

Report Date: September 25, 2013

South Carolina Retirement System Investment Commission

Performance Incentive Compensation Audit

For FYE June 30, 2013

To: Darry Oliver, COO
Hershel Harper, CIO

We recently completed a review of the internal controls and procedures related to Retirement System Investment Commission (“RSIC”) Performance Incentive Compensation (PIC) for fiscal year ending June 30, 2013. The performance based nature of RSIC’s business and the need to comply with the policies established by the Commission to attract and retain qualified personnel requires that the organization have effective controls in place to ensure appropriate oversight and payment of PIC.

Our audit was performed in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. In order to address the audit objectives, we performed certain procedures, which included, but were not limited to those listed in the Approach and Methods section of this report.

Based on the work performed, we concluded internal controls as they relate to the Performance Incentive Compensation process for FY 2013 are adequate and operating effectively as designed. However, we noted that improvements to the design of the internal control structure were necessary. The nature and extent of the improvements observed are summarized as well as detailed in the Executive Summary: Overall Process Evaluation and the Action Matrix: Issues and Observations sections of this report, respectively.

We would like to thank the staff of RSIC for their cooperation and assistance.

Sincerely,

Internal Audit & Compliance

CC: Allen Gillespie, Audit Committee Chair
Reynolds Williams, Investment Commission Chair

Background

Background

In early 2012, the Commission hired McLagan (an industry-leading compensation consultant) to review the design features of the Retirement System Investment Commission (“RSIC”) incentive plan included within RSIC Compensation Policy. The goal was to evaluate the Performance Incentive Compensation (“PIC”) that was currently in place to ensure alignment of interest and consistency with industry norms. McLagan benchmarked RSIC against comparable public pension plans with similar asset size, investment strategy, and/or geography. As a result of this review, the Commission approved a set of revisions to the Compensation Policy primarily focused around PIC. These revisions provided eligible RSIC employees (full time investment professionals) non-recurring performance incentive compensation to be paid subsequent to close of each fiscal year, consistent with the approved annual budget. The updated PIC structure provided a formulaic and quantitative approach to determining payouts for eligible position classifications (e.g. Directors, Officers, Analyst). It included a sliding scale based on performance above policy benchmark and weighting in favor of long-term plan investment results.

The revised PIC process was approved by the Commission at the March 23, 2012 meeting with the full Compensation Policy subsequently adopted at the May 17-18, 2012 meeting. The first PIC payout under the new plan was for FY2012 and occurred in October 2012 after approval by the Commission during the September 20, 2102 meeting.

The Compensation Policy requires the Commission to approve maximum PIC opportunities for different classes of PIC eligible positions (e.g. Director, Officers, Analyst). Actual individual PIC opportunities for all eligible RSIC employees, other than the CIO, are determined by the CIO in consultation with the Director of Operations/COO and within the approved annual budget for personal services. The CIO’s maximum incentive level are reviewed and approved by the Commission.

PIC payment calculations are performed after the end of each fiscal year in accordance with the RSIC Performance Award Scale (which the Commission confirms in writing near the beginning of each fiscal year) and the “Transition Provision for Newly Incentive-Eligible Positions” chart as seen in Appendix A of the Compensation Policy. Portfolio performance for purposes of the PIC calculation is measured annually as of June 30th and initially computed by Custodial bank and then submitted to the Consultant for a second independent review. The Consultant will also review the Portfolio for compliance with the AIP in effect during the performance period as an additional risk measurement. The Commission should receive the Consultant Reports (Compliance Report and Investment Performance report) no later than September 30. The Commission must approve and deem the Compliance report acceptable for purposes of this policy and cause PIC Payments to be made to eligible employees who are entitled to PIC payout within 180 days after fiscal year. FY2013 PIC payouts and related Consultant reports are anticipated to be presented at the September 26, 2013 Commission and paid shortly thereafter.

Objectives and Scope

Objectives

The objectives of this audit were to evaluate the accuracy and appropriateness of the fiscal year 2013 PIC proposed payout.

Scope

- Review the relevant sections of RSIC Compensation Policy (Section V. Guidelines & Implementation for the PIC Plan)
- Evaluate compliance with policy provisions and adherence to such in the calculation of the PIC payout for FY 2013
- Examine and determine the accuracy of the PIC calculation for FY 2013
- Evaluate procedures for authorization and determination of PIC

Scope Exclusions

Areas outside of the scope of this audit include:

- Validation of the Consultant's reports. IAC performed no additional review or testing of the figures provided by HEK in regards to Compliance or Investment Performance Review Report. Both reports are to be provided to the Commission and the Compliance report is subject to acceptance of the Commission during a meeting after the date of this report.
- The determination of the 90th percentile amounts for which the Compensation Policy notes PIC opportunities are calculated to provide participants, in combination with salary, total cash compensation opportunities that are at such level. IAC relied upon the compensation report procured and relied upon by the Commission from McLagan, an internationally recognized management consultant firm.

Approach and Methods

Summary of Audit Procedures Performed

Procedures performed included:

- Reviewed RSIC Compensation Policy (Last amended on May 17, 2012) with specific attention paid to Section V Guidelines and Implementation of the PIC Plan.
- Reviewed supporting documentation related to PIC Plan:
 - FY2013 PIC Calculation prepared by COO in discussion with the CIO
 - Verified respective employees eligibility for participation in FY2013 PIC Plan
 - Verified accuracy of PIC calculation
 - Consultants (Hewitt EnnisKnupp) AIP Compliance Letter (dated September 12, 2013) and Investment Performance Review Report (dated September 16, 2013)
 - Investment Commission meeting minutes/presentations where PIC plan was discussed which includes the following meetings: March 23, 2012, May 17 – 18, 2012, September 20, 2012 and May 23, 2013
- Interviewed key personnel including, COO, CIO, Administrative Manager and members of Investment Commission Compensation Committee.

Control Structure

Summary of Control Strengths

- Commission reviews and approves maximum PIC opportunity for different classes of PIC eligible positions
- Portfolio performance results are initially computed by Custodial bank
- The Consultant performs an independent review of investment performance calculations related to the PIC plan prior to issuance of any PIC payment
- The Consultant reviews the portfolio for compliance with AIP in effect during the performance period as an additional risk management measure
- The Commission receives above noted consultant reports no later than September 30
- The Commission must approve and deem the compliance report acceptable for purposes of this policy
- The Commission must cause payment to be made to eligible employees who are entitled to receive PIC payment within 180 days following fiscal year end in which the payment has been earned, unless another provision of the policy or any applicable laws prohibits or defers eligibility of payment

Summary of Control Opportunities

- The policy which dictates the PIC process should be revised to add additional clarity in certain provisions, specifically Section V(D) Maximum PIC Opportunities and Appendix A “Transition Provisions for Newly Incentive-Eligible Positions”.

Framework for Rating Risk of Audit Observations

When evaluating control gaps and developing observations, we used a framework to prioritize our observations. We used the framework to rate observations from the review. Each observation was assigned a risk/prioritization rating of “High”, “Medium”, or “Low”. The rating is an evaluation of the significance of an individual issue that is being reported. We intend that the rating assist management in prioritizing their efforts to implement recommendations and to provide a measure of the risk involved with each issue.

These criteria take into account the processes, systems, functions, and other internal and external factors that are affected. They are not intended to be all-inclusive.

High

Management should address the observation promptly because it could have a significant adverse impact on the integrity of the RSIC’s internal controls. This implies that management should take immediate and sustained action to remediate the finding and mitigate the associated risk. If the overall risk assessment of a process area has been evaluated at a “High”, this rating assessed to an individual finding may take on an increased level of significance. The criteria used to assess the risk rating should include any **one or all** of the following:

- A control weakness appears to undermine the overall integrity of a system or process because it compromises the achievement of the controls and business objectives.
- The financial impact of a control weakness may be significant, or appears to have the potential to be significant.
- Adequate compensating controls do not exist to mitigate risks identified.
- Key controls or compensating controls do not appear to be functioning as designed, or they appear to be nonexistent.
- The current process does or could violate critical regulatory requirements or internal policies.
- Adequate segregation of duties does not exist leading to the potential for material errors and omissions and potential fraudulent activity.
- Potential or existing weaknesses in the system of internal controls previously identified through audit activities have not been sufficiently corrected and/or adequate mitigating controls have not been implemented.
- Significant policies and procedures do not exist, or current practices are not in-line with documented and approved policies and procedures, which could potentially undermine the system of internal control.
- Management has the ability to override significant systems driven controls.
- The control weakness or potential control weakness may have a significant adverse impact on RSIC’s reputation.

Corrective Action: Immediate and basic improvements with ongoing management involvement and monitoring until controls are substantially improved. Dependent on the complexity of the issue, management should attempt to begin implementing its corrective action plans within 30 days from the date the issue was surfaced within the report.

Medium

Management should address the observation in a reasonable time frame because it could have an adverse impact on the integrity or effectiveness of the RSIC's internal controls, but it is not likely to have a critical, immediate and significantly adverse impact. This implies that management should institute plans to remediate the finding and pay attention to the associated risk. The criteria used to assess the risk rating should include any **one or all** of the following:

- A control weakness may not undermine the overall integrity of the system or process, but it appears to compromise a component of the system or process that is designed to achieve a business or control objective.
- The financial impact of a control weakness appears to be moderate, but it does not appear to have the potential for a broad impact on the corporation's financial position.
- Key controls do not appear to be functioning as designed, or appear to be nonexistent, but compensating controls exist to mitigate the risks identified.
- Policies and procedures exist but have not been recently reviewed and updated. Management has documented action plans to correct gaps within a reasonable timeframe.
- The current process could violate less critical regulatory requirements or internal policies.

Corrective Action: Implement improvement plans with ongoing management involvement and monitoring until controls are substantially improved. Dependent on the complexity of the issue, management should attempt to begin implementing its corrective action plans within 60 days from the date the issue was surfaced within the report.

Low

A risk/prioritization rating of low applies to an observation that does not have a significant adverse impact on the RSIC's internal controls. Management should consider implementing recommended actions. The criteria used to assess the risk rating should include any **one or all** of the following:

- Key controls and processes may be non-existent, however, significant compensating controls exist and the risk of potential weaknesses in the overall system of internal control is insignificant.
- Although sufficient compensating controls exist where weaknesses are noted, enhancements to existing processes or systems would improve effectiveness and/or efficiency.
- The financial impact of a control weakness, or potential for financial impact, appears to be limited in its amount and extent; or non-existent.

Corrective Action: Management may determine that cost-saving measures are available but the time and effort required may be extensive. Additionally, Management may determine alternative ways of addressing the issues identified. If management has determined that it will address the issues and dependent on the complexity, management should attempt to begin implementing its corrective action plans within 120 days from the date the issue was surfaced within the report.

Other – Best Practice and or Process Improvement Opportunities

In addition, we may report additional observations and recommendations to management that would improve performance or internal controls through the adoption of a particular best practice. Often, these observations and recommendations are quick “wins” that the RSIC can implement in an efficient manner and without significant incremental cost to RSIC. In our judgment, these issues may enhance RSIC’s internal control environment, but they do not pose a significant risk to the effectiveness or integrity of RSIC’s internal controls.

Risk Acceptance

A risk acceptance of “No” in this report indicates that management agrees with the observation and will make recommended improvements or propose alternative steps to reduce the risk(s) identified.

A risk acceptance of “Yes” in this report indicates that management disagrees with the observation and declines to make suggested improvements or to propose alternative steps to reduce the risk(s) identified. Management thereby implicitly agrees to accept the business impact and risks noted within the observation.

Executive Summary: Overall Process Evaluation

As part of our FY2014 Audit Plan, we evaluated the accuracy and appropriateness of the FY2013 PIC proposed payout.

Based on the work performed, we concluded that the PIC proposed payout was accurate; however, we noted the following observations regarding the process:

	<u>Observation</u>	<u>Risk Rating</u>
1.	The required timeframe of 60 days in which the Consultant is to provide a report on portfolio performance results and compliance does not appear adequate.	Low (L)
2.	The annual process for the Commission's approval FY2013 RSIC Performance Award Scale and maximum PIC opportunities for each position classification was not clearly documented in writing.	Low (L)

Action Matrix: Issues and Observations

Observation #1 [Low]

The required timeframe of 60 days in which the Consultant is to provide a report on portfolio performance results and compliance does not appear adequate.

Compensation Policy V(E)4. notes “The Consultant should complete the review of the Portfolio performance results and compliance not more than 60 days after fiscal year end”. However we noted in FY2013 the consultant’s reports were received after 60 days, as was the case for FY2012. It appears that given consideration of the time it takes for BNYM to close FYE records, the Consultant’s report were received in a reasonable timeframe.

Risk/ Business Impact

Additional delays in Consultant reports could impede timeliness of PIC Payout.

Recommendation

The required timeframe be amended within the Compensation Policy from 60 days to 75 days to allow the consultants appropriate time to analyze required data in order to complete their review of Portfolio performance results and compliance.

Management Actions: Management will commence work with the Compensation Committee to ensure this observation is resolved in next 120 days. Compensation Committee will then make recommendation to Commission on updated policy.

Owners: Darry Oliver/Compensation Committee

Target Date: Discussions with Compensation Committee to begin in next few months, with plan to have Compensation Committees recommendations to the Commission for their first meeting in 2014.

Risk Acceptance: No

Individual(s) Responsible

Darry Oliver, COO

Target Date for Completion of Corrective Actions January 31, 2013

Action Matrix: Issues and Observations

Observation #2 [Low]

The annual process for the Commission's approval FY2013 RSIC Performance Award Scale and maximum PIC opportunities for each position classification was not clearly documented in writing.

The Compensation policy states:

- Near the beginning of each new fiscal year, the Commission will confirm, in writing the maximum PIC opportunity for each eligible position classification (e.g., Directors, Officers, and Analysts).
- Also near the beginning of each new fiscal year, the Commission will confirm, in writing, RSIC's Performance-Award Scale.

Per review of numerous Commission meeting materials (March 5, 2012, March 23, 2012 and September 20, 2012,) we noted a voluminous amount of discussion related to the Compensation policy and specific provisions within it. The final Compensation policy (which was approved by the Commission) and circulated in numerous meetings included both the Performance Award Scale and maximum PIC opportunity for FY2012, however there was not a formal vote or written documentation that clearly stated approval for FY2013. However per review of meeting materials and discussions with Commissioners and staff, there appeared to be a clear understanding that these data points would also be applied to FY2013 (which in fact was the case).

We noted these issues have already been remedied as these two items for FY2014 calculation purposes were presented and documented in writing to the Commission during the May 23, 2013 meeting.

Risk/ Business Impact

N/A- observation has already been remedied for FY14

Recommendation

No recommendation (as observation has already been remedied for FY14)

Management Actions -N/A – observation has already been remedied

Owners:

Target Date:

Risk Acceptance:

Individual/(s) Responsible

N/A – observation has already been remedied

Target Date for Completion of Corrective Actions

N/A – observation has already been remedied