

Report Date: September 21, 2015

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# **South Carolina Retirement System Investment Commission**

***Performance Reporting***

**For FYE June 30, 2014**

To: Andrew Chernick, Managing Director of Operations and Operational Due Diligence  
Jon Rychener, Director of Investment Reporting and Performance

We recently completed a review of the accuracy and completeness of the Retirement System Investment Commission's ("RSIC") Performance Reporting ("PR") disclosed for the fiscal year ending June 30, 2014. We also reviewed the internal controls and procedures related to Performance Reporting that existed during the period of July 1, 2013 – June 30, 2014. The South Carolina Code of Laws does require that RSIC provide investment reports, at least quarterly during the fiscal year to the State Budget and Control Board, The Speaker of the House of Representatives, the President Pro tempore of the Senate, and other appropriate officials and entities. Certain details of investment performance are also disclosed in the Annual Investment Report and in the Retirement Systems' financial statements. To help ensure compliance with the statutory requirement prescribed in 9-16-90 (A) and ensure the accuracy of information disclosed, it is incumbent upon RSIC staff to establish and monitor the effectiveness of internal controls around the disclosure and reporting of performance.

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 that overall, performance reporting for Fiscal Year 2014 was materially accurate and complete, and complied with statutory requirements. We noted that the internal control structure for reports produced by the Performance Reporting team appeared to be adequate, however we found that the Performance Reporting process extends beyond the work that this team does and that the internal control structure for the process as a whole is evolving and further improvements are needed. We have summarized and detailed the nature and extent of our observations in the "Executive Summary: Overall Process Evaluation" and in the "Action Matrix: Issues and Observations" sections of this report, respectively.

We would like to thank the RSIC Investment Reporting and Performance staff for their cooperation and assistance.

Sincerely,



Monica Houston, CPA  
Chief Audit Officer

CC: Allen Gillespie, Audit Committee Chair

Michael Hitchcock, Executive Director

Ed Giobbe, Investment Commission Chair

## Background

### Background

The RSIC Investment Reporting and Performance team is required to disclose certain performance data related to the investing and managing of the assets of the South Carolina Retirement System Pension Trust Funds (“SCRS”) during each fiscal year as mandated by statute. Note that this audit will be primarily focused on testing RSIC’s compliance with 9-16-90 (A) as shown below since we test compliance with 9-16-90 (B) during our audit of the Annual Investment Report (“AIR”). See extract of statute from South Carolina Legislature Online shown below:

**SECTION 9-16-90.** *Quarterly and annual investment reports; contents.*

*(A) The commission shall provide investment reports at least quarterly during the fiscal year to the State Budget and Control Board, the Speaker of the House of Representatives, the President Pro Tempore of the Senate, and other appropriate officials and entities.*

While Investment Reporting and Performance at RSIC is required to be compliant with the statutory mandate excerpted above, there are additional performance reporting requirements that are outlined in RSIC’s Governance Policies and its Statement of Investment Objectives and Policies (“SIOP”). Some of these performance reporting disclosures are required to be disseminated in certain ways and therefore RSIC is required to be compliant with such. Performance Reporting for purposes of this audit, encompasses all of the disclosures or releases of RSIC performance data that are made to the Commissioners and the public via any and all available outlets. These outlets can include but are not limited to the RSIC website, the Internet, news releases, various media outlets and open forum Commission meetings.

*Section 9-16-90 (B)* addresses the required reporting of annual performance data which is covered in our audit of the Annual Investment Report. The most recent version of the annual performance data released via publication of the AIR was as of June 30, 2014 which was published and released in January 2015.

Note that since the balance of management fees and expenses is a required disclosure, RSIC discloses these balances in its Annual Investment Report and provides this data to Public Employee Benefit Authority (“PEBA”) for their disclosure in the annual Comprehensive Audited Financial Report (“CAFR”). This process was recently audited and the report published in February 2015.

# Objectives and Scope

## Objectives

The objectives of this audit were to:

- Determine through testing and review whether the current investment reporting as published or presented complies with the minimum statutory requirements of the South Carolina Code of Laws per 9-16-90 (A).
- Determine through testing and review whether current investment reporting as published or presented complies with RSIC governance documents such as the Statement of Investment Objectives and Policies (SIOP).
- Determine whether adequate controls exist to ensure accuracy and completeness of the published data related to RSIC's performance and if such controls are effective.
- Determine whether the process for gathering performance data has been consistently applied, as of July 1, 2013 to June 30, 2014.
- Determine through testing that the performance data provided during the quarterly and annual periods to both the Legislature and Commissioners was accurate and complete.
- Identify any areas of reliance on third party vendors relative to the provision or validation of information included in investment reports.

## Scope

To provide executive management with an opinion on whether RSIC's current Performance Reporting complies with South Carolina statute as outlined in Title 9 Chapter 16 and the adequacy of the controls over the accuracy and completeness of the process that generates reported performance data. The audit will include the following:

- Identifying whether controls exist in the performance reporting process and the effectiveness and adequacy of those controls.
- Identifying the level of reliance that the Performance Reporting team places upon the data furnished by certain third party service providers during disclosure of our performance metrics.
- Determining through testing whether the Performance Reporting team has been compliant with the portions of South Carolina's statutory requirements specifically related to performance reporting for FY 2014.
- Reviewing the process that management undertakes for ensuring completeness and accuracy of the performance data that is reported.

# Approach and Methods

## Summary of Audit Procedures Performed

Procedures performed included but were not limited to:

- Obtaining an understanding and performing a walkthrough of the Performance Reporting process.
- Identifying the controls that exist in the collecting, validating and publishing of the performance data as well as documenting any gaps.
- Through inquiry, observation, review and re-performance determining the adequacy of the identified controls. This included
  - o Reviewing the reasonableness comparison of the Bank of New York Mellon (BNYM) data to the HewittEnnisKnupp (HEK) data.
  - o Examining the review of the BNYM SOC-1 prepared by the Performance Reporting team in conjunction with PEBA.
- Reviewing the South Carolina statutory requirements for Performance Reporting and determining RSIC's level of compliance.
- Reviewing RSIC's governance documents with regard to RSIC's compliance with its monitoring and reporting via its performance reporting.
- Determining whether the process for reporting performance data has been consistent over the audit period.
- Identifying any areas of reliance on third party vendors relative to the provision of performance data and the controls around that process.

# Control Structure

## Summary of Control Strengths

- Performance Reporting does obtain and review the Bank of New York Mellon (BNYM) SOC-1 report over the custodial and securities lending services that they provide to RSIC. The current SOC-1 shows that BNYM has adequate controls over the services that RSIC utilizes.
- RSIC has hired a third party administrator, Conifer, which will allow greater transparency and additional performance reporting capability. The relationship with Conifer is expected to provide detailed report capability as well as increase the Performance Reporting team's ability to provide more in depth analysis to the investment team and the Commissioners. Management continues to work with Conifer to develop the enhanced reporting capability.
- The RSIC Performance Reporting team has been gaining experience, honing its methodology and continuously upgrading current procedures in its efforts to make the performance reporting process more efficient.
- The Performance Reporting team performs a reasonableness comparison of the BNYM data to the HewittEnnis Knupp (HEK) data at the plan level which is reviewed by the Director of Investment Reporting and Performance for accuracy.

## Summary of Control Opportunities

- RSIC Performance Reporting team's review of the BNYM SOC-1 did not cover the entire fiscal year and did not adequately address some of the user considerations outlined in the report.
- Evidence of management's review of the reasonableness comparison performed by the Performance Reporting team of the BNYM performance numbers to the numbers generated by HEK was not maintained for the period tested.
- Internal Audit noted that RSIC places reliance on the data and services provided by HEK. However, HEK does not prepare and provide a SOC-1 and there does not appear to be adequate internal controls established by RSIC to ensure the completeness and accuracy of HEK's data and services.

### Summary of Control Opportunities - Continued

- Internal Audit noted that the Performance Reporting team's responsibility for performance reporting is limited to those reports generated within the department. It appears that overarching responsibility for RSIC's performance reporting as a whole has not been assigned to a specific individual or team at the senior management level who would be responsible for the full spectrum of performance reporting coming from RSIC including that published by media and presented by third parties at public meetings.

## 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 FY 2014-15 Audit Plan, we evaluated the accuracy and completeness of the Retirement System Investment Commission’s (“RSIC”) Performance Reporting (“PR”) disclosed for the fiscal year ending June 30, 2014. We further determined whether the disclosed performance complied with statutory requirements. Additionally, we assessed the adequacy and effectiveness of the internal controls and procedures related to the PR that existed during the period of July 1, 2013 – June 30, 2014.

Based on the work performed and the results obtained, we concluded that Performance Reporting for Fiscal Year 2014 was materially accurate and complete, and compliant with statutory and other requirements. However, the following observations were noted during the audit:

	<u><b>Observation</b></u>	<u><b>Risk Rating</b></u>
1.	Through examination and inquiry, Internal Audit noted that the Performance Reporting team places reliance on the data provided by Bank of New York Mellon (BNYM). While a review of the BNYM’s SOC-1 was performed, RSIC did not obtain a bridge report to cover the part of the fiscal year that was not covered by the SOC-1 (April 1, 2014-June 30, 2014). In addition, RSIC did not adequately address some of BNYM’s user considerations outlined in the report.	<b>Medium (M)</b>
2.	The Performance Reporting team performs a reasonableness comparison of the BNY Mellon performance numbers to the numbers generated by HewittEnnisKnupp (HEK) which is reviewed by the Director. However, the Director of Investment Performance and Reporting was unable to provide evidence of his review of the reconciliation for the audit periods tested.	<b>Low (L)</b>
3.	Internal Audit noted that although RSIC places reliance on the data provided by HewittEnnisKnupp (HEK) and its reports are provided to the Commissioners, there appear to be inadequate controls within RSIC around the completeness and accuracy of HEK’s data to support that reliance. Additionally, HEK does not prepare a SOC-1 and therefore Performance Reporting was unable to obtain and review HEK’s controls around the services they provide to RSIC.	<b>High (H)</b>

4.	Internal Audit found that the overarching responsibility for all of RSIC's performance reporting as a whole has not been assigned to a specific individual or team at the senior management level who would be responsible for the full spectrum performance reporting coming from RSIC including that published by media and presented by third parties at public meetings.	<b>High (H)</b>
	<b><u>Other - Best Practice and or Process Improvement Opportunities</u></b>	
	None noted	

## Action Matrix: Issues and Observations

### Observation #1 [Medium]

Through examination and inquiry, Internal Audit noted that the Performance Reporting team places reliance on the data provided by Bank of New York Mellon (BNYM). The data provided by BNYM is used in the quarterly reporting package presented to the Commissioners and made available to the public. While a review of the BNYM's SOC-1 was performed, RSIC did not obtain a bridge report to cover the part of the fiscal year that was not covered by the SOC-1 (April 1, 2014 – June 30, 2014). In addition, RSIC did not adequately address some of the user considerations outlined in the BNYM report.

### Risk/ Business Impact:

Reliance on a SOC-1 from a service provider can be a key part of an internal control system. However, in order to rely on a SOC-1 as part of a good internal control structure, the user has to review the report in order to determine that the service provider's auditors addressed their specific points of control reliance and that the report is applicable to the entire fiscal year.

Performance Reporting's failure to obtain a bridge report and adequately document their review of the user considerations outlined in the BNYM SOC-1 could result in misplaced reliance on the data received from BNYM due to a change to an unfavorable opinion or change in the current controls and or RSIC not having the proper user considerations in place to support reliance. This could result in the performance reporting team providing inaccurate or incomplete information to the Commissioners and the public.

### Recommendation:

Internal Audit recommends that Management develop and document the procedures for preparing a review of the user considerations outlined in the BNYM SOC-1. In addition, RSIC should change the timing of its review in order to obtain and review a SOC-1 from BNYM that covers the entire fiscal year thus eliminating the need for a bridge report.

**Management Actions:** Management will work to implement Audit's recommendation

**Owners:** Managing Director of Operations and Operational Due Diligence, Andrew Chernick

**Recommended Target Date:** October 2015

**Risk Acceptance:** No

**Individual/(s) Responsible:** Director of Investment Reporting and Performance, Jon Rychener

**Target Date for Completion of Corrective Actions:** Per RSIC management, corrective action completed as of date of report

## Action Matrix: Issues and Observations

### Observation #2 [Low]

The Performance Reporting team performs a reasonableness comparison of the BNY Mellon performance numbers to the numbers generated by HewittEnnisKnupp (HEK). While the initial preparation is documented in the desktop procedures, the manager's review is not included. Upon completion, the reasonableness comparison is then sent to the Director of Investment Reporting and Performance for his review and approval prior to final release of the data. However, the Director of Investment Reporting and Performance was unable to provide evidence of his review for the audit periods tested.

### Risk/ Business Impact

Documented review procedures aid in ensuring completeness and accuracy of the data. Documentation of the prescribed review procedures, in addition to a listing the procedures, should include:

- A listing of the reports used to prepare the validation;
- Validation procedures, if any, required to verify the accuracy and completeness of source data;
- A listing of staff members responsible for the completion and review of validation.

Evidence of the Director's review and approval should be documented and maintained for a reasonable time period. Errors of a material nature could result in the understatement or overstatement of performance data and damage to RSIC's public image. Additionally, not documenting the review performed by someone with the requisite higher level knowledge, could result in a loss of the ability to transfer knowledge and disrupt the continuity of this function if other employees are not properly trained.

### Recommendation:

Audit recommends that the performance reporting team preparing the reasonableness comparison obtain evidence of the Director's approval and the Director maintain evidence of his review for a reasonable time period.

**Management Actions:** Management will work to implement Audit's recommendation.

**Owners:** Managing Director of Operations and Operational Due Diligence, Andrew Chernick

**Recommended Target Date:** February 2016

**Risk Acceptance:** No

**Individual/(s) Responsible:** Director of Investment Reporting & Performance, Jon Rychener

**Target Date for Completion of Corrective Actions** Per RSIC Management, corrective action completed as of date of report

## Action Matrix: Issues and Observations

### Observation #3 [High]

Through examination and inquiry, Internal Audit noted that RSIC places reliance on the data and services provided by HewittEnnis Knupp (HEK). It was further noted that although reliance is placed on HEK and its reports are provided to the Commissioners, there appear to be inadequate controls around the completeness and accuracy of the data and services provided. HEK does not prepare a SOC-1 and therefore Performance Reporting was unable to obtain and review HEK's controls around the data and services provided to RSIC. Although the Performance Reporting team does perform a reasonableness comparison of HEK and BNY Mellon data, there was insufficient evidence supporting the work performed. In addition, HEK reports that present private market assets on a dollar weighted basis and multiple on capital invested are not readily comparable. Consequently, RSIC management can provide limited assurances as to the completeness and accuracy of HEK's data and services.

### Risk/ Business Impact

Failure to implement a robust system of controls around the data and services provided by HEK could lead to misplaced reliance on inaccurate and incomplete information. This could result in the provision of inaccurate or incomplete information to the Commission and external stakeholders.

### Recommendation:

Internal Audit recommends that Management develop and document its plan for gaining adequate assurance on the completeness and accuracy of the data and services provided by HEK.

**Management Actions:** Management will work to implement Audit's recommendation.

**Owners:** Managing Director of Operations and Operational Due Diligence, Andrew Chernick

**Recommended Target Date:** September 2015

**Risk Acceptance:** No

**Individual/(s) Responsible:** Managing Director of Operations and Operational Due Diligence, Andrew Chernick

**Target Date for Completion of Corrective Actions:** December 31, 2015

## Action Matrix: Issues and Observations

### Observation #4 [High]

During our audit of RSIC's Performance Reporting process, we noted that responsibility for certain aspects of the process were outside the accountability parameters of the Performance Reporting team. As a result we found that there was insufficient oversight and documentation relative to the Investment team's review of specific HewittEnnisKnupp (HEK) data presented to the Commissioners and external stakeholders. Additionally we found that management decisions made relative to the monitoring of performance data reported to or by external sources (e.g. in newspaper articles) was not appropriately documented at times.

### Risk/ Business Impact

Failure to assign accountability for the completeness and accuracy of RSIC's performance reporting as a whole could result in misstated or improperly disclosed performance data of a material nature being released to the Commissioners and external stakeholders as well as damage to RSIC's public image. Further, lack of documentation relative to the action management decided to take or not take in the notification and/or correction of publicly disseminated information could result in the limitation of management's ability to defend the organization against claims of wrong doing.

### Recommendation:

Internal Audit recommends that the responsibility for the accuracy and completeness of RSIC's performance reporting as a whole be assigned to an individual or a team with the requisite knowledge and background and at the appropriate level of management (comparable to that of a Chief Financial Officer). Additionally we recommend that all decisions relative to the reporting and/or monitoring of performance information reported be appropriately documented and retained.

**Management Actions:** Management has decided to accept risk and take no action.

**Owners:** RSIC Executive Director, Michael Hitchcock

**Recommended Target Date:** September 2015

**Risk Acceptance:** Yes

**Individual/(s) Responsible** Managing Director of Operations and Operational Due Diligence, Andrew Chernick

**Target Date for Completion of Corrective Actions:** N/A