

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

***MOVING FORWARD***



**November 13, 2014 Presentation to the  
South Carolina Senate Finance Subcommittee  
to Review the Investment of State Retirement Funds**



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  - **Align fiduciary duties and responsibilities**
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  - **Improve the custodian relationships**

## Funston Advisory Services LLC

- **Formed in 2010, Funston Advisory Services LLC (FAS) is a Michigan based firm.**
- **The core competencies and experience of the FAS team include governance, strategy, risk, compliance, investment operations, investment accounting, benefits administration and stakeholder engagement.**
- **Over the past four years, FAS has addressed complex fiduciary and governance issues in public pensions at:**
  - The California Public Employees' Retirement System (CalPERS),
  - The Oregon Office of the State Treasurer and Oregon Investment Council,
  - The Common Retirement Fund ("CRF") managed by the Office of the New York State Comptroller,
  - The School Employees Retirement System (SERS) of Ohio, and
  - The South Carolina Retirement System Investment Commission (RSIC).

# The FAS Team on the RSIC Engagement

## Presenting Today:

- Rick Funston, Managing Partner and former national practice leader for Deloitte's Governance and Risk Oversight Services. Created concept of Risk Intelligence. Principal author of "Surviving and Thriving in Uncertainty".
- Randy Miller, Principal, former senior Deloitte consulting partner. Project leader.
- Keith Johnson, attorney and Chair of the Institutional Investor Legal Services team at Reinhart Boerner Van Deuren S.C. and former legal counsel to the State of Wisconsin Investment board (SWIB) for more than 21 years.

## Team Members:

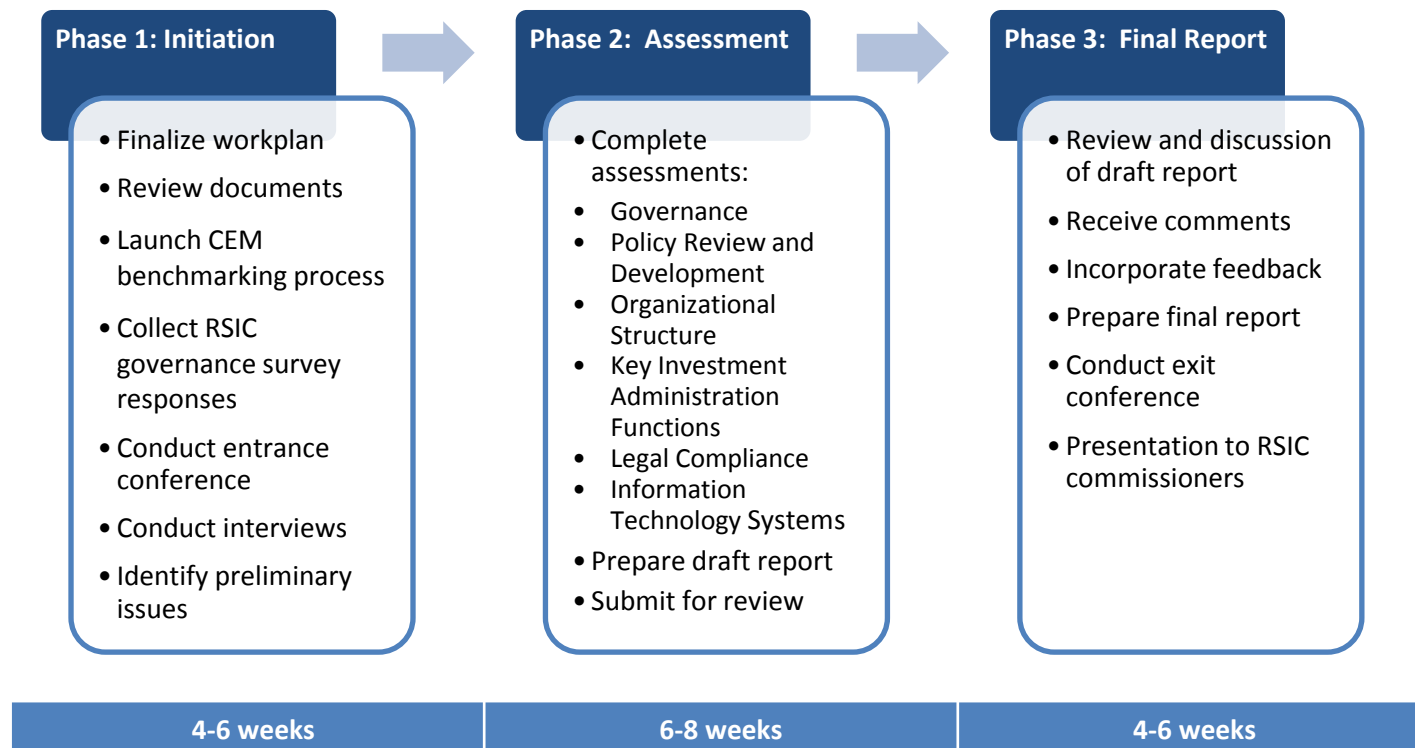
- Keith Bozarth, retired Executive Director of the State of Wisconsin Investment Board (SWIB) (June 2012) (9th largest public pension fund in the United States) and prior CEO of the Orange County Employees Retirement System in California.
- Virginia Brizendine, Chief Financial Officer for the School Employees Retirement System (SERS) of Ohio from 1999 until 2010.
- Marv Damsma, former Chief Investment Officer for BP America, The Kellogg Company and the New York City Retirement Systems.
- Ken Johnson, former Chief Operating Officer and Chief Financial Officer for the State of Wisconsin Investment Board (SWIB) (retired in 2010).
- Jon Lukomnik, former Deputy Comptroller for pensions for the City of New York, currently serves on three investment committees, is a trustee for the Van Eck mutual fund complex and a member of their Audit Committee.

## Purpose of the Fiduciary Audit

- **The scope included a critical evaluation the fiduciary roles and responsibilities of the RSIC Commissioners and staff, the relationship with other fiduciaries of the Retirement System, and the operational policies and practices of RSIC.**
- **The goal of the review was to identify areas of strengths and weaknesses, provide comparison with leading practices of other public pension plans, and make improvement recommendations.**
- **Because RSIC is a relatively new state agency, the review was designed to be broad in nature, spanning all key functions. The review of these functions was organized into six categories:**
  - Governance;
  - Policy Review and Development;
  - Organizational Structure;
  - Investment Administration;
  - Legal Compliance; and
  - Information Technology.

# Process

- The audit began Dec. 4, 2013. We reviewed nearly 800 documents and interviewed over 50 people (several multiple times).
- Comments and feedback were received from RSIC, STO and PEBA on Preliminary Recommendations and also on the Draft Final Report.
- The final fiduciary performance audit report was submitted April 18, 2014.



# Product

- **In developing our report, we addressed six fundamental questions:**
  1. Who are the RSIC fiduciaries?
  2. What are their duties?
  3. What are their authorities?
  4. Do their authorities match their duties? Are these duties in conflict with other roles played by the various fiduciaries?
  5. How is the RSIC performing?
  6. Where and how can the RSIC improve?
- **One hundred twenty-four recommendations were identified.**
  - 108 can be addressed directly by the RSIC.
    - 38 of these require the direct involvement of the Commissioners.
  - 12 require action by the Legislature.
  - 4 require action by the State Treasurer’s Office.
- **The primary purpose of today’s presentation is to discuss priorities and implementation considerations that directly involve the Legislature.**

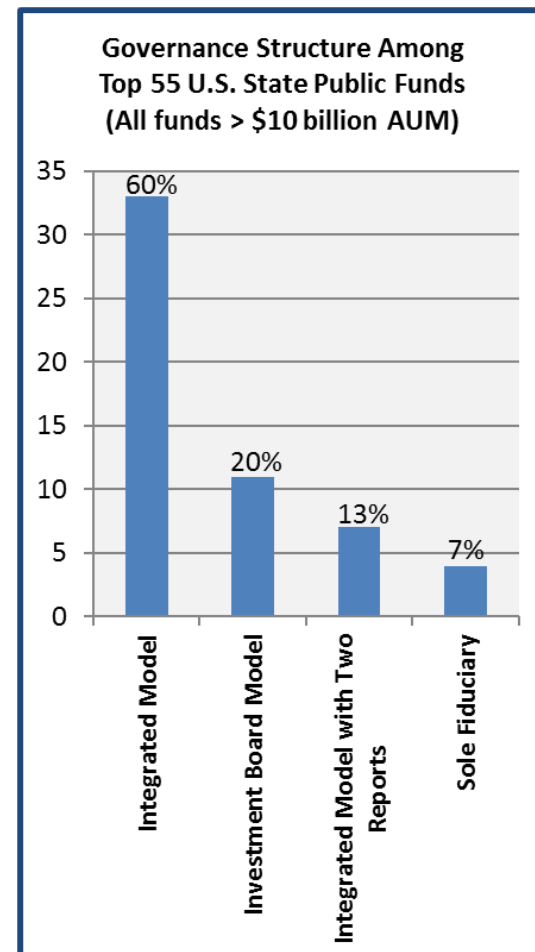
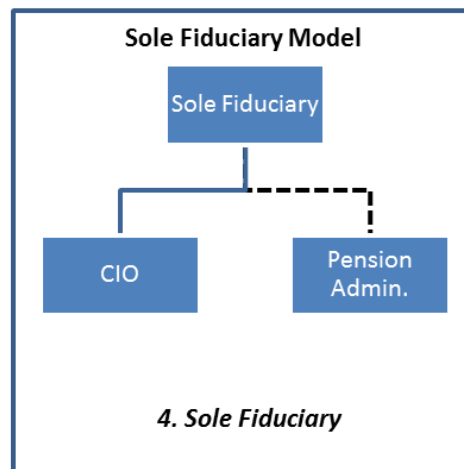
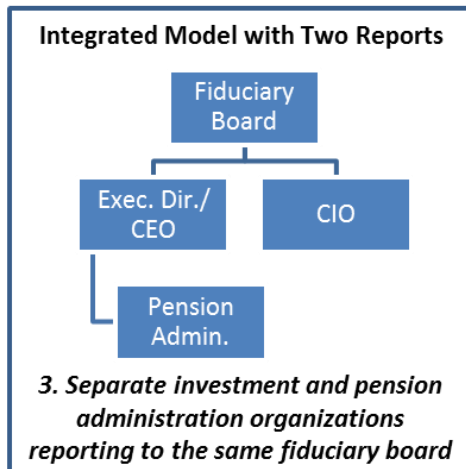
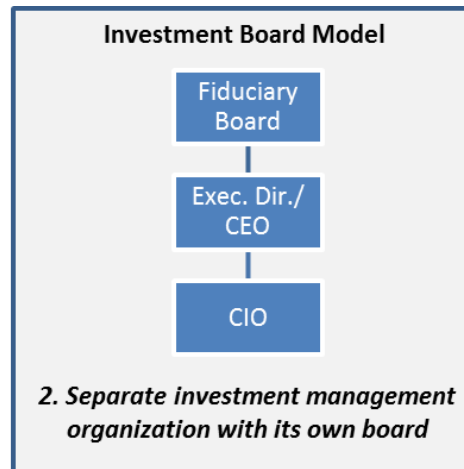
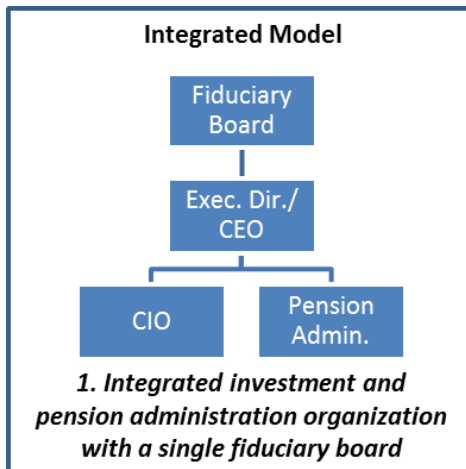
## Key Findings

- **There are no red flag indicators of malfeasance or misfeasance.**
- **RSIC has one of the most complex and fragmented governance structures among U.S. public pension funds.**
- **Investment fee transparency, policies and controls have improved significantly and disclosure of fees is the most complete in the industry.**
- **Although RSIC has selected a high cost strategy, fees to external managers are normal for its asset allocation and are not excessive.**
- **RSIC has been implementing a number of strategies which should result in lower external manager costs.**
- **RSIC's lack of infrastructure results in growing operational risks, and ultimately financial risk. There are several contributing factors including:**
  - The annual legislative budget approval process;
  - Existing state procurement laws and policies relating to acquisition of investment systems and support; and,
  - The indirect relationship RSIC has with the custodial bank.
- **RSIC has already implemented many improvement initiatives over the past two years.**



# Governance Structure

- There are four basic public pension fund governance models employed by U.S. state public pension plans, with variations on each.
- The South Carolina RSIC is an example of one of the eleven funds utilizing the Investment Board Model, of which eight have a structure similar to the RSIC.



# Governance Structure

- **The peer investment boards generally reflect one of two models:**
  - Expert Advisory Board: An ex officio lay board with an expert advisory board.
  - Lay Oversight Board: A board with several expert members combined with active member and retiree representation.
- **The current RSIC model is somewhat unique in that it is an expert oversight board.**

Expert Advisory Board Model			
	Florida SBA	Minn. SBI	Mass. PRIM
Ex Officio Members	Gov., CFO, AG	Gov., AG, Sec., Auditor	Gov., Treas.
# of Trustees	3	4	9
Member Representation	None	None	5
# of Investment Adv. Council Members	9	17	9
Other Advisory Committees	Audit	None	Real Estate/ Timber, Admin & Audit, Comp.
Investment Manager Selection	Exec. Dir./CIO & Investment Staff	Board	Board
Appointee Expertise Qualifications	No appointees	No appointees	Investment or Financial Management (one appointee)
<ul style="list-style-type: none"> <li>• State Board of Administration of Florida</li> <li>• Massachusetts Pension Reserves Investment Management Board</li> <li>• Minnesota State Board of Investment</li> </ul>			

Lay Oversight Board Model			
	SWIB	WSIB	ISBI
Ex Officio Members	Sec. of Dept. of Administration	Treasurer, Ret. Sys. Dir., Labor & Industries Dir.	Treas., Comptr., Senator, Judge
# of Trustees	9	15	9
Member Representation	2	5	None
Investment Committee	Committee of the Whole	Private Mkts., Public Markets	Investment Policy Comm.
Other Board Committees	None	Audit, Administrative	Audit, Executive, Emerging Mgr.
Investment Manager Selection	Internal Investment Committee	Board	Board
Appointee Expertise Qualifications	Financial or investment experience (5 appointees)	None (Investments for 5 non-voting members only)	None
<ul style="list-style-type: none"> <li>• State of Wisconsin Investment Board (SWIB)</li> <li>• Washington State Investment Board</li> <li>• Illinois State Board of Investment</li> </ul>			

# Governance Structure

- The current RSIC governance structure is very complex and fragmented.

## Legislature

### Policy and Legal Framework:

- Sets RSIC legal authorities
- Sets fund assumed rate of return

### Oversight:

- Approves budget annually
- Approves headcount annually
- Approves Performance Incentive Compensation (PIC) plan annually

## Budget & Control Board

### Named Trustee and Fiduciary

### Policy and Legal Framework:

- Approves RSIC purchasing policy
- Appoints 4 of 7 Commissioners

## State Treasurer

### Fiduciary

### Responsibilities:

- Custodian of the funds
- RSIC Commissioner
- Member of Budget & Control Board

## Public Employee Benefit Authority

### Named Trustee and Fiduciary

### Responsibilities:

- Sets RSIC accounting policies
- Provides investment accounting and financial reporting
- Directs external auditing
- Provides RSIC IT support

## Retirement System Investment Commission

### Fiduciary Responsibilities:

- Invests and manages pension funds

## Attorney General

### Oversight:

- Approves retention and rates of external counsel
- Approves hiring of temporary internal counsel

## Comptroller General

### Oversight:

- Conducts accounts payable and payroll procedures audit

## Inspector General

### Oversight:

- Conducts annual fiduciary performance review

## State Auditor

### Oversight:

- Selects external auditor

## Pervasive Themes

**Synthesizing the findings across the six categories of the audit, there were five overall themes for improvement:**

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

**Specific recommendations to the Legislature are found in the fourth and fifth themes.**

# Suggested Priorities for Consideration

## The Legislature should:

- Delegate operating budget, staffing and compensation approval to the Commission.
- Extend RSIC's authorities for procurement to include investment-related services and systems.
- Eliminate the inherent conflicts in the role of the Treasurer by:
  - Designating PEBA as the custodian of all retirement funds; and,
  - Delegating selection of the custodial bank to RSIC.
- Revise Commissioner qualifications to recognize experience.
- Revise legislation to allow an Executive Director and change CIO reporting.
- Authorize an external audit or agreed upon procedures review of fund valuations, procedures and/or controls.
- Add 1 to 3 additional voting Commission members and increase beneficiary representation.
- Consider term limits for Commissioners.
- Regularly review the assumed rate of return and underlying assumptions every five years, or delegate the function to PEBA or RSIC.

**BCB should allow a modified information systems procurement process.**

**The Attorney General should set high level criteria and delegate sourcing of external counsel to RSIC.**

## 4. Align fiduciary duties and responsibilities.

- The Commission has the authority to invest \$27 billion and commit hundreds of millions of dollars in manager fees annually.
- However, RSIC’s internal annual spending budget of \$12-14 million, as well as staffing and compensation levels, must be approved annually.
- It has been difficult for RSIC to build out the infrastructure required to control risks and reduce overall costs due to this one-year budget horizon and lack of certainty of approval.
- Leading practice at other state investment boards is to delegate budget and staffing headcount and compensation to the trustee board.

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

\* RSIC has authority to recommend only.

## Roles of the Treasurer

- **The three fiduciary roles, authorities and responsibilities of the Treasurer have inherent conflicts:**
  - 1. *Member of Budget and Control Board (BCB):*** The Treasurer is in the position of having oversight of himself as a Commissioner. The Commission, in turn, must objectively evaluate the custody services it receives from a fellow Commissioner, who is also an overseer on the BCB.
  - 2. *Commissioner on Retirement System Investment Council (RSIC):*** The Treasurer is faced with the challenge of resolving potentially conflicting fiduciary duties between his role as one of several commissioners on the RSIC and his separate obligations as Custodian.
  - 3. *Custodian of the funds:*** When the statutes vested exclusive investment authority in RSIC, it seemed to preclude subsequent exercise of a de facto veto by one of the commissioners, regardless of the role (in this case as Custodian) in which that fiduciary is acting.

## 5. Improve the custodian relationships.

- **Ensure the RSIC has the custodial services it needs to do its job.**
- **Align responsibilities to facilitate efficient and effective custody operations.**

### **1. The Legislature should:**

- a. Consider options to improve the custodial relationship.
- b. Delegate selection of the custodial bank to RSIC.

### **2. Until the custodial relationship is changed, the Treasurer should:**

- a. Review positions required to sign for release of cash transfers.
- b. Instruct the custodial bank to accept signatory changes from RSIC.
- c. Continue to allow standing instructions for the custodial bank to receive incoming funds and sweep cash.
- d. Allow electronic payment authorization.

### **3. The Commission should determine the future of Securities Lending.**



## 5. Improve the custodian relationships.

- There are four potential options to consider regarding custodial duties.
- We believe only Options 3 and 4 would solve the problem.
- In any case, RSIC should select the custodial bank and manage the relationship.

Option	Description
<b>Status Quo:</b> <b>Custodian: Treasurer</b> <b>Relationship: Treasurer</b>	<ul style="list-style-type: none"> <li>• No significant changes</li> <li>• The Treasurer remains the custodian</li> <li>• STO implements its new Custody Officer role</li> <li>• RSIC proceeds to implement its investment administrator role</li> <li>• This structure is unique to South Carolina among U.S. state investment boards with an independent investment staff</li> </ul>
<b>Option 1: Improved Status Quo</b> <b>Custodian: Treasurer</b> <b>Relationship: RSIC</b>	<ul style="list-style-type: none"> <li>• The Treasurer remains the custodian</li> <li>• The Treasurer delegates authority to RSIC to conduct custodial bank selection, negotiate the contract, and manage the contract and relationship for the retirement funds</li> <li>• Authorization processes are streamlined to not require STO signatures and utilize electronic payment authorization</li> <li>• Service level agreement and performance feedback are implemented by RSIC</li> <li>• The internal accounting system is updated (not related to custodian)</li> <li>• Similar to Washington State Investment Board (WSIB) structure</li> </ul>
<b>Option 2: RSIC Custody Relationship</b> <b>Custodian: Treasurer</b> <b>Relationship: RSIC</b>	<ul style="list-style-type: none"> <li>• The Treasurer retains the title of Custodian</li> <li>• Legislative change provides for delegation of authority to RSIC to conduct custodial bank selection, negotiate the contract, and manage the contract and relationship for the retirement funds</li> <li>• Similar to the Illinois State Board of Investments (ISBI) and New Mexico ERB structure</li> </ul>
<b>Option 3: PEBA as Custodian</b> <b>Custodian: PEBA</b> <b>Relationship: RSIC</b>	<ul style="list-style-type: none"> <li>• Legislative change provides for:               <ul style="list-style-type: none"> <li>– PEBA to become the custodian of record</li> <li>– RSIC to contract with its own custodial bank and manage the custodial bank relationship for the retirement funds</li> </ul> </li> <li>• Similar to the Minnesota State Board of Investments (SBI) structure</li> </ul>
<b>Option 4: RSIC as Custodian</b> <b>Custodian: RSIC</b> <b>Relationship: RSIC</b>	<ul style="list-style-type: none"> <li>• Legislative change provides for RSIC to become the custodian of record and to contract with its own custodial bank and manage the custodial bank relationship for the retirement funds</li> <li>• Similar to Florida SBA, Massachusetts PRIM, West Virginia IMB, and SWIB structure</li> </ul>

# For further information

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