State Treasurer Curtis M. Loftis, Jr.
Revised January 17, 2014

Subcommittee Questions – Red Flag Letter

1. **The "red flag" letter was written by William J. Condon, Jr., General Counsel of the Office of State Treasurer. Since the letter was written by your General Counsel, do you agree with / endorse the contentions offered in the letter to the Inspector General?**

   Yes.

   As the IG stated, a lack of communication and the restrictive confidentiality practices employed by the RSIC led me, a commissioner and fiduciary, to have significant concerns about the potential of wrongdoing at the RSIC. The Attorney General had previously released an opinion stating that fiduciaries are required to share information, yet the restrictive confidentiality practices did not improve. I sought the intervention of the Trustees, the B&CB, to correct the RSIC's actions, yet the confidentiality matters did not improve. I discovered an investment in which a commissioner's private law firm made $150,000 off of an investment deal, and I reported the instance to the Attorney General and the Ethics Commission.

   A specific impropriety that alarmed me was that the current Chairman of the RSIC, Reynolds Williams, and his law partner at the firm Willcox, Buyck and Williams, profited from an investment approved by the Commission. Mr. Buyck performed legal and underwriting work on the American Timberlands investment and made approximately $150,000 for his services. State law, specifically §9-16-360, prohibits a fiduciary (a Commissioner) or his business to profit from the investments of the pension fund. It is unconscionable and indisputable that Chairman Williams' law and insurance firms, of which he is a named partner and owner, profited from his work at the RSIC. The Attorney General recently declined to send this matter to the State Grand Jury, but that decision does not exonerate Chairman Williams and does not dispute the evidence that his business profited from his position on the RSIC. An investigation by the State Ethics Commission is ongoing.

   Because of the continued restrictive actions taken by the RSIC toward a fiduciary, because of the profiting from an investment deal by a commissioner, and because of the on-going and unresolved significant risks cited by auditors/consultants in 2008, 2011, and 2012. I believed these instances of potential wrongdoing warranted an investigation by the IG.

   Please note that the IG declined to investigate Chairman Williams and his law firm concerning the American Timberlands investment approved by the RSIC as part of the investigation. He did so because SLED and the Ethics Commission were conducting separate investigations into the matter.

2. **The members of the Special Subcommittee to Review the Investment of Retirement Funds (Subcommittee) heard testimony from the Inspector General (IG) Pat Maley. The IG categorized the 33 issues mentioned in the "red flag" letter into six issues of potential wrongdoing. These issues are listed in an attachment to this list of questions along with the IG's findings and recommendations. Please provide the subcommittee with a list of those findings with which you agree and disagree. If you have additional information not discovered by the IG in his investigation, please supply that material to the subcommittee. The subcommittee would also be interested in your comments on each of the six issues.**

I objected to the IG's bundling of 33 red flags into 6 categories. In addition to minimizing some of the red flags, other red flags were dismissed and not included in the 6 categories. For example, the red flag concerning American Timberlands and the ones mentioning possible misstatements of material facts or possible omissions of material facts were not addressed by the IG.

Finding III-A: ***Misstatement of Management Fees in the FY 2012 Audited Financial Statements***

Due to my calls for transparency, full disclosure and proper reporting of fees and expenses, the RSIC has finally correctly reported the vast majority of its fees and expenses in the most recent SCRS Financial Statements, as prepared by the PEBA. It took nearly three years, but my repeated calls and the IG's recommendation finally caused the RSIC to act.

I disagree with the IG's conclusion that the SCRS Financial Statements were not materially misstated and believe that the SCRS did not fully account, or disclose, management fees, performance fees, and other investment expenses paid to external investment managers.

In FY 2012, the Financial Statements reported the investments fees and expenses totaling approximately $55 million. However, the actual investment fees and expenses totaled nearly $304 million—a difference of almost $250 million or a quarter-billion dollars. A similar material understatement of investment expense occurred in the FY 2011 audited Financial Statements.

The Financial Accounting Standards Board (FASB), Concept No. 8 states, "*Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information.*"

The Governmental Accounting Standards Board (GASB), Statement 25 requires disclosure of the, "*total investment expense, separately displayed, including investment management and custodial fees and all other significant investment-related costs.*"

After the IG released his report, I contacted the Governmental Financial Officers Association (GFOA) to inquire whether the Financial Statements, and particularly the underreporting of investment fees and expenses, were materially misstated. Upon review

of the Financial Statements, a Director at the GFOA concluded, "*The concept of materiality embraces both quantitative and qualitative factors. Given the sheer magnitude of the difference and the inherent political sensitivity of investment-related fees (which accounts for the GAAP requirement to report them separately), it is difficult to argue that a departure from GAAP in this case is 'immaterial'.*"

Based on the FASB and GASB accounting standards, and upon the GFOA's review of the Financial Statements, I disagree that the SCRS and RSIC fully accounted for and disclosed all investment fees and expenses. Further, due to the magnitude of fees and expenses not included in the investment expense in the Financial Statements, I believe that the SCRS accounting and disclosure is a material misstatement and not in compliance with GAAP, GASB, FASB or GFOA. I am pleased that the RSIC has since taken corrective measures to address this matter.

Finding III-B: ***False Representation of Investment Valuations in Audited Financial Statements***

I still question the valuations of many of SCRS' alternative investments. First, I have asked for, but have not received, sufficient documentation to confirm that the PEBA and/or the RSIC have satisfied applicable accounting standards regarding the valuation of alternative investments. Second, various reports and the RSIC's own internal audit staff have questioned the RSIC's ability to properly value the SCRS' alternative investments, which at June 30, 2012 approximated $14 billion.

The 2008 fiduciary audit found that the RSIC did not perform adequate pre-investment due diligence regarding the accounting work associated with alternative investments. Specifically, the RSIC was not engaging in active involvement with the Strategic Partners and did not utilize alternative investment monitoring services.

The 2011 Deloitte Report found eleven areas of risk; seven of which were high-risk and four of which were medium-risk (zero no-risk areas). Concerning asset valuations, Deloitte stated, "*The Commission does not have a standardized due diligence process across asset classes and the current processes do not appear to include a complete operational and technology risk assessment to each manager... Examples of additional items for consideration when implementing these practices may include, 'Assessing the manager's valuation policy, confirming that the policy is in line with leading practices across peer firms, and meeting with operations and administrative staff (internal or third party) to determine if the valuations performed as part of the net asset value process or portfolio valuation process conform to the state policy.*" The report further stated, "*The Commission does not have documented policies and procedures in place for ongoing manager or Strategic Partner oversight*" specifically recommending the RSIC conduct, due to absence of the RSIC reconciling fees, "*Reconciliation of manager fees for each period to the provisions within the IMA's or similar agreements.*" Lastly, the report also states, "*SCRS performs the reconciliation only for those managers that invoice the Commission. SCRS does not review management fees for managers that withdraw the fees directly from the Commission's accounts.*"

Again in 2012, the Deloitte Report clearly stated, "*The Commission currently does not maintain initial/on-going due diligence and financial reporting controls to support the valuations of the External Managers.*"

On August 18, 2012, the RSIC's Internal Audit and Compliance Officer made the following report to the RSIC Audit Committee, "*Due diligence and financial reporting controls to support the investment valuations of the External Managers do not currently exist or are inadequate.*" Citing the 2012 Deloitte report, she continued, "*While the Commission may look to the External Managers to perform the valuation calculations, the Commission is ultimately responsible for the valuations of the investments reported in the plan's financial statements, which SCRS prepares.*"

From 2010-2013 the audited notes in the PEBA (SCRS) CAFR include the following disclaimer, "*The fair values of alternative investments... are valued in good faith based on the most recent financial information available for the underlying companies and reported by the investment managers at the measurement date.*"

Since 2008, multiple reports from third party professional firms, the RSIC audit staff and the PEBA financial statements confirm that the RSIC, in no uncertain terms, did not have the proper controls to support the investment valuations of External Managers. These assets are held outside of the State's custodial bank. If the assets were held in custody with BNYM, the valuation of each individual securities held by BNYM would be readily available to the RSIC and PEBA.

Finding III-C: ***Inappropriate RSIC Employees' Travel or Perks Paid by External Managers***

In 2010 and 2011, former CIO Bob Borden took two business trips to Bermuda on private jets that were paid for by an external investment manager doing business with the State. Both State law and regulations prohibit this practice. State ethics law §8-13-100 and §8-13-710(B)(1-2a) require that Mr. Borden, as a fiduciary and agency head, report these flights as a gift on his required annual Statement of Economic Interest form filed with the State Ethics Commission. Mr. Borden did not disclose either of these flights on any of his Statement of Economic Interest filings. Also, Regulation 1-101.17 requires that foreign travel by any State employee be approved by the Budget & Control Board regardless of the source of funds expended for the trip. Neither Mr. Borden nor the RSIC sought and received approval from the Budget & Control Board for either trip to Bermuda.

Additionally, the IG only requested whether any travel payments were provided to the RSIC employees by the RSIC's Strategic Partnerships and not from any of the multiple underlying funds/firms that make up the Strategic Partnerships. The information requested and received by the IG cannot result in the conclusion that there has been no abuse of travel or perks or that no potential conflicts of interest exist/have existed. Also, merely asking the Strategic Partners, who have a conflict of interest by earning fees from the SCRS, about travel/perks is not a procedure that provides much assurance as to whether a Strategic Partner provided travel payments or other perks to the RSIC employees.

Finding III-D1: ***RSIC Has Inadequate Controls for Alternative Investment Management Fees***
Please see response to Finding III-B.

Please note that the IG confirmed that there are opportunities to improve and that the RSIC should explore market-based technology to improve its fee validation process in terms of increased speed and assurance, as well as personnel costs.

Finding III-D2: ***RSIC Has Inadequate Controls for Alternative Investment Management Fees***
Please see response to Finding III-B.

I agree with the IG that the $18.3 million reporting error serves as an example of a potential impact, in terms of dollars and financial statement accuracy, of an inadequate fee validation process.

Finding III-E1: ***RSIC's Process for Approving Investment Contracts Has Flaws***
Please see response to Finding III-B.

Finding III-E2: ***RSIC's Process for Approving Investment Contracts Has Flaws***
The IG recommended that the Commission should examine the practice of delegating wide discretion delegation authority to the CIO in regards to investments with Strategic Partnerships. I believe the Commission should establish prudent investment approval thresholds for RSIC staff, who in turn, should make a report to the Commission at each meeting to provide for optimum transparency and accountability.

Finding III-E3: ***RSIC's Process for Approving Investment Contracts Has Flaws***
I agree with the IG that the RSIC's ambiguous investment approval process needs to be fully standardized and streamlined. Had the investment information I requested, which they are obligated to provide to a fiduciary, been provided to me, the costly Supreme Court lawsuit would never have been necessary.

Finding III-E4: ***RSIC's Process for Approving Investment Contracts Has Flaws***
I agree with the IG that the RSIC Chairman should be accountable and provide the necessary leadership to ensure investment managers are not incurring higher fees than the Commission approved and to make sure all investment issues are addressed in a timely manner.

Finding III-F1: ***RSIC Improperly Restricts Information to the Treasurer***
I agree with the IG that the RSIC inappropriately restricted information to my professional senior staff and to me as State Treasurer. The RSIC presented the STO with a non-disclosure agreement that did not provide for proper access to information and as the IG testified, it was not a document that he would have signed and was a document

that the Budget & Control Board's legal counsel advised against as well. After two Attorney General opinions, a special hearing of the Budget & Control Board, litigation in the Supreme Court and an IG investigation, over a two year period, all confirmed that a fiduciary is entitled to access any and all necessary information. State law in §9-16-360(B)(7) acknowledges that staff of a fiduciary has access to confidential information. Finally, the RSIC acknowledged that the restrictive procedures previously employed were wrong. A few months ago, the STO and the RSIC signed a non-disclosure agreement.

However, ongoing requests for information continue to be ignored and incomplete. One example in particular concerns a request for information concerning Commissioner's and RSIC staffs' seats (filled or unfilled) on investment boards and any potential compensation/fee supplied by the investment boards with whom the RSIC conducts business. Both the former COO and the current Acting-COO have either not answered or provided incomplete information to me, respectively. This example is detailed in ***Exhibit A*** and is a simple example of an unfilled request for information from a fiduciary that sheds light on an egregious practice that must stop.

Finding III-F2: ***RSIC Improperly Restricts Information to the Treasurer***
The RSIC's inappropriate restriction of confidential information is the root of the problems with the RSIC. The RSIC's failure to provide complete and timely information to the fiduciary, and his staff, that requested it created an air of distrust and added to the Commission's dysfunction. The repeated and well-documented resistance to providing me, as fiduciary, information, which I am entitled to review, is the cause of the breakdown in communications that led the IG to investigate *potential wrongdoings* at the RSIC and is the reason a costly and unnecessary law suit was filed in the Supreme Court by the RSIC.

If my requests had been fulfilled, there would have been no need for the perceived voluminous and repetitive requests for information. The RSIC has a fiduciary obligation to provide information to another fiduciary. As State Treasurer, I have an obligation to carry-out my fiduciary responsibilities to the Trust, beneficiaries, active participants and taxpayers of South Carolina.

Finding IV-A1: ***Dysfunctional Communications***
I believe the issues that are materially impacting the RSIC's ability to effectively execute its mission relate, in part, to the findings in the 2008, 2011 and 2012 audit/assessment reports and the risk factors that have not been mitigated. Additionally, prior misstatements in the Financial Statements regarding investment fees and expenses and the continuing lack of controls and due diligence regarding investment valuations in the Financial Statements are a cause for concern.

To review issues that materially impact the RSIC's ability to effectively execute its mission, please review the responses for Finding III-A and Finding III-B.

Finding IV-B1: ***RSIC Operational Control Processes***

I agree with the IG that some tangible efforts have been made to address the concerns cited in the 2008 fiduciary audit, the eleven high and medium risks discovered in the 2011 Deloitte Report and the subsequent performance deficiencies stated in the 2012 Deloitte Report.

However, I disagree that the risks to the portfolio have dissipated. The RSIC has had nearly seven years to "close the performance gap." The RSIC made a conscious decision at its inception not to invest in the proper and necessary operational infrastructure to manage professionally the investments of a $27 billion pension portfolio. Due to the RSIC's decision to send immediately billions of dollars of retiree's money out of South Carolina without proper due diligence, accounting procedures, reporting protocols, internal controls, risk and compliance programs, and necessary technology—the portfolio has underperformed, paid the highest fees in the nation and has undocumented risk. Most, if not all, of these problems would not have occurred if the RSIC had put an emphasis on creating a professional internal investment operation that mitigated the risky structure that has been identified in multiple reports, audits and internal reviews spanning a five year period.

Additionally, the RSIC has elected not to utilize their annual appropriation to invest in their internal operations. Between FY 2007/2008 and FY 2011/2012, the RSIC did not expend $11,132,563 of its budget authorization. These funds should have been used to mitigate the major risk-areas identified in numerous reports dating back to the 2008 fiduciary audit.

Finding IV-C1: ***RSIC Investment Strategy***

I agree that the RSIC's mixed-message public communications has been misleading and lacks a consistent, robust data presentation that brings together peer results, robust benchmarks, and the long-term investment strategy. The RSIC, as noted in the IG's report, has previously been misleading about investment returns and portfolio results. I also agree with the IG's recommendation that the RSIC should establish a reporting mechanism that integrates peer results in a concise manner and that is understandable to the public and accountable to the stakeholders.

I also agree that the RSIC should publicly report the annually adopted AIP along with details of the debate, dialogue and rationale for its decision. Any mechanism to enhance transparency is important, particularly with a $27 billion pension fund.

3. **Given the harshness of the accusations on Page 1 coupled with the admission on Page 35 that certain documentation to support some of the beliefs was lacking, was any consideration contemplated to simply offer the IG only those suspicions that were supported with documentation?**

   I met with the IG prior to the "red flag" letter and provided the Office of Inspector General with documentation throughout the course of the review.

   As is stated throughout the "red flag" letter, the purpose of requesting the IG's investigation was to review "potential wrong doings" at the RSIC. As the IG concluded in his report and stated during his testimony before this subcommittee in December, my concerns regarding "potential wrong doings" were justified because of the restrictive confidentiality provisions placed on me as a fiduciary. Due to the RSIC's failure to provide requested information to a fiduciary, the RSIC's restrictive confidentiality interpretation, and inability to cooperate with a fellow fiduciary, there were incomplete documents to provide to the IG prior to the initiation of his investigation. My office was unable to procure previously requested information and documentation from the RSIC.

4. **On Page 1 of the "red flag" letter, while discussing the alleged secrecy of the RSIC, Mr. Condon writes "…approximately 70% of the SCRS' investments are held outside the custody of the State Treasurer and his custodial bank." Please explain how investments held in custody by the Treasurer are more transparent than those assets held outside the purview of the custody of the State Treasurer.**

   This question is a false premise in that it does not correlate with the quoted statement. I would first note that pursuant to §9-1-1320, the State Treasurer is custodian of all funds of the Trust.

   When the previous CIO resigned in December 2011, he left with a rolodex of information concerning the RSIC's investments. In many cases, he was the only member of staff that had this information and once he was gone the RSIC had to spend months culling through documents to identify the investment information necessary to manage the funds. Had these investments been in the custody of BNYM, the departure of the former CIO and the subsequent time and manpower spent acquiring investment information would have been unnecessary as BNYM would have had all the information readily available. Keeping assets in-bank provides a much higher level of safeguards for the management of a $27 billion portfolio.

   Additionally, staff at BNYM provides reporting, proper accounting, analytics, training, valuations and most importantly data and safeguards of all funds in-bank. RSIC can review all data on the investments and utilize the services offered by BNYM in an expedited and organized manner. Thus, keeping the assets in-bank allows built-in accountability and provides transparency to the RSIC in regards to investment data.

Assets that are not in-bank are spread over multiple money managers in various funds and investment vehicles. These investments are typically opaque and difficult to accurately valuate. Because these assets are not in-bank and are in the control of multiple investment managers/custodians, retrieving information and ensuring the assets are properly safeguarded become more onerous and difficult.

Lastly, investment fees and expenses are readily available for in-bank assets and therefore would meet the recommendations by Deloitte to have a mechanism to properly report investment expenses.

To reiterate, §9-1-1320 makes the State Treasurer the custodian of all funds of the Trust.

5. **On December 11th, the subcommittee received testimony from the RSIC's external investment consultant, Ms. Suzanne Bernard. During her presentation, she offered a general endorsement of the diversified portfolio weighted to alternative investments due to their relative stability compared to equity markets and due to the better risk/return trade off compared to equity markets. Please explain why investments in publically traded stocks and bonds are less risky.**

Let me be clear; I am not opposed to alternative investments and believe it is prudent to allocate a sensible percentage of our assets into alternative investments. I have never said I oppose alternative investments. What I have said, and what I believe, is that the RSIC's allocation to alternative investments, from a high of over 60% to current low just under 50%, is unbalanced and an outlier among our peer public pension plans—nearly double the average.

Publicly traded stocks and bonds trade in an active, regulated market. While regulation does not eliminate risk, it certainly reduces risk. One is provided a greater sense of assurance that the information about these investments is reliable and accurate because the analysts providing the information are held accountable for any improprieties. The valuation of stocks and bonds sold on regulated exchanges are known and readily available, which reduces valuation risk (risk of an assigned value not being correct). The SCRS FY2013 is a good example of the difference between the certainties the State has regarding these particular valuations. Publicly traded stocks and bonds are priced by BNYM according to the market price at the close of the fiscal year. Anyone with access to the internet can verify the valuations.

In contrast, alternative investments are valued on "good faith" basis (as discussed in Question 2, Finding III-B) by the very managers who are compensated based on the valuation and performance.

Publicly traded stocks are managed and analyzed by professionals who are required to disclose any interest they may have in the investment. Many stocks also pay dividends that increase returns to the pension fund.

The RSIC's investments in publicly traded stocks and bonds are held in the custody of the BNYM. If the investments suffer losses or should any funds be missing, the Treasurer, as custodian of the funds, and the RSIC have the ability to find out what happened in a prompt manner because the BNYM has records of all movement of funds and all performance information. This built-in accountability provides for the safeguarding of our funds, prompt access to information, and reduces risk. However, should one of the RSIC's Strategic Partners suffer massive losses, file for bankruptcy, or become insolvent, neither the RSIC nor the Treasurer would have the ability to promptly access the information to determine what occurred—thus, this framework is lacking in accountability and adding unnecessary risk. Whereas, the funds held in the custody of BNYM, and therefore, the State Treasurer provide accountability. The majority of the funds invested by the RSIC have been moved out of the custody of the statutory custodian of the State, the State Treasurer, who is assigned responsibility for the safekeeping of these funds.

It should also be noted that the fees and expenses assessed to investments outside of the custody of the BNYM are inherently higher.
Lastly, concerning the returns on investments in the stock market ***(Exhibit B)***:

- The return on investment in the stock market has topped the RSIC's performance over a 1-year, 3-year and 5-year period;
- The DOW has more the doubled the RSIC's performance over a 5-year period; The Barclay's Aggregate has topped the RSIC's performance over a 5-year period.

Subcommittee Questions – Chronology *(Exhibit C)*

Subcommittee Questions – Securities Lending

6. Please offer an explanation of securities lending. What were the parameters of the securities lending arrangement before the lawsuit? What was the original impetus behind the decision to file a lawsuit?

Securities lending is the act of loaning a stock, derivative, or other security to an investor or firm. Securities lending requires the borrower to put up cash collateral to secure the loan. When the security is loaned, the title and ownership of the security is also transferred to the borrower. Securities lending is important to the practice of short selling, where an investor borrows securities in order to immediately sell them. The borrower hopes to profit by selling the security and buying it back at a lower price. Because ownership has been transferred temporarily to the borrower, the borrower is liable to pay any dividends received out to the lender. The contract custodian for institutional investors manages the lending to approved lenders and the reinvestment of the cash collateral received pursuant to a securities lending contract that defines the guidelines for lending, parties or entities to whom the lender may lend the borrower's securities and the guidelines for the reinvestment of cash collateral. As in most investment scenarios, the greater the risk on the reinvestment, the higher the return.

The State of South Carolina, through the Treasurer's Office, began lending securities through its custodial contract with J.P. Morgan in the 1980s during Treasurer Patterson's administration. In 1996, J.P. Morgan transferred its custody business, including the S.C. accounts to the Bank of New York. The Bank of New York entered a new securities lending agreement ***(Exhibit D)*** with the State of South Carolina during the term of Treasurer Eckstrom. This contract was re-executed with no material change by then Treasurer Grady Patterson in 2000 ***(Exhibit E)***. This contract remains in place until a new securities lending agreement is executed.

In 2009, Treasurer Chellis became concerned about losses incurred in the securities lending accounts. After bringing the matter to the attention of the RSIC, the Commission elected not to be a party to the lawsuit. Treasurer Chellis initially hired Willoughby & Hoefer, P.A. to perform an investigation of the matter. Upon investigation, Willoughby and Hoefer determined that a case existed to charge the Bank with breach of contract and breach of fiduciary duties relating to the purchase of certain asset backed securities based upon the use of Expected Final Maturities by the Bank to comply with the Contract's Final Maturity language relating to the reinvestment of cash collateral received as consideration for loaned securities in the State's accounts. The largest portion of the losses was incurred in investments in notes owed by Lehman Brothers. Bank of New York argued that these notes met the investment guidelines at the time they were purchased. Several theories were developed as to why these notes should have been sold at minimal loss to the state's accounts prior to the Lehman Brothers bankruptcy. In 2010 Treasurer Chellis and Attorney General McMaster entered a contingent fee agreement with Willoughby and Hoefer to further investigate and bring the suit if the parties agreed to do so. In January 2011, Willoughby and Hoefer sought to add Montgomery Willard, LLC as co-counsel and the Attorney General and the Treasurer approved the request. This did not change the contract between the state and the lawyers, it added Montgomery Willard as additional counsel to the State at no cost to the state. The suit was filed in January, 2011 prosecuted for more than two years and ultimately settled in May 2013.

The original impetus to file the lawsuit was to try to recover as many of the losses incurred in the State's various securities lending collateral reinvestment accounts as possible. That original purpose was accomplished.

7. **How much money did the State of South Carolina lose as a result of the breach of contract by the BNYM through their securities program? What amount of that loss is attributable to the South Carolina Retirement Trust Fund?**

Whether or not the Bank of New York Mellon breached its contract is a question of fact that can only be determined by a Judge or jury. Proving the alleged breach was not a certainty. The contract dispute arose around the interpretation of the term "maximum final maturity" in the State's investment guidelines. The state contended that this term referred to legal final maturity. The Bank asserted that it was interpreted by them and industry wide as expected final maturity. The dispute centered around a term of art rather than the performance or non-performance of a particular act. The Bank vigorously

contested the fact that it had breached the contract or its fiduciary duties. The State incurred the alleged losses in two areas.

The first area dealt with the allegation that the Bank of New York purchased asset backed securities for the accounts of the state that had final maturities that were beyond the State's investment guidelines. This area was hotly contested in that the vast majority of the securities purchased over a multi-year period paid off in full and paid a high yield to the State's accounts. The amount of damages in this area changes almost daily and has been diminishing as a result of market activity that has raised the prices on these instruments since the financial crisis in 2008. The question of losses relating to these items is largely the result of timing – many payments will be made beyond the three year window. In preparation for Mediation in September 2012, it was estimated that the ABS losses were as follows:

Accounts	**At 08/30/2012**	**Amounts**
Treasurer	Held	$ 8,021,218.00
RSIC	Converted to Strategos	$41,022,272.44
Total		$49,043,490.44

These damages continued to diminish since August 30, 2012 due to improvements in the ABS market and continued payments to the State by the impaired bonds. As of July 31, 2013 the losses in the treasurer's account had been reduced by more than 15% to just over 6.8 MM. These losses continue to diminish as the bonds continue to pay and their market value continues to rise. While the state will ultimately suffer some loss, that final loss is not presently determinable, but may be less than half of the amount identified in September 2012.

RSIC's situation is different as it removed these assets from the bank and tendered them to Strategos Capital Management, a specialist in US Residential Mortgage Backed Securities. If Stragetos' active management realizes similar or better results than the Bank's strategy allowed by the Treasurer, RSIC's losses should continue to be reduced as well. At 7/31/2012 Strategos reported that it had improved the RSIC's losses by approximately $23.5 million through its strategy versus the assets being not managed.

The second area of losses was based upon the Bank's purchase of Lehman Brothers notes in the Securities Lending Collateral Reinvestment Accounts. The State alleged that while these investments arguably met the contract guidelines at the time that they were purchased, the State alleged that the Bank had a duty to monitor and sell the assets and could have done so prior to the bankruptcy at minimal loss to the state. The Bank believed that Lehman would survive and did not want to incur any losses where it held that belief. Ultimately, Lehman filed Bankruptcy and the notes were sold.

At 8/31/2012 the estimates losses for Lehman were $122,643,050.43. This was based upon partial sales. These losses, like the calculated losses were 80% in the RSIC accounts and 20% in the Treasurer's accounts. The final losses for Lehman ended up

totaling $114,529,380.09 of which $90,130,396.49 was attributable to the RSIC accounts and $24,241,290.97 was attributable to the Treasurer's accounts. This is, of course, before the application of any settlement proceeds or the utilization of any benefits that are available to the state pursuant to the settlement.

The RSIC had exposure to Lehman in other funds. It is believed that their losses in these funds were nearly $100,000,000 and that they did not recover any of those losses.

8. **If the bulk of the loss from the breach of contract related to securities lending was Retirement System funds, and the function of the securities lending is to yield a return on investment, why is this not a function of the RSIC?**

   Whether or not the Bank of New York Mellon breached its contract is a question of fact that can only be determined by a Judge or jury. The legislature has provided the Treasurer with the sole legal authority to engage in securities lending. This is because securities lending is a function of custody. It is designed to yield marginal returns on funds held by the custodian.

9. **Upon initial discussions with the BNYM regarding their breach of contract with the administration of their securities lending program, did the Bank offer a settlement? If so, what were the elements of that settlement offer?**

   Whether or not the Bank of New York Mellon breached its contract is a question of fact that can only be determined by a Judge or jury. The bank offered a settlement at mediation in September 2012. This provided for the payment of just over $16,000,000.00 to the state. No other benefits were available and all costs and fees, including all legal expenses, would have been paid out of the $16,000,000.00 sum. This was the only firm settlement offer received. The Bank had offered Lehman "support" which consisted of partial refunds of some portion of its future earned fees to both the Treasurer and the RSIC. I understand that neither entity participated in any of these offers as there were a number of legal and practical problems involved.

10. **If there was a settlement offer rejected, what were the reasons for rejection?**

    Whenever a settlement offer is rejected, it is rejected because a party believes that it is inadequate. That was the case with the mediation offer made by BNY. Neither the Attorney General nor the Treasurer nor their respective counsel believed that the offer was sufficient in light of the information available at that time.

11. **If the settlement is not yet to be closed, what actions are outstanding and must be resolved to effectuate the terms of the settlement?**

    Upon the advice of counsel, the settlement was consummated and approved by the Court after the Attorney General and Treasurer recommended its approval as being in the best interest of the State.

Subcommittee Questions – Legal Staff

12. How was the private legal staff chosen (special skills and qualifications for Willoughby and Hoefer as well as Montgomery Willard)?

The private legal staff was initially selected by the prior Treasurer, Mr. Chellis and the prior attorney general Mr. McMaster. Counsel was selected based upon their litigation experience and particularly their demonstrated understanding and knowledge of the contract and securities issues involved. Counsel was also willing to agree to the terms of the State's standard contingent fee agreement. Mr. Willoughby requested that Montgomery Willard be added to the matter based upon his professional experiences with Mr. Montgomery, Mr. Montgomery's legal expertise and desire to add to his team. This was approved by both Attorney General Wilson and Treasurer Loftis. The addition of Montgomery Willard had no cost to the State.

13. What was the approval process for securing the private legal staff?

Private legal staff was approved utilizing the State's customary process as conducted by the State's chief legal officer, the Attorney General.

14. What was the agreed upon arrangement for remuneration of the private legal staff?

Private Counsel agreed to the State's standard contingent fee contract. The "Litigation Retention Agreement for Special Counsel" has been posted on the Treasurer's website since the lawsuit was filed. All documents and letters are included in ***Exhibits F1-F5.***

15. What was the reasoning for expanding the private legal staff to include Montgomery Willard?

Mr. Willoughby requested this addition, and it was determined to be in the best interest of the State by both the Attorney General and State Treasurer.

16. Was the additional staff assigned to a specific task?

The lawyers worked together on all aspects of the case.

17. Has the private legal staff been paid? If so, how much?

The settlement of funds paid by BNYM and not paid by the State, at the request of the Attorney General, was approved by the Attorney General and a judge to be paid outside of the settlement to the State. As a part of the settlement, the BNYM paid the total sum of $9 million to the legal staff. The payment included not only fees but all costs advanced by Counsel. These payments would not have been made to the State by the bank.

18. Were any time sheets, billing documents or other related bills submitted prior to or after the conclusion of negotiation? If so, please provide these documents to the Subcommittee.

No time sheets or billing documents have been submitted by counsel to the State as the State paid no fees. Legal fees were paid in whole by BNYM. Counsel conducted dozens of depositions across the country, reviewed hundreds of thousands of pages of documents and advanced all litigation costs and expenses necessary to pursue the State's case. This was a contingency fee case and the fees and costs were paid by BNYM separate from the settlement of the State.

19. Was any contingency fee agreement with either private legal firm agreed upon?

There was a single contingent fee agreement between the private attorneys and the State. It was the standard contingency fee agreement used by the Attorney General. It was entered by Treasurer Chellis and Attorney General McMaster with the Willoughby & Hoefer law firm. When the Bank agreed to pay the fees, the Bank's payment was accepted by the Attorneys as full satisfaction for any obligation that the State may have had under the contingency agreement. This was agreed to by the Attorney General, the Treasurer and the lawyers.

20. How were fees ultimately calculated?

The fees were negotiated based upon an understanding of the potential benefits to the State if the State took advantage of the discounts and other opportunities available in the contract. The Bank had a copy of the Contingent Fee Agreement (it was a public document) and was aware of and presumably considered these terms as the related to the value of the settlement benefits including the cash payments, future discounts and opportunities for further discounts in negotiating the amount it paid in attorney fees and costs.

21. How were legal negotiations conducted?

A mediation was held in September of 2012. Representatives of the Attorney General's office, the Treasurer's Office and the RSIC were present. The mediation was unsuccessful. Thereafter counsel continued a dialogue with representatives of the Bank of New York while the litigation continued to be prosecuted. In March of 2013 a meeting took place in the office of the Bank's lawyers where Counsel, representatives of the Treasurer's office, the Attorney General's office and RSIC were present. An agreement in principle was reached and thereafter the parties spent two months negotiating a final settlement agreement which was approved by the Court in May 2013.

22. Upon the addition of Montgomery Willard, were both representatives of Willoughby and Hoefer and Montgomery Willard present at all negotiations with representatives of BNYM that eventually culminated in the proposed settlement?

Montgomery Willard was added before the case was commenced. Representatives of both firms were present either in person or by telephone at all negotiations with counsel and representatives of the Bank.

23. Was the RSIC legal staff included on any or all negotiations?

After Willoughby & Hoefer, PA made a presentation to the RSIC concerning the potential BNYM liability to the RSIC in the spring of 2010, the Commission independently elected not to be party to the suit, but stated they would fully support the State Treasurer with staff time and effort. The plaintiffs were the Attorney General of the State of South Carolina and the Treasurer of the State of South Carolina. Because the RSIC was a beneficiary of the lawsuit, RSIC legal staff was invited to attend and did attend the major negotiations. The RSIC attorneys also monitored the litigation and attended many of the depositions conducted in South Carolina. Counsel also regularly communicated with and advised RSIC legal staff of the status of negotiations and the case in general as it progressed. RSIC staff attorney(s) were present at both the mediation and during the negotiations leading to the settlement terms agreed to in March 2013.

Subcommittee Questions — Proposed Legal Settlement

24. Please provide a detailed accounting of the final settlement agreement to include a value estimate of the various elements provided by BNYM.

Please see the attached Potential Savings ***(Exhibit G)*** based upon BNYM settlement concessions.

25. Please compare the elements of the final settlement to the initial offer made by BNYM if such an offer was made. Please be specific as possible with value in terms of dollars.

The initial offer and the settlement agreement are not comparable because the initial offer did not include additional discounts, savings or that the legal fees would be paid outside of the settlement with the State. The settlement agreement was significantly more advantageous to the State. Please see the response to Question 9 for additional information.

26. What is "Hedgemark?"

HedgeMark, an affiliate of BNY Mellon, is a specialist in the structuring, oversight and risk monitoring of hedge fund investments. HedgeMark's Risk Analytics offers a position-level transparency and risk analytics platform that provides exposure and risk reports on hedge funds for institutional investors. In addition, HedgeMark offers a Dedicated Managed Account solution that has been designed to provide institutional investors with an improved framework for managing their hedge fund investments including independent control (manager's focus is now on trading only), daily (t+1) position-level transparency, oversight, and high-frequency client reporting. HedgeMark supports the structuring, building and oversight of a customized investment platform that provides separate accounts managed exclusively for each Dedicated Managed Account client. HedgeMark provides the operational infrastructure, middle office services, managed account expertise and hedge fund risk monitoring and analytics to support each client's custom platform.

HedgeMark does not have discretionary authority with respect to the management of the assets of the Dedicated Managed Accounts nor does HedgeMark provide discretionary investment advice to the investors in such managed accounts.

27. Who is Ken Phillips?

Ken Phillips is:

I. FINRA Registered Representative and Principal from 1984-2002 (he intentionally and voluntarily did not renew his license in 2002 because he was no longer a broker and only an investment advisor);
II. Founding participant in the Wilshire Cooperative 1985 and affiliated with Wilshire Associates (Institutional Investment Consulting);
III. Member—Advisory Board of the Investment Management Consultants Association (IMCA) and the recipient of numerous awards and recognition certificates from the IMCA over a fifteen year period;
IV. Founder and President of Portfolio Management Consultants (PMC), now Envestnet/PMC, asset manager and administrator of more than $500 billion of clients assets;
V. Founder and CIO of RCG Capital Advisors (2002-2009), an international investment management firm specializing in hedge funds and fund of funds investments;
VI. Founder and CEO of HedgeMark International (2009-present), an affiliate of BNYM Mellon, operating pursuant to detailed oversight, compliance and reporting guidelines established by BNYM:
    - Specializing in transparency and risk analytics, not money management;
    - Reports to BNYM Asset Management Compliance Department and BNYM's Strategic Risk Committee;
    - BNYM's Vice Chairman Curtis Arledge, Chief of Staff Richard Brueckner, and Co-CIO Vince Sands hold seats on HedgeMark's Board (since 2010).

VII. SEC Registered Investment Advisor (1984-present) under three different corporate entities;
VIII. Has never had a client complaint (SEC);
IX. Has never had a FINRA complaint or regulatory issue;

The RSIC's patently false and intentionally misleading comments to the press and stakeholders (and presumably this subcommittee due to this question being asked) regarding Mr. Phillips having been charged by the SEC for an infraction, is simply untrue. In 1993, the SEC opened a case based on "theories of best execution", looking into theoretical regulatory action at PMC. Not only did the SEC decline to charge Ken Phillips with any infraction, but in fact stipulated that he assume the roles of both President and CEO of PMC as part of the settlement agreement. The SEC went further in specifically carving out a provision in the settlement stating clearly that Mr. Phillips was not involved in the trading matter in which they were litigating. Ken Phillips was not barred and was not suspended from the industry. Also, his supervisory privileges were not suspended in any way and he did not pay any fines. In summary, Ken Phillips has never had any client complaints and has never been charged by the SEC.

28. Did the Office of the State Treasurer perform "due diligence" on "Hedgemark?" If so, please provide specific examples.

HedgeMark is an affiliate that falls under the auspices of BNYM. BNYM is the world's largest custodian of institutional financial assets with approximately $27,600,000,000,000 (trillion) under custody and administration. As this is a service issue rather than an investment, and the services would be utilized by the RSIC, the Treasurer's Office did not perform "due diligence" as if this were an investment. The Treasurer's Office understands that the RSIC had several meetings with HedgeMark, including an onsite visit in Boston, and at the time of the settlement was informed and believed that the RSIC was interested in having the HedgeMark platform available in order to reduce its costs and better manage its outside manager funds.

29. What is the amount of capitalization managed by Hedgemark? How many clients does Hedgemark have? Given the longer term nature of the proposed settlement with BNYM, what is the absolute value and net present value of the terms of the agreement to BNYM?

HedgeMark does not perform traditional portfolio management services. As noted above, HedgeMark provides services that support a client's ability to obtain better transparency and retain more control with respect to its hedge fund investments with managers that are unrelated to HedgeMark. HedgeMark currently has 21 clients across its Risk Analytics and Dedicated Managed Accounts businesses.

30. What is the value of BNYM services to be provided to your staff and the staff of the RSIC? Were these estimate costs compared to other prices with BNYM or its competitors? Was the staff a RSIC consulted on this services obligation?

The Treasurer's Office conducted a procurement for custody and securities lending services in 2012. During that procurement process, the evaluators learned that every custody bank was a defendant in similar lawsuits regarding collateral reinvestment of securities lending cash collateral. All stated that the unprecedented financial crisis rather than some overt act, breach of contract or negligence was the reason for the losses. As a result of the procurement process, the Bank of New York Mellon was recognized as the highest ranked offeror of custody services. It also had the best pricing. The settlement provides the ability for the state to realize additional discounts on already favorable pricing. The RSIC assisted in the drafting of the RFP and members of staff served on the RFP evaluation committee.

31. Why was a settlement for breach of contract essentially combined with a long term contract for custodial banking services, an obligation for capitalization by the State and South Carolina and investment services?

Whether or not the Bank of New York Mellon breached its contract is a question of fact that can only be determined by a Judge or jury. The settlement afforded an opportunity for the state to realize additional benefits that provided a synergy towards resolving a dispute with the provider who was the highest ranked offeror of custody services and resolving the lawsuit. It enabled additional benefits including an annual extra training allowance, discounts on services with HedgeMark, which was being evaluated by RSIC and additional custody discounts with substantial and significant benefits to be made available to the state that enhanced the value of the settlement and provided significant money and other benefits to the state. The settlement also created an opportunity for the strengthening of a beneficial relationship between the State and the Bank in improving custody services, accountability and transparency of the State's financial operations. These tangible and intangible benefits made the settlement attractive for both parties and created the possibility for the parties to realize a win-win in an otherwise expensive and risky process of litigation, which had become even more complicated with the filing of an affidavit by the Bank of New York secured from former Treasurer Thomas Ravenel ***(Exhibit H)***. If believed, the Ravenel affidavit would have likely resulted in the dismissal of the litigation and no recovery for the State and the RSIC.

Other complications that significantly weakened the State's position were brought to light while conducting multiple depositions. For example, it was discovered that the RSIC was not properly monitoring the accounts in question. Also, the RSIC was not reconciling, and in some cases not even opening, the bank statements when they were sent to the RSIC. RSIC audits dating back nearly six years, revealed high-risk operational deficiencies (which were not remedied until 2012), the inadequate due diligence process employed by the RSIC and the lack of account monitoring hurt the case. The RSIC expedited the diversification of the portfolio without having built their internal operations.

Thomas Ravenel's affidavit (if believed), combined with the revelations concerning the RSIC's lackadaisical management of the assets discovered while conducting multiple depositions, and with the three-year statute of limitation (§15-3-530) governing this case—all significantly weakened the State's case and very likely would have caused the lawsuit to have been dismissed by the Court. The State and the RSIC were fortunate to have settled this lawsuit and received the impressive recovery (and discounted services) it did.

32. Were other firms considered to provide these services rather than agreeing to a settlement with BNYM? What other firms have the credentials to provide custodial banking services to the State of South Carolina?

Yes. The Treasurer's office considered other firms through the procurement process. The other firms that were deemed qualified included State Street Bank and Trust and Deutsche Bank.

33. Given that BNYM essentially breached a contract that cost the Retirement Systems tens of millions of dollars, why did you choose to obligate the State to continue a business relationship for the next decade.

Whether or not the Bank of New York Mellon breached its contract is a question of fact that can only be determined by a Judge or jury.

Also, investing of any kind is not a process in which there are always earnings. Each investment carries a risk of loss. Even investment grade notes and bonds can result in losses to purchasers as occurred with Lehman Brothers. The state has a complex financial exposure. The goal of this office has been to illuminate risks and endeavor to solve problems to improve the process. The losses about which the Bank of New York case was filed happened in 2006 and 2007 when the investment decisions were largely made and when the accounts were not properly monitored. Contemporaneous audits recognized these risks and pointed them out and yet nothing was done. The losses were revealed over time after the financial crisis hit and Lehman Brothers declared bankruptcy. The Treasurer's office worked diligently to recover as many dollars as possible on the claims against the Bank. The Bank had strong arguments. Nothing is ever certain in litigation. The Treasurer's Office and the State's Counsel worked hard, in concert with the Attorney General and the RSIC to realize the best possible outcome. I believe that we did that. The Treasurer's Office has reviewed the Bank's processes and believes that the financial crisis and our lawsuit – as well as others with States and institutional investors that continue to do business with the Bank of New York Mellon have improved their processes. The RSIC and the Treasurer's Office have also improved our processes. I believe that in doing so, we have substantial reasons for continuing the relationship in an effort to build a partnership that will be beneficial to the State and its citizens for many years to come.

34. How do the terms of our settlement compare to other similar organizations who also experienced a breach of contract in their security lending program with BNYM?

Whether or not the Bank of New York Mellon breached its contract is a question of fact that can only be determined by a Judge or jury.

To the extent that we have been able to learn of other settlements we believe that our settlement is better than any we have observed. Independent industry analysts have confirmed that "South Carolina did well." We are pleased that we were able to end the lawsuit favorably, but continue working to improve processes, transparency communications and accountability with the Bank to prevent any such future occurrence.

Subcommittee Questions – Other Funds Budget

35. Does the settlement create the need for the General Assembly to act regarding the appropriation of other fund authorization? If not, please explain your reasoning. If so, what is the amount and to what budget units should the authorization be added?

No, the settlement does not create the need for the additional appropriation of other fund authorization.

The State Treasurer's Office does not require an increase in authorization. The RSIC also does not require an increase in authorization. Pursuant to §9-16-315(7)(H)(1), all administrative costs of the RSIC must be paid from the earnings of the state retirement system. Since the inception of RSIC, custodial expenses have always been paid from the earnings of the retirement system because custody is, without question, an administrative expense of the RSIC. Custody is also a necessary and important component of every pension plan in the country. It is important to note, of the $427.5 million the RSIC paid in fees and expenses in the previous fiscal year, custody expenses included in that total amounted to less than 0.25% of all administrative fees and expenses paid by the earnings of the retirement systems.

Had these fees and expenses not been paid in accordance with §9-16-315(7)(H)(1), the General Assembly would have authorized the following other fund appropriations to cover the total fees and expenses incurred by the RSIC:

- $176 million in 2009;
- $314 million in 2010;
- $332 million in 2011;
- $304 million in 2012;
- $427.5 million in 2013.

Subcommittee Questions — General Comments

36. As State Treasurer, you have been a vociferous critic of the RSIC. Please provide the specific changes that you would like to see done at the RSIC to remedy your concerns. What asset allocation do you recommend to minimize fees, minimize risk, and maximize returns?

I would like to thank the Senate Subcommittee for asking this question as it shows your understanding of the importance of the issues at hand. As State Treasurer, I have asked questions in an effort to improve the practices of the RSIC. I have endeavored to provide a presence for retirees and taxpayers in South Carolina who are not privy to the issues and concerns at the RSIC, but who are ultimately impacted by every RSIC decision. I believe that instituting the changes below will better serve our retirees, current employees and all taxpayers in our State.

- **Reduce expenses** - No one can think it is prudent to pay the highest percentage of fees in the country. Renegotiating contracts to reduce fees and expenses will ultimately help the system and our unfunded liability. Each year, approximately $1 billion is added to our unfunded pension liability. The fact that other state plans with assets three to five times our size pay a third of what we do in fees is cause for review and change.

- **Custody of funds in BNYM** - Funds outside of the custody of the BNYM are at increased risk and expenses are inherently higher. Current agreements should be reviewed and negotiated to custody funds in BNYM. Future contracts should be negotiated to ensure funds are held at BNYM. This provides additional safeguards and will lower the excessive fees the RSIC pays.

- **Provide necessary documents and contracts in a timely manner** – RSIC staff should endeavor to be as accommodating and forthcoming with necessary and requested information as possible so that Commissioners can make informed decisions.

- **Impose term limits on Commissioners** – Commissioners should have term limits similar to the Public Employees Benefits Administration (PEBA). The fund would benefit from a rotation of Commissioners. The General Assembly recognized the importance of term limits, and legislated term limits, when it created PEBA. Term limits also provide the opportunity for the appointment of new Commissioners who can bring expertise and fresh ideas to the RSIC.

- **Review qualifications to serve as a Commissioner** - Currently three of the seven Commissioners have strong backgrounds in academia; however, only one Commissioner has active and direct investment experience. We need Commissioners diverse in experience from across the State who will play an active role in providing oversight for our investments.

- **Increase the number of commissioners** - Additional commissioners should be appointed by the legislative branch. An increase in the number of commissioners will help provide diversity and additional experience to the board.

- **Move to a more balanced asset allocation** - We must have a more balanced asset allocation, including movement from active to passive management to help reduce the high cost we spend on fees and expenses. Our asset allocation for alternatives is high and nearly double the national average, yet 80% of the other plans outperform us in returns.

- **Provide a regular schedule to perform due diligence** - Ongoing due diligence and internal controls are critical and should continue on a regular basis following an agreed upon schedule.

- **Execute contracts approved by the Commission as voted** – Until recently, terms and conditions were not verified. They are now confirmed with a document of Legal Sufficiency. This improvement should continue and Commissioners should be informed if there are any changes before an agreement is signed.

- **Require audited financial statements from every manager**—PEBA informed the STO that we do not receive audited financial statements from every manager, because they are not available or do not exist. Most separately managed investment accounts are not audited and aren't required to be. It is imperative that fiduciaries receive audited financial statements from every manager.

- **Amend §9-16-360 to add a "revolving door" restriction –** Similar to the lobbying restrictions placed on former public officials and employees in §8-13-755, a former fiduciary or former employee of the RSIC should be required to wait one-year before gaining employment or being associated with any business (investment firm, law firm, consulting firm, etc) currently engaged by the RSIC. This provision should also require that any current fiduciary or employee of the RSIC that is approached by a business currently engaged by the RSIC or the SCRS immediately report the contact to the RSIC Audit Committee. This provision would assist in preventing any potential conflict of interest and remove the appearance of any "revolving door" improprieties.

  As State Treasurer, I want our investments to improve and succeed. I want to work with the RSIC, and I appreciate that the Inspector General concluded that I have made important changes to the Commission. I will continue to work diligently for the retirees and people of our State. Once again, I appreciate the Senate Subcommittee's inquiries and the opportunity afforded to me to highlight pertinent issues impacting the State's largest asset.