organized today to determine if staffing is aligned with AUM, complexity and risk.	Critical	Easy	N	N	
O3.7	RSIC should develop an internal governance process to plan and manage capability and infrastructure development.	Critical	Easy	N	N	
O4	RSIC should adopt a standard process for documenting, approving and updating operational procedures and should continue its effort to provide on-line access to them as they are completed.	Important	Easy	N	N	
O3.4	More formalized staff training and development plans and programs should be developed.	Necessary	Medium	N	N	
O3.5	RSIC should utilize succession planning, including cross-training and other actions, to develop staff for broader responsibilities.	Necessary	Medium	N	N	
P4.2	The Commission should engage an independent consultant to conduct a new peer compensation study at least every three years to assess the current level of RSIC staff compensation and make revisions to the target ranges, as appropriate.	Critical	Medium	Y	N	
P5	To facilitate timely acquisition and implementation of information systems, RSIC should develop a proposed modified procurement process for approval by the BCB or the Legislature which would allow acceptable transparency and objectivity, improve the ability to evaluate, select and implement new systems, as needed, and include documentation to allow oversight on a post-purchase audit basis (rather than imposing pre-purchase restrictions).	Critical	Medium	N	Y	BCB
P1.2	When the Commission's investment beliefs have been articulated, they should be included in the Statement of Investment Objectives and Policies (see Recommendation G10.1).	Critical	Easy	Y	N	

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P3.2	Review the positions required to sign to release cash transfers with the custodial bank and revise the requirements to allow two appropriate RSIC signatories, one from investments and the other from operations.	Critical	Easy	N	Y	STO
P3.3	Instruct the custodial bank to accept signatory changes based upon a letter from the Commission Chair or the RSIC COO and CIO (or CEO if a CEO position is created).	Critical	Easy	N	Y	STO
P4.1	The Compensation Committee should conduct an annual review of RSIC's implementation of the Compensation Policy.	Critical	Easy	Y (Comp Committee)	N	
P1.1	The Commission should, as a general rule, preclude Commissioners' involvement in investment due diligence except as an observer for occasional educational purposes (see also Recommendations G10.3 and I5.1).	Critical	Easy	Y	N	
P1.3	The Governance Policy Manual should be revised to describe the potential role of a Commissioner in due diligence activities as an observer for educational and quality assurance purposes only, and that as a general rule Commissioners are not involved in due diligence activities (see also Recommendations G10.3 and I5.1).	Critical	Easy	Y	N	
P2.9	RSIC should develop a referral tracking and reporting mechanism, like the sourcing and conflict disclosure process used for investments, to cover service provider referrals.	Critical	Easy	Y	N	
P2.1	A counterparty acceptance and monitoring policy should be developed and implemented.	Important	Easy	N	N	
P2.2	The broker selection policy should be strengthened and require periodic reaffirmation by the fixed income team.	Important	Easy	N	N	
P2.7	The Sudan divestment policy should be finalized (see Recommendation L4.2).	Important	Easy	N	N	BCB, PEBA, AG
P2.4	Policies which describe responsibilities for securities litigation activities should be refined to clarify approval roles of RSIC Legal, the Commission and Attorney General.	Necessary	Medium	Y	Y	

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P2.3	RSIC should finalize the proxy voting rules that are in development, require that investment managers vote in the best interests of plan participants, monitor how managers are voting proxies and include a field to track voting in Tamale.	Necessary	Easy	N	N	
P2.5	The staff conflict of interest policies should be modified to include more guidance on what is covered by the statutory standards of conduct.	Necessary	Easy	N	N	
P2.6	RSIC should consider developing and implementing a policy which requires Commissioners and senior investment staff to disclose personal financial or legal distress.	Necessary	Easy	Y	N	
P2.8	RSIC should consider developing a flowchart which describes the investment review and approval process, including responsibilities and timelines.	Necessary	Easy	N	N	
P3.1	Continue to allow standing instructions for the custodial bank to receive incoming funds and allow sweeping of cash to maximize income.	Necessary	Easy	N	Y	STO
P3.4	STO should revise its policies to allow electronic payment authorization for release of funds to cover capital calls using the existing technology offered by BYN Mellon.	Necessary	Easy	N	Y	STO
IT1.1	IT1.1: Guided by an overall business and IT plan, RSIC should complete the acquisition of systems to: -Track commitments and provide return calculations for private market investments -provide security-based risk management that includes position level transparency and risk and performance analytics -monitor compliance of investment policies and contracts -automate trade order management -warehouse data for the whole investment portfolio in ordre to seamlessly feed other systems for analysis	Critical	Difficult	N	N	Done- now implementation
IT2	Guided by a business plan for the whole organization, RSIC should seek the number and types of additional IT staff needed to adequately support its expanding systems infrastructure (see Recommendation O3.6).	Critical	Difficult	N	Y	Legislature for budget approval

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IT3.1	Guided by a business plan for the whole organization, RSIC should develop a strategic IT plan with clearly defined objectives, a full assessment of the current state of its systems and a timetable for completing needed improvements (see Recommendation O3.6).	Critical	Difficult	N	N	
IT4.1	RSIC should be authorized to procure investment systems under a modified procurement process that includes appropriate accountability (See Recommendation P5).	Critical	Medium	Y	Y	BCB
IT4.2	RSIC should continue to pursue the eventual move of IT support from PEBA to RSIC.	Important	Difficult	N	Y	PEBA
IT1.2	The QED internal accounting system provided by vendor contract with the State Treasurer’s Office should be upgraded or replaced.	Important	Medium	N	N	
IT3.2	RSIC should establish a project governance process with representation from across the organization to determine IT priorities and monitor progress of initiatives, and to assure resources are appropriately targeted and that issues are addressed promptly. See also Recommendation O3.7	Important	Easy	N	N	