

## **A Report by the Special Subcommittee to Review the Investment of State Retirement Funds**

Senator Kevin Bryant, Co-Chairman  
Senator Darrell Jackson

Senator Joel Lourie, Co-Chairman  
Senator Ray Cleary

Commission: The Subcommittee was commissioned by Chairman Leatherman in a letter of October 30, 2013. In the letter, the Chairman assigned the Subcommittee to "conduct hearings and thoroughly review the historical changes related to the investment of state retirement funds, the Inspector General's report on the RSIC, the RSIC's management fees and diversification of investments, as well as the securities lending agreement settlement with the Bank of New York."

Information Collection: The Subcommittee collected information in the form of written submission and formal testimony. All who have testified have been sworn under oath. All written testimony received may be viewed at the Senate Finance Committee location on the legislative website. Additionally, oral testimony was recorded and posted for viewing at the same website.

Below is a list of hearings and the subject matter:

### December 5, 2013- 1hour 55 minutes

David Avant, Interim Director, Public Employee Benefit Authority, provided testimony to the subcommittee in regard to the history of the investment authority for the funds of the State Retirement Systems. The State Inspector General (IG), Pat Maley, then offered testimony on the IG's "Review of the Red Flag Indicators of Potential Wrongdoing at the Retirement System Investment Commission."

### December 11, 2013- 2 hours 9 minutes

Suzanne Bernard, Hewitt EnnisKnupp, and Hershel Harper, Retirement System Investment Commission, both provided testimony to the subcommittee to provide insight into the philosophy and practice of the investments at the Commission.

### January 16, 2014- 1 hour 48 minutes

Testimony received by the Honorable Curtis M. Loftis, Jr., Treasurer, State of South Carolina on the following topics:

- Red Flag Letter of April 9, 2013 from William J. Condon, Jr. to IG Pat Maley
- The Bank of New York Settlement
- Securities Lending

### January 23, 2014- 1 hour 10 minutes

The Subcommittee received public testimony regarding the retirement funds from the following individuals: Carlton Washington, Donald Tudor, Wayne Bell, Sam Griswold, and Jeff Moore. There were around 30 people in attendance.

### January 30, 2014- 1 hour 59 minutes

Follow-up testimony received by the Honorable Curtis M. Loftis, Jr., Treasurer, State of South Carolina on the following topics:

- Red Flag Letter of April 9, 2013 from William J. Condon, Jr. to IG Pat Maley
- The Bank of New York Settlement
- Securities Lending

February 25, 2014- 1 hour 56 minutes

Greg Ryberg, Chief Operating Officer, Retirement System Investment Commission (RSIC), provided testimony to the subcommittee.

Sarah Corbett, Director of Operations, RSIC, then gave a presentation on the Commission.

March 4, 2014- 1 hour 15 minutes

Reynolds Williams, Chairman of the Retirement System Investment Commission, provided testimony to the subcommittee.

Sarah Corbett, Director of Operations, RSIC, then gave a presentation on the Commission.

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**Summary of Findings**

- ✓ The Inspector General's Report is an accurate roadmap for understanding the history and current status of the Retirement System Investment Commission and its interaction with the State Treasurer. The attached Appendix lists the Inspector General's findings from his investigation.
- ✓ Communication between the Commission and the State Treasurer is dysfunctional.
- ✓ Fiduciary roles are currently muddled and need to be streamlined and clarified.
- ✓ Based on testimony received, accusations of criminality at the Investment Commission by the State Treasurer are unfounded.
- ✓ Operational infrastructure to ensure due diligence was sorely lacking during the nascent stages of the Investment Commission. In recent years, operational infrastructure has markedly improved and continues to improve as the Investment Commission is authorized more resources.
- ✓ The investment strategy of the Commission is purposely weighted towards alternative investments to minimize risk. The Subcommittee is somewhat uncomfortable with this approach but recognizes the legitimacy of the strategy. By the nature of alternative investment structures, fees related to those investments are higher than traditional bond/stock portfolios. Further, the Investment Commission's disclosure of fees may be the most transparent among its peer group, so any comparison of fees with peers should be carefully reviewed.
- ✓ The State Treasurer's settlement with the Bank of New York Mellon over the administration of a securities lending contract was procedurally acceptable but managerially perplexing. The State Treasurer's responsibility to serve as custodial banker for the Investment Commission is organizationally misaligned.
- ✓ The Special Subcommittee recommends that its assignment continue so that the Funston fiduciary audit be received, reviewed and translated into legislation for consideration.
- ✓ The Special Subcommittee recommends the immediate consideration of legislation to add members to the Investment Commission. These new members would be chosen from among the constituent groups the Investment Commission is designed to serve and they would hold qualifications. This proposed change should help reduce the fear these groups of public servants are experiencing from the acrimony exhibited at Commission meetings and in the media.

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## **Observations and Recommendations by the Subcommittee**

This report is organized in accordance with the assignment to the Subcommittee by Chairman Leatherman and emerging themes evident from the testimony received by the Special Subcommittee. The sections of this report are:

- ✓ Inspector General's Report
  - Communication
  - Fiduciary Roles
  - Accusations of Criminality in the Red Flags Letter
  - Operational Infrastructure
- ✓ Investment Strategy
- ✓ Bank of New York Settlement
- ✓ Next Steps

*Background Note: §9-16-380 of the 1976 Code of Laws directs the appropriation of sufficient funds to the Office of the State Inspector General to employ a private audit firm to perform a fiduciary audit on the Retirement System Investment Commission. The audit firm is selected by the State Inspector General. Proviso 117.26 of the Fiscal Year 2013-14 Appropriations Act directs the Retirement System Investment Commission to transfer \$700,000 to the Inspector General to underwrite the costs of the fiduciary audit.*

*Through a competitive bid process, Funston Advisory Services was chosen to perform the audit. As of early March, Funston completed preliminary overall conclusions and recommendations. Officials from Funston provided the preliminary conclusions and recommendations to the Special Subcommittee. There are references to the Funston fiduciary audit in this report. The Special Subcommittee looks forward to the release of the final report at the end of April 2014.*

### **Inspector General's Report**

The Subcommittee commends the report of the Inspector General to every member of the Finance Committee and each member of the Senate. The report is thorough in its information collection and analysis as well as fair in its recommendations. The Subcommittee generally agrees with the findings of the Inspector General. The following discussion in this section is related to the formal report and the testimony of the Inspector General as well as the testimony and written submissions of others appearing before the Special Subcommittee.

**Communication** - At the core of the dysfunctional relationship between the State Treasurer and the Retirement System Investment Commission is communication. The relationship between the Retirement System Investment Commission and the State Treasurer likely deteriorated when the Investment Commission incorrectly withheld information from the Treasurer in his fiduciary role due to their sensitivity to confidentiality of management contracts as cited by the Inspector General on page four of his report. Communication deteriorated further as the Treasurer's legal staff suggested in a letter to the Inspector General that crimes had been committed either by other members of the

Retirement System Investment Commission or by the staff of the Commission. To date, multiple investigations have found no criminal wrongdoing. Irrespective of the dysfunctional communication issues, the Subcommittee strongly agrees with the finding of the Inspector General that all available information should be readily shared with any and all system fiduciaries.

While the Subcommittee endorses the free flow of information to all fiduciaries, the Subcommittee has concerns about the use of that privilege as a tool to stymie day-to-day operations. The Inspector General reported (p.28) that from February 3, 2012 through May 2, 2012, the Investment Commission staff received ninety-three information requests from Commissioners. Ninety of these requests came from the Treasurer's Office, forty-four from Treasurer Loftis and forty-six from the Treasurer's staff.

In 2013, the dysfunctional communication and general business relationship between the Investment Commission membership and staff continued to deteriorate. Two specific events bear out this fact. First, the Commission hired Mr. Derry Oliver as its new Chief Operating Officer in late February of 2013. Mr. Oliver resigned from that position in November of 2013 (E-Mails submitted to Subcommittee per testimony of Senator Greg Ryberg, pp.40-42). Mr. Oliver is credentialed as a certified public accountant and has over 30 years experience in the administration of organizations that invest large sums of money. Upon tendering his resignation to the Investment Commission, Mr. Oliver cited verbal abuse by Treasurer Loftis as the cause for his departure.

The second event substantiating deteriorating communication was a legal dispute between the Investment Commission and the Treasurer. On November 8, 2012, the Investment Commission unanimously approved a commitment to a private equity fund. The staff of the Investment Commission moved forward with the process of honoring a capital call in March of 2013 for the investment of funds to the chosen investment entity. The Treasurer, citing a lack of relevant information in his role as the fiduciary responsible for custodial banking, refused to release those funds. Hours before the case was to be heard in the South Carolina State Supreme Court, the Treasurer said his information requirements had been satisfied and he released the funds for investment. During the hearing before the State Supreme Court, Justice Beatty said "We don't appreciate trying to referee kids in a sandbox." The case was dismissed as moot given the funds had been released (Opinion No. 27242 filed April 17, 2013).

In late 2013 and in 2014, the relationship between the Investment Commission and the Treasurer deteriorated even further to sniping by press release. Perhaps this latest devolution of decorum, respect and cooperation to a more primitive animosity can best be summarized by a newspaper report published in the Hilton Head Island Packet on January 6, 2014. In the article which is titled "Loftis Continues Attack Against SC Pension System During Hilton Head Stop," Treasurer Loftis is quoted as saying that the Commission's work is "sinful" and "lacks a moral core." The same article quotes Senator Ryberg in his role as Chief Operating Officer for the Commission. Senator Ryberg retorted that "Curtis Loftis' serial abuse of state employees for his own political gain truly is sinful and lacking a moral core."

To offer some historical context, the South Carolina Retirement Investment Commission was created in 2005 with the passage of S618 (Act 153, Section IV). That legislation finds its origin in the Senate Finance Committee. Among the goals of that legislation was to create a forum where learned professionals could make informed decisions about retirement system investments for the benefit of retirees, active employees and taxpayers. During the 2005 legislative session, the perception of some members of the Finance Committee was that the previous venue for these important decisions, the Budget and Control Board, had become more politicized over time and some of the discipline for long term prudence had eroded. Thus, it is most ironic that the organization created almost nine years ago to foster an environment for sound financial decision making and protect the process from the folly of political maneuvering has now developed into the very venue it was designed to eliminate.

Under no condition does the Subcommittee wish to censor the State Treasurer or members and staff of the Retirement Investment Commission. However, we do offer the observation that such stark differences in viewpoint did not exist between the Commission and Treasurer Converse Chellis, Interim Treasurer Ken Wingate, Treasurer Thomas Ravenel or Treasurer Grady Patterson. Dr. W. Edwards Deming, the renowned management expert, once said, "A manager of people needs to understand that all people are different. This is not ranking people. He needs to understand that the performance of anyone is governed largely by the system that he works in, the responsibility of management."

As members of the General Assembly, it is our role to assess the structure of management at the Retirement System Investment Commission and make changes when necessary. Additionally, given the testimony of Systems stakeholders who conveyed concerns of confusion and fear among their membership, the Special Subcommittee is also obligated to provide clarity and reassurance to those groups and their membership. We are confident that the Funston fiduciary audit will offer a "best practices" structure so that the future focus of the Investment Commission is on performance rather than endless bickering.

Fiduciary Roles - Each member of the Retirement System Investment Commission is a fiduciary. Additionally, statute specifically names the members of the Budget and Control Board as sharing that fiduciary role. Further, the State Treasurer is a fiduciary in his role of selecting and directing the chosen custodial bank. These multiple fiduciaries have led to confusion and unnecessary roadblocks in the implementation of duly approved investment decisions by the Commission. These fiduciary roles need to be streamlined and clarified.

Accusations of Criminality in the Red Flags Letter - It is imperative that members of the General Assembly, affected constituent groups and the general public understand that no criminal wrongdoing has been detected, even amid intense scrutiny. The Inspector General included in his report (page 2), "there is no criminal conduct or wrongdoing at the RSIC pertaining to any of these six "red flag" issues (0%)."

The Treasurer's distrust of Commission members and Commission staff was piqued as a result of the lack of information sharing. This led the Treasurer to levy accusations of potential criminality to certain members and employees of the Commission. To date, with multiple entities investigating, no wrongdoing has been discovered. These investigations include the Attorney General, the State Law Enforcement Division, the Ethics Commission and the Inspector General. Two other entities have been engaged in reviewing the issue, the Legislative Audit Council and Funston Advisory Services.

The Subcommittee recognizes the right and the duty of each fiduciary to bring to light potential wrongdoing. However, with regard to the accusations listed in the "Red Flags" letter written by the State Treasurer's legal counsel on April 9, 2013, the wrongdoing alleged is substantiated by listing shortcomings in due diligence processes, in perceived disclosure and the timing of disclosure. While past due diligence processes of the Commission certainly needed improvement and information sharing was guarded due to the less than amiable relationship between the Commission and State Treasurer, there is a distinct difference between describing an environment where wrongdoing may exist and alleging wrongdoing that may include "public corruption, securities fraud and other violations of securities laws, mail and wire fraud, common law fraud, State ethics violations and breached of fiduciary duties." The Subcommittee considers the accusations as unfortunate as they have increased the dysfunctional nature of the relationship between the Commission and the State Treasurer.

Operational Infrastructure - In the early stages of the Commission, operational infrastructure was sorely lacking. This resulted in a risk to the Retirement Fund. In recent years, necessary procedures to ensure the proper handling of funds has improved dramatically. The Subcommittee observes that an important decision by the Commission which acknowledged operational shortcomings was obtaining Deloitte to perform a risk assessment in April of 2011. Thus, the Commission recognized their operational shortcomings long before the Inspector General began his investigation. Since the delivery of the Deloitte report in September of 2011, the Commission has made great progress in improving processes that ensure due diligence (Corbett presentation, page 23). Obviously, there is much more to be accomplished, but, the Subcommittee is reassured by the progress made in recent years.

### **Investment Strategy**

For much of the history of existence of the South Carolina Retirement Systems, the investment of retirement funds was restricted to securities. South Carolina was one of the last states to allow investment of retirement funds in equities. The passage of a constitutional amendment in 1997 permitted the investment of retirement system funds in domestic equities. During that same time, the Retirement Systems Investment Panel was created to advise and recommend an investment strategy to the Budget and Control Board.

In 2005, Act 153 brought into existence the Retirement System Investment Commission. Then, in 2007, another constitutional amendment was approved by voters which deleted the restriction that equity investment be domestic in origin.

In 2012, Act 278 created the Public Employee Benefit Authority to administer the various retirement plans under the umbrella of the Retirement Systems.

This year, the passage of Act 121 (S22), the South Carolina Restructuring Act of 2014, eliminated the Budget and Control Board as of July 1, 2015 and provided for a successor entity, the State Fiscal Accountability Authority (SFAA). The SFAA is comprised of the same members as the Budget and Control Board, but their responsibilities are dramatically diminished. It is difficult to rationalize the membership composition of the Retirement System Investment Commission appointed by the five members of the SFAA when that Authority has little direct influence over the management of state finances and the implementation of the annual state budget.

When taken in the context of iterative changes over time, it is clear that voters of South Carolina and the General Assembly have offered increasing investment flexibility for the entity assigned the task of investment of retirement funds. The investment of retirement funds is now significantly more sophisticated than the system in place before 1997.

The Subcommittee heard multiple testimonies substantiating the fact that the Commission's strategy is and should be attaining balance of return and risk rather than simply seeking the greatest return possible. It is evident that the Commission felt that guarding against risk and volatility was paramount given the challenging funding ratios of the various retirement programs. The actuarial funding ratio is the ratio of actuarial value of assets to the actuarial accrued liabilities. Gabriel Roeder Smith and Company, the Public Employee Benefit Authority's actuarial consultant, reported in their valuation of the SCRS retirement system for the year ending June 30, 2013 that the funding ratio for that system is 62.5%. For comparison, the funding ratio in 2003 was 82.8%. By way of information, the assumed rate of return for the retirement investment portfolio is 7.5% and can only be changed by the General Assembly.

Diversification - A fully diversified portfolio is the key to minimizing risk. The Commission made the conscious decision to weight the portfolio heavily to alternative investment to lower risk and decrease volatility. The returns to these alternative investments resemble the traditional stock market but many financial analysts believe they are less volatile over time. Regardless, in the period from 2005 through 2010, the Investment Commission purposely chose to heavily weight the portfolio mix towards alternative investments when compared to many public pension funds. This strategy is essentially a hedge on a market correction or a bull market. For the Investment Commission to retreat from this strategy before the next significant market correction could expose the portfolio to smaller returns since the portfolio did not capture, from a relative standpoint, the increased value of the traditional stock market from 2008 forward. Regardless, based on the testimony received by the Subcommittee, the annual portfolio allocation plan is among the most important decisions considered and approved by the members of the Commission.

### 2013 Retirement System Investment Commission Asset / Liability Study Alternative Portfolio Return and Risk Expectations

Asset Class	Current Target Policy	Alternative 1: Proposed Solution	Alternative 4: No Alternative Investments
Global Equity <sup>1</sup>	38%	40%	60%
Real Assets <sup>2</sup>	6%	8%	0%
Opportunistic <sup>3</sup>	15%	18%	0%
Diversified Credit <sup>4</sup>	21%	19%	0%
Fixed Income <sup>5</sup>	20%	15%	40%
Total	100%	100%	100%
<b>10 Year Expected Return</b>	<b>7.00%</b>	<b>7.14%</b>	<b>6.15%</b>
10 Year Expected Risk	12.52%	11.54%	12.98%
10 Year Sharpe Ratio	0.456	0.506	0.374
10 Year Expected Inflation	2.30%	2.30%	2.30%
<b>30 Year Expected Return<sup>6</sup></b>	<b>7.55%</b>	<b>7.68%</b>	<b>6.79%</b>
30 Year Expected Risk	11.93%	11.04%	12.19%
30 Year Sharpe Ratio	0.415	0.460	0.344
30 Year Expected Inflation	2.30%	2.30%	2.30%

<sup>1</sup> Global Equity is comprised of Global Public Equity and Private Equity; <sup>2</sup> Real Assets is comprised of Real Estate and Commodities; <sup>3</sup> Opportunistic is comprised of Hedge Funds and Global Asset Allocation (GAA); <sup>4</sup> Diversified Credit is comprised of High Yield Bonds, Bank Loans, Emerging Market Debt, and Private Debt/Opportunistic Credit; <sup>5</sup> Fixed Income is comprised of Core Fixed Income, International Bonds, Intermediate Credit, Short Credit, Short Gov't Bonds, and Cash; <sup>6</sup> Private Market Investments (Private Equity, Private Debt, and Real Estate) and Hedge Funds are capped at 20% of the total asset allocation.

The Commission retains the services of a professional credentialed consultant to provide independent advice on the allocation plan. The company providing those services is Hewitt EnnisKnupp (HEK). The partner assigned as lead analyst to the RSIC is Ms. Suzanne Bernard, CFA, CAIA. In this advisory relationship, she reports directly to the Commission. During her testimony to the Subcommittee, Ms. Bernard provided a summary of alternatives for portfolio management she utilized to brief the Commission (Page 6 of Bernard presentation). Her information displayed above.

In the information submitted by Ms. Bernard, she displays the Investment Commission's current target policies (at that time), her company's proposed solution and a traditional investment strategy of bonds at 40% of the portfolio and stocks at 60% of the portfolio.

The Treasurer states in his written response to questions from the Subcommittee (Page 8, Question #5) that he is not opposed to alternatives. Instead, the Treasurer's preference is for a lower ratio of the portfolio to be invested in alternative investment. He further elaborates about his concern about "valuation risk" since alternative investments are not traded on an open market. By way of illustration, should the Investment Commission decide to alter the plan to more market-valued investments (public traded equities), then the Retirement portfolio would have class ratios similarly displayed in Alternative 4 above. The difficulty with that strategy is that it does not produce the requisite 7.5% assumed rate of return over the 30 year time horizon while measures of risk increase due to increased exposure to a stock market correction. The investment strategy of the Commission is weighted heavily to alternative investments, but their decisions are informed. The Treasurer's concerns about valuation risk can be greatly mitigated by the continued development of due diligence processes by the staff of the Commission.

During his testimony, the Treasurer said he had procedural difficulty in submitting an alternative investment plan for the Commission to consider. Further, after an exchange of questions and answers with members of the Subcommittee, he also stated his intent to develop and propose an alternative investment plan. In Senator Ryberg's testimony (Page 4 and 5), he refutes the Treasurer's assertion by submitting a letter dated February 20, 2014 inviting any commission member to submit an agenda item. During her testimony, Ms. Sarah Corbett, the Investment Commission's Director of Operations, assured the Subcommittee that all alternative plans would receive consideration and a thorough review. Since this testimony, one meeting of the Investment Commission was held on March 13, 2014. No alternative plans were submitted to the Commission at that meeting.

Regardless, the Subcommittee observes it is the fiduciary role of every member of the Commission to review recommendations of staff and consultants and offer alternatives if they believe those recommendations do not serve the interests of the Retirement Fund. Eventually, all submitted allocation plans should be duly considered, voted upon and then implemented.

Management Fees - ***Reported*** management fees are among the highest in the nation. There are two reasons for this aberration. First, South Carolina's retirement investment portfolio is heavily weighted in alternative investment which by their nature generate greater fees. This conscious choice leads to higher fees since the remuneration for participation in managed funds that invest in capital assets usually have flat up- front fees and percentage of profit arrangements. Second, the RSIC discloses their fees in absolute terms whereas many other public pension plans report their fees as net value. According to testimony, the Investment



Commission's reporting of fees is among the most transparent in the industry. However, this additional transparency makes the Commission's fee reports vulnerable to an "apples to oranges" comparison.

### **Bank of New York Settlement**

Securities lending has been practiced by the State of South Carolina since the 1980s during the administration of Treasurer Grady Patterson. It is the practice of loaning assets (stocks, bonds or other securities) to another entity. In South Carolina's instance, this practice was executed by the State's custodial bank, the Bank of New York - Mellon (BNYM). This arrangement was governed by a detailed contract, and BNYM was prohibited from investing the State's cash in collateral from these loans for terms longer than three years (Note: a more robust description can be found in Treasurer Loftis' written submission to the Subcommittee on Page 10, Question #6).

In September of 2009, Treasurer Converse Chellis hired Willoughby and Hoefler, P.A. to investigate BNYM after the State of South Carolina experienced significant losses in the securities lending account. The largest portion of the losses were attributable to investment in notes issued by Lehman Brothers. BNYM contended that the Lehman Brothers notes met the practices permitted in the contractual arrangement for securities lending. In 2010, Treasurer Converse Chellis and Attorney General Henry McMaster approved a contingent fee agreement with Willoughby and Hoefler to continue the investigation. Eventually, this led to preparations to file a suit against BNYM.

In January 2011, shortly after assuming office, Treasurer Loftis decided to formally file the lawsuit. During that same time, the law firm of Montgomery Willard, LLC was added to the State's legal team of Willoughby and Hoefler. The two local private legal firms represented the State of South Carolina and engaged with representatives of BNYM. As the case was prepared for trial, both parties reached a settlement in May of 2013.

Of course, no one can predict the outcome of any court case. Should the case have gone to trial in the location of the Richland County Court House, the State's attorneys would have had to impugn the integrity of a previous Treasurer because of an affidavit submitted by BNYM counsel (Exhibit H submitted by Treasurer Loftis). In that affidavit of February 26, 2013, former Treasurer Thomas Ravenel testified that he was "well aware during my time as Treasurer that the Bank of New York was, as part of securities lending, investing in asset-backed securities backed by mortgages ("ABS") on behalf of the State." While understanding the complexities of the case against BNYM, the decision to agree to the cash settlement compared to the estimated losses seems legally timid and conservative, especially given that the venue for the trial would have been several city blocks from the South Carolina State House.

The loss of assets to the State's Retirement Fund is subject to interpretation. In a written response to questions by the Subcommittee, the Treasurer responded that as of August 31, 2012, the estimated losses attributable to Lehman were \$122,643,050, of which \$90,130,396 were attributable to assets owned by the Investment Commission.

The final legal settlement was a multi-faceted package deal. A summary of the estimated monetary value of the settlement is displayed on Exhibit G of Treasurer Loftis' written submission to the Subcommittee. In the final settlement, the State of South Carolina received \$25M in cash, a value of non-cash benefits of \$44.2M over a ten year period and \$9M in attorney's fees paid by BNYM to the State's attorneys.

The real value of the settlement is a point of contention. The Treasurer asserts that this arrangement with BNYM is of significant value over an extended period of time. In contrast, the staff of the Investment Commission view the value of the settlement as solely the cash payment of \$25M (Senator Ryberg's written testimony, page 26). The Subcommittee sees four points that are troubling related to the settlement and subsequent continued use of BNYM as the custodial banker for the RSIC and the State Treasurer's Office.

- First, it is counterintuitive for an entity to continue to do business with a company that it sued because of a contention of a breach of contract. The Treasurer asserts that all large banks committed similar breaches with clients during the latter part of the last decade. Regardless, other banking service providers were not accused of breach of contract by the State of South Carolina.
- Second, part of the value assigned to the settlement was contingent on the investment of funds from the Investment Commission into the BNYM financial platform. One specific contingency is related to the use of Hedgemark, a subsidiary of BNYM. In that arrangement, an assigned annual value of \$5.2M from the settlement over a ten year period would accrue to the benefit of the State of South Carolina. Yet, the Investment Commission would have to invest significantly in Hedgemark to realize those negotiated discounts, most likely at a monetary level of hundreds of millions. Treasurer Loftis responded to a question by the Subcommittee about his Office's due diligence related to the use of Hedgemark by writing, "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 it were an investment."

Organizationally and procedurally, the lines of authority and decision making are tangled and confusing. In essence, because of his statutory authority over custodial banking services, the Treasurer brokered an arrangement with BNYM that assumes his colleagues will endorse investment management decisions that may or may not be advantageous to the investment portfolio.

- Third, nearly 80% of the funds lost as a result of the handling of the securities lending program were assets of the Retirement System. Yet, the Investment Commission does not have the ability to choose its own custodial banking arrangement. This is an example of organizational and fiduciary misalignment.
- Fourth, the level of remuneration to the State's contracted attorneys was \$9M of which \$7M was payment to Willoughby and Hoefler and \$2M was to Montgomery Willard. Based on testimony, this amount was determined in final negotiations that led to the settlement with BNYM. Initially, Willoughby and Hoefler agreed to represent the State of South Carolina on a contingency fee basis which assumes an actual court proceeding. Later, the fee arrangement was changed from a contingency fee basis to a negotiated fee basis. The Subcommittee views this change in the remuneration method as unusual.

The Subcommittee has no problem with attorneys representing the State of South Carolina being paid fair compensation. But, the overall negotiated fees for legal services do not seem to have any direct correlation to the work performed. The numbers displayed in Exhibit G (submitted testimony from Treasurer Loftis) related to the value of the settlement were based on the Treasurer's discussions with BNYM during the settlement process. If the value of \$78M for the settlement as defined by the Treasurer is used as a benchmark, then the \$9M in legal fees seems to be in line with expectations for legal remuneration. However, should the cash

payment of \$25M be used as the benchmark, then the \$9M in attorneys' fees represent a much higher percentage of the settlement.

The Subcommittee finds the process of settling the lawsuit and subsequent negotiation of a new custodial banking arrangement to be procedurally legal. The Attorney General was properly consulted, and the Attorney General approved the settlement as well as the attorneys' fees award. Likewise, the Treasurer was not required to face a competitive bidding process to procure custodial banking services since the Treasurer's Office received an exemption from the procurement code for this type of service decades ago. The Treasurer did respond to the Subcommittee in writing that other firms deemed qualified to provide custodial banking services included State Street Bank and Trust and Deutsche Bank (p. 19, answer to question 32). Further, the Treasurer reported that he conducted a procurement in 2012 for custodial banking services, and "the Bank of New York Mellon was recognized as the highest ranked offeror of custody services. It also had the best pricing." (p. 18, answer to question 30). Regardless of the procedures, the outcome brings about questions of organizational and fiduciary misalignment. Ideally, a clear delineation of the responsibilities of custodial banking functions and investment functions should exist.

### **Next Steps**

The Subcommittee was briefed on the preliminary fiduciary performance audit being conducted by Funston Advisory Services. The final report is expected to be issued in late April.

Based on our briefings, we believe the Funston report will provide numerous tangible actions that should be taken. Some of these actions involve the General Assembly, whether it be through legislative changes or through legislative oversight. As such, the Subcommittee recommends to extend the service of the Special Subcommittee to Review the Investment of Retirement Funds to consider the recommendations in the Funston fiduciary audit and determine if the recommendations should be considered for permanent statutory changes.

Further, given that the assumed rate of return for the Retirement Investment portfolio is set in statute, consideration should be given to an annual review of the rate of return by the Senate Finance Committee or an appropriately appointed subcommittee.

At the meeting of January 23, 2014, the Subcommittee received testimony from stakeholders of the State's various retirement systems. The testimony from two participants was compelling. First, Mr. Jeff Moore, Executive Director of the Sheriffs' Association, told the Subcommittee that his members are simply confused. He also suggested that the General Assembly bring some clarity to the issues related to the Retirement System Investment Commission so that his members might actually be able to discern "truth." Second, Mr. Donald Tudor, President of the State Retirees Association, suggested a "media timeout" between the Commission and the Office of the State Treasurer.

Because of all the events that have transpired over the past three years, those who have earned the right to be served by a well- functioning Investment Commission are fearful and confused about the tenor of interaction between the Investment Commission and the Treasurer. The best way to drive out fear for these public servants is to restructure the Commission membership and give them a formal seat at the decision- making table. Just two years ago with the creation of the Public Employee Benefits Authority (PEBA), the General Assembly embraced this concept. Among the membership of PEBA are a retired state employee, a teacher, an active state employee and a county sheriff.

Based on written testimony, Treasurer Loftis also endorses this approach. On page 23 of his written responses to the Subcommittee's questions, the Treasurer endorses the idea of increasing the number of commissioners. He wrote, "Additional commissioners should be appointed by the legislative branch. An increase in the number of commissioners will help provide diversity of additional experience to the board." In his power point presentation before the Subcommittee, Treasurer Loftis stated "We need stakeholders to be represented in demonstrable fashion, not groups who rubberstamp the Commission's flawed strategy and decisions."

The Subcommittee will develop legislation to add qualified membership from the stakeholder community to the Retirement System Investment Commission.

## **Appendix : Summary of Findings and Recommendations of the State Inspector General**

### **A. Misstatement of Management Fees in the FY 2012 Audited Financial Statements**

The Fiscal Year (FY) 2012 South Carolina Retirement System (SCRS) Financial Statements appear to be materially misstated because the SCRS did not fully account, or disclose, management fees, performance fees, and other investment expenses paid to external investment managers (EIM);

Finding III-A: SCRS's explanation, coupled with supporting data, of management fee presentation in its FY 2012 financial statements appears reasonable, and there are intentional plans to increase the timeliness of RSIC's fee data collection process which will then permit enhanced transparency in the financial statements in the near term.

### **B. False Representation of Investment Valuations in the Audited Financial Statements**

In FY 2012, PEBA, the administrator of SCRS, represented to its external audit CPAs the fair market valuation of Alternative Investments (AIs), yet PEBA's management did not perform sufficient due diligence required to ascertain the accurate fair market valuation of these AIs which could have impacted the CPA's unqualified opinion of the financial statements;

Finding III-B: In FY 2012, the RSIC conducted due diligence, though documented in a substandard manner, coupled with SCRS's compensating controls provided a foundation for RSIC and PEBA managers' representation letters on the fair valuations of AIs.

### **C. Inappropriate RSIC Employees' Travel or Perks Paid by External Managers**

External Investment Managers (EIMs) potentially paid for travel and perks for RSIC employees, which could be an abuse by RSIC employees and create potential conflicts of interests exploitable by EIMs in business transactions;

Finding III-C: No abuse of travel or perks, both in general and specific to funding from EIMs, was identified.

### **D. RSIC Has Inadequate Controls for Alternative Investment Management Fees**

RSIC had inadequate controls for the payment of AI management fees, to include an \$18.3 million dollar error in a specific AI.

Finding III-D1: Prior to August 2011, the RSIC did not have an adequate process to validate management fees from EIMs regarding AIs. While its current process is improved, it still has opportunities to improve through the application of appropriate technology and risk-based testing as it gains experience in this area.

**Recommendation III-D1:** The RSIC should explore market-based technology opportunities, such as “Private I,” to improve its fee validation process in terms of increased speed and assurance, as well as lower personnel costs.

Finding III-D2: The \$18.3 million error was a reporting error, rather than an RSIC overpayment, yet it still serves as an example of the potential impact, both in terms of dollars and financial statement accuracy, of an inadequate fee validation process.

**Recommendation III-D2:** The RSIC Executive Management should personally engage EIM’s to address improving their reporting, particularly fee and expense reporting, in a more robust, timely, and standardized format, and add technology to increase testing and assurance the fees and expenses are consistent with contract terms.

## **E. RSIC’s Process for Approving Investment Contracts Has Flaws**

RSIC's process for approving investment contracts has flaws, to include the potential of final investment contracts paying excess fees or inappropriately finalized outside of established policy;

Finding III-E1: The allegation that higher fees were paid in the identified Standard and Poors (SP) executed investment contract than approved by the Commission in the original proposal was determined to be unfounded, but the corresponding proposal memo lacked clarity to fully describe the SP investment.

**Recommendation III-E1:** The RSIC should approve recommendations set forth in its internal audit report, dated April 5, 2013, which include future investment proposals; should provide detail of all investment options along with all fee options when that information is available at the time of the proposal; and establish a procedure to ensure that fees included in the final partnership agreement are materially consistent with the fees or estimated fees included in the investment proposal approved by the Commission (recently approved by the Commission).

Finding III-E2: The SP investments approved by the Commission essentially delegate authority, apparently with wide discretion, to the SP partner and CIO for future investments involving hundreds of millions of dollars without further Commission approval.

**Recommendation III-E2:** The Commission should examine this practice and consider establishing formal reporting thresholds, if not approval thresholds, as the SP makes future specific investment decisions in order to maintain closer control and supervision of these large, complex investments.

Finding III-E3: The RSIC’s investment approval process contained procedural ambiguities which led to the TA and Warburg crises.

**Recommendation III-E3:** The RSIC staff should address the procedural ambiguities in the investment approval process, as well as initiate the practice of analyzing all Commission policy motions for opportunities to clarify or remove ambiguity through more specific procedures which then can be ratified by the Commission in subsequent meetings.

Finding III-E4: The SP, designed to be less costly and provide better liquidity and transparency, has unresolved issues concerning its operations, which are not being timely addressed and

potentially incurring higher fees by not using this platform for assets having a higher fee structure.

**Recommendation III-E4:** The RSIC Chairman should provide necessary leadership, guidance, and direction to RSIC staff and Commissioners to resolve issues in this SP, preferably with all parties in the same room with complete data.

## **F. RSIC Inappropriately Restricts Information to the Treasurer**

RSIC inappropriately restricts information to the State Treasurer, a RSIC fiduciary, which undermines the State Treasurer from carrying out his fiduciary duties and creates an inappropriate appearance of secrecy at the RSIC.

Findings III-F1: RSIC staff failed to robustly disclose confidential investment information to the Treasurer and his staff.

**Recommendation III-F1a:** The RSIC should provide complete access to all RSIC records, to include confidential information, to a small number of STO staff upon executing NDAs or any appropriate basis to ensure the protection of confidential information, as well as allow the Treasurer to print documents from the secure Internet portal coupled with protocols for storing and destroying copies.

**Recommendation III-F1b:** The Treasurer should personally approve all data requests to RSIC and be personally accountable to fellow Commissioners in the judicious use of RSIC staff resources in both preparing data and facilitating STO staff's efforts on behalf of the Treasurer's oversight duties.

**Recommendation III-F1c:** The RSIC should build a monitoring mechanism, likely a simple spreadsheet, accessible by all parties through the RSIC secure internet portal to measure workload, customer satisfaction in response, and any unprofessional interactions between the STO and RSIC staff to support proactive management of this issue impacting RSIC productivity, and bring clarity to allegations from the STO and RSIC staff of alleged abuses or inadequate responses, respectively.

**Recommendation III-F1d:** The RSIC Commission Members should require CIO Harper to report on this issue at each Commission meeting until resolved, given this issue's negative and corrosive impact on RSIC operations.

Finding III F2: The RSIC's less than robust disclosure of confidential information to the Treasurer and his staff coupled with the Treasurer's tone and repetitive, voluminous information requests has created an air of distrust and dysfunction, which has negatively impacted RSIC operational productivity.

## **Root Cause Analysis of "Red Flag" Indicators:**

### **A. Dysfunctional Communications**

Finding IV-A1: The RSIC Commission's dysfunctional communication is materially impacting RSIC's ability to effectively execute its mission.

**Recommendation IV-A1:** The Budget and Control Board should address the current communication dysfunction at the Commission level by setting heightened expectations for RSIC Commissioners to resolve the current dysfunction with accountability mechanisms; create a mediation mechanism to bring stability to the Commission; insert a new subject matter consultant reporting directly to the BCB for “fresh eyes” on the operational issues; or make changes in leadership.

## **B. RSIC Operational Control Processes**

Finding IV-B1: The RSIC’s operational capabilities and controls have lagged behind fully supporting its investments since its inception, but RSIC has made tangible efforts with measurable results in the past two years to attempt to close this performance gap.

**Recommendation IV-B1a:** The STO should actively provide input, particularly areas of operational concern, in the State Inspector’s independent process to develop the requirements for the fall 2013 fiduciary audit.

**Recommendation IV-B1b:** Upon obtaining results of the fiduciary audit, the RSIC should seek legislative authority from legislative appropriators for improvements with the clear knowledge any increase in its administrative costs can be more than offset by enhanced operational capabilities and reductions in consultant and external management fee expenses, as well as provide assurances to trustees, fiduciaries, and beneficiaries of the plan.

## **C. RSIC Investment Strategy**

Finding IV-C1: The RSIC’s ability to communicate its investment results and strategy has been blurred by mixed messaging in the media and the lack of a consistent, robust data presentation that brings together peer results, robust benchmarks, and its long-term strategy.

**Recommendation IV-C1a:** The RSIC should establish a reporting mechanism, at least annually, that integrates peer results, robust benchmarks, and long-term strategy in a concise manner understandable to the public.

**Recommendation IV-C1b:** The annual Commission investment strategy, which is a key component of the current communication dysfunction, should be publically reported along with details of the debate, dialogue, and rationale for its annual decision.